

## **VAT: so what's a business activity?**

*Audrey Fearing outlines HMRC's new approach to determining business activity for VAT purposes*

HMRC has published a new policy paper and revised guidance explaining how it will now determine whether an activity represents business activity for VAT purposes.

This is an especially important development for not-for-profit organisations as their level of business income affects their liability to register for and charge VAT in respect of those activities, and also their entitlement to charity VAT reliefs and to recover VAT on the costs they incur. The new policy may also impact other taxpayers whose activities HMRC might regard as a hobby or private pastime and therefore ineligible for VAT recovery on related costs.

### **What has changed?**

For many years, a six-point test developed from 1970s VAT appeals has been used to establish whether an activity is 'business'. However, HMRC now considers those decisions to have been superseded by more recent tribunal decisions and has confirmed that it will use a new two-stage test, principally derived from those cases, which considers:

1. whether the activity results in a supply of goods and/or services in exchange for consideration – this requires a legal relationship to exist between the supplier and the recipient; and
2. whether the supply is made for the purpose of obtaining income (remuneration) – simply because a payment is received for goods and/or services does not itself mean that the activity is business. HMRC regards an activity as business where there is a direct or sufficient link between the supplies made and the payments given and the activity is carried out for the purpose of obtaining income, even if the charge is below cost.

HMRC identifies five factors to help determine whether supplies are made for the purpose of obtaining income.

1. Is a purpose of the consideration to create income? Examples of non-business activity, despite a charge being made, include a notional consideration charged simply to create a binding contract or a small charge made to ensure that numbers accessing a service are recorded and/or controlled.
2. Is there an intention to make a profit? While a strong indicator that activities are intended to generate income, the absence of a profit motive does not necessarily mean there is no business activity. Even if supplies are made at a loss, this may be to generate income to defray related costs.
3. Is the payment so low as to be a concession? If the consideration is much lower than the value of a supply, this may show that the activity is not carried out for the purpose of obtaining income.
4. Is the activity conducted based on sound business principles? Activity to obtain income generally needs to be pursued with recognisable continuity and seriousness, with a level of preparation and investment made to promote the activity. For example, business activity:
  - will normally involve bookkeeping and annual accounting;
  - is likely to be advertised or publicised to attract customers;
  - is less likely to be done for pleasure as would a hobby or pastime; and
  - is less likely to be an isolated transaction or a one-off endeavour.
5. What is the scale of the activity? An activity that is intended to bring in £10 a week is much less likely to be for the purpose of generating income than one intended to bring in £10,000 a week.

HMRC has also confirmed its existing position that an organisation cannot rely solely on its charitable objectives or any profit motive when considering the business or non-business nature of an activity.

### **What this means for charities and businesses**

The policy paper confirms HMRC's change of mindset to one that focuses on more up to date case law when deciding whether an activity is business for VAT purposes. Its public statements on this issue are now more closely aligned with its position in recent VAT appeals; for example, a case in which the tribunal

agreed with HMRC that a farming company's low level haymaking activity did not amount to a business, with the consequence that a large input VAT recovery claim on a capital purchase was disallowed. That said, the business/non-business test cuts both ways – non-business status may be favourable for some organisations that do not incur significant amounts of VAT on costs, as it may mean they do not have to register for and charge VAT. It may also help not-for-profit organisations qualify for charity VAT reliefs on certain purchases.

Overall, the emphasis on the more recent decisions in the new guidance, where it was found that an activity of an organisation with charitable status was business for VAT purposes, suggests that HMRC will regard more activities as business under the new interpretation than it may have done in the past. Charities may therefore no longer be able to rely on statements and rulings from HMRC based on its previous policy.

With regard to the practical consequences, an incorrect interpretation of the business test could be the difference between qualifying or not qualifying for:

- the zero-rate of VAT on a new building constructed for a 'relevant charitable purpose' – to qualify, charities must demonstrate that their total business use of the building does not exceed 5%, albeit if it subsequently exceeds 5% within 10 years of construction, HMRC may be able to claw back a proportion of the VAT saving;
- relief from VAT on the cost of rented premises – the 'option to tax' on commercial properties is disapplied when a building is put to a non-business charitable use by the tenant and VAT is not chargeable on the rent provided non-business use does not exceed 5%.
- the reduced VAT rate of 5% that applies to fuel and power (e.g. electricity and gas) when it is used for a non-business charitable activity.

### **Action required**

HMRC can be expected to apply increased scrutiny in this area of tax, based on the new policy as it is currently written. However, the newly published materials do not provide an exhaustive guide to how to apply the new two-step test. For example, they do not explain in any detail where HMRC considers the line should be drawn between a nominal charge for a service (non-business) and a charge that while possibly below cost, is still economic (business). Charities have also asked HMRC to provide some more real-world examples of what might be regarded as remuneration in this context. It is therefore hoped that HMRC will build on this guidance in the coming months in response to such feedback.

In the meantime, organisations that are potentially affected should carry out a detailed review of their activities to confirm the business or non-business status of each under the new policy.

- Audrey Fearing is a Partner and Co-Head of NHS at RSM UK. Call +44 (0)20 3201 8777