[2018] UKFTT 0087 (TC)

TC06345

Appeal number: TC/2015/3537

VAT – whether proposed partial exemption special method fair and reasonable – yes – appeal ALLOWED

FIRST-TIER TRIBUNAL
TAX CHAMBER

DYNAMIC PEOPLE LTD **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE AMANDA BROWN
JO NEILL

Sitting in public at Taylor House, 88 Rosebery Avenue, London on 7 December 2017.

Mr M Kaney of XVAT instructed by EA Associates, for the Appellant

Mr M Donmall of Counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

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DECISION

1. The appeal concerns HM Revenue & Customs' ("HMRC") rejection of a partial exemption special method ("the Method") proposed by Dynamic People Ltd ("the Appellant") as representative member of a VAT Group. The VAT Group includes the trading activity of the Appellant and two non-trading associated companies.

Bacground

2. The Appellant's principal activities concern the provision of domiciliary care to patients in their own home. Such supplies are exempt from VAT as the provision of care pursuant to section 31 and Item 9, Group 7 Schedule 9 Value Added Taxes Act 1994 ("VATA") The Appellant is also a registered provider of training. Manual handling training will be provided by the Appellant to its own staff as it is required to be so provided to every individual employed by the Appellant on an annual basis. The Appellant also provides such training to third parties. Prior to January 2017 such third party training was a taxable supply as the Appellant is not an eligible body and thus the education exemption did not apply. Since 2017 the Appellant has been in receipt of government funding for such training and where such funding is received the supplies of training are exempt from VAT under the provisions of Item 1 Group 6 Schedule 9 VATA.

3. The Appellant company was originally registered for VAT on 4 April 2005.

4. The Appellant company first sought to claim input tax in respect of costs relating to the standard rated training services in 2011. In 2011 the Appellant company incurred costs associated with the purchase and refurbishment of two properties known as Unit 1 and Unit 3. The Appellant sought to reclaim the costs and such claim was originally rejected by HMRC. In 2012 the Appellant's advisers then applied to HMRC for a Partial Exemption Special Method ("PESM").

5. The terms of the method were that general or residual costs would be sectorised: costs associated with Unit 1, costs associated with Unit 3 and general costs. Costs would be recoverable in relation to Units 1 and 3 by reference to the physical use of the buildings determined by floor area. General costs would be recoverable according to a turnover calculation akin to the standard method. The Appellant company provided details of the floor area of each unit and advised of the use of each room within each unit. The attribution to taxable supplies resulting from the application of the proposed room use amounted to 58.4% of the costs incurred in connection with the properties. Only 1.59% of the general costs attributed on the basis of turnover was recoverable. Following a visit to the Appellant's premises HMRC approved the proposed PESM as giving rise to a fair and reasonable apportionment.

6. For the first year of operation it was calculated that 58.4% of the £4,036.86 property cost input tax be recoverable (and no adjustment under the capital goods scheme on the basis that there had been no change of use of the building justifying a different apportionment to that used in the year of acquisition). For the remaining

£14,592.71 residual input tax the turnover based calculation of 1.59% was to be applied.

7. The Tribunal asked Mr Donmall whether, with the benefit of hindsight HMRC took the view that the method should not have been accepted originally in 2012. Mr Dunmall said that it formed no part of their case that HMRC had been wrong to accept the method in 2012 HMRC stood by the use of the agreed PESM until the VAT group was formed. This agreement being so despite it being agreed that the other companies in the group were non-trading companies which did not, in any way, use the buildings.

8. On or around 18 March 2014 Duru Investments Limited and SCKC Group Limited and the Appellant sought to be registered together as a VAT group with the Appellant as its representative member.

9. As the effect of the creation of a VAT group is that the group, through its representative member, becomes a new taxable person on 1 April 2014 the Appellant sought confirmation from HMRC that the previously agreed PESM be used by the VAT Group. HMRC did not accept the proposal and invited the Appellant to make a formal request for approval of a PESM which should include the activities of the other group members.

10. As the Appellant company was the only trading member of the VAT group on 25 June 2014 the Appellant's representatives submitted a proposal for a PESM. The proposal sought to reflect the use to which residual inputs were put. By this time the Appellant company and therefore the VAT group made supplies of exempt domiciliary care, taxable cleaning of client properties and taxable training. As with the agreed 2012 method general costs were to be apportioned on an income based method. For the property costs it again proposed a floor space method substantially replicating the 2012 method. The floor space method would be used both for the purposes of attributing general property costs and for the purposes of the capital goods scheme adjustments required to be carried out for the ten years following acquisition of the properties in 2011. The method however did not particularise the actual use to which any part of either building was put merely that floor space would be the basis on which taxable and exempt use was to be determined.

11. As under the 2012 agreed method the Appellant had asserted that a basement office and breakout area in Unit 1 were used exclusively for the purposes of taxable training and that the whole of Unit 3 was similarly used.

12. HMRC sought additional information and correspondence ensued.

13. On 18 November 2014 HMRC rejected the proposal the reasons given for rejection were:

> "The method proposed suggests that the floor areas in all of unit 3, inclusive of the front entrance hall, kitchen and corridor, WC etc will be exclusively used for taxable supplies, and in unit 1, the basement area office and rear lobby/kitchen have also been stated to be exclusively used to make taxable supplies. Floor

space can be used as a measure of the use of input tax, but only where the facilities are designed for a specific function – an example might be the apportionment of a building which comprises residential and commercial spaces could be apportioned by the floor area because each area has a unique purpose and supply. However, the information obtained so far gives no indication that these spaces are only intended to be exclusively taxable, they could serve any purpose, so this makes the method very difficult to audit.

The method also assumes that an empty room is used and can only be used, for taxable supplies. It is our opinion that if no taxable training is taking place, the rooms could and should be treated as residual because there is nothing in the design of the room that limits its used to taxable supplies. The method proposal should reflect actual use, which this PESM proposal does not do. Whilst the main business activity may use the building costs in a different way to the training services, you need to demonstrate that the choice of the floor space provides a more accurate measure of the use of the building costs than outputs".

14. The Appellant requested a review and subsequently appealed HMRC's review decision upholding the rejection of the proposed method.

Evidence and findings of fact.

15. The Tribunal heard evidence from Ms Charlyn Duru managing director of the Appellant company. From that evidence the Tribunal finds the following facts.

(1) The Appellant company is the sole trading company within the VAT group. In 2013 its income was approximately £2.2m from the provision of domiciliary care and £35k from taxable training which was provided to individuals not employed by the Appellant.

(2) The Appellant company purchased units 1 and 3 with the intention of significantly expanding the provision of third party training which, at the time was taxable and so remained until January 2017.

(3) The Appellant company also opted to tax unit 3 such that any letting of the building also gave rise to taxable supplies. The Appellant did let unit 3 to Jewish Care on a taxable basis.

(4) Unit 1 is essentially the administration centre for the business. Contrary to the schedule produced in 2012 attributing floor space between general business activity and training, Ms Duru's evidence was that no part of unit 1 was used exclusively for making taxable supplies of training. The more limited training facilities in unit 1 are used for training of the Appellant's employees.

(5) Unit 3 is the training centre. On the first floor there is a large training room in which manual handling training is exclusively given. The room is kitted out with beds hoists etc and other equipment necessary to provide the manual handling training. Manual handling training is provided in that room to the Appellant's own staff and to third parties.

(6) Each individual employed by the Appellant is required by law to be trained in Manual Handling each year. Ms Duru stated that this requires her to run a training session for her own employees approximately once per month. This evidence contradicted assertions made by her representatives in letters however, the Tribunal accepts her evidence in this regard. It is this clear that the first floor of unit 3 was not used exclusively for taxable purposes as asserted by the Appellant and accepted by HMRC in 2012.

(7) Through Ms Duru's evidence it was also apparent that other rooms in unit 3 were used in the training of her own staff. However, she was adamant in evidence in chief and in cross examination, that the computer training room, and meeting room in unit 3 were used only by the trainers of the third parties and in connection with such training. The floor space for these rooms totals 79.42m^2. That represents 20.9% of the total floor area of the two units.

(8) Ms Duru also explained that the aspiration to be a substantial training provider had not come to fruition and that, in any event, from 2017 the business had begun providing training to government funded students with the consequences that such training was also an exempt activity.

16. It is apparent from the evidence that the calculations undertaken in 2012 allocating the floor space to taxable use and residual use were at least from 2014, inaccurate with only 20.9% of the total floor space in fact being used exclusively for taxable purposes. It is also to be noted however that those parts of the building which were not exclusively used for taxable purposes were assumed for input tax recovery purposes to be exclusively used for exempt supplies as that is the natural consequence of the operation of the Method.

Legislation

17. Section 26 VATA, so far as material, provides that "(1) The amount of input tax for which a taxable person is entitled to credit at the end of any period shall be so much of the input tax for the period (that is the input tax on supplies … in the period) as is allowable by or under regulations as being attributable to …. (2)(a) taxable supplies". By virtue of section 26(3) the attribution of input tax is required to be fair and reasonable.

18. The regulations are set out in Value Added Tax Regulations 1995 Part XIV. In summary these provisions lay out the basis on which attribution of input tax is to be undertaken. The default method for attribution is prescribed in regulation 101. Under regulation 101 all directly attributable input tax is attributed by reference to its use in making taxable supplies (thereby giving rise to input tax credit/recovery) or exempt supplies (thereby precluding recovery). Any residual (or non-directly attributable) input tax is attributed to taxable supplies in the proportion that the value of such supplies bears to the value of all supplies. This is known as the standard method.

19. At the direction of HMRC on a prospective basis, or on the proposal of the taxpayer (retrospectively or prospectively) an alternative method of attribution may be used by virtue of regulation 102. These methods may, for instance, be floor space,

time, headcount etc, all methods will seek to approximate use of inputs on a fair and reasonable basis. These are known as special methods.

20. In the circumstances specified in regulations 107B (for the standard method) and 102A (for special methods) where either the standard method or a special method does not produce a fair and reasonable attribution by reference to the use of inputs the method will be overridden and a use (or alternative use) based method will be used. The criteria for application of the override do not apply in the present case as the tolerance, by reference to which the override is applicable, significantly exceeds any discrepancy between the competing methods in the present appeal. However, the override provisions emphasise the importance of establishing as accurately as possible the use to which inputs are put when determining a fair and reasonable input tax attribution method.

Appellant's submissions

21. The appeal was lodged on a number of grounds particularly focused on the interaction between the capital goods scheme and general the partial exemption provisions. During the hearing the Appellant's representative abandoned all but one of his arguments.

22. The only matter which it became necessary to determine was whether the Method was a) gave rise to a fair and reasonable attribution of input tax as between taxable and exempt supplies and if so, b) whether that result was more fair and reasonable than the standard method which was the only other alternative offered by either party.

HMRC's submissions

23. HMRC's position was that the standard method as set out in regulation 101 Value Added Tax Regulations 1995 most fairly reflected the use to which the respective inputs were put. Regulation 101 provides for the apportionment of non-attributable input tax on the basis of the proportion that taxable supplies bears to total supplies.

24. HMRC contended that their approval to an alternative method will be given when the proposed method demonstrably gives rise to a more fair and reasonable attribution of input tax by reference to use. They contended, by reference to the judgment of the Court of Justice of the European Union in *Finanzamt Hildesheim v BLC Baumarkt GmbH & Co KG c-511/10* paragraph 24 that any special method was required to "guarantee a more precise determination of the deductible proportion of the input VAT than that arising from the application of the turnover-based method".

25. In connection with property related costs HMRC submitted that both physical and economic use needed to be considered when determining an appropriate attribution.

26. Without direct precedent HMRC asserted that an approved method must be auditable by HMRC which required the Appellant to be able to evidence precisely

what use was made of the various spaces. They argued that the outcome and the operation of the method were both relevant in determining its fairness and reasonableness. He referred to paragraph 8 of the Supreme Court judgment in *Volkswagen Financial Services Ltd v HM Revenue & Customs [2017] UKSC 26* as assisting though not directly confirming his view.

Discussion

27. The journey to resolution of disputes between HMRC and taxpayers in connection with the attribution of input tax is a very well-trodden path with the consequence that the tests to be applied by this Tribunal are relatively uncontroversial and were not seriously in dispute between the parties.

28. As determined by the High Court in *Banbury Visionplus Ltd v Revenue Customs Commissioners [2008] EWHA 1024* when determining whether to accept a proposed special method HMRC must exercise their discretion so as to achieve the statutory objective of achieving a fair and reasonable attribution of input tax. The exercise of that discretion is reviewable by the Tribunal in an appellate capacity such that the Tribunal may substitute its own judgement for that of HMRC.

29. It is the Tribunal's role to evaluate whether each of the methods proposed meet the requirement that they achieve a fair and reasonable attribution. However, as is obvious, multiple methods may produce results within the bounds of fair and reasonable. Where the fair and reasonable threshold is met the Tribunal must then determine, which of the competing methods advanced by the parties produces the most fair and reasonable result.

30. The standard method has been previously described by the Tribunals and Courts as a method which balances its simplicity of operation with accuracy. For some businesses a values based method will inherently produce a fair and reasonable result but for others it will not. In such circumstances a taxpayer will be entitled to use the standard method as, absent an alternative (and absent meeting the criteria for the standard method override to kick in), it is the default method. HMRC may only enforce the use of the standard method, when a special method has been proposed, where HMRC can demonstrate the standard method produces a more fair and reasonable method than the proposed alternative.

31. As is apparent from the line of cases leading to the judgment in *Volkswagen Financial Services* the role of the Tribunal is not to identify a method of attribution but to adjudicate between the methods proffered by the parties. That may be limited to 2 alternative methods or there may be more. In the present case there are but 2 alternatives.

32. In 2012 the Appellant proposed and was granted permission to use a method which, the attribution of property costs including any adjustment required under the capital goods scheme, was by reference to floor space. Approval was given after HMRC had visited the Appellant business and had, presumably, seen the buildings

and obtained an overall sense of the Appellant's business. Albeit, at that time, a business which was not part of a VAT group.

33. The method then proposed, and re-proposed in 2014, was a simply stated method that attributed property costs on the basis of the physical use of the building by reference to the floor space assigned exclusively to taxable activities on the one hand and general business use (including taxable activities) on the other. The method assumed that only exclusive use for taxable purposes would give rise to recovery of property costs. In essence all mixed use of the property was assumed to be exempt use.

34. Non-property costs were recovered on a turnover basis.

35. When the method was originally proposed the Appellant's intended use of the building for the purposes of its business in providing care workers was the same as in 2014 and presently i.e. Unit 1 for the running of the business and Unit 3 as a training centre. There is space in Unit 1 for desk based training which is used by the Appellant for its own staff. Unit 3, as stated in 2012, by reference to the proposal and by reference to the evidence given, was used for only for training subletting. The principal intended use for Unit 3 was, and remains, the use for providing training for third party organisations. The actual use of the building has been limited and the tax liability of the training provided has now changed.

36. By reference to the evidence it appears that the Appellant's accountants in 2012 had not correctly stated which rooms in unit 3 would be solely used for the purposes of the third party taxable training. However, the question for this Tribunal is not what the percentage of recoverable input tax determined by the method should be but only whether the method as proposed gives rise to a fair and reasonable result and then whether that the result is more fair and reasonable than the standard method.

37. HMRC contend that the proposed method cannot be used because it cannot be monitored or audited in order to ascertain the actual use of the individual rooms in Unit 3. They contend on this basis that it is not fair and reasonable. They refer to paragraph 8 in *Volkswagen Financial Services* and to paragraph 24 in *Baumarkt*. In *Volkswagen Financial Services*, reporting what was said by the First-tier Tribunal, the Supreme Court merely acknowledges "other aspects of what amounts to a fair and reasonable attribution, such as ease of audit and operation, are not at issue". In *Baumarkt* the CJEU acknowledges that a floor space method may be used "guarantees" a more determination of the deductible proportion of input tax.

38. Bearing in mind that the deductible proportion is the amount of input tax attributable to taxable supplies, by reference to use, the Tribunal considers that all the court/tribunals are saying is that use should be what drives recoverability provided that use can be reasonably determined through methodology that can be operated and audited in a proportionate way. A method that is all but impossible to operate or verify will not be a fair and reasonable method however accurate its outcome. Similarly a simple calculation which gives rise to an allocation which manifestly does not represent use will also not be a fair and reasonable method.

39. This Tribunal accepts that operation and audit are relevant to the fairness and reasonableness of a method. However, the Tribunal considers that the Method proposed is materially identical in terms of operation and audit to that proposed in 2012 when HMRC accept it was fair and reasonable. They submitted that they were not in error in doing so in 2012. To now conclude that VAT grouping with non-trading entities that in no way influences how the property inputs are used is perverse. There may well be weaknesses in the operation of and auditability of the method but they are precisely the same weaknesses as were present in 2012 and HMRC accepted it as a fair and reasonable method. The Tribunal sees no reason to now conclude that the method is not one within the relatively broad group of possible methods which could be considered to be fair and reasonable.

40. That leads to the necessity to determine whether the standard method, giving recovery of a little over 1% recovery of the property costs based on turnover for Unit 3 is more fair and reasonable than a method determined by reference to floor area. It is to be noted that the Method itself leaves the precise attribution of floor area to be agreed. However, by reference to the evidence given to the Tribunal and the associated findings of fact, the floor space method essentially treats all property costs for Unit 1 as irrecoverable and the property costs for Unit 3 as recoverable by reference to the exclusive use of a limited number of rooms for third party taxable training.

41. The facts as found are that Unit 3 is in fact used on a relatively limited basis. It is not the Unit from which the business of providing care workers is provided. All administration and the operational aspects of the business are carried on from Unit 1. The computer training room, kitchen and meeting room in unit 3 were used only by the trainers of the third parties and in connection with such training and were therefore used exclusively for taxable purposes albeit on a limited number of occasions. The recoverable proportion under the method (prior to the commencement of the exempt third party training which the Appellant accepted necessitated a new method) is 20.9% and is verified (as previously) by confirmation from the Appellant as to actual use.

42. It appears to the Tribunal that the standard method cannot reflect the use of a building which largely lay empty (but which had been the subject of an option to tax so disposal or unrelated lettings would have been taxable) and, where used some areas were exclusively attributable to taxable supplies. A method which allocates 1% as compared to one that allocated circa 20% does not seem to be more fair and reasonable in the attribution of the property costs which in fact represent a small sum of input tax. In 2013 the property input tax incurred was a little over £4k. The difficulties that HMRC articulated in the operation and audit of the proposed method do not in the Tribunal's view render the standard method more fair and reasonable.

Decision

43. The Tribunal determines that given that HMRC accepted that for the period 2012 – 2014 the proposed method was fair and reasonable there is no basis on which

to conclude that VAT grouping with a non-trading business could render the method not fair and reasonable.

44. When undertaking a comparison between the proposed Method and the standard method the Tribunal considers that the proposed Method does produce an outcome more fair and reasonable than the standard method despite the perceived difficulties in auditing the method.

45. The decision has been taken by reference to the business model and operation in 2014 when the method was proposed. Since January 2017 the Appellant has begun providing third party training which qualifies for exemption rendering the Method inoperable as the rooms previously exclusively used for taxable supplies are now too mixed use rooms. An alternative method will need to be agreed effective from January 2017 when those supplies began. This was acknowledged by the Appellant. However, this appeal related to the time at which the Method was proposed in 2014. It is for HMRC to determine how the method should be rectified from 2017 given the delay in this matter coming to hearing.

46. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

AMANDA BROWN
TRIBUNAL JUDGE

RELEASE DATE: 14 FEBRUARY 2018