TC04283

Appeal number: TC/2013//05437

VAT – partial exemption – special method - refusal of HMRC to approve special method – appropriateness of method – appeal dismissed – regulation 102, VAT Regulations 1995

FIRST-TIER TRIBUNAL
TAX CHAMBER

THE HURLINGHAM CLUB **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE NICHOLAS ALEKSANDER
MRS GILL HUNTER

Sitting in public in London on 5 and 6 June 2014

Timothy Brown, counsel, instructed by haysmacintyre chartered accountants, for the Appellant

Erika Carroll, an officer of HMRC, for the Respondents

DECISION

1. This is an appeal by The Hurlingham Club ("the Club") against a decision by HMRC not to allow them to use a special method for the calculation of their creditable input tax.

2. The Club was represented by Mr Brown and HMRC was represented by Ms Carroll. We heard evidence from Gordon Dewar, the Club's Finance Executive, and from John Nesling, the officer of HMRC responsible for making the decision not to allow a special method. In addition a bundle of documentary evidence was submitted by the parties.

The law

3. The issues in this appeal relate to traders who are partially exempt – in other words not all of their supplies are taxable, and therefore their ability to claim credit for their input tax is limited. The relevant provisions of section 26, VAT Act 1995 ("VAT Act") provide as follows:

> **26 Input tax allowable under section 25**
>
> (1) The amount of input tax for which a taxable person is entitled to credit at the end of any period shall be so much of the input tax for the period (that is input tax on supplies, acquisitions and importations in the period) as is allowable by or under regulations as being attributable to supplies within subsection (2) below.
>
> (2) The supplies within this subsection are the following supplies made or to be made by the taxable person in the course or furtherance of his business—
>
> (a) taxable supplies;
>
> (b) supplies outside the United Kingdom which would be taxable supplies if made in the United Kingdom;
>
> (c) such other supplies outside the United Kingdom and such exempt supplies as the Treasury may by order specify for the purposes of this subsection.
>
> (3) The Commissioners shall make regulations for securing a fair and reasonable attribution of input tax to supplies within subsection (2) above […]

4. Part XIV of the VAT Regulations 1995 (SI 1995/2518) ("VAT Regulations") address the attribution of input tax to taxable supplies. The relevant regulations are as follows:

> **101 Attribution of input tax to taxable supplies**
>
> (1) […] the amount of input tax which a taxable person shall be entitled to deduct provisionally shall be that amount which is attributable to taxable supplies in accordance with this regulation.

(2) […] in respect of each prescribed accounting period—

(a) goods imported or acquired by and goods or services supplied to, the taxable person in the period shall be identified,

(b) there shall be attributed to taxable supplies the whole of the input tax on such of those goods or services as are used or to be used by him exclusively in making taxable supplies,

(c) no part of the input tax on such of those goods or services as are used or to be used by him exclusively in making exempt supplies, or in carrying on any activity other than the making of taxable supplies, shall be attributed to taxable supplies,

(d) […] there shall be attributed to taxable supplies such proportion of the residual input tax as bears the same ratio to the total of such input tax as the value of taxable supplies made by him bears to the value of all supplies made by him in the period,

(e) the attribution required by subparagraph (d) above may be made on the basis of the extent to which the goods or services are used or to be used by him in making taxable supplies

[…]

102 Use of other methods

(1) […] the Commissioners may approve or direct the use by a taxable person of a method other than that specified in regulation 101

(1A) A method approved or directed under paragraph (1) above—

(a) shall be in writing,

(b) […]

(c) shall identify the supplies in respect of which it attributes input tax by reference to the relevant paragraph or paragraphs of section 26(2) of the Act.

[…]

5. These provisions of our domestic legislation are intended to give effect to the following corresponding provisions of the Principle VAT Directive 2006/112/EC:

Article 168

In so far as the goods and services are used for the purposes of the taxed transactions of a taxable person, the taxable person shall be entitled, in the Member State in which he carries out these transactions, to deduct the following from the VAT which he is liable to pay:

[…]

Article 173

1. In the case of goods or services used by a taxable person both for transactions in respect of which VAT is deductible pursuant to Articles

168, 169 and 170, and for transactions in respect of which VAT is not deductible, only such proportion of the VAT as is attributable to the former transactions shall be deductible.

The deductible proportion shall be determined, in accordance with Articles 174 and 175, for all the transactions carried out by the taxable person.

2. Member States may take the following measures:

(a) authorise the taxable person to determine a proportion for each sector of his business, provided that separate accounts are kept for each sector;

(b) require the taxable person to determine a proportion for each sector of his business and to keep separate accounts for each sector;

(c) authorise or require the taxable person to make the deduction on the basis of the use made of all or part of the goods and services;

(d) authorise or require the taxable person to make the deduction in accordance with the rule laid down in the first subparagraph of paragraph 1, in respect of all goods and services used for all transactions referred to therein;

[…]

Article 174

1. The deductible proportion shall be made up of a fraction comprising the following amounts:

(a) as numerator, the total amount, exclusive of VAT, of turnover per year attributable to transactions in respect of which VAT is deductible pursuant to Articles 168 and 169;

(b) as denominator, the total amount, exclusive of VAT, of turnover per year attributable to transactions included in the numerator and to transactions in respect of which VAT is not deductible.

[…]

6. In summary, a partially exempt trader is required to identify (a) input tax on goods or services used by him exclusively in making taxable supplies; (b) input tax on goods or services used by him exclusively otherwise than in making taxable supplies; and (c) all other (residual) input tax. The input tax falling in (a) is fully allowable as a credit. The input tax falling in (b) is fully disallowed. The residual input tax falling in (c) is creditable on a pro-rata basis. This is known as the "standard method".

7. However HMRC have discretion under Regulation 102, HMRC have discretion to allow traders to use other methods to determine their creditable input tax. These are known as "special methods".

8. Taxpayers have a right of appeal against a decision of HMRC not to allow a special method under s83 VAT Act. This is a "full" appeal, and the Tribunal has

power to substitute its own decision for that of HMRC (see *Banbury Vision v HMRC* [2006] STC 1568.

Background Facts

9. The Club is a private members' club located on the banks of the River Thames in Fulham, London. The Club has extensive sports and social facilities, including a large clubhouse, and some 42 acres of grounds. It is the clubhouse that is the focus of this appeal. The Club was formed in 1869. In the early 1900s the Club embarked on a considerable scheme of improvements to the clubhouse and grounds. The clubhouse was extended relatively recently, with the addition of the "East Wing". The East Wing contains substantial banqueting, entertaining and conference facilities. There is access to the East Wing both from the main clubhouse, and from a separate entrance.

10. In 1996 the Club agreed a special method with HM Customs & Excise under the predecessor to under regulation 102. In 2007 the special method was updated ("the 2007 special method").

11. Under the 2007 special method, the Club had to first identify supplies used exclusively in making taxable supplies, this input tax was fully recoverable.

12. It then had to identify supplies used exclusively in making exempt supplies or activities other than making taxable supplies. Such input tax was irrecoverable. The special method agreement included the following provision at clause 6(c):

> For the avoidance of any doubt, any input tax incurred in relation to goods and services used on any part of the estate comprising sports areas and buildings is to be considered as directly attributable to the exempt supplies of membership.

13. The recoverability of remaining input tax was based on a two sector approach – namely input tax arising in respect of the main clubhouse and all other input tax. Recovery of input tax arising in respect of the main clubhouse was recovered pro rata to the area of the clubhouse allocated to preparation, supply and consumption of food and drinks. Other input tax was recovered pro rata to the proportion of taxable supplies made by the Club.

14. The effective recovery rate for the Club in respect of input tax relating to the main clubhouse was 89.4%.

15. On 12 May 2010, the Club wrote to HMRC seeking amendments to the 2007 special method. In particular, the Club wanted to exclude paragraph 6(c). The Club charged output VAT on guest fees for the use of sporting facilities, which increased the value of taxable supplies, and which should, therefore, have increase the recovery rate. But this output VAT was not taken into account in the special method.

16. But since the agreement of the 2007 special method, the Tribunal's decision in *Bridgnorth Golf Club* [2009] UKFTT 126 (TC) had been released. The *Bridgnorth*

decision concerned the recoverability of input tax by a golf club. The decision recognised that although the lounge and bar in the clubhouse was primarily used for the supply and consumption of food and drinks, it also contributed to the overall ambiance of the club and its attractiveness to new members. The Tribunal held that the costs incurred in refurbishing these facilities was not used exclusively in making taxable supplies (of food and drink), but also used in the making of exempt membership supplies. The input tax incurred in respect of these costs was therefore "residual" and was only partially recoverable.

17. Following correspondence between HMRC and the Club, HMRC expressed a concern that using floor area in the Club's special method might be flawed where the clubhouse area might not be used exclusively for taxable supplies (in the light of the decision in *Bridgnorth*). Following a meeting and further correspondence, on 3 September 2010, the Club wrote to HMRC asking that the Club revert to the standard method of calculating its recoverable input tax, and this was agreed by HMRC on 28 September 2010.

18. The reason why the Club wanted to revert to the standard method was because it was embarking on extensive investment in its sporting facilities, and under clause 6(c) of the special method, any input tax incurred in constructing the new sporting facilities would be treated as attributable to exempt outputs, and would be entirely non-recoverable. However under the standard method, at least some recovery of input tax would be allowed.

19. Having completed the investment in its sporting facilities, the Club sought to put in place a new special method, and on 14 December 2012 the Club wrote to HMRC requesting that a new special method be adopted, based on a two sector approach – similar to that previously adopted.

20. Under the 2007 special method, the area of the clubhouse was allocated to one or other of two categories, The first category was the area of the clubhouse allocated to preparation, supply and consumption of food and drinks, and the second category was all other areas. In order to take account of the *Bridgnorth* case, the Club now proposed that under the new special method, the floor space of the clubhouse be allocated among four categories, These were areas allocated exclusively to taxable supplies, areas allocated exclusively to exempt supplies (or activities other than taxable supplies), and areas allocated to mixed use, and areas excluded from the calculation.

21. The "taxable" area was floor space used exclusively for taxable supplies. This included, for example, kitchens, food and drink storage and preparation areas, servery areas (where there was (in the Club's submission) no element of contribution to the overall ambiance of the Club) and the banqueting and conference facilities in the East Wing.

22. The "exempt" area was floor space used exclusively for exempt supplies (or other activities), This included, for example, lounges where members could relax and

read magazines and newspapers (but not including bars and restaurant areas), offices relating to membership administration and committee rooms.

23. The "excluded" area was corridors, cloakrooms and toilets.

24. All other floor space (excluding plant rooms) was "mixed".

25. 569.6m^2 floor space in plant rooms (mainly in the East Wing basement) was allocated to the "taxable", "exempt", "excluded" or "mixed" categories pro rata to the allocation of the floor space that the plant room serviced. So, for example, an 80m^2 boiler room was allocated as to 60.6m^2 as taxable, and as to 19.4m^2 as excluded, based upon the floor space that was heated by the boilers in that boiler room.

26. The Club's input tax would be recoverable based on two sectors.

27. Sector A related to residual non-attributable input tax incurred on construction, repair, maintenance, servicing and cleaning of the clubhouse. Sector B was all other residual non-attributable input tax.

28. Sector A would be recoverable using the following ratio: Taxable floor area divided by (taxable plus exempt) floor area.

29. Sector B would be recoverable pro rata to the proportion of taxable supplies made by the Club.

30. The Club produced a series of spreadsheets which detailed each room in the clubhouse (together with its area), and allocated each room to the categories described above. The total area of the clubhouse was 7004.67 m^2. Of this, 3941.4 m^2 was treated as taxable, 620.2 m^2 was treated as exempt, 1428.1 m^2 was treated as mixed and 1015 m^2 was treated as excluded.

31. We note that HMRC question the totals given in the spreadsheets, as their calculation of the total floor area is 6977.70 m^2.

32. Applying the Sector A formula gave an input tax recovery percentage of 86.4%.

33. Following meetings and correspondence with the Club, on 13 March 2013 Mr Nesling wrote to the Club rejecting the Club's proposed special method. In his letter Mr Nesling gave the following reasons for his decision to reject the proposed special method:

(1) The Club had not given a valid reason as to why the standard method does not produce a fair and reasonable result for the business.

(2) A special method should improve on the accuracy of the standard method. The Club's calculations show an input tax recovery proportion of 36% under the standard method (which would also apply to Sector B). The recovery ratio for Sector A would be 86.4% - a 50% increase above the standard method ratio.

(3) Floor area ratios will only provide a fair and reasonable recovery where the vast majority of the floor area can be identified and allocated to exempt and taxable supplies exclusively. The allocations suggested by the Club leave 34.88% of the floor area outside the special method calculation, as only 65.12% of the floor area can be allocated exclusively to the making of taxable or exempt supplies.

(4) Mr Nesling also identified concerns about the basis on which the floor area was allocated and how easily the allocation could be audited by HMRC – particularly (but not exclusively) in relation to the plant rooms.

34. A statutory review of Mr Nesling's decision was requested, and Ms Jenkins, the review officer wrote to the Club on 11 July 2013 upholding Mr Nesling's decision. On 6 August 2013 the Club appealed to this Tribunal.

Contentions of the parties

35. Mr Nesling's decision letter gives four reasons for rejecting the proposed special method.

36. The first reason is that the Club gave no reason why the standard method does not produce a reasonable result. Mr Brown, representing the Club, notes that the 2007 special method gave the Club a recovery rate of 89.4% in respect of the residual expenditure attributable to the clubhouse. As this special method had been agreed with HMRC, HMRC must have agreed that this produced a fair and reasonable result. If the 2007 special method (which did not take account of guest fees) gave a fair and reasonable result, then the proposed special method which results in a recovery rate of 86.4% must also be fair and reasonable. Mr Brown submits that the use of room area has to be more accurate than the standard method. The current (standard) method, which gives a recovery rate of 36.4%, is not fair and reasonable.

37. The second reason given by Mr Nesling is that the proposed special method does not improve on the accuracy of the standard method. In particular Mr Nesling was concerned about why there was a significant difference between the recovery ratios under the proposed special method and under the standard method. Ms Caroll noted in her submission that the purpose of a special method was to more accurately reflect the use of input tax, and not to maximise input tax recovery. Mr Brown's response is that the difference in the percentage amounts is an irrelevant consideration in reaching a decision as to which method objectively gives the fairer result.

38. The third reason is the exclusion of some of the overall floor area. Mr Nesling in his evidence notes that when he totals up the floor area of the clubhouse he reaches a total of 6977.70m^2 and not 7004.67m^2. But on the basis of the Club's calculation 2443.10m^2 is excluded – being 34.88% of the total floor area. Mr Nesling considered that excluding over a third of the floor area from the calculation would produce a distortive result. Mr Brown submits that a floor space based calculation has to be more accurate than the standard method in respect of determining the recovery of input VAT relating to the fabric of the building.

39. Mr Nesling finally questions the allocation of floor space to categories. He questions whether the allocation of floor space suggested by the Club is always appropriate. In the course of his evidence he gave the "Harness Room" as an example. Photographs of the Harness Room and its associated servery were included in the bundle of documentary evidence. The Harness Room is a cafeteria where members of the Club consume food and beverages. The food and beverages are purchased in the adjacent self-service servery, and then taken through to the Harness Room for consumption. Both the Harness Room and the associated servery are allocated on the Club's spreadsheet to "taxable" floor space. Mr Nesling questioned in his evidence whether there might be an exempt membership component to the use of the Harness Room. More generally, the subscriptions paid by members gave access to the clubhouse, and for that reason, in Mr Nesling's view, there would be a membership component to all the rooms in the Clubhouse. Mr Brown submits that the use and allocation of each of the rooms in the Clubhouse can be checked by HMRC and is a matter of fact, and that determining input tax recovery by reference to floor area has to be more accurate than the standard method. He also noted that the allocation of rooms to the different categories had not been challenged by HMRC.

Discussion

40. Both the VAT Act and the Principal VAT Directive provide as a general rule that recovery of input tax should be based on the proportion of the taxpayer's turnover that is taxable. In the case of *Fianzamt Hidesheim v BLC Baumarkt GmbH & Co KG* [2012] EUECJ C-511/10 the Advocate General stated at paragraph 33:

> Thus […] the general rule laid down in Article 19 of the Sixth Directive, based on the correlation between the amount of turnover relating to transactions in respect of which VAT may be deducted and the amount of turnover relating to transactions in respect of which VAT may not be deducted, relies on accounting information which is readily available for all taxable persons and enables, in principle, a fair and reasonably accurate calculation of the amount which is ultimately deductible. Further, that rule is, naturally, the one which the European Union legislature primarily chose, since, while the directive merely mentions other possible methods available to the Member States, the turnover method is the only one which is defined and for which the details of the calculation process are laid down.

41. In its decision, the European Court of Justice said:

> 24 The Sixth Directive does not therefore preclude Member States […] from applying, for a given transaction, a method or allocation key other than the turnover-based method, such as, in particular, that based on the floor area […] on condition that the method used guarantees a more precise determination of the deductible proportion of the input VAT than that arising from application of the turnover-based method.

42. For the Club to succeed in its appeal (and the onus of proof is on the Club) it must demonstrate that the use of floor space in the proposed special method

guarantees a more precise determination of the Club's recoverable input tax than the turnover based standard method.

43. We find that the Club's proposed special method does not more precisely determine its recoverable input tax than the standard method, and for this reason dismiss its appeal.

44. Our reasons are as follows.

45. First, we consider the fact that HMRC had agreed a floor space based special method in the past as irrelevant in reaching our decision. This is a new application for a special method, and needs to be considered on its own merits. The 2007 (and prior) special methods were agreed prior to the decision of this Tribunal in *Bridgnorth*. In addition, (with the benefit of hindsight), there must be some doubt as to whether the 2007 special method did give a more precise determination of the Club's recoverable input tax than the standard method, as it ignored the impact of guest fees.

46. Secondly, we note that under the Club's allocation of rooms to the various categories, over one third of the floor area is excluded from the special method calculation. This is because that floor area is either allocated to the "mixed use" or the "excluded" categories. A special method that is predicated on floor space being a better measure than turnover for allocation of recoverable input tax – yet which takes over one third of that floor space out of the calculation – has to be flawed. We cannot see how such a special method can provide "a more precise determination of the deductible proportion of the input VAT than that arising from application of the turnover-based method".

47. Thirdly, we agree with Mr Nesling that the basis on which the Club allocates floor space to the taxable category is inconsistent with the decision of this Tribunal in *Bridgnorth*.. Although we recognise that it may be possible to treat as "taxable" floor space those rooms that are inaccessible to members and which are exclusively used for food and beverage preparation (such as kitchens and food storage areas) – the allocation of floor space to the "taxable" category where the room can be accessed by members is troublesome. Even though (for example) the Harness Room may only be used for consumption of food and beverages, the availability of the facilities of the Harness Room is likely to contribute to the overall attractiveness of the Club to members, and so has an exempt element (just like the lounge and bar in the *Bridgnorth* clubhouse). If these factors are taken into account, an even greater proportion of the floor space in the clubhouse will be allocated to the mixed category, and an even greater proportion of the floor space will be taken out of account in the calculation.

48. In his evidence, Mr Dewar said that corridors, toilets and cloakrooms were excluded from the special method calculation, because they were used generally – and their use could not be allocated to a specific category. We consider that there seems no logical basis why these should not be treated as "mixed use". But this just illustrates that the fact that the proposed special method ignores mixed use floor space in the calculation is distortive, as there will be some element of taxable utilisation for

that space. The fact that it is difficult to determine what proportion of the mixed use floor space is used for taxable or exempt supplies is an indication that floor space is not an appropriate measure of the taxable utilisation of the clubhouse.

49. We also find troublesome the manner in which the Club allocates the floor space of the plant rooms. When dealing with heating and air conditioning, is the floor area of the space that is heated or air-conditioned an appropriate measure of economic use – or should the calculation take account also of the volume of the space, its location within the building, and the manner in which that space is utilised? In this context we note that some of the spaces in the East Wing have very high glazed ceilings, or glazed walls – and others are internal spaces with solid walls and lower ceilings. Alternatively, should the plant rooms be allocated to the "mixed use" category, as the heating and air-conditioning generated in these rooms is allocated (ultimately) to both taxable and exempt supplies? In our view the proposes special method does not deal with the allocation of these spaces appropriately.

50. Finally, the fact that the Club applied to withdraw from the 2007 special method in 2010 does suggest that a floor space based special method does not give a fair and reasonable recovery rate in the context of this case. Mr Dewar sought to explain this away in his witness statement by saying that "a recovery in the region of 30% which the standard method gave was, while not being fair and reasonable, better than no recovery under the fallacious special method" (it was the treatment of guest fees that Mr Dewar apparently found objectionable in the 2007 special method). Mr Dewar's explanation in our view underpins the fact that a floor based special method does not provide in the circumstances of this case a more precise determination of the deductible proportion of the input VAT than that arising from application of the turnover-based method.

Conclusions

51. We therefore dismiss the appeal.

52. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

NICHOLAS ALEKSANDER
TRIBUNAL JUDGE

RELEASE DATE: 12 February 2015