

**Partial exemption - Standard method override**  
***Abbeyview Bowling Club (20661)***

**Summary**

In a recent case the VAT Tribunal found that HMRC had omitted to take into account taxable 'use' of a building extension in calculating a standard method override (SMO) adjustment. Correction of that omission brought the adjustment below the SMO 'substantial difference' threshold and therefore the SMO was not applicable to the Appellant.

This case, and the Tribunal's comments, raise concerns regarding the way, and circumstances, in which HMRC currently seeks to apply the SMO provisions.

**Background**

The Appellant, a members' bowling club, extended its original premises by the addition of an indoor bowling rink. Funding of this extension was obtained from commercial lenders in the licensed trade. They were, the Tribunal accepted, persuaded to lend funds for the development due to the prospect that the Appellant's turnover from, and therefore purchases of, their goods would significantly increase as a result of the development.

The bowling rink was surrounded by 'walkways' where tables and chairs were provided for spectators, bowlers and people using the bar facilities via a serving hatch into the bowling rink, and the Tribunal accepted that the walkway within the bowling rink was used for taxable purposes.

The Tribunal accepted that the Appellant had a dual purpose in extending the premises: 1) to provide indoor bowling facilities to its members (membership being VAT-exempt); and 2) to increase its taxable turnover from the sales of taxable goods, which would in turn enable it to continue to service its borrowings and continue to exist. In the Tribunal's view, neither of these purposes could have been achieved independently of the other.

Following the development, the outdoor bowling membership had remained at the maximum 200, whilst the new indoor membership was 800, and the Tribunal considered that it was reasonable to assume that increases in taxable bar turnover could be ascribed to the increase in indoor membership.

The Appellant applied the standard method (turnover-based) partial exemption calculation (reg 101 VAT Regulations 1995, SI 1995/2518) to calculate the recoverable proportion of its residual input VAT over the development period between May and September 2003. This resulted in recovery of 77% of its residual input VAT.

HMRC visited the extended premises and, as the Appellant's residual input VAT exceeded £50k (c.£135k related to the extension), performed a SMO 'use-based' calculation for the purposes of reg 107. That calculation essentially differed from the standard method in that it used figures from a letter written by the designer of the extension to distinguish between the element of cost of the extension works which related to the bar and catering facilities and that which related to the indoor bowling rink. HMRC allowed recovery in full of the input VAT incurred on the former, and 5% recovery on the latter, that being the ratio of taxable visitors' to exempt members' bowling fees. The difference between this calculation and the standard method calculation was c.£59k in favour of HMRC, and therefore there was a 'substantial difference' for the purposes of the SMO.

The Appellant disputed the way in which the SMO had been calculated, contending in particular that:

- income generated from the consumption of drinks and snacks in the indoor rink area should have been included in the calculation of 'use' of that area;

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- indoor rink members' subscription income should have been excluded from the calculations because separate consideration was payable by members who wished to use the indoor bowling facility;
- an allowance was due for the portion of the roof and the wall that rendered part of the lounge area wind and watertight after the new construction; and
- that a proportion of the costs of the rink analogous to the extent of the 'walkways' should be allowed.

### **Decision**

The Tribunal rejected the Appellant's second contention on the facts before it. It also expressed reservations about, but did not dismiss, the third, on the basis that the existing building would have had to have been kept wind and water tight in any case.

However, the Tribunal considered that it was reasonable for the SMO to take into account a proportion of the additional bar and catering turnover in determining the extent to which the rink area including the 'walkways' was 'used' for taxable purposes. It estimated that at least one third of the additional bar income could be attributed to sales to persons within the indoor rink area.

The effect of including this additional taxable turnover within HMRC's SMO calculation was to increase the recoverable percentage of input VAT deemed to relate to the indoor rink area from 5% to 30%. The difference in the amount of residual input VAT recoverable by the Appellant according to HMRC's SMO consequently reduced to c.£39k, well below the 'substantial difference' adjustment level of £50k. On that basis, the appeal was decided in favour of the Appellant.

### **Implications**

This case highlights the difficulties which are faced by both HMRC and business when faced with regulations which require attribution and apportionment of residual input VAT on the basis of 'use' but do not specify how 'use' is to be determined.

It is notable that the Tribunal Chairman in this case commented as follows:

*"There were several difficulties and complexities in the matter one result of which was recognised by the Respondents not seeking to impose a misdeclaration penalty. A further reason for that action by the Respondents might be found in the introductory material they promulgated when the regulations were amended to bring in this concept of "override". It is plain from the note they produced at the time that the reason for the introduction of the override was the targeting of aggressive tax avoidance. It was conceded that this description did not apply to the Appellant's activities.... They were (viewed reasonably) unintended victims of the change by HMRC."*

4 Eyes Ltd is aware that HMRC appears to be relying upon the SMO provisions to extend their application beyond cases involving perceived VAT avoidance. This is likely to lead to further litigation and again highlights the complexity surrounding partial exemption issues and the need for appropriate advice to be taken in agreeing and operating partial exemption methods.