VAT focus

VAT deduction and non-economic activities: art or science?

Speed read

Not only exempt supplies lead to a VAT cost. Non-economic activities can too. Once thought the preserve of charities and 'non-business' entities, a succession of recent cases has confirmed that even fully taxable, wholly for-profit businesses can find themselves engaged in non-economic activity with a consequent VAT hit. It is not always clear when it is possible to look through such activity and preserve VAT recovery. It seems clear that an 'objective' approach is required, but the outcome can be challenging to predict. Case law suggests that the size, importance and regularity of the non-economic activity and its underlying purpose all seem important, together of course with the amount of related VAT that HMRC might argue it 'consumes'.

Karen Killington
KPMG
Karen Killington works for KPMG in London specialising in advising financial services, public sector and charity clients. She spent six years in HM C&E (as it then was) and has worked for KPMG since 1997. Email: karen.killington@kpmg.co.uk; tel: 020 7694 4685.

Peter Dylewski
KPMG
Peter Dylewski leads KPMG's EMA region financial services indirect tax practice. He has more than 15 years' experience in FS VAT, with a particular focus on investment management and international VAT issues. Email: peter.dylewski@kpmg.co.uk; tel: 020 7311 8497.

Parents reading this article may have just passed through the delights of GCSE or A Level season (or still be in the throes of battling histograms, Hitler and the Haber Process). If they have been roped into helping with revision, they may find themselves questioning their memory and wondering whether the subjects were not somewhat more straightforward in their day.

Similarly, longstanding practitioners of the 'simple tax' may find HMRC's developing approach towards the question of non-economic activity and the non-recovery of associated input tax to be somewhat puzzling. Drawing on their recent experience of GCSE Science revision, the authors decided to evaluate this perception to see whether conclusions can be reached about the principles to be applied.

Background

It is a longstanding tenet that VAT incurred in relation to a non-economic activity is irrecoverable. The VAT Directive's definition of economic activity is widely drawn, including any activity supplying services or exploiting tangible or intangible property to derive income therefrom. However, since at least *Securenta* (Case C-437/06), it has been clear that a taxable person may do things which, whilst entirely commercial, are nevertheless non-economic activities.

Historically in the UK, the economic/non-economic split has often been equated with the business/non-business dichotomy. Fully taxable businesses (those making no exempt supplies) have thus rarely been concerned with the non-recovery of input tax, apart from the typical client entertainment, etc. The terms 'non-business' and 'non-economic' are *not* wholly interchangeable, however. It is possible to have a *non-economic business activity*. This is a non-economic activity but which is something the taxable person was set up to do and so falls within their broader 'corporate purpose' (see *VNLTO* (Case C-515/07)).

Services given away for a non-business purpose and most gifts of goods are deemed taxable supplies and so are *not* non-economic activities. VAT is deductible but output tax is then due. With non-economic business activity, however, there is no deemed onward supply which would alter the non-economic analysis with related VAT incurred not being recoverable.

Hypothesis: a shift from simple filtering to more complex extraction?

Recent case law and guidance (such as that for holding companies) shows HMRC now seeking to identify non-economic activities more often in commercial contexts. In consequence, a 'fully taxable' business no longer has a 'simple' filtering exercise separating the pure recoverable input tax related to taxable supplies from, say, blocked VAT on client entertainment. Several different steps are now needed to separate out the recoverable input VAT – not unlike the reduction reactions which extract iron from its ore in a blast furnace.

The 'pure' product sought is that the VAT is sufficiently linked to taxable supplies made in the course of business (which one might call 'taxable business economic activity'). Even where a fully taxable business has received supplies, used them for business purposes and ultimately reflected the costs in onward supplies, HMRC may still seek to disallow VAT, asserting no sufficient link to taxable supplies. In other words, the VAT has been *used* by the business non-economic activity and is non-deductible. (This is a new category of waste product to be removed from the VAT return 'blast furnace'.)

Evaluation: non-economic activity – complete or incomplete combustion?

Of course, as this is VAT, it is not as simple as disallowing input tax where ever you have associated non-economic activity. Depending on the context, it may be possible to argue that the tax has not fully 'reacted' with the non-economic activity and can still to some extent be linked to taxable supplies.

This may remind the 'exam support team' parents (and the chemists) of the difference between the blue and yellow flame on a Bunsen burner, which depends upon whether its air hole is open or closed. In both cases, the methane fuel is still burned, and heat and light are produced. However, the level of oxygen will affect whether there is complete or incomplete combustion.

Considering the non-economic activity cases that have gone to court, a pattern of sorts emerges.

HMRC's biggest recent success is *Vehicle Control Services* [2016] UKUT 316. A parking business, which derived most of its income from parking fines (a non-economic activity), had an equivalent percentage of its input tax disallowed. The relative size of the non-economic activity played a part but the self-contained nature of the activity may also have been relevant.

In *JDI International* [2017] UKFTT 329, the VAT incurred on tools was found to be used in the non-economic activity of

leasing them to a sister company for free. The FTT rejected the argument that this was to create more demand for spare parts which JDI would later sell, creating a link to taxable supplies and a right to recover VAT. This brings to mind the 'but for' distinction from *C& E Commrs v Southern Primary Housing Ltd* [2003] EWCA Civ 1662.

The advocate general in *Iberdrola* (Case C-132/16) meanwhile concluded that VAT incurred by the taxable person in repairing a sewage plant owned by the local authority was not deductible. The repair was done 'for free' and only benefited the local authority. There was a causal and accounting link to taxable supplies and a clear commercial driver but, for VAT purposes, the payments could not be seen as a cost component of taxable activity. Although the repair was a necessary condition for planning consent to build the holiday village in order to generate taxable income for Iberdrola, it was still a non-economic business activity. The non-economic process involved the 'complete combustion' of all of the related VAT incurred, leaving none to combine with Iberdrola's taxable activities.

In cases the authorities have lost, by contrast, the court has found it possible to discern an objective link to taxable supplies. In *Sveda* (Case C-126/14), a CJEU decision which many see as seminal, a grant-funded nature trail with free admission was built with the objectively evidenced intention that visitors would ultimately buy food and souvenirs. The court decided that the provision of access to the trail without direct charge (albeit subsidised by grants from the Lithuanian government) did not itself preclude there being a sufficient link with taxable supplies (i.e. the intended sales to visitors by the company).

At a domestic UK level, in *Associated Newspapers Ltd* [2017] EWCA Civ 54, retailer vouchers were given away 'free' to readers as a promotional cost directly aimed at selling more papers. HMRC asserted that the cost of the vouchers was 'used for making a non-taxable supply' and therefore the associated input VAT should not be reclaimable. The Court of Appeal decided to first ask whether the voucher costs were cost components of a taxable supply. If there was found to be a sufficient connection with 'taxable economic activities', the test would be met. However, if the costs were 'directly (and exclusively) linked' to the free supply of vouchers, then the VAT would be irrecoverable.

Reviewing the European precedents, the court discerned that what was required was 'an objective analysis in terms of the taxpayer's identifiable economic activities of why the input supplies were acquired'. The mere fact that the costs may also have facilitated 'the making of supplies which in themselves were either exempt or outside the scope of the Principal VAT Directive' should not necessarily cause one to ignore their absorption into general business running costs.

In *F A Smart and Son* [2016] UKUT 121, VAT was incurred purchasing single farm payment units, which entitled the holder to receive EU grants by reference to land held. HMRC asserted that the units were purchased for the purpose of obtaining the single farm payment grants – a non-economic activity. Therefore, no right of deduction should arise. Furthermore, it argued that the company had not demonstrated the payments for the units were properly cost components of the farm's taxable supplies.

The First-tier Tribunal found there was both subjective and objective evidence that the grants were spent in expanding the taxable supplies of a farm. The Upper Tribunal confirmed this and reaffirmed that the cost component test for overheads is satisfied as soon as there is an objective link with the business's economic activities. There is no need to trace through to the cost base of particular onward supplies and it was therefore irrelevant that the cost of the units was recouped, economically, from the annual receipts of the single farm payments (rather than from the farm's taxable income streams). The tribunal helpfully distinguished between:

- the scenario in *Abbey National plc v C&E Commrs* [2001] ECR I-378 and *Kretztechnik AG v Finanzamt Linz* (Case C-465/03), where the out of scope operation was found to be carried out for the benefit of a taxpayer's economic activity in general;
- the *Securenta* case, where the input tax was incurred both for economic and non-economic activities simultaneously; and
- the *University of Southampton v HMRC* [2006] STC 1389, where there was a direct link to a distinct activity (publicly funded research) which was an aim in itself.

Conclusion: the Heisenberg uncertainty principle?

When does a non-economic activity break the chain which links costs to taxable economic activities? How do you know whether the VAT Bunsen flame is yellow or blue (or somewhere in between)?

From the case law, it seems clear that an 'objective' approach is required, but the outcome can be challenging to predict.

First of all, you must, of course, identify the non-economic activity; free services, in particular, can be rather hard for the in-house tax department to spot!

If the non-economic activity is a free service, the key question seems to be why the service has been given away? Is the cost incurred directly to increase taxable supplies? Or does the free service use up the VAT as an aim in itself? *JDI* shows this 'intention to increase taxable supplies' argument is not always successful – the facts in each case are determinative. A direct economic benefit deriving from the free service for the 'donor' taxable person (and not just for the recipient of the free service) seems to be important.

If the non-economic activity involves income, what will that income be used for? Will it support taxable supplies? For some scenarios, there may be specific assistance available. HMRC's recent guidance on holding companies helpfully confirms, for instance, that the receipt of dividends from a subsidiary will not affect VAT deduction rights where the parent provides taxable management services to it. It also recognises a category of 'stewardship costs' which by their nature are agreed to be overheads of the business as a whole. The clear implication, however, is that there are costs which will not fall into this category.

VAT deduction still seems more art than science in this area: each decided case raises more questions. What we can say is that the size, importance and regularity of the non-economic activity and its underlying purpose all seem important, together of course with the amount of related VAT that HMRC might argue it 'consumes'. More 'experimental data' is likely needed before definitive hypotheses can be identified, tested and the inherent uncertainty here reduced (for example, the next stage in *HMRC v University of Cambridge* [2015] UKUT 305).

In the meantime businesses would be well advised to consider potential non-economic business activities they may be carrying on and how to address any associated VAT risk. ■

For related reading visit www.taxjournal.com

- M&A input tax recovery by holding companies: an elementary issue? (Peter Dylewski & Philippe Gamito, 16.2.17)
- Cases: *JDI International Leasing v HMRC* (3.5.17)
- Cases: *Associated Newspapers v HMRC* (14.2.17)
- The curious case of *VCS* (Etienne Wong, 26.10.16)
- *Sveda UAB* and input tax recovery (Graham Elliott, 29.10.15)