

Institution **CIOT - CTA**
Course / Session **APS VAT and Other Indirect Tax**

Exam Mode **OPEN LAPTOP + NETWORK**
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Event **NA**

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Answer-to-Question-_1_

Report for Larketon Festivals Ltd

Date: 3 November 2023

1. Scope and background

Larketon Festivals Ltd ('LF' or the 'Charity') has requested advice from Bacon & Swann LLP ('BS' or 'we') regarding the tax implications and recommendations on the Courthouse project (the 'Project').

This report focuses on:

- advice and recommendations as to whether for LF to carry out the Project in its own name or set up a wholly-owned trading subsidiary (the 'Sub') to carry out the operation
- advice and recommendations regarding VAT registration
- the tax liability of the proposed income streams
- the VAT recovery position in respect of the capital costs

This report has been prepared under our letter of engagement dated 20 December 2018 and based on the information provided by the Board of Trustees of LF. This report is for the sole use of LF only and cannot be relied upon by a third party.

2. Glossary

The following abbreviations have been used in this report:

- CGS - Capital goods scheme
- SDLT - Stamp duty land tax
- CT - Corporation tax
- RCP - relevant charitable purpose
- OTT - Option to tax

CGS - Capital goods scheme

MTD - Making Tax digital

3. Executive summary

3.1 Larketon Festivals Ltd ('LF') is exempt from CT on profits arising from its primary trading activities. A small trading exemption exists but following the refurbishment of the courthouse site, its non-primary trading activities are expected to exceed the small trading tax exemption limit. The estimated CT liability if operations were to be carried out by LF is £34,675.

3.2 Due to the significant tax liability, we recommend that a wholly-owned subsidiary ('the Sub') is incorporated and for the non-charitable trading activities to be carried out by the Sub.

3.3 The Sub can donate its taxable profits to LF via Corporate Gift Aid scheme so the CT liability will be none to minimal (but CT charge may arise where distributable reserves do not match CT profits).

3.4 The donation must normally be made during the account year but a wholly-owned subsidiary can make the donation within 9 months of accounting year end and carry it back to the year.

3.5 The donation must be made in cash and cannot be made on 'paper' only. Cash flow should be considered closer to the time.

3.6 A company need to be incorporated on Companies House. Care should be taken to ensure conflict of interest is managed and that LF is not seen as financially benefiting the Sub on a non-commercial basis as it may affect any tax exemptions or relief.

3.7 As the taxable turnover will exceed the VAT registration threshold soon after the site is complete, it is recommended that

a VAT group is set up once the subsidiary has been incorporated to allow input VAT recovery.

3.8 The application will need to be submitted via the VAT online registration service and a VAT50/51 needs to be submitted to set up the VAT group. The group will need to use MTD software to maintain certain business records and submit VAT returns to HMRC.

3.9 The group will have a mix of business, non-business, taxable and exempt income. Business/non-business apportionment and partial exemption calculations will need to be undertaken to determine input VAT recovery:

- VAT on costs relating to both business and non-business must be apportioned on a fair and reasonable basis
- VAT on costs directly relating to non-business are not recoverable
- VAT on costs directly relating to exempt supplies are not recoverable (unless de minimis)
- VAT on costs directly relating to taxable supplies are recoverable
- VAT on costs relating to both taxable and exempt business supplies are partially recoverable based on partial exemption method

3.10 Construction costs will be subject to VAT at 20% as no VAT relief is available because it is not a new RCP building or annexe. The VAT is a general overhead of the business as it relates to both business (taxable, exempt) and non-business supplies made by the group.

3.11 The recoverable VAT on the construction is estimated £158,244. The construction cost is a CGS item therefore usage must be monitored over a period of 10 years and an adjustment may be required.

3.12 LF will need to charge the Sub for its use of the premises,

as the lease currently prohibits this, it is advised that LF pays the alteration fee to allow it to charge the Sub.

4. Approach to the Courthouse project

4.1 Option 1 - LF to build out the Courthouse project in its own name

Charities are exempt from profits arising from primary-purpose trading activities, for LF these would be the admission supplies under the cultural exemption. We understand LF has treated this income as exempt for VAT and CT which was agreed with HMRC so assume it meets the conditions and have not undertaken any analysis regarding eligibility.

Where LF carries out trading activities which are not primary-purpose (ie activities carried out in the furtherance of its charitable objects), there is a small trading tax exemption which exempts profits from turnover from non-primary purpose up to the lower of £80,000 or 25% of the total turnover.

Considering the proposed income stream:

- we don't think foodie events would be considered "cultural events" so would not be primary-purpose.
- we think outreach and education programmes would fall under the charitable object enabling personal development so would be primary-purpose
- as the exemption does not extend to the sale of food and drink, cafe and bar sales would also count as non-primary purpose trading

Based on the projected turnover, the turnover from non-primary purpose trading is expected to significantly exceed the small trading limit. If these activities are all carried out by LF then LF would need to pay CT on the profits from these non-primary purpose trade. The estimated CT liability is significant at

£34,675 (excluding any capital allowances).

4.2 Option 2 - Operation to be carried out by a wholly-owned subsidiary

Due to the significant CT liability, it is recommended that LF proceed with option 2 and set up a wholly-owned subsidiary (the 'Sub'). The main benefits include ringfencing certain activities and risks in the Sub and minimising tax payable.

It is recommended that LF carries out charitable activities (exempt admission to cultural events) and charitable outreach and for the Sub to carry out all the other trading activities.

Under the corporate gift aid scheme, the Sub can donate its taxable profits to LF which is tax deductible by the Sub and exempt in the hands of LF. Where the Sub matches its donations to its taxable profits, it will not have any CT to pay. The donation must normally be made during the accounting year but a wholly-owned subsidiary has up to 9 months after the accounting year end to make the donation and carry back to the year so the Sub will have time to calculate its taxable profits to determine how much to donate.

It is important to note that the donation must be made in cash and can't be made on paper only. HMRC does not tend to view circular loan arrangement favourably (ie where the Sub makes a donation and LF lends the money to the Sub) so consideration should be given regarding cash flow as I note there may be a concern about cash balance.

It is also important to note that a donation is a distribution therefore under company law, a company can only lawfully distribute up to its distributable reserves so where there is a mismatch between accounting profits and CT profits, there may be

some CT to pay so again, cash flow needs to be considered.

There is additional admin and time involved with this option as additional Companies House and return filings are required and will come with additional accountancy costs but we think the benefit will outweigh these downsides, especially if the activities are expected to grow even more in the future.

To proceed with this route, a subsidiary will need to be incorporated. This is an investment decision so LF is required to ensure that it is done for the benefit of the charity and that LF is not taking any undue risks. We recommend documenting clearly the rationale for incorporating a subsidiary and check that the constitution allows for this (if not, LF would need to ask the Charity Commission for approval to amend its constitution).

I understand the trustees will become the directors of the new Sub, care should be taken to ensure that any conflict of interest is managed appropriately. It may be worth considering adding an independent person as director of the Sub.

LF also can't provide financial support on a non-commercial basis so LF will need to recharge rent, shared resources and staff that works on both LF and the Sub's activities. Any such support may affect tax exemptions and relief.

5. VAT liability of income

To determine the VAT registration position, VAT recovery and any relief available, it is important to establish the VAT liability and treatment of the income streams.

5.1 Revenue and capital grants

Provided that no supplies are provided in return, revenue and

capital grants received are non-business and outside the scope of VAT.

It is our view that the capital grants from Department of Culture and UK Lottery Cultural Fund are non-business and outside of scope. Whilst it imposes some restrictions, it appears to be 'housekeeping' conditions only and LF is not required to provide any benefits / supplies in return.

With respect to the trustee's concerns about whether the restriction might prevent LF from benefiting from VAT refund, our view is that the clause exists to 'clawback' any VAT that is recoverable from HMRC as this is not a real cost to LF. It is common for grantor to fund the costs (sometimes plus any irrecoverable VAT). We would however recommend confirming with the Department of Culture to confirm the understanding is correct.

5.2 Bar and Cafe sales

Bar and cafe sales is a business would be a supply of catering and generally subject to VAT at 20%, unless there are any cold takeaway food or drinks that is ordinarily subject to the zero-rate.

As mentioned above, this is not a primary-purpose trading activity so the Sub should be carrying this activity.

We considered whether the cultural exemption may extend to the bar and cafe sales. It is not clear from the business plan but on the assumption that the bar and cafe will be open to the public and not just attendees of cultural events, it is our view that the exemption does not apply.

5.3 Admission to performance

Admission to cultural performance is a business activity for VAT

purposes and as mentioned above, a primary-purpose trading activity for CT. Where admission continues to be provided by LF, the VAT liability of ticket sales will be exempt. This is based on our understanding (please let us know if otherwise) that LF is precluded from distributing profit, applies profits to the continuance and improvement of facilities relating to the cultural events and is managed and administered on an essentially voluntary basis.

It is important to note that the exemption does not extend to the Sub so if the Sub was to provide admission, output VAT will be due on the ticket sales, estimated at £85,000 of additional VAT per annum based on 2025 figures. This does mean that the associated input VAT on costs directly related to admission will be recoverable as well as improving the recovery position of the capital costs on refurbishing the courthouse site. However, as income from ticket sales are significant and assuming most customers will be the general public so the VAT will be a cost, we don't think it is worth 'breaking' the exemption as the output VAT on ticket sales will be significant and the benefit will be eroded relatively quickly.

For completeness, some eligible bodies may decide to 'break' the cultural exemption by remunerating management (where allowed to) or applying profits on other activities to turn the income into taxable. HMRC also consider that the status of an eligible body should remain the same for at least a number of years, if not longer, and will resist what they view as manipulation of the relief. We would recommend not changing the status in such a way, which is also the trustee's aim to remain ethical and best practice.

5.4 Admission to foodie events

These events do not fall under the cultural exemption as it is not admission to a museum/gallery or a theatrical, musical or

choreographic performance of a cultural nature. The admission tickets will therefore be subject to VAT at 20%. VAT incurred directly in relation to these events will be recoverable. We recommend that this is carried out by the Sub as it is not primary-purpose trading.

5.5 Open mic

HMRC will apply a 2-stage business/non-business test in determining whether an activity is 'business':

- the supply results in consideration
- the supply is made for the purpose of obtaining remuneration

As the open mic events are provided for free, this in itself is not a business activity. However, as income is expected to arise from food and bar sales, which is a taxable activity, VAT is potentially recoverable on related expenditure as it may be possible to establish a direct link between performance costs and the bar sales. This contrasts a recent case where it was found that VAT on performance costs does not have a direct link to catering and is linked to exempt admission because there is no consideration for the entry in this case. We think there are grounds to support this view and recommend considering this further.

We recommend that this activity is carried out by the Sub.

5.6 Outreach programmes

As above, as outreach and educational programmes are provided for free, this is not seen as a business activity. For completeness, if these programmes are partly funded by grants then there are some recent cases which suggest that grant-funded education may be third-party consideration for an exempt activity. However, HMRC has not changed their position so it is our view that it is still considered a non-business activity.

6. VAT registration and input VAT recovery

As the taxable turnover is expected to substantially exceed the VAT registration threshold of £85,000, there will be a requirement for VAT registration. There are a number of options.

6.1 Option 1 - Standalone registration(s)

the Sub will be required to register for VAT on a compulsory basis. It is also possible to register for VAT voluntarily before the threshold is breached. We would recommend doing so and registering for VAT as soon as the subsidiary is set up as it appears that the VAT threshold will be breached very shortly (possibly during the month when the courthouse site is complete, based on Y/E September 2024 projections). This will allow input VAT recovery and there will not be a need to monitor taxable turnover to avoid late registration penalties.

Where LF's taxable turnover remains below the VAT registration threshold, it will not have a compulsory requirement to register for VAT. However, it would mean LF will not be able to recover any VAT on costs it incurs. Although LF does not currently have any taxable activities, as mentioned, it will need to recharge costs to the Sub which majority will likely be taxable so will count towards its VAT registration threshold and it will need to monitor its turnover. Furthermore, where the Sub recharges costs to LF, LF will not be able to recover VAT so there will be VAT leakage.

We also considered LF and the Sub registering for VAT separately on standalone basis. Recharges (eg management fees) from LF to the Sub should give it an entitlement to register for VAT. In

respect of the rent, where LF opts to tax the property in theory it will be making taxable supplies to the Sub which will allow it to recover VAT on some of the capital costs. However, LF as the grantor will be using the courthouse for non-eligible purposes (exempt supplies of admission) and will occupy the site for more than 2%, the OTT anti-avoidance will be triggered and the supply will become exempt. As such, we would not recommend these options.

6.2 Option 2 - VAT group

We would recommend setting up a VAT group with LF and the Sub as members. The main benefit is that recharges between the two entities can be disregarded for VAT purposes and will resolve the OTT anti-avoidance issue. The group's cumulative income will be considered when determining VAT recovery of overheads which will likely improve the position.

The other main implications of VAT group include: supplies are treated as made to and by the representative member; return is rendered by the representative member but members are jointly and severally liable for VAT debts.

6.3 - Recovery

The group will have both business, non-business, taxable and exempt supplies so will need to carry out business/non-business apportionment and partial exemption calculations to determine its input VAT recovery position. This is a two step process: Business/non-business apportionment can be on any fair and reasonable methods but partial exemption calculation is by default income-based standard method, unless a special method is agreed with HMRC. It is also possible to apply for a combined method. As the group is newly partially exempt, it is possible to recover VAT on overheads based on use/intended use in the first year without prior permission from HMRC.

In summary,

- VAT on costs relating to both business and non-business must be apportioned on a fair and reasonable basis
- VAT on costs directly relating to non-business are not recoverable
- VAT on costs directly relating to exempt supplies are not recoverable (unless de minimis)
- VAT on costs directly relating to taxable supplies are recoverable
- VAT on costs relating to both taxable and exempt business supplies are partially recoverable based on partial exemption method

It should be noted that where a member of a group has 'special status' (in this case, LF is an eligible body for cultural exemption purposes), it is necessary to look at who actually makes the supply. Therefore if admission to cultural events is supplied by the Sub then the cultural exemption will not apply even if the representative member (assuming LF) has special status.

6.4 Practicalities

A VAT registration application will need to be submitted to HMRC via the online VAT registration service. Where a VAT group is formed, a VAT50/51 form will need to be submitted. As we are aware there are some delays and it is not possible to backdate a VAT group registration, we recommend this is submitted as soon as possible once the Sub has been incorporated.

MTD is now compulsory for all VAT-registered businesses unless exempt under limited circumstances. Businesses are required to maintain digital records and submit returns to HMRC via functionally compatible software, so we recommend start using an MTD software, if not already. Normally, the transactions for LF and the Sub will need to be combined and any business/non-business

apportionment and partial exemption carried out (HMRC confirmed this can be done outside of the MTD software) and submitted via a 'bridging' software. Further advice can be provided if required.

6. Courthouse project and VAT liability of construction costs

On the basis that LF proceeds with route 2, it will engage the contractor and incur the construction costs.

There is a zero-rate relief available to construction of a new property used solely for RCP and construction of a RCP annexe (ie used for non-business charitable purposes or as a village hall or similar). Sole use means 95% or more non-business use. However, based on the building plan, it appears that the project involves refurbishment, conversion or extension of the existing building. Zero-rating relief does not apply even if the property is solely used for charitable purpose.

We considered whether extension to the existing building could be restructured such that a annexe is created (it will need its own independent access, captable of independent function) but as the extension is used as the cafe, this would not be a non-business use so zero-rating will not be available even if it is an annexe.

As such, we consider that the project will be subject to VAT at 20%. As no relief is available, we then turn to recovery of the costs.

On the assumption that the Trustees will proceed with our advice and that the Sub will operate various activities which will utilise the courthouse, as mentioned above, LF is required to charge the Sub for shared resources on an arms length basis, which I understand the Trustees are already planning to do by charging a market value rent.

As mentioned above, without an OTT LF's supplies to the Sub will be exempt and we also consider that even if LF were to OTT the site, its OTT will be disapplied so we recommend setting up a VAT group.

As noted, overheads of the group that relate to both business and non-business activities will need to be apportioned. As the site will be used for both business and non-business activities, construction costs will fall under this category and need to be apportioned. The business portion of the construction costs will then need to be apportioned between taxable and exempt based on either the standard method or in the first year, the use-basis. The estimated recoverable input VAT based on the standard method on construction is £158,244 (see Appendix 2). However, standard method override will need to be considered if the recovery based on use differs substantially.

As the construction costs are capital costs and the value exceeds £250,000, it is a CGS item so use will need to be monitored over a period of 10 years. If there is a difference between the level of initial use and future years usage (taking into account business, non-business, taxable, exempt), CGS adjustments will be required.

7. Other issues

Lease with Ministry of Justice

As the lease with the Ministry of Justice prohibits use of the property, we advise paying the alteration fee and ask for agreement from Ministry of Justice to charge rent to the Sub.

7.1SDLT

Generally LF does not have to worry out SDLT as LF benefits from SDLT exemption where the site is used for more than 50% charitable purposes (but a clawback exists if a disqualifying

event, such that it's not used for charitable purposes) happen within 3 years. LF and the Sub are in an SDLT group so no SDLT is due on the property.

7.2 Capital allowance

As LF is exempt from primary purpose trading and property income, and the Sub is able to donate its profits to LF, although significant capital costs will be incurred, there are not much real benefits to claiming capital allowance as it is mostly academic for the group.

7.3 Concern about cash balance

I note you raised a concern about cash balance in relation to the outreach programme. A recommendation is that LF may want to consider expanding its revenue streams and selling donated goods (a zero-rated supply) or organising fund-raising events. The supplies are exempt from CT and VAT (supplies which are zero-rated can still be zero-rated, eg donated goods) on the basis that the events are advertised as such. It can be organised either by LF or the Sub (as the Sub donates its profits to LF). However, please be aware that additional exempt income will impact input VAT recovery.

Appendix 1

	Charitable / non-business £		£Trading		Notes
Capital grants	1.5m				
Revenue grants	95,000				

Ticket sales	425,000				
Foodie Event			250,000		
Cafe			290,000		
Bar			550,000		
Total income from activities	425,000		1,090,000		
Admin	(30,000)		(30,000)		Assume 50/50 split
Performance staff	(160,000)				
bar and cafe staff			(280,000)		
Performance fees	(150,000)				
Performance Overheads	(220,000)				
Bar costs of sale			(600,000)		
Overheads			(35,000)		
Depreciation	Added back to calculate CT profits		Added back to calculate CT profits		
Outreach					
Admin	45,000				
Programme	150,000				
Other	20,000				
Profits	exempt		145000		
CT@ 25% (with marginal	exempt		34,675		

relief)						

Appendix 2

Business/non-business apportionment:

Business days of operation: 250

Non-business days of operation: 50

Business % = 83%

Non-business = 17%

Income from activities (excluding grant):

Taxable: 250,000 + 290,000 + 550,000

Exempt: 425,000

Recovery percentage: $1090000 / 1515000 = 72\%$

Construction VAT:

£264,800

Business portion: 219784

Non-business (not recoverable): 45016

Taxable portion of business: £158,244

Exempt portion of business: 61539 (wholly irrecoverable as above
de minimis)