Don't fence me in

JULIE BUTLER explains a recent court decision on the VAT agricultural flat rate scheme. This confirmed that financial advantage was not a sufficient reason to be excluded from the facility.

With the complexities of Brexit being considered in depth by the farming community it is ironic that, in *Shields & Sons Partnership v HMRC* [2017] C262-16 (tinyurl.com/ya4ew9lt), the Court of Justice of the European Union (CJEU) confirmed the VAT position of a farm. The court decided that HMRC cannot exclude a farming business from the agricultural flat rate scheme (AFRS) simply because this resulted in the payment of less VAT than would otherwise arise. The scheme had resulted in the business being substantially better off than if it had simply registered for VAT and used normal VAT accounting rules.

Setting the scene

For those unfamiliar with the scheme, it is an alternative to regular VAT recording and calculating for farmers. It is designed to compensate farmers for the VAT they suffer on purchases by simplifying and streamlining the VAT cashflow.

Farmers can use the AFRS as long as their income from non-farming sources does not exceed the VAT registration threshold – it does not matter that their farming income may exceed that limit. In fact, farmers who have previously registered for VAT in the normal way (say because their farming income was more than the threshold) can deregister and join the AFRS instead.

KEY POINTS

- The benefits of the agricultural flat rate scheme.
- Its use as an alternative to normal VAT registration.
- HMRC guidance placed a monetary limit on the benefit accruing from the scheme.
- The European VAT Directive does allow the exclusion from the scheme of some categories of farmers.
- The Court of Justice of the European Union confirmed the scheme can be used even if there is a substantial benefit.
- The validity of the scheme must be considered on a macroeconomic scale by reference to *all* flat rate farmers.

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The scheme can also be used on a voluntary basis by farmers whose income is below the registration limit if they would otherwise be eligible for voluntary VAT registration.

HMRC may certify the business to join the AFRS if, on application, it is satisfied that:

- the business is carrying on one or more 'designated activities' – broadly, in agriculture, forestry and fishing; and
- it complies with the conditions for admission to the scheme.

The designated activities are set out at in section 3.1 of HMRC's *VAT Notice 700/46: Agricultural flat rate scheme* (see tinyurl.com/pdu5c3p), but they include these six categories.

- Crop production.
- Stock farming.
- Forestry.
- Fisheries.
- Processing by a farmer of products derived from his own activities within the above categories using only such means as are normally employed in the course of such activities.
- Supplies of agricultural services by a person who also carries out one or more other designated activities falling within the categories above.

A person cannot join the scheme if:

- their primary activity is to buy and sell animals (for example, as a dealer or trainer); or
- they are engaged in an activity once removed from farming, such as processing farm produce.

The flat rate

Although it will have a scheme certificate and reference number, a farming business using the AFRS is not officially VAT registered, so it cannot recover the VAT incurred on input costs. Instead, the farming business charges a flat rate addition (FRA) at 4% on its qualifying sales to other VAT-registered businesses. Those businesses, in turn, reclaim the FRA as if it were VAT. Meanwhile, the first farming business retains the 4% FRA it charges on sales.

Note, however, that the flat rate is *not* charged on the supplies of goods and services that are not designated under the scheme – an example might be sales of plant and machinery – nor is it charged when designated supplies are made to non-registered persons, such as the public or other flat-rate farmers. Note also that, if the value of non-farming activities is more than the VAT registration threshold, a farmer cannot join the AFRS.

Some reluctance

Although the AFRS has operated for many years, HMRC does not tend to publicise it. Further, the department has routinely cancelled farmers' entitlement to use the scheme if it considers that its financial benefit substantially exceeds the input VAT that they would have been able to deduct if subject to normal VAT arrangements.

In fact, in *VAT Notice 700/46* at section 4.6 'Can you refuse my application?', the department says:

'We can refuse if…

- your non-farming activities are over the VAT threshold;
- you would recover substantially more money through the flat rate scheme than the input tax you claim through VAT registration. This might happen because your input tax, when compared to your sales, is a much smaller percentage than the flat rate addition. But your application on these grounds will only be refused if the amount you stand to gain is more than £3,000 in the year following your application. This is calculated by comparing the flat rate addition that you would be able to charge with the input tax you would normally be able to reclaim.'

However, although HMRC's view in the VAT notice is targeted at a single business with a specific £3,000 limit, the making of such individual 'profits' by farmers is not one of the conditions that precipitate compulsory cancellation of the AFRS as set out in the VAT regulations. Instead, the VAT Regulations SI 1995/2618, reg 206(1)(i) says:

'The Commissioners may cancel a person's certificate in any case where … they consider it is necessary to do so for the protection of the revenue.'

The *Shields & Sons* case

Shields & Sons is a farming partnership that HMRC removed from the AFRS in 2012. The department's ground for doing this was that the partners had benefited from the scheme by about £375,000 over seven years. They were therefore substantially 'better off' under the AFRS and, as specified in the VAT notice, they were ineligible to use the scheme. Shields & Sons challenged HMRC's decision, but the First-tier Tribunal dismissed the firm's appeal against the department's decision. The partners then took the matter to the Upper Tribunal which referred the case to the CJEU.

HMRC argued that the AFRS should be used solely to reduce administrative burden and if it was financially advantageous the department should be able to exclude the business. However, the CJEU confirmed that the Revenue did not have a general discretion to remove individual farmers from the AFRS if they were simply recovering more monetary advantage using the scheme than they would under standard VAT accounting rules. The European VAT Directive does allow the exclusion of some categories of farmers, but not those who are simply good at working the system.

The CJEU also explained that a farming business must be able to assess objectively, in advance, whether it can legitimately expect to meet the criteria to access and remain in the AFRS. Excluding successful farmers from the AFRS on the basis that their reward from it is 'substantially more' than that of another farmer does not meet the objective criterion of being a 'category' of farmer that is allowed to be excluded.

Consequently, the partners eventually won their case as confirmed by the Upper Tribunal (tinyurl.com/ydbtktxh).

A general not specific position

The reality of the AFRS is that the member state sets flat rate percentage based on the guidelines provided by the EU. The guidelines say that the rate should not be set at a level that would result in farmers benefiting by more than the input VAT they would recover if they were VAT-registered. However, the validity of the AFRS must be considered on a macroeconomic scale – in other words, by reference to *all* flat rate farmers rather than separate businesses.

Consequently, as confirmed by the CJEU, HMRC could not target Shields & Sons simply because the partners benefited individually. The scheme is designed to assist with the administrative burden of farmers, so only categories of farmers who will *not* suffer administrative difficulties can be excluded. Farmers who would be substantially better off using the scheme than had they registered for VAT under normal circumstances are not a valid category for exclusion and they can stay in the scheme as long as they meet all the other requirements.

Conclusion

VAT for the farm industry is notoriously complex. With diversification, there can be difficult decisions as to what is and what is not a standard-rated supply. Likewise, partial exemption can be a complex calculation. The AFRS may not be used by the many farmers who receive regular VAT repayments, but it will be relevant to some businesses. One possible advantage is that, on cancelling a VAT registration to join the scheme, the business will not have to pay VAT on its stocks and assets.

This was a victory for Shields & Sons because it followed the rules, applied them correctly and went to tribunal to ensure that the correct result was achieved.

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