

Non binding effect of a business/non-business apportionment agreement Oxfam (20752)

Summary

The Tribunal has held that the charity could not treat an apportionment agreement as binding on HMRC such that a subsequent change in case law entitled it to recover substantial additional amounts of input VAT. Apportionment was a matter for the taxpayer alone, and HMRC would not have entered into a binding contract which would have prevented it from meeting its statutory obligation to deny recovery of input VAT which was used for non-business purposes. This decision will be of interest to any business which is required to make business/non-business and other 'use-based' apportionments of input VAT.

Background

The Appellant is a charity which has a mixture of business and non-business activities. Its business activities include some which attract input VAT recovery and some which do not. In 2000, the Appellant and HMRC formalised a 'business/non-business' apportionment method (the Approved Method) to identify how much of the VAT incurred by the Appellant was incurred in the course of its business activities. [The Tribunal found as fact that, at the time of the agreement, the Appellant and HMRC had a 'shared understanding' of the VAT treatment of certain costs which subsequently caused the present dispute.]

The Approved Method required the Appellant to identify the amount of VAT (A) which was directly attributable to business activities and the amount of VAT (B) which was directly attributable to non-business activities. The remaining VAT (C) which was not directly attributable in this way was apportioned using the 'Approved Method formula' $C \times A/(A + B)$ and the resulting amount (D) was added to A to give the amount of the Appellant's input VAT. That amount of input VAT (A + D) was recoverable to the extent that it related to the Appellant's taxable business activities using a partial exemption calculation (which was not in dispute).

The Appellant engaged professional fund-raisers who would solicit donations from private individuals, typically by approaching them in the streets. The fund-raisers' fees were liable to VAT, and the VAT was initially regarded as directly attributable to the non-business donation income and wholly irrecoverable. However, in 2005, the High Court in *Church of England Children's Society (CECS) v Commrs of Revenue and Customs* [2005] EWHC 1692 (Ch) decided that the receipt of voluntary donations was not a supply for VAT purposes, but if voluntary income from donations was 'unrestricted' (i.e., available to fund all the charity's activities, some of which were business activities for VAT purposes) the VAT incurred on unrestricted fund-raising expenditure was partly recoverable by the charity.

In March 2006 following this decision, the Appellant submitted a claim to HMRC for additional input VAT recovery. The Appellant's claim had two elements:-

- It re-classified the VAT incurred on professional fund-raisers' fees, deducting it from the amount of VAT which was directly attributed to non-business activities and adding it to the amount of VAT which could not be directly attributed.
- It sought to adjust the denominator of the Approved Method formula by deducting the amount of the VAT incurred on professional fund-raisers' fees.

The effect of the claim was both to increase the amount of non-attributable VAT (C) and to increase the extent to which the Approved Method formula attributed the non-attributable VAT to business activities.

HMRC accepted the first element of the claim (i.e., the re-classification) and repaid the resulting input VAT adjustment. However, HMRC rejected the adjustment of the Approved Method formula on the basis that the Approved Method no longer produced a fair and reasonable result once the calculations were adjusted in the light of CECS.

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In May 2006, HMRC withdrew the Approved Method and later confirmed the rejection of the second element of the claim by letters in which HMRC stated that the Approved Method had not envisaged the CECS treatment of VAT on professional fund-raising fees, it resulted in recovery exceeding 50% when the Appellant's publicity suggested that more than 80% of the Appellant's unrestricted donation income was applied to charitable non-business purposes, and adjusting the Approved Method formula would unfairly increase the Appellant's recovery rate.

The Appellant sought judicial review of the rejection of the second element of the claim, but this was stayed pending the outcome of the Tribunal appeal.

HMRC argued that:-

- it was not contractually bound to accept the outcome of an approved business/non-business method if that method permitted recovery of VAT which was not attributable to a trader's business purposes;
- on the contrary, it was statutorily responsible for preventing this from happening and could not contract out of that statutory responsibility by agreement with a taxpayer;
- it had not entered into any contract with the Appellant which would prevent it from assessing retrospectively if the Approved Method subsequently failed to give a fair result;
- in *R v Customs and Excise Commissioners, ex parte Littlewoods Home Shopping Group* [1997] STC 317, the High Court had decided that HMRC was not bound by a retail scheme agreement, despite the decision in *GUS Merchandise Corp Ltd (No 2)* [1995] STC 279 cited by the Appellant (see below); although HMRC's guidance was silent on retrospective adjustments to an agreed business/non-business method, HMRC had the power to revisit a method;
- partial exemption methods could not be retrospectively amended because that was the statutory scheme, but there was no such statutory scheme for business/non-business apportionments;
- if there was a binding contract it could not conflict with HMRC's statutory obligations and, if it did, it would be necessary to read into it such terms as would enable HMRC to meet those obligations; and
- that implied term would be necessary because it would correct the Approved Method's effect of unlawfully entitling the Appellant to recover input VAT incurred on non-business activities and not, as the Appellant sought to argue, because it yielded a higher level of VAT recovery than HMRC had agreed under a 'commercial bargain'.

The Appellant sought to argue as follows:-

The method had been used since 1995 and formalised in a 2000 agreement following correspondence. It should therefore be binding on both parties, following *GUS Merchandise Corp Ltd (No 2)* [1995] STC 279, where a retail scheme agreement reached after extensive correspondence was held to be binding.

The method could be challenged by either party if it was no longer fair and reasonable, but that should be with prospective effect only.

HMRC could contract out of statutory obligations to the extent that it was empowered to settle claims and reach compromises under its responsibility for the care and management of the tax, which afforded it a 'wide managerial discretion'.

There was no need to read any implied term into the Approved Method: it stood as it was and, because it included terms concerning change in business circumstances, it could not be an oversight on HMRC's part that there was no term concerning changes in VAT treatment.

In any case, CECS did not herald a change in VAT treatment, it simply revealed what the correct VAT position had been when the agreement took place.

Held

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The Tribunal found as fact that the Appellant's claim, if allowed, would have yielded recovery of c.85% of the VAT which it incurred, despite the fact that the Appellant had adduced no evidence to suggest that any part of its unrestricted donation income was applied to its business activities.

It considered that the legal frameworks for agreements on partial exemption and retail schemes were significantly different than that for business/non-business agreements, as they determined the basis on which HMRC could vary or terminate partial exemption and retail scheme agreements.

A business/non-business apportionment fell only within s 24(5) VAT Act 1994, which simply stated that VAT on supplies, acquisitions, and importations:

"shall be apportioned so that only so much as is referable to [the taxpayer's] business purposes is counted as his input tax".

Neither the legislation nor HMRC's guidance described how this should be achieved, nor did it require HMRC to prescribe, agree, vary or terminate an agreement. The guidance made it clear that an officer could not challenge the principles of the method used, and could only challenge the amount of recovery that it yielded. The guidance also permitted a retrospective change of method by the taxpayer, if the earlier method did not produce a fair and reasonable result.

HMRC was therefore not bound by the terms of a legal framework governing business/non-business methods but could enter into agreements if this would assist the taxpayer. If HMRC was to renounce a partial exemption or retail scheme out with the terms on which the legal framework permitted it to do so, that would be in breach of its statutory obligations, but there was no such framework to prevent HMRC resiling from a business/non-business agreement.

The Tribunal referred to the High Court's decision in *Victoria and Albert Museum Trustees v Customs and Excise Commissioners* [1996] STC 1016. The Appellant had sought to argue that it was required to operate a method laid down by HMRC in a Notice and, having done so, it had understated its input VAT entitlement. The court held that the Notice in question had been expressed in permissive and not mandatory terms and the Appellant could not change its method or make an adjustment because it had not made an error. In the Tribunal's opinion, that judgment supported the view that the choice of a method is a matter for the taxpayer alone and did not support the view that an approved method constituted a binding agreement. Although the Tribunal in *The Labour Party (17034)* had found that HMRC had entered into an apportionment agreement with the intention that the parties should not resile from it, that agreement had encompassed both business/non-business and partial exemption.

As regards the intentions of the parties when the agreement was made in 2000, the Tribunal found that there had not been an intention to negotiate or enter into a contract. The Appellant had wished to retain its existing method and HMRC, after seeking to persuade it to change the method, had simply followed the guidance concerning documenting the Approved Method. This accorded with the Tribunal's analysis of the legal framework concerning business/non-business apportionments.

The Tribunal also agreed with HMRC's argument that it could not have intended to enter into an agreement which would have exceeded or frustrated its statutory obligation to manage the tax, e.g. in a way that would entitle VAT to be recovered in respect of non-business activities.

Finally, the Tribunal considered that the Appellant was incorrect to suggest that HMRC was seeking retrospectively to revisit the Appellant's Approved Method. The Tribunal pointed to the "shared understanding" of the parties when the agreement had been made that VAT incurred on professional fundraising fees was wholly irrecoverable. In the Tribunal's opinion, it was the Appellant which was seeking to revisit the agreement when viewed in the context of that 'shared understanding' and it had effectively submitted a new claim to input VAT recovery, rather than an adjustment. The Appellant had not, however, adduced any evidence in support of that new claim (i.e., it had not shown that the additional VAT claimed under the second element of its claim was attributable to taxable business activities) and therefore it had failed to discharge the burden of proof required to support the new claim.

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Consequently, the appeal was dismissed.

Implications

This is an interesting case which touches on several basic principles of the VAT legislation, and HMRC's powers and obligations. It is a reminder that the method to be used for business/non-business apportionment of VAT incurred on costs is a matter for the taxpayer, another of those areas (along with reg 103 'specified supplies', the standard and special method overrides and the reg 103B apportionment of VAT incurred on 'incidental' financial supplies) where the law is not prescriptive about 'use'.

A written agreement might still be useful in circumstances where a business is seeking to defend a challenge to its input VAT recovery rate by HMRC. In that case the Tribunal might be more sympathetic to the taxpayer if HMRC and the taxpayer had made an agreement and there had not been any significant change, either in the taxpayer's circumstances or in the rate of recovery yielded by the method.