

muddle. The problem seems to arise from the interaction with machines that provide a game of chance. Clarity is given in the briefs and indeed two new Treasury Orders come into effect on 1 November 2006, whereby the definition of 'gaming machine' and 'game of chance' are established, and the application of VAT to pinball machines is restored.

The key tax planning advice has to be that for all those businesses, sports clubs, social clubs, public houses and bookmakers with any form of gaming machine they must check that the VAT has been treated/charged correctly.

### The bookmaker and the provision of TV services

Business Brief 17/06 dated 19 October 2006 deals with the provision of TV services by bookmakers. Betting is an exempt supply for VAT and gaming machines are not. Do we pity the bookmaker who has to deal with the partial exemption computation? There is more complication from the Brief, but in the bookmakers' favour. The Business Brief follows Tribunal decisions in *Town & Country Factors* (19616). The Tribunal

found in favour of the company on the principle that the TV facilities had a direct link to TV racing service. Again, here is an interaction with the gaming machine which highlights the need to correctly establish the VAT position on the ancillary services provided by the bookmaker.

### The tax rock of Gibraltar

On the basis that online (internet) gaming companies are all essentially 'dotcom' businesses, it has been relatively simple for these companies to establish themselves in the low tax jurisdiction of Gibraltar. Such establishment presents a significant tax saving, as they do not have to pay the UK corporation tax rate of 30%. Online gaming companies generally have low staff and premises costs and therefore escape the disadvantages of Gibraltar's tax focus. This could be considered a substantial advantage for shareholders.

The European Union has been trying hard to abolish Gibraltar's exempt company tax regime. The European Commission deemed that these tax rules provide companies domiciled in Gibraltar with a rather distinct unfair tax advantage.

It was actually described as 'regional selectivity'. Could this mean that the online gaming companies based in Gibraltar could find themselves paying 30% corporation tax? No. A recent European Court ruling stated that Gibraltar's 1969 constitution provides Gibraltar with fiscal autonomy and it should be able to continue to provide companies with a low cost tax regime up until the end of 2010.

### Blink and it all changes

The gambling industry is changing and growing on a daily basis. It is essential that the tax adviser keeps in touch with all that is happening in the UK gambling industry.

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# VAT time bomb for farms' diversified activities

**Once upon a time barns and farm buildings were full of farm produce and machinery, and farm cottages were full of farm workers.**

It would appear that very few farmers and landowners have calculated their VAT partial exemption calculations correctly. Indeed, many do not even realise that they are partially exempt traders. Historically, the farming VAT return was a simple affair. Agricultural outputs were zero-rated, so there was virtually no output VAT and the maximum input VAT could be claimed, subject to minor debates about the private use of telephones and the dreaded 'scale charge' for motor vehicles. The only other problem was 'blocked' input tax on non-business activities.

How times have changed. The majority of farmers have moved away from the pure trade of farming and into the 'land and property' sector. The implications include not only charging tax on standard-rated supplies but also restricting input tax claims to take account of exempt supplies (the 'partial exemption' calculation), not to mention consideration of the 'option to tax'. Many farmers have not enjoyed a VAT inspection for some time (in some cases, for as long as ten years) and there could be a potential time bomb.

The first step must be for the farmer

to list all the supplies made by the farm and note any which are standard-rated or VAT-exempt. So what qualifies as standard-rated?

Examples are income from holiday cottages, caravan and camping pitches; from parking and sporting facilities; and from selling the right to fell and remove standing timber. The farmer must then ensure that VAT is charged and accounted for on all standard-rated supplies. However, more complex and serious problems are likely to arise when the farm generates substantial VAT-exempt income.

### VAT-exempt residential and commercial lets

As the farm workers have disappeared, their cottages have been re-let. Likewise, old agricultural buildings, such as pig sheds and dairies which are no longer needed, have been converted and let out for residential use. Except in the case of holiday lets, residential lets are an exempt supply for VAT. Often the farm income has grown with the residential lets, but the input VAT on the expenses of the whole enterprise has been reclaimed. What of consideration for partial exemption?

It is quite normal for a 1,000 acre farm to have say ten surplus cottages. Many farms have completed conversions of old farm buildings, which can result in a greater income from lets than from farming. Often it is only the letting income which ensures that the overall enterprise is profitable. Unless an 'option to tax' is made, commercial lets will also be an exempt supply.

Readers will be familiar with the mechanics of partial exemption, so they will not be explained here, but the following points are worth emphasising.

#### Calculating the input tax restriction

Where a farm is making some exempt supplies, the farmer must remember that the legislation denies relief not only for input tax directly attributable to the exempt supplies (for example, input tax on the cost of repairs to a let residential building), but also for a proportion of the input tax suffered on the 'mixed costs' of the farm – the 'overhead expenses' which relate to both taxable and exempt supplies. Under the 'standard method', input tax on the 'mixed costs' is allowed in the ratio of taxable sales (zero- and standard-rated) to total sales. Accordingly, where a high proportion of the farm income is VAT-exempt, an equally high proportion of the input VAT on 'mixed costs' will be disallowed.

The key here will be a careful analysis of the input tax incurred and its allocation between taxable and exempt activities. In exceptional circumstances, an application to use a 'special method' could be considered, but the benefit to be gained is unlikely to be enough to make this worthwhile.

#### Easement for smaller businesses

However, many smaller farms will be able to benefit from the easement which

allows a trader to obtain full VAT recovery where the 'exempt' element is relatively small. This is fully explained in VAT Notice 706 *Partial Exemption* (December 2006), but in outline the farmer will be treated as a fully taxable trader, able to recover all his input tax, if the farm's input tax attributable to exempt supplies (counting both the VAT directly attributable to exempt supplies and the appropriate proportion of VAT on 'mixed costs') exceeds *neither* £1,875 a quarter *nor* 50% of all the input tax incurred. Note, however, that the relief given will be clawed back if, over the farmer's VAT year as a whole, the VAT attributable to exempt supplies exceeds *either* £7,500 ( $4 \times £1,875$ ) *or* 50% of all the input tax incurred in the year.

Conversely, if the annual recalculation shows that the farmer's exempt input tax is within the *de minimis* limit, taking the year as a whole, the trader will be treated as fully taxable for the whole year. Any input tax he did not claim on a VAT return during the year because he was above the *de minimis* limit for that quarter (or month) may then be recovered.

This easement does not affect the treatment of 'blocked' input tax (for example, on cars and business entertainment), which is always non-recoverable.

Partial exemption annual adjustments (which are correctly carried out and entered in the farmer's VAT account for the correct period) are not errors and do not have to be notified to the local VAT Business Centre under the voluntary disclosure procedure. However, the farmer should remember that a trader cannot use the annual adjustment to correct actual errors, such as input tax incorrectly treated as exempt when in fact the goods or services were used to make taxable supplies from the outset. Errors such as these should be corrected in accordance with the guidance in Notice 700/45 *How to correct VAT errors and make adjustments or claims*.

#### Using the option to tax

Where a farmer lets a mix of commercial and residential property, the complexity of partial exemption can make opting to tax the commercial buildings (as explained in Notice 742A) a very attractive alternative. This is because it may allow all the input tax, in respect of

both standard-rated commercial and exempt residential property, to be reclaimed in full.

#### 'Clawback' and 'payback'

In principle, input tax is allocated to the use the trader intends to make of the relevant purchase. However, Notice 706 para 11.3 emphasises the problem for the farmer. To quote: 'The land and property sector is an area where it can be particularly difficult to establish what your intentions are when you receive supplies. [For example] a supply that would otherwise be exempt may become taxable if an option to tax is made and notified to HMRC ...'. Accordingly, to avoid distortions, a system of 'clawback' and 'payback' applies.

Input tax relief claimed will be clawed back where:

- ◆ the farmer has claimed input tax on goods or services because he or she intended to use them in making taxable supplies but in the event used them, or formed an intention to use them, in making either exempt supplies or both taxable and exempt supplies; *or*
  - ◆ the farmer has claimed input tax on goods or services because he or she intended to use them in making both taxable and exempt supplies but in the event used them, or formed an intention to use them, in making exempt supplies only,
- and in either case the change of intention occurs within six years of the beginning of the period covered by the VAT return in which the original intention was formed.

If 'clawback' applies, the farmer will be required to recalculate the input tax he has claimed in the past tax periods and repay any amount over-claimed. The farmer must do this on the return for the tax period in which the use occurs or the revised intention is formed. The farmer's recalculation must be carried out using the partial exemption method the farmer used when making the original claim to input tax.

Conversely, 'payback' arises where:

- ◆ The farmer has not claimed input tax on goods and services because the intention was to use them in making exempt supplies but in the event they were used, or the farmer formed an

## Halifax case

In February 2006 the European Court of Justice (ECJ) gave its decision in the case of *Halifax plc, Leeds Permanent Development Services Ltd and County Wide Property Investments Ltd v C & E Comrs* (Case C-255/02) [2006] STC 919 (the *Halifax* case). That decision was in response to questions referred by the VAT Tribunal. The next step was for the Tribunal to make its final decision in the case, in light of the ECJ's guidance. However, on 8 March 2007 the taxpayer withdrew its appeal in the case. Accordingly, the case is now settled in favour of HMRC. There will be no further Tribunal hearing or decision, see HMRC Brief 30/07. ■

intention to use them, in making taxable supplies or both taxable and exempt supplies; or

- ◆ the farmer has not claimed input tax on goods or services because he or she intended to use them in making both taxable and exempt supplies but in the event used them, or formed an intention to use them, in making only taxable supplies, and in either case the change of intention occurs within six years of the beginning of the period covered by the VAT return in which the original intention was formed.

If 'payback' applies the farmer should write to the local VAT Business Centre applying for a sum equal to the under-claimed input tax to be repaid. When the local VAT Business Centre has confirmed the amount to be repaid, the farmer can enter this in his VAT account as an under-claim and include it in his next VAT return. When the farmer calculates the amount under-claimed, he must use the partial exemption method used when making the original claim to input tax.

## Proactive action for the farmer to take

So the farmer, having come to terms with the consideration that 'partial exemption' might apply to his business, now has to look at proactive action he can take.

Many farmers did not have long-term plans to move into the land and property VAT sector. Many have been aware of

## Input tax deduction without valid VAT invoice

HMRC Brief 36/07 announces the publication of 'Input tax deduction without a valid VAT invoice – Statement of Practice March 07', which replaces the Statement of Practice (SP) published in July 2003. The SP should be read by all taxpayers dealing in any of the goods subject to widespread fraud and abuse, namely: computers, telephones, alcohol and oils that are held out for sale as road fuel. The revised SP continues to apply in cases where an invalid invoice is held. It does not apply where HMRC are not satisfied that a supply has taken place or are questioning the underlying supply. It incorporates a number of changes to reflect developments in this area and includes:

- ◆ clarification on the right to deduct

the partial exemption rules but have been unaware of the possible advantage of 'payback'. By contrast many farmers have been aware of the disallowability of input VAT but find it all too complicated and are just awaiting the next VAT inspection, when the helpful official from the HMRC (VAT Office) will tell them how much extra VAT they owe and advise them how to move forward with partial exemption calculations. There must be a better way!

## Cottages held outside the trading activity

Many farm cottages are held outside the trade of farming, the rent being shown directly on the farmer's self-assessment tax return as income from land and property. There are no apparent VAT problems – but what of the loss of potential inheritance tax relief? The case of *Farmer's Executors* [1999] STC (SCD) 321 comes to mind. A Special Commissioner held that 22 let units (cottages and premises for small businesses) were eligible for inheritance tax (IHT) business property relief because they were part of the wider farming business – included in the farm accounts, organised from the farm office, etc. This is an example of a situation where perception can become reality – because the let units look like part of the farm business, they may be treated as business property for IHT!

The stamp duty land tax (SDLT) implications of moving property from a

input tax in circumstances where HMRC question whether there is an underlying supply;

- ◆ information about invoices reflecting amendments to the VAT Regulations, SI 1995/2518 reg 14 (contents of VAT invoice) and reg 16 (retailers' invoices) brought about by SI 2003/3220; and
- ◆ details of the requirement to provide evidence of a supply where no valid invoice is held; that such a supply must be for the recipient's business; details of checks needed to establish the bona fides of a supplier; evidence of normal commercial arrangements, including payment arrangements and details of how the relationship between the supplier and buyer was established. ■

farming partnership to individual ownership, or *vice versa*, should also be given full consideration.

## The farmer's long-term plan

It is essential to produce a full list of all property included in or linked to the VAT registration. A 'property audit' should be carried out, to consider not just VAT but also IHT, capital gains tax, income tax, corporation tax, SDLT and national insurance contributions. Such an audit is necessary, not least because many farmers are unclear as to who owns what and why.

This should be an opportunity to review not just partial exemption but the 'option to tax' and the full VAT position on the interaction of land and property with the trading activity of farming. With the 'VAT attack' on shooting there is scope to incorporate shooting rights and property leases. And a final point – have all rights, licenses and general casual letting been checked for the correct documentation and VAT treatment? The rural world is changing and in line with ONEhmrc, front page November 2006, HMRC stated it wants to extend the shooting project to cover farms' diversified enterprises.

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