

Introduction

VAT is a transaction-based tax (whether a profit is made is irrelevant) and is charged on any taxable 'supply' of goods or services made in the UK by a VAT registered entity in the course or furtherance of a business (or in European law terms, economic activity). Aside from some specific reliefs for certain goods and services, a charity is treated the same as any other organisation for VAT purposes, and a charity that is making taxable supplies above the VAT registration threshold in any 12-month period (currently £85,000, fixed until March 2020) must register for VAT.

VAT chargeable on taxable supplies is called output tax and must be collected and paid over to HMRC. VAT incurred on expenditure is called input tax, and in principle this can be deducted from the output tax that is due to HMRC.

The first issue for any charity is to consider whether it is making any supplies in the course of a business or economic activity and to establish whether it has an obligation to register for VAT.

The scope of VAT is very wide. The questions a charity should ask to ensure it meets its VAT obligations and pays/incurs the correct amount of tax are as follows:

- Is the charity making supplies in the course or furtherance of business/economic activity?
- If so what is the VAT liability of those supplies?
- Are there any reliefs available so that the charity does not incur VAT on purchases?
- Where VAT is charged on an expense, can it be reclaimed?

1. Supplies in the course or furtherance of business/economic activity

To be a 'supply' for VAT purposes, the activity needs to be carried out in the course or furtherance of business. 'Business' is also referred to as 'economic activity'. There is no legal definition of what constitutes 'business' in UK law. 'Business' has a different definition from 'trading' for direct tax, and an activity can still be considered 'business' for VAT purposes but not be a 'trading activity' for direct tax purposes. In European law, with which UK VAT legislation must comply while the UK is in the EU, 'economic activity' is defined widely and applies to any person or entity which "independently carries out ... any economic activity ... whatever the purpose or results of that activity". Economic activities comprise all activities of producers, traders and persons supplying services. The exploitation of tangible or intangible property for the purpose of obtaining income on a continuing basis is regarded as an economic activity.

A charity can be carrying on a business for VAT purposes even if it is only undertaking its primary-purpose activities on a not-for-profit basis. Activities on which charities simply cover their costs or even make a loss can still be 'business'.

'Supply' is not defined in the legislation. It includes all forms of supply, but not anything done otherwise than for consideration (payment). For VAT purposes consideration means everything paid to a supplier by a purchaser where there is a direct link between the goods and services received

and the consideration paid for these. Note that consideration does not have to be paid in money, so a barter transaction could still be a supply.

If there is a direct link between a supply and the consideration (which can be monetary or non-monetary), then there is likely to be an economic activity, regardless of whether a profit is generated, unless there are specific reasons why this rule should not apply.

Once an organisation establishes that it is undertaking economic activity i.e making supplies in the course or furtherance of business, it must establish the VAT liability of those supplies as that will determine any obligation to register for VAT.

2. VAT liability of supplies

In principle, all business supplies of either goods or services that are made in the UK will be 'taxable' (i.e. liable to VAT at the standard, reduced or zero-rate) unless they are included within the schedule of exempt supplies in VAT legislation. All taxable supplies will be subject to the standard rate of VAT (currently 20%) unless they fall within the reduced rate (currently 5%) or the zero rate schedules.

In summary, all business supplies made by a VAT registered charity will fall into one of the following categories:

- Standard rated supplies
- Reduced rated supplies
- Zero rated supplies
- Exempt supplies

Whilst there is specific legislation that lists the zero and reduced rates and exempt supplies, there is no such list for standard rated supplies. The starting point for any VAT registered charity is to consider the supplies that it makes and to identify the VAT liability of that supply. Not only will that ensure that the correct amount of output tax is paid to HMRC, but as outlined below, this will also determine the extent of any entitlement to VAT recovery. Common exempt supplies made by charities include:

- Health, welfare, care, and medical supplies
- Education/vocational training
- Fund raising events
- Cultural services
- Certain membership subscriptions
- The provision of certain sporting or leisure services

There are specific conditions that must be met to for these exemptions to apply and therefore guidance should be sought. In addition to the above, there are a number of exemptions for land/property related transactions and these too are subject to specific rules before they can be applied.

3. Reliefs from VAT on charity expenditure

The best way of mitigating VAT for any charity is not to be charged VAT in the first place, if possible. There are a number of zero rate reliefs available both generally and to charities in the following areas:

- Advertising
- Certain construction services
- Works to assist disabled access in buildings

- Provision of disabled bathrooms, lavatories, washrooms
- Books/publications
- Children's clothing
- Drugs, medicines, and aids for disabled people
- Certain goods used for medical/veterinary research, training, diagnosis, or treatment
- Medicinal products

In addition to the zero rates, there are also services which will be subject to the reduced rate. In particular:

- Fuel and power
- Energy saving materials in residential accommodation
- Grant funded installations in residential accommodation
- Residential conversions, renovations, and alterations

As with the exemptions, specific conditions must be met before the zero/reduced rates can apply. Indeed, in many cases there is a requirement to issue a certificate confirming entitlement to a relief.

4. Deduction of VAT on costs

Where a charity does incur VAT, it can only deduct such VAT on its VAT returns if the VAT has been incurred wholly or partly in the course of making taxable supplies. Any VAT registered charity must apply a process called 'direct attribution' and separate VAT on costs into the following categories:

- VAT incurred on costs attributable to non-business activities – cannot be recovered
- VAT incurred on costs attributable to exempt activities – not recoverable, subject to certain de minimis limits
- VAT incurred on costs attributable to taxable supplies – can be recovered in full
- VAT incurred on costs such as overheads that are not attributable to any particular supply – can be partly recovered. This is known as "residual VAT".

There are a number of methods that can be used to determine the extent of VAT recovery of residual VAT. The overriding test being that the method must produce a 'fair and reasonable' result. The most common method is one based on turnover as follows:

Taxable income/ Total income = % applied to partly recoverable VAT

However, where an organisation receives large donations or grants, this method may not be suitable and alternative methods should be considered. These can be based on expenditure, VAT costs, floor space, staff count or indeed a sectorised calculation with different methods for different parts of the organisation. Such methods will require the approval of HMRC, but negotiating such methods, can reduce a charity's VAT costs in the long term.

Summary

VAT is a complex area for the charity sector and just like any other VAT registered organisations, there can be penalties for getting things wrong. However, complexity can allow for opportunity to structure efficiently and to the benefit of your organisation. Clear record keeping in a format that allows for accurate calculations is key to submitting correct VAT returns. This document only scratches the surface of the VAT rules that need to be considered in this sector. However, taking time to become aware of how these rules should be applied and taking appropriate advice where needed, can reduce both the administrative and cost burden of this tax.

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