

Recovery of VAT on hire purchase contracts

Who may be affected?

All entities that sell goods under HP agreements.

HM Revenue & Customs (HMRC) have issued Revenue & Customs Brief 31/07 (The Brief) setting out their policy in respect of the recovery of overhead VAT pertaining to hire purchase (HP) contracts and the recent Tribunal Decision in RBS (VTD 19983).

Background

Until 2001, there was an agreed industry method to apportion input VAT to HP business which allowed a recovery rate of 15 percent for HP businesses. Both the industry and HMRC resiled from this method as the industry felt that there had been significant changes since the method was agreed and HMRC sought to move towards methods that better reflect use. HMRC have been in discussions with the Finance & Leasing Association (FLA) in respect of how overheads attributable to HP are used. HMRC consider that the overhead input VAT must be used in respect of the exempt finance where the price of the goods is not uplifted. The FLA has not agreed with this view. There have been a number of developments with regard to this issue since the dispute arose in 2001. Chief amongst these was the recent RBS tribunal decision in which RBS successfully argued that a transactions-based recovery method was fair and reasonable. Using this rationale RBS was able to convince the Tribunal that a 50 percent recovery rate was appropriate. This decision has been appealed by HMRC and will be heard in the Court of Session.

Issue

The Brief states HMRC consider that as the goods subject to HP agreements are normally sold at cost, none of the overhead costs are a cost component of the taxable sale. Rather all overhead costs are consumed by the exempt finance attached to the HP agreement. Hence HMRC maintain that zero percent recovery is the only reasonable recovery rate. HMRC recommend that any entities that currently operate a partial exemption method which does not accord with HMRC's view in relation to the HP component of their business should seek to review it and should contact HMRC. The Brief mentions the RBS Tribunal Decision only to say that they are planning to appeal it.

Comment

Although this Brief does not seem to signal any great shift with regards to HMRC's attitude toward this issue, it is the first time that they have published their policy on HP. It is interesting that they have done this so soon after the RBS decision where they did not raise the zero percent issue and where the Tribunal Chairman made it clear that he did not consider the policy to be sensible. Whilst the Brief suggests that HMRC did not raise the cost component point in RBS because the appeal pre-dates the Brief, discussions between HMRC, taxpayers and industry bodies on the cost component point have been ongoing for a number of years.

HMRC's view that costs need to be a cost component of a taxable transaction and that there should be a direct and immediate link between the input and the output is correct, but case law has not necessarily established that the costs should be reflected in the selling price of the taxable transaction. The ECJ case of EA Rompelman referred to by HMRC does use the term selling price but subsequent case law seems to have moved away from price being determinative. If HMRC are correct, no overheads would be recoverable in relation to supplies made at a loss and as VAT is a transaction tax rather than one on profits, this would seem to be a new approach.

HMRC are concerned that if HP businesses can recover some overhead VAT, it would result in a net recovery of VAT for this type of business. However this would not seem to interfere with the principles of VAT given that VAT on the asset must be recoverable and those costs that relate (at least in part) to the

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asset sale must give rise to some recovery. After all, in some cases, this could be an asset on which VAT is chargeable twice due to the way HP agreements are analysed for VAT.

Given that there is a fundamental technical issue at point here, it seems likely that the issue will head to the Courts. There has been inconsistency of application of this policy from local HMRC officers in the past, indeed the officer in RBS did not agree with the zero policy. It is understood that this Brief will be followed by all local officers.

What now?

Affected businesses should be looking at their current partial exemption methods. Most will not currently be in line with HMRC's policy and businesses will need to be prepared for challenges from their local officer.