

# Navigating the VAT Recovery Maze

## RSM Indirect Tax Services

The Upper Tribunal (UT) case — Royal Opera House Covent Garden Foundation (ROH) (UKUT0132) calls into question the approach to be taken by organisations that undertake non business (outside the scope of VAT) and business activities (taxable and exempt) to determine the quantum of VAT incurred on expenditure that they are entitled to recover.

The ROH argued that production costs incurred on putting on a performance were directly linked not only to the VAT exempt ticket sales, but also VATable catering and bar sales. This being on the basis that but for the performance there would be no catering/bar income. It should be noted that HM Revenue and Customs (HMRC) had already accepted that there was a direct and immediate link of performance costs to VATable program sales, certain merchandise sales.

The UT has held that there was not a direct and immediate link as the production costs were not a cost component of the catering/bar income. Whilst it was clear that there was an indirect link this was not sufficient to enable additional VAT recovery in relation to the production costs.

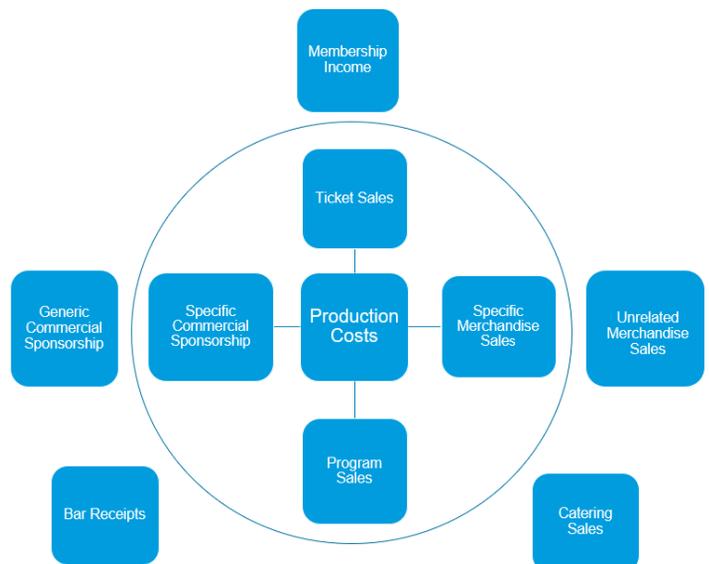
We anticipate that HMRC will be looking to revisit how methodologies have been applied in practice to ensure that charities have adopted the correct approach. Due to the complexity of this aspect of the VAT legislation and what on the face of it appear to be contradictory decisions, it is likely that there will be a number of disputes.

## So How Do you Navigate the Maze?

The key to navigating the VAT recovery maze is there has to be a direct and immediate link from cost(s) to a supply(s). You need to show that the expenditure is a cost component of, or directly consumed in the delivery of a supply(s). If the answer is yes – then the VAT recovery status will be determined by reference to the nature and associated VAT recovery status of that supply(s).

So in the case of the ROH only those supplies where there is a direct and immediate link (those within the circle) should be taken into consideration when determining the value of VAT to be recovered in relation to the production costs.

When viewed through this lens other VAT cases which appeared to contradict each other now make more sense. In the University of Cambridge case (CJEU C-316/18) HMRC successfully argued that the investment manager fees were wholly consumed in delivering the non-business investment activities and none of the associated VAT costs were eligible for recovery. The fact that the investments generated income that in turn was used to support the University's broader



activities was seen to be an indirect link, rather than direct link, and not sufficient to enable recovery of any of the VAT incurred.

If the expenditure is not a cost component of, or directly linked to a supply(s) then you need to ask “what has the expenditure enabled me to do”. The VAT recovery status will then be determined based on that activity(s).

For example in the case of Sveda, (CJEU C-12614/15) the tax authorities had tried to argue that the expenditure incurred on constructing a path was linked to a non-business supply, namely the free use of the path. The ECJ held that the free use of the path was not an activity/supply in and of itself but that there was a direct link between the cost of constructing the path and future VATable sales, in this case, in the on-site shop.

Similarly in Frank Smart (UKSC – 2018-0073) the Supreme Court held that the purchase of the Single Farm Payment (SFP) units and the subsequent subsidies that the farm was entitled to receive were not separate transactions. There was a direct and immediate link between the purchase of the SFP units and the deployment of the net proceeds of the subsidies in subsequent economic (VATable) activities.

In both these cases the expenditure incurred was not a cost component of /directly linked to a supply/activity rather they were an enabler.

So if there is a direct and immediate link between a cost to a supply, that is what determines the right to VAT recovery. If there is no direct and immediate link to a supply/activity then you need to understand what has the cost enabled you to do and it is this that will determine if the VAT is eligible for recovery

## Managing Enquiries from HMRC

Currently for most charities costs such as performance, exhibition, animal enclosure costs etc would fall to be residual and recovered according to the agreed Partial Exemption apportionment methodology.

HMRC may seek to apply the Partial Exemption standard method override or withdraw approval for the use of Partial Exemption special methods if they feel that the current Partial Exemption method does not produce a fair and reasonable result.

The RSM Indirect tax team can help your charity to assess if your approach to VAT recovery is :

- sustainable, if not we can assist in quantifying the impact, and help you devise an alternate methodology that will meet HMRC's fair and reasonable test
- overly prudent. We can assess the financial impact and if applicable help to devise an alternate approach to recovery.

**Our aim is to ensure that you can proactively manage the VAT costs of the charity.**

## For more information please contact:

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