Mixed supply challenges: apportioning output tax

Indirect Tax



19 April 2023

HMRC has issued improved guidance about apportioning output tax when individual items sold in a bundle of goods or services are subject to different rates of VAT.

Key Points

What is the issue?

If a bundle of goods or services sold by a business are subject to the same rate of VAT – or all but one of the items in the package are incidental and can be ignored – the challenges of output tax apportionment will not be relevant. So, it is firstly important to identify when a mixed supply outcome is evident.

What does it mean for me?

HMRC has recently issued improved guidance in its manuals – and also a Revenue and Customs Brief – to help a business calculate how much output tax to pay in mixed supply situations. The guidance aims to ‘encourage’ a method based on retail selling prices for individual items but this is not compulsory.

What can I take away?

If a past method of apportionment is flawed and has overpaid output tax, a business might be able to adopt an alternative method for the last four years if there are good grounds for doing so. An error correction submission to HMRC can be considered.

VAT and mixed supplies is a hotbed topic that has probably perplexed HMRC’s policy teams more than most other issues. That is hardly surprising when the outcome often comes down to shades of grey decisions such as customer perception and a human viewpoint about whether individual goods or services within a package are incidental or otherwise.

To give a practical example, when I buy a zero-rated rail ticket that includes a standard rated cup of tea during the journey, advisers will probably agree that the tea is a minor part of the supply and the sale should be wholly zero-rated; i.e. it is only the train journey that counts.

But what if a sandwich is added to the deal? And then a packet of crisps? And how about a glass of champagne to bring some luxury to the proceedings? Is part of the fare now standard rated as catering? As I hammered out the word ‘champagne’ on my trusty typewriter, I could imagine many readers raising their hand and shouting out: ‘Now it’s a mixed supply.’

In this article, I will consider when a mixed supply outcome is relevant and also HMRC’s Revenue and Customs Brief 2/2023 (issued on 3 March 2023) about how output tax should be apportioned in such cases (see bit.ly/414oF9M). The Brief only announced improvements to HMRC’s guidelines rather than any changes to the law, which is welcome.

Landmark ECJ decision in 1999

The most important historic case about VAT and mixed supplies was *Card Protection Plan v HMRC* (Case C-349/96), heard by the European Court of Justice in 1999. It considered whether services supplies made by Card Protection Plan Ltd (CPP) to its customers related to a standard rated supply of administration services; an exempt supply of credit card insurance; or a combination of both.

I referred to the case in my article to celebrate the 50th anniversary of our favourite tax (see '50 not out: the anniversary of VAT' in April 2023) but the main conclusions deserve to be highlighted. See ***Card Protection Plan Ltd***.

The most significant guidance in the CPP decision is probably the need to consider if it would be artificial to separate the individual supplies in a package. For example, if I buy a washing machine that includes a 30 page glossy brochure about how to use it, then I am only buying the washing machine and not a zero-rated brochure. However, if I buy a package that consists of a paperback novel and a pen, each item can be used independently – and, as a customer, I am buying the package because I want both the pen and the book. It is a mixed supply.

***Card Protection Plan Ltd*: The key findings**

The key conclusions from the ECJ case of Card Protection Plan v HMRC to determine if there is a single or mixed supply are set out below:

- For a supply to be separate, it should be regarded as distinct and independent.
- A transaction that is a single supply from an economic point of view should not be artificially split into separate supplies.
- There is a single supply where one or of the elements constitutes the principal or dominant supply, while the other elements are ancillary to that principal supply.
- A supply is ancillary to the principal supply if, for the average consumer, it is not an end in itself but a means of better enjoying the principal supply. (The VAT treatment of an ancillary supply will follow that of the principal supply.)
- The assessment is made from the perspective of the typical consumer, not the supplier.

- Where there are two or more supplies and a single price is charged, it is necessary to apportion the amount.

Other tribunal cases

VAT enthusiasts will recall the First-tier Tribunal case of *Ice Rink Company Ltd* [2020] UKFTT 350 about whether a company that charged children a standard rated fee to use a skating rink made a partly zero-rated supply when an extra amount was charged to hire out skates.

The sale or hiring of children's clothes is zero-rated by virtue of the Value Added Tax Act (VATA) 1994 Sch 18 Group 16. The case was won by the taxpayer but the judge highlighted that separate pricing – an extra charge to hire the skates – does not automatically create a mixed supply outcome; it is the overall package and customer perception that counts.

In the case of *Europcar Group UK Ltd* [2021] UKFTT 359, the challenge was to consider whether an extra fee to hire children's car seats at the same time as hiring a car was:

- a single standard rated supply of a 'car with children's seats'; or
- a mixed supply of a standard rated charge for hiring the car and a separate payment to hire the children's seats, which would be subject to 5% VAT.

The judge allowed the company's appeal, commenting that the two supplies were 'economically distinct' and the customer had 'a genuine economic choice' to hire the seat or otherwise.

Output tax apportionment

The legislation does not specify any method of output tax apportionment that must be applied by a business where there is a mixed supply outcome. The method must be fair and supported on a logical, calculated basis (VATA 1994 s 19). However, this is not the end of the story: if HMRC decides that a method is unfair and has resulted in an underpayment of output tax, an officer has the power to issue a retrospective assessment for the last four years based on their 'best judgment' (VATA 1994 s

73(1)).

There are two main apportionment methods:

Cost prices: If each item in a bundle of goods is purchased separately, an apportionment can be made based on these buying prices. For example, a business buys:

- a zero-rated book for £6; and
- a pen for £10 plus VAT.

The business will account for output tax on 1/3 of the VAT inclusive retail selling price when it is sold as a single package; i.e. 6/18.

Retail prices: The same calculation process as above is carried out but by using the selling prices of individual items.

The complication with both methods is twofold.

- Firstly, it is very difficult to use cost prices if part or all of the bundle relates to services rather than goods, as with the rail ticket example.
- Secondly, what will a business do if it only supplies items as a package and never on an individual basis?

In such cases, the business will have to use an alternative method that gives a fair and reasonable outcome. The method must be regularly reviewed to ensure it is still appropriate.

Revenue and Customs Brief 2/2023

HMRC issued a consultation paper in 2021 headed ‘VAT and value shifting’ and indicated that it would change the law to make it compulsory for output tax on mixed supplies to be apportioned according to individual retail selling prices. In my view, that would have created a big can of worms. A business could have fixed individual selling prices that were weighted in favour of the zero-rated/exempt part of the package, while fixing the prices so high that customers would only opt for the combined purchase option; i.e. the mixed supply. Anti-avoidance legislation would then have been needed.

The outcome of the consultation was to improve HMRC's published guidance and not amend the law with the issue of Revenue and Customs Brief 2/2023. There have also been well-written amendments to HMRC's VAT and Valuation Manual (see VATVAL03000 to VATVAL04300). Another reference point is VAT Notice 700 s 31.

The most important comment in the Brief is as follows:

> 'The changes (to the guidance) encourage businesses to first consider a selling price method, where appropriate and available, before considering a cost price method or any alternative.'

What does this mean in practice?

HMRC powers

If a business follows HMRC's recommendation to use an apportionment method based on retail selling prices, this reduces the risk of a future challenge. However, HMRC does not have the right to override a taxpayer's chosen method if it is fair and reasonable.

The updated guidance only gives HMRC's views about this tricky subject and is intended to avoid or reduce non-compliance by taxpayers. To quote from the policy manual VATVAL03700: 'Businesses are not obliged to use any of these methods and apportionment methods based on some other method should not be rejected out of hand.'

The manual also gives a clear instruction to officers dealing with mixed supply challenges: 'If you employ an alternative method you will need to explain why the example methods were considered inappropriate.' (Author's note: the 'example methods' relate to cost and selling price methods.)

Retrospective adjustment?

The Brief uses the word 'encourage' as far as a retail selling price method is concerned. Does this mean that a business could be faced with a big assessment going back four years if HMRC challenges an alternative method, perhaps based on cost prices? The answer should be a definite 'no'. It is a bit like government policy on alcohol consumption – we are encouraged to drink no more than 14 units per week

but there is no fine or punishment if we drink more.

As a final challenge, what happens if your business thinks it has overpaid output tax on mixed supplies in, say, the last ten years because it has adopted a flawed method of calculation? There is no scope to adjust years one to six because they are out of time under the four-year error correction period but there might be a window of opportunity with the later years.

This issue is very helpfully dealt with by VATVAL04300 in HMRC's guidance. Here is a summary:

- You must be able to provide 'convincing evidence' to show why the previous method was unfair.
- Your new method must produce a 'substantially more accurate attribution of values than the old method'.
- A lower output tax liability is not a sufficient reason to justify a new method.

Conclusion

VAT recently celebrated its 50th birthday and there has been much agreement among advisers and authors that a reduced standard rate on all goods and services and the abolition of zero-ratings, exemptions and the 5% reduced rate supplies would be very sensible to simplify the tax for everyone. And, as a further argument in support of this strategy, the challenges of mixed supplies would also disappear.

That would be welcome, although I would miss writing about the twists and turns created by this fascinating subject. C'est la vie.

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