

VAT Recovery

Value Added Tax (VAT) is a substantial cost to the majority of charities in the UK. The cost is incurred principally through VAT which is charged by a supplier being irrecoverable by the Charity. In the first of 12 factsheets aimed specifically at assisting fundraisers, Russell Moore of the Saffery Champness Charity VAT team outlines the rules for determining when charities are able to recover, either fully or partially, VAT they incur on costs and expenses.

The Charity VAT Problem

VAT is a consumer tax levied on 'business' transactions involving the supply of goods or services for a consideration. This being so, it does not sit comfortably with the voluntary sector where the majority of income and activities for many organisations are received and undertaken for what are termed non-business purposes. For example, the receipt of a donation or legacy is not in return for a supply of goods or services and therefore these incomes are not 'business' incomes for VAT purposes. Similarly, a free telephone helpline which is not provided in return for a payment, or an overseas emergency aid programme funded by Government Grant are 'non-business' activities.

However, whilst it is beneficial that no VAT needs to be declared on, or extracted from these incomes, there is the detrimental consequence that no VAT incurred on attributable costs and expenses can be recovered. It is a basic fundamental of VAT accounting that VAT incurred on costs and expenses can only be recovered when it is attributable to what is termed a 'taxable' supply. These are supplies made at the standard (17.5%), reduced (5%) or zero (0%) rate. This places a tremendous financial burden upon the voluntary sector with an estimated cost approaching £1 billion of irrecoverable VAT being suffered per annum.

When VAT is incurred on a supplier's invoice, the charity is required to consider whether the expense can be solely attributed to either a taxable, exempt or non-business activity. If it can, then the VAT will be either wholly recoverable (if relating to a taxable activity), wholly irrecoverable (if relating to a non-business activity) or subject to the partial exemption de minimus regulations if relating to an exempt activity.

Exempt Incomes and Activities

In addition, there are specific reliefs which exempt certain business incomes and activities from VAT. For example, certain health and welfare activities; and educational activities, or the staging of a one-off fundraising event are specifically exempt from VAT (see figure 2).

VAT incurred on costs relating to an exempt activity can only be recovered when it falls below two prescribed de minimus limits as follows:

- a) The exempt input tax is no more than £7,500 per annum; and
- b) The exempt input tax is less than 50 percent of the total input tax incurred in the year

Unrestricted vs. Restricted Income

Although it is a basic principle of VAT accounting that VAT incurred on costs attributable to 'non-business' incomes cannot be recovered, a distinction needs to be drawn between 'restricted' and 'unrestricted' incomes.

Following a ruling by the High Court in 2005 in a case brought by *The Church of England Children's Society*, VAT incurred on the costs relating to the generation of unrestricted income can be partially recovered, to the extent it is used for taxable business activities. The recoverable element will usually be determined using the overhead recovery calculations explained overleaf.

General overhead costs

A sizeable proportion of expenses are general overheads of the Charity which cannot be said to 'solely' relate to one specific activity. The VAT on these costs is therefore termed as being 'non-attributable' or 'POT' costs. This will include central

overheads such as building costs, IT, HR, Finance etc. In order to determine how much of this non-attributable 'POT' can be recovered the Charity is required to undertake two separate and distinct calculations so that this 'POT' can be apportioned between the taxable, exempt and non-business activities and thus determine how much VAT can be recovered. These calculations are as follows:

a) The business/non-business apportionment

The first stage is to determine how much of this VAT relates to the non-business activities of the Charity. Once this has been established it is known that this non-business element of the 'POT' is wholly irrecoverable.

b) Partial exemption calculation

The second stage is to apportion the remaining business input tax between the taxable and exempt activities of the Charity. All of the taxable input tax will be fully recoverable. The exempt input tax (including the directly attributable exempt input tax) will be recoverable only if it falls below the partial exemption de minimis limits.

There are no statutory methods by which these calculations have to be made. The only two requirements are that they are 'fair and reasonable' and in respect of the partial exemption calculation that it is approved in advance by HMRC. This being so, it is a fairly subjective exercise and an opportunity to negotiate a favourable arrangement. The most common methods are either based on income, expenditure, salary exclusive expenditure, input tax and staff numbers. It is also possible to use a different method for each calculation.

Summary

As can be seen, the rules for determining how much VAT a Charity can recover are relatively straightforward. As set out at figure 3 the recovery of VAT incurred on costs and expenses is determined by the activity to which it relates.

Where however, an activity generates incomes with different VAT liabilities it is important that this is identified to establish the correct VAT recovery position. For example, where an exempt one-off fundraising event generates only exempt income from the sale of admission tickets the VAT incurred on related costs is

likely to be wholly irrecoverable. However, if the same event also generates zero-rate income from the sale of donated goods at an auction then VAT on related costs is partially recoverable as it cannot be wholly attributed to only the exempt income.

It is therefore vitally important that the VAT liability of every income and activity of the Charity is known so that the correct VAT recovery position can be established. Of course, the best way to mitigate irrecoverable VAT is not to incur it in the first place! A later fact sheet will look in detail at those purchases a charity can make that do not attract a VAT charge.

Figure 1- VAT liability of incomes and activities

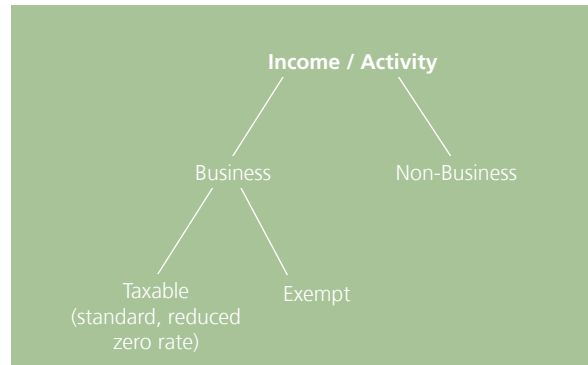
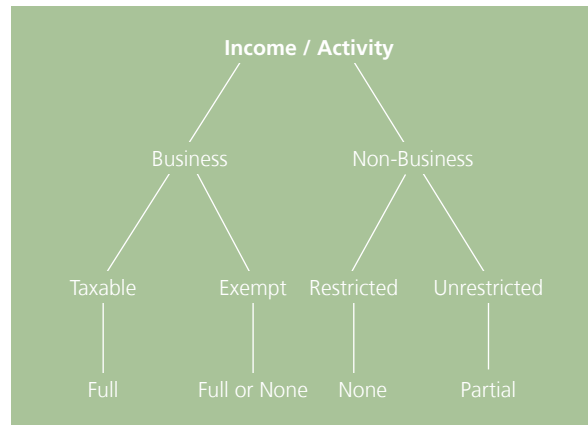


Figure 2- Exempt incomes include:

- Health and welfare services
- Education
- One-off fundraising events
- Lotteries
- Domestic property rents

Figure 3- VAT recovery principles



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