

Input tax recovery

(Lecture B1109 – 14.26 minutes)

Many clients and advisers find the difference between exempt and zero-rated difficult to understand – they are very different in the VAT world – a zero-rated sale effectively charges VAT at 0% so therefore input tax can be reclaimed on related expenses, and the income is included as a taxable sale as far as the £85,000 registration threshold is concerned for a non-registered business. But it is also very important to understand the difference between non-business, private and exempt use, both in relation to buying and selling goods.

This session is based on practical examples.

Exempt use - Example 1

Foxwood Golf Club has purchased some very sophisticated grass cutting equipment to use on the courses at a cost of £100,000 plus VAT. The club is a non-profit making members club and is registered for VAT.

Most of the golf playing income is exempt from VAT, including joining fees, members' subscriptions and individual green fees. The only taxable golf income is likely to be from corporate green fees eg the Lexis Nexis Annual Golf Day ie booked by a business rather than individuals.

The input tax of £20,000 on the equipment relates to both taxable and exempt sales so is classed as 'residual input tax' for partial exemption purposes. This means that some VAT is claimed and the amount claimed is usually based on the standard method:

$$\text{Input tax to claim} = \frac{\text{Taxable sales (excluding VAT)}}{\text{Taxable plus exempt sales}} \times \text{Residual input tax}$$

The standard method should produce a favourable result for our club because the taxable sales figure will include bar and catering sales which is often as much as 30% of total income, whereas the corporate green fees revenue could be less than 1% of total income. The committee should encourage corporate bookings because they ensure input tax on course costs is residual rather than wholly exempt where no input tax would be claimed.

Planning tip – a small amount of VATable income for a mainly exempt activity means that some input tax will be claimed.

Annual adjustment

Here is a VAT poser: if Foxwood's taxable sales for the March VAT quarter are £30,000 and the total exempt income is £250,000, and this is the period when it bought the grass cutter, how much input tax will the club claim on the equipment?

The answer is: you don't know. The amount claimed with the quarterly calculation will be £2,200 ie £30,000/£280,000 is 10.71% - this percentage is rounded up to the nearest whole number ie 11% x £20,000 = £2,200. But the final amount claimed will depend on the partial exemption annual adjustment calculation, which is made at the end of March,

April or May (depending on the VAT periods adopted by the business), so March in the case of Foxwood. The annual adjustment could produce a residual input tax figure that is either higher or lower than the quarterly amounts claimed and the taxpayer has the choice of either adjusting the VAT on the return that coincides with the end of the tax year (March, April or May) or the following period.

The figures in my example are like many sporting clubs ie where a lot of exempt subscriptions and joining fees are received in the first calendar VAT quarter, and a lot of spending also takes place in the same period when there is cash to burn. This means that a low percentage of input tax will be claimed on the quarterly return because of the higher than usual exempt income but this will sort itself out with an input tax windfall when the annual adjustment calculation is carried out. I know that some advisers think the annual adjustment process is a waste of time but it makes a significant difference when income is received on a fluctuating basis, as is the case with many sports clubs.

Private use - Example 2

Smith and Smith Solicitors have an office in two acres of land just outside Hereford. They have purchased the same grass cutting equipment as Foxwood Golf Club for £100,000 plus VAT. It will be used by the business during the week but taken home by the partners every weekend to use on their private houses. How much input tax can Smith and Smith claim on the purchase of the equipment?

This is an example of when it is important to be clear about the difference between 'private use' and 'non-business use' – the use of the grass cutter by the partners is private use, which means there are two alternative ways of dealing with the VAT:

Input tax apportionment – this is the easier route. It seems that 5/7 of total use will be for business purposes (weekday use ie 5 days out of 7), so input tax of £14,285.71 can be claimed. The other 2/7 is not input tax because it is relevant to private use.

The Lennartz mechanism – this method has had many twists and turns over the years but it means that input tax is fully claimed when goods have both business and private use and then output tax is paid over the life of the asset to adjust for private use. However, it cannot be used for ships, aircrafts and interests in land or buildings, known as 'non-Lennartz assets'.

Note – if the use of goods is for a 'non-business' rather than a 'private' purpose, it cannot benefit from the Lennartz option.

The result of Lennartz accounting will be the same as with input tax apportionment but with a cash flow advantage to the business:

All Lennartz adjustments are made over a five-year period (60 months) unless the business knows that the goods will be disposed of before five years have passed e.g. our business might have a policy of changing its grass cutting equipment every three years, so adjustments will be made over three years (36 months).

Assuming the 2/7 private use applies for five years, the output tax adjustment made by Smith and Smith each quarter will be as follows: £20,000 input tax x 2/7 divided by 20 VAT quarters = £285.71

At the end of five years, the business will have claimed £20,000 input tax on the initial purchase of the grass cutting equipment and then accounted for output tax of £5,714.20 (£285.71 x 20 quarters) – a net claim of £14,285.80 being the same as with input tax apportionment (apart from 9 pence of rounding differences).

Non-business use - Example 3

Animal Homeless Charity is VAT registered because it has taxable sales from a charity shop. It uses a van to collect and deliver stock for the shop but it is also used to collect stray dogs and find them new homes, which is a non-business activity. The van was purchased for £10,000 plus VAT.

The Lennartz mechanism is not available because there is no private use of the van – only a combination of taxable and non-business use. Input tax apportionment is the only way of deciding how much can be claimed

Non-business activities are most commonly found within organisations such as local authorities, charities and further education establishments. Any method can be used by the charity to apportion its input tax but the calculations must be fair and reasonable to properly reflect use for taxable activities.

Tip for repair costs

There is good news for Foxwood, Smith and Smith and Animal Charity as far as repair and maintenance costs are concerned. Even though the taxable use of the grass cutter and van is less than 100% of total use in all cases, a full input tax claim can still be made on repair and maintenance costs i.e. no deduction is needed for private or non-business use (VAT Notice 700/64, para 5.1). The logic of HMRC (previously Customs and Excise) has always been that assets need to be in good working and properly maintained in order to do any business use, hence the 100% claim being allowed.

Selling the goods

A twist to the tale is that if only a percentage of the VAT was claimed on the purchase of an item because of the non-business or private use adjustments, output tax is only payable on the same percentage when it is sold (HMRC Input Tax Manual – VIT25240). The logic is that the initial input tax block took that part of the asset out of the business, so no output tax is payable when it is sold. So, if Smith and Smith sold their cutter for £30,000 plus VAT, the VAT would be calculated as follows: £30,000 x 20% x 5/7 = £4,285.71.

However, not such good news for Foxwood Golf Club: even though it only claimed perhaps 35% input tax on the grass cutting equipment due to the restrictions of partial exemption, it must still account for output tax at 20% when it is sold in the future. However, if the equipment had been wholly used for exempt purposes, and no input tax claimed, the onward sale would have been exempt from VAT and not subject to output tax (VATA1994, Sch 9, Group 14).

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