VAT's your purpose?

Indirect Tax



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Natasha Siddiqi considers the challenges of input VAT recovery

Key Points

What is the issue?

Input VAT recovery is not always a clear-cut process for any business. Due to the subjective nature of VAT law, particularly in relation to input VAT deduction, it is not always clear what is and what is not eligible for input tax deduction

What does it mean to me?

Every business has an interest in the recovery of input VAT. Care is required to ensure that input VAT is not recovered incorrectly, resulting in either an under- or overpayment of VAT. It is also important that taxpayers are not paying VAT unnecessarily since this represents a cost to businesses

What can I take away?

An understanding of the two most subjective conditions in determining whether a claim for input VAT deduction can be made, the ‘business purpose’ test and the concept of a ‘direct and immediate link’

Generally, fully taxable businesses are entitled to recover their input VAT. However, this right is restricted for some businesses, including those that are partly or fully exempt. What is not always appreciated is that restrictions on VAT recovery extend to all businesses unless particular conditions are met.

There are seven basic conditions that must be satisfied for a business to reclaim their input tax:

1. a supply of goods or services has been made;
2. the supply was made to a taxable person;
3. the supply must have been made for a business purpose;
4. the supply was made to the person claiming the deduction;
5. the recipient intends to use the goods or services for the purposes of their business;
6. the goods or services supplies must have a direct and immediate link to a taxable transaction; and
7. input tax must have been correctly charged.

Most of these conditions are self-explanatory, although some are not as simple as they seem. However it is the third and sixth that seem to cause most problems for business given that they introduce a degree of subjectivity in deciding whether a claim can be made. It follows that there is an excess of case law on each.

Condition 3: business purpose

There is no absolute definition of what it means for a supply to have been made for the purpose of a business. This introduces an element of uncertainty, and is why many businesses fail this test. Clearly, as HMRC notes in its guidance, it would not be viable or sensible to produce a list of what does and what does not qualify as being carried out for a business purpose.

To determine whether this test has been satisfied, businesses need to consider three distinct questions.

1. Are the supplies being made in the pursuit of a business purpose?

This question is particularly relevant for businesses and charities that undertake multiple activities, with at least one considered as non-business.

Numerous cases have explored this, including *C&E Commrs v Lord Fisher* [1981] STC 238, *C&E Commrs v Morrison's Academy Boarding Houses Association* [1978] STC 1 and *C&E Commrs v St Paul's Community Project Ltd* [2005] STC 95.

Although the court decided in favour of *Morrison's Academy*, noting that the concept of business did not need to be restricted purely to a profit-making activity, it was different in *St Paul's Community Project* and *Lord Fisher*. Here the organisations were found to be predominately unconcerned with the making of taxable supplies for a consideration so input tax could not be reclaimed.

Therefore, it is important to consider the intrinsic nature of the enterprise and the overall purpose of the activity when determining whether this test has been met. For organisations that have failed this test, HMRC has noted the presence of factors such as a lack of commerciality or the intent of the activity being merely to cover costs.

2. What was the intention behind this purchase?

A subjective test again, but a useful question for businesses to ask themselves to determine whether a purchase is for a business purpose.

Ian Flockton Developments v C&E Commrs [1987] STC 394 is the best known case in this area. Ian Flockton Developments, a plastic storage tank supplier, incurred VAT on the upkeep of a racehorse, stating that the sole purpose of this expenditure was

to promote the company. Although – in my mind at least – there is no obvious link here, input tax deduction was allowed.

Therefore, it is clear that the intention behind the purchase is an important consideration in determining whether it is for a business purpose.

3. Is there a clear connection between the use of supplies and the business activities?

Businesses should consider whether there is an association or link between the expenditure and the purpose of the business. It is likely that the less obvious this link is, the more likely HMRC will question whether there is a business purpose. It is not enough to simply believe that the purchase was for a business purpose. To satisfy this test, consideration should be given as to whether the purchases will be used within the company.

Condition 6: direct and immediate link to a taxable transaction

To satisfy this test, it has been argued that the purchase or expenditure for which VAT was incurred should be a cost component of that supply when it was made.

BLP Group plc v C&E Commrs [1995] STC 424 is key. The case confirmed that businesses cannot look through to the ultimate purpose of that business to illustrate a direct and immediate link between that purpose and input VAT incurred.

BLP, a taxable holding company, sold one of its subsidiaries to raise funds to stay in business. BLP incurred VAT on the costs of the sale. It argued that, since the purpose of the sale was to continue being able to supply taxable management services, there was a direct and immediate link between the costs and taxable transactions. However, there is no link to any particular transaction here and the case confirmed that the overall purpose of the business bears no relevance to input VAT recovery. To satisfy this condition, it is necessary to focus on the link between particular transactions and input VAT incurred.

It is also useful to consider *C&E Commrs v Midland Bank plc* [2000] 1 WLR 2080, Case (C-98/98). The issue was whether it was possible to recover in full input VAT on legal expenses in defending the business in relation to implementing a taxable

transaction before the expense was incurred. It was decided that, as a partly exempt business, Midland Bank was not entitled to a full recovery. Although there was no dispute that the expense was for a business purpose, it was clearly not a cost component of the supply made at that time. Therefore, we can establish that, to have a true direct and immediate link to a transaction, the purchase must have been made before the supply and it must be directly tied to a particular transaction.

Developments in this area include the release of *Revenue & Customs Brief 43 (2014): VAT on pension fund management costs*, which gives further guidance on the presence of a direct and immediate link in this context. The brief sets out HMRC's position on the eligibility of pension schemes to recover input VAT and was published after the decisions in *Fiscale Eenheid PPG Holdings BV cs te Hoogezand*, Case (C-26/12) and *ATP Pension Services*, Case (C-464/12). VAT incurred on general management of an occupational pension scheme was allowed deduction, in line with normal rules, on the basis that the costs represented overheads of the business and there was a direct and immediate link to the business activities.

However, any VAT incurred on investment management costs of pension funds was considered by HMRC as related to the activities of the pension fund rather than the business itself, so were therefore only deductible by the fund.

HMRC has now changed its position and accepted that there may be a direct and immediate link between management costs and businesses overheads, instead of transactions in the investments, as long as the supply is received and paid for by the business, not the fund.