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The Chartered Tax Adviser Examination

November 2017

Application and Interaction Question 5 VAT

Suggested Solutions

Letter from Syd Smith to the CEO of C&K Holdings Sdn Bhd

Ho Luan Dong
C&K Holdings Sdn Bhd
First Street
Anytown
AD12 4FG

Northern Tax Advisers
1 Central Place
Anytown
AS1 1AB

8 November 2017

Dear Ho

Development Activities in the UK

In accordance with the instructions in your letter of 1 November 2017, I have set out our advice in connection with the structure of your business activities in the UK, including transactions with your Head Office which is resident in Malaysia. Please be aware that under our existing engagement we cannot provide any advice to the residential joint-venture if a new partnership or limited company is constituted. This would require a separate engagement, which we would be happy to discuss further. We can of course continue to provide advice to a group company in relation to its role in the joint venture.

Summary of recommendations

I would recommend the following:

1. The UK companies and branch should form a VAT group registration and elect to submit VAT returns on a monthly basis to maximise credit for input tax incurred in the UK.
2. The VAT group should apply for an EORI number to allow recovery of some of the VAT paid at import.
3. C&K Commercial Ltd should opt to tax the commercial properties in the Office Park, but should defer opting to tax over the Financial District at the moment. Opting to tax at a later stage would delay but not prevent retrospective recovery of VAT on development costs but see our comments below in relation to VAT on overhead costs.
4. C&K Residential Ltd should apply to join C&K Holdings Sdn Bhd and C&K Commercial Ltd in the VAT group registration.
5. The VAT group will have income which is subject to VAT but also income which is exempt from VAT. It should approach HMRC to negotiate an agreement on the amount of VAT on costs which can be reclaimed by the group. We would be happy to assist the group in this exercise.
6. In view of the tax difficulties surrounding title to the property, we recommend that the residential development is carried on through an unincorporated arrangement under which each party accounts for VAT on its own share of the joint venture activities rather than a partnership or a limited company. This would also allow C&K Residential Ltd to make its own sales and to join the VAT group.

1 The VAT and Customs Duty implications of the group's UK business activities

VAT registration in the UK

A person is required to register for VAT in the UK if his taxable turnover exceeds certain limits. "Person" does not only apply to natural persons but also to corporate bodies. Each of the group companies need to be considered separately therefore for these purposes.

Therefore it is not strictly necessary for either of the companies or the UK branch to register for VAT immediately since there are no sales due in the near future. Legally VAT registration could be left until property income subject to VAT commences or has exceeded £85,000. (1 mark)

However, until you are registered for VAT, you are unable to recover any VAT on costs and it is sometimes still possible to register in advance of reaching these mandatory limits. In this case, it is likely an advantage since it would allow C&K Holdings Sdn Bhd to recover some of the VAT paid on the importation of the computers and allow C&K Commercial Ltd to recover some of the VAT it will incur on development and overhead costs, which otherwise may be lost. To accept registration on this basis, HMRC must be satisfied by objective documentary evidence that the companies have an intention to make taxable supplies in the future. No time limit is specified for this purpose.

It is also possible to make a claim on the first VAT return in respect of VAT incurred on services received in the 6 months prior to the date of VAT registration (for example in connection with company set-up costs) and for VAT incurred on any goods or assets acquired in the previous 4 years which are held at the date of registration. It is a condition of the claim that the goods and services are used in the business once it is registered for VAT. (2 marks)

Once registered, the companies will have to submit VAT return declarations. Since in the development phase, VAT will be incurred by the subsidiary companies on costs with no corresponding VAT payable on sales, HMRC will refund the amount of VAT incurred. Although VAT returns are normally submitted on a quarterly basis, it will be possible to make an application to submit monthly returns. This will allow earlier repayment of VAT incurred and assist cash flow. (1 mark)

C&K Holdings Sdn Bhd cannot register for VAT in its own right since it will not make any sales which are subject to VAT. It also follows therefore that it cannot reclaim any VAT on its costs or imports. Potentially C&K Holdings Sdn Bhd could review its decision not to recharge the costs it incurs on behalf of the subsidiaries. This would create taxable supplies, thus enabling a VAT registration, though it should be recognised that the subsidiaries may not be in a position to pay these recharges for some time. Alternatively, it would be possible to register C&K Holdings Sdn Bhd with C&K Commercial Ltd and C&K Residential Ltd as part of a group registration. This type of registration is possible when a number of UK resident companies are under common control as in your case. Group registration permits all members of the group to share a single VAT number and submit a single consolidated VAT return. In this respect, for VAT purposes only, the companies are treated as if they were branches of the same company. A major advantage of group registration is that no VAT is charged on sales between the group members. It should be noted that in a group registration, all the members are liable for any VAT due to HMRC from the group. (3 marks)

The eligibility of a holding company to register and reclaim VAT as part of a VAT group registration has long been a controversial topic. The debate started some time ago when a European case called Polysar established that a 'pure holding company', that is a holding company which plays no role in the management of its subsidiaries nor provides any services to them, is not carrying on an economic activity and is not entitled to reclaim VAT. The issue was addressed again in a case arising out of the takeover of British Airports and most recently has been considered in the cases of Larentia and Minerva. (2 marks)

Following these decisions, HMRC has relaxed its view and in published guidance has now accepted that a holding company in the circumstances of C&K Holdings Sdn Bhd is eligible to register in a VAT group and reclaim on its costs where those costs support the taxable activities of the group. (1 marks)

Since the costs of the UK branch of C&K Holdings Sdn Bhd will support the activities of its trading subsidiaries, the branch will be able to form a VAT group registration with its subsidiary companies. This will allow it to recover input tax on its costs. However this will be restricted according to the amount of

activities undertaken by the subsidiary companies which are subject to VAT. In this regard, please see our comments below in relation to C&K Commercial Ltd. and its option to tax. However if C&K Residential Ltd is also included in the VAT group, its activity will be subject to VAT, albeit at nil rate in some cases but this would increase the amount of taxable activity in the group and thereby the amount of VAT which can be recovered on the overhead costs of C&K Holdings SDN Bhd. (2 marks)

The payment of dividends by the subsidiary companies will not be affected by the formation of a VAT group. The dividends would have been outside the scope of VAT in any event and this treatment will continue within a VAT group. Similarly, the formation of a VAT group will have no effect on the tax treatment of the dividends. (1 mark)

Importation of computer hardware and software

At present the UK is a member of the European Union, which is a customs union. The effect of this is that any goods imported into the EU are subject to a duty of customs. The rate of duty is set out in the UK Trade Tariff and you, or more likely your appointed shipping agent, will need to establish the appropriate classification when the computers enter the UK. The duty will be payable at the point of importation. (1 mark)

It is possible to make arrangements to defer payment of the duty until the month following importation. However, this would require provision of a financial guarantee to HMRC. Alternatively, it may be possible to defer the payment of duty by using the shipping agent's account. (1 mark)

Unlike VAT, there is no mechanism whereby customs duty can be reclaimed. It is therefore a cost of the business but will be an allowable deduction in computing the company's profits liable to corporation tax. (1 mark)

The computers will have to be valued for the purpose of charging any duty in accordance with the rules of the Union Customs Code, which is based on World Trade Organisation principles. There are a number of ways in which this can be done. The majority of imports are valued using the price paid for the sale of the goods. This method can be used between related companies but where, as here, the transaction is between branches which are part of the same legal entity, the prices shown on inter-company transfer or accounting documents cannot be used to establish the customs value. This is because a company cannot be deemed to sell to itself for these purposes. (1 marks)

In view of this, the UK branch will have to use another method of valuation. This could be the price of identical or similar computers entered into the EU at the same time. It will be necessary to demonstrate the price by reference to documentary evidence for an actual importation into the EU. Alternatively, the value could be based on the sales price of the computers in the EU. Delivery costs are included in the customs valuation. (1 marks)

VAT will also be payable on the value of the imported goods including the duty. You will therefore also need to register for an EORI (Economic Operator Registration and Identification) number. You can apply for this at the same time as you apply for a VAT number. Your shipping agent will provide the EORI number to HMRC when it submits the import declaration for the computers. (1 mark)

HMRC will use the EORI number to produce a certificate of the amount of VAT paid at importation (C79). This certificate is produced monthly and will include details of all importations made in the previous month. C&K Holdings Sdn Bhd will then be able to use the certificate to claim a credit for some of this VAT through its VAT return. The amount will depend on its agreement with HMRC (see below). (1 mark)

If you intend to continue importing goods, you may wish to consider applying for Authorised Economic Operator (AEO) status. This is for businesses that are established in the EU, actively involved in customs operations and international trade and have an Economic Operator Registration and Identification (EORI) number. AEO is internationally recognised and indicates that your role in the international supply chain is secure and that your customs controls and procedures are efficient and compliant. Whilst it is not mandatory, it gives quicker access to certain simplified customs procedures. (2 marks)

The importation of software by electronic means is not subject to customs duty since it is a supply of services rather than goods. (1 mark)

Under the UK's VAT grouping provisions, a company must have an establishment in the UK to join a UK VAT group. However, the whole body corporate is part of the VAT group, not just the establishment (branch or head office) in the UK. Therefore services provided between an overseas establishment and a UK establishment of the body are not supplies for UK VAT purposes, as they are transactions within the same taxable person. In any event, since there is no payment, there cannot be a VAT liability. (2 mark)

C&K Commercial Ltd

The development agreement is currently in the name of C&K Holdings Shn Bhd but can be novated to C&K Commercial Ltd or any other group company. There will be no VAT consequences arising from the assignment provided no consideration is exchanged. In any event, our advice is to include both companies in a VAT group and no VAT can arise on transactions between members of a VAT group. (2 marks)

Rental income from commercial properties is exempt from VAT in the UK. The effect of this is that, without taking any action C&K Commercial Ltd will not be entitled to register for VAT and consequently will not be able to recover VAT which it will incur on both the development costs and the recharges from C&K Holdings Sdn Bhd.

However, it is possible to unilaterally elect to charge VAT on the rent. This is known as "opting to tax" the property. C&K Commercial Ltd does not need permission from its tenant or strictly does not even need to consult with his tenant before exercising an option to tax. Once an option to tax has been notified to HMRC, VAT must be charged on all income from the property, including rents and service charges. It will also apply to any future disposal, although, please see the comments below in respect of your proposed sale to investors. The benefit of opting to tax is that C&K Commercial Ltd will then be able to register for VAT and reclaim the VAT paid on its development costs, including professional fees of the properties covered by the option to tax. It will also want to make certain that any existing lease allows VAT to be charged in addition to the amount of the rent.

(2 marks)

An option to tax, once notified is irrevocable for twenty years. C&K Commercial Ltd could therefore notify an option to tax now, recover VAT on development costs but then find on completion that a VAT charge on rents is unattractive to tenants. Depending upon the timing of this, it may not be possible at that point for C&K Commercial Ltd to cancel the option and repay the VAT on development costs.

(1 mark)

Where, as here, the tenants of the Office Park operate in the retail or commercial sector it is likely that they will be registered for VAT and able to reclaim the amount of VAT paid on rent. It is likely that local property agents will be aware whether leases in the area are subject to VAT. However, there may be some small businesses which are not VAT registered and would therefore have to suffer the cost of any VAT. In addition, market conditions may also change prior to the completion of the development.

(2 marks)

C&K Commercial Ltd therefore faces an important decision concerning the desirability and timing of the option to tax. It will need to balance the benefit of reclaiming VAT as it is incurred on its development cost, thereby reducing capital costs, against the possible negative effect of charging VAT on future rental income which may act a disincentive to tenants and investors.
(1 mark)

Once an option to tax has been exercised, VAT will be payable on rental income and this will increase the amount of rent payable by the tenant. However if the tenant operates in the retail or commercial sector, it is likely that it will be registered for VAT and able to reclaim the amount of VAT paid on rent. A tenant which works in the financial sector will be unlikely to be able to reclaim all of the VAT since the provision of financial services is largely exempt from VAT. The exercise of an option to tax may therefore have an adverse impact on the amount of rent which the tenant is prepared to pay.
(2 marks)

Our advice is to exercise an option to tax over the retail and commercial properties in the Office Park. It is then likely that VAT will be recoverable by the tenants and C&K Commercial Ltd will be able to recover the VAT on its own construction costs.
(1 mark)

In relation to the properties in the Financial District, however, it is the case that all the tenants will not be able to recover VAT in full and therefore VAT will be an additional cost to them. This may put additional pressure on rental yield. C&K Commercial Ltd could opt to tax the Financial District, reclaim VAT on the build costs and then accept a reduced rent but it is likely that the best course therefore is not to opt to tax on the Financial District at present. This does mean that the company will not be able to recover VAT on construction costs but no VAT will be charged upon rents. It would still be possible to opt to tax at a future date and recover some VAT on the development costs at that point. This would be in proportion to the time the building is opted during the first 10 years of the life of the building. If C&K Commercial Ltd opts to tax on completion, prior to granting any leases, since it will already be registered for VAT (as a result of opting the Office Park), it will be able recover all the VAT on development costs (though it would have suffered some cashflow disadvantages).
(2 marks)

Since the Financial District will comprise a single concourse, any option to tax will affect all the buildings on the concourse .C&K Commercial Ltd will have to bear this in mind when deciding whether to opt to tax, unlike the Office Park where the decision can be made on a separate building by building basis.
(1mark)

Since the company will have rental income which is subject to VAT and rental income which is exempt from VAT, it will require a partial exemption method to decide how much VAT it can recover on its own costs. It is a general principle that VAT will be recovered on the costs of business activities which will produce income subject to VAT. Initially this will only be those costs which relate to the opted property. However, if at a later stage an option to tax is made over all the retail and commercial buildings, VAT on all the costs which relate directly to this development will become recoverable . Assuming no option to tax is made in the financial district, the future rental income will be exempt and no VAT can be recovered on the direct cost of this development.
(2 marks)

That leaves the matter of general business expenses and professional fees which cannot be separately identified. The standard method of establishing how much can be recovered is by establishing the proportion of total income subject to VAT and then applying the same percentage to the VAT on overhead costs to establish the amount which is reclaimable.
(2 marks)

However this will create obvious problems in relation to these developments, since in the early years there will be no income at all and therefore the resulting percentage would result in zero recovery.(1 mark)

There is a general concession that during the first year of business, the group can recover an amount of VAT based on anticipated use, for example projected future income subject to VAT as a percentage of total expected future income. (1 mark)

Based on the income forecast, if an option to tax is made over the Office Park, the recovery percentage on overhead costs is likely to be 78%

$$\frac{\text{Office Park Construction services + opted rents}}{\text{Total income}} = \frac{\text{£2100 (1500 + 600)}}{\text{£2700}} = 78\%$$

If no option to tax is made, there is unlikely to be any recovery.

(2 marks)

The budget does not include any allowance for VAT on costs. If an option is exercised over the properties the Office Park, the VAT on construction costs will be recoverable. Do note however that it will be necessary to pay VAT to the supplier and reclaim the amount of VAT as a credit on the group VAT return.

Unless and until an option is exercised over the Financial District, no VAT is recoverable on the construction costs. We have commented below on the effect of making an election at some point on the future.

If as seems likely the group has some income which subject to VAT and some income which is exempt from VAT, there will be a further cost in respect of on VAT incurred on overheads since this will not be recoverable in full as described above.

(2 marks)

The earlier an option to tax is exercised, the greater will be the recovery of VAT on overheads. In the second year of development, the group will probably need to agree a special partial exemption method with HMRC based on the above principles. In subsequent years, the group could continue with a special method or revert to the standard income method once income is generated.

(2 marks)

One point to bear in mind is that if input VAT is incurred on a building which it is expected produce rental income which will be exempt from VAT but subsequently an option to tax is made, input VAT on development costs will then become recoverable. However, the same principle does not attach to overhead input tax which has been recovered in part. Even if the percentage of actual taxable use increases, it is not possible to revisit overhead input reclaims unless they fall in the year when the intended use changes.

Delaying the decision on the option will therefore restrict input tax recovery on overhead costs and these needs to be balanced against the advantage of delaying a decision on the option.

(2 marks)

In relation to the works which are required under the section 106 agreement, these will not be subject to VAT when delivered to the council. This is because they are provided under a statutory provision. (1 mark)

The VAT incurred on the development costs of the S106 works will be recoverable in the same proportion as the VAT on overhead expenses. This is because these works are essentially a cost of obtaining the planning permission for the developments. Input tax recovery on overhead costs, unlike direct costs cannot generally be reallocated later, for example to reflect an increased use of options to tax. The only occasion when an initial recovery can be increased is where no initial recovery has been made.

(2 marks)

Both the Office Park and the Financial District will potentially be subject to adjustments known as the capital goods scheme. This applies to buildings where the cost of construction costs exceeds £250,000 or more. The Capital Goods Scheme is a mechanism which adjusts the amount of reclaimable VAT on construction works to reflect the use of the building over a 10-year period.

In the case of The Office Park, assuming an option to tax is made, which will be irrevocable for 20 years, the rental income will continue to be fully subject to VAT and therefore no adjustment will arise. Assuming the Financial District is not opted at the outset; the rental income will be exempt from VAT and no VAT on construction costs can be recovered.

However, if an option to tax is subsequently exercised, a proportion of VAT incurred on construction costs would become recoverable.

For example if the VAT on construction of the Financial District is £300,000 and an option to tax is exercised after 5 years the amount of recoverable VAT will be

$$\frac{300,000}{10} \times 5 = \text{£}150,000.$$

(2 marks)

If you make exempt supplies and then decide to opt to tax, you may need permission from HMRC to change the VAT treatment of the rent and you would need to be check that the leases allow you to charge VAT in addition to the rental amount. (1 mark)

2 C&K Residential Ltd - structure for the joint venture

In relation to the residential joint venture, there are three structures you could consider.

1. the parties could incorporate a new joint venture limited company
2. the companies could create a partnership.
3. the development could be carried on through an unincorporated joint-venture.

(1 mark)

These three possibilities are considered below.

I should say that we cannot advise either a joint venture partnership or limited company unless separate engagements were to be set up. We can continue to advise C&K Residential Ltd in relation to its role in the joint-venture.

If, as is likely, there is sufficient 'mutuality of interest' to allow us to advise both parties, this course could be followed but both parties should consider seeking independent advice on whether it is appropriate. With the agreement of the parties, we may also resolve the potential conflict by appointing a separate team to act for each client, who maintain ethical "walls" to prevent confidential information relating to one party becoming known to the team acting for the other. (2 marks)

1. joint venture limited company

The company would be a separate entity from the joint venture parties and would pay corporation tax based on its own profits. The parties could withdraw dividends from the company if there is sufficient profit. (1 mark)

The joint venture company would have to register for VAT in its own right, (unless C&K Residential Ltd owned more than 50% of the shares, in which case it could consider VAT grouping). (1 marks)

It is likely that C&K Residential Ltd will not have to charge VAT to the joint venture company on its construction services (and this would include its design fees where part of a design and build contract) This does not mean that C&K Residential Ltd does not have to register for VAT. Its construction services will be technically subject to VAT but at a nil rate (zero rated). C&K Residential Ltd needs to register for

VAT therefore and although it will not have to charge VAT on its services, it will be able to reclaim VAT incurred on its own costs. Services from other third parties will be subject to VAT. Even if it were possible to do so, it is unlikely that AB Land Holdings Ltd would accept the inclusion of the joint venture company in a VAT group controlled by C&K Holdings Sdn Bhd.

(2 marks)

A difficulty which will arise with this structure is the ownership of the property which is presently held by the other party to the joint venture. In order to carry out the development, the property may have to be transferred to the limited company. There may be reluctance on the part of the existing owner to do this even if some arrangement could be developed whereby it retained an option to reacquire the property. In any case this structure would incur additional costs, notably Stamp Duty Land Tax (SDLT) in the transfer of the property and would possibly crystallise a gain subject to tax for the existing owner.

(2 marks)

2. a partnership.

An alternative strategy could be to operate the development through a partnership in which each party holds a share. In that case the profits would be allocated to the partners in the ratio of their partnership interests and will be taxed at corporate tax rates. Any trading losses would be available to offset against profits elsewhere in the C&K group of companies.

(1 mark)

The contribution of goods and services by the venture parties to the partnership activities will not be subject to VAT since these companies would comprise the partnership. However this would need to be carefully monitored as the profits would be calculated on a partnership basis regardless of the contribution of each partner.

(1 mark)

Again there will be a difficulty in terms of the ownership of the property. For VAT purposes, to register for VAT and make a sale of the completed houses which will allow recovery of VAT on costs, the partnership should ideally hold the title to the property, rather than ownership remaining with one partner. There may be a reluctance to do so and in any case, as with the limited company, this will incur further costs. (1 mark)

In the UK, two parties can own a property as joint tenants or as tenants in common. In the former case, the parties hold an indivisible share in the property and the property cannot be sold without the agreement of both owners.

(1 mark)

Alternatively if the property is held as a joint tenancy, each party owns a specific share on the property. It may therefore be possible to rearrange the ownership to create tenants in common and transfer a small share in the property to C&K Residential Ltd to satisfy the rules. In the case of tenants in common, each party can dispose of its own share in the property.

(2 marks)

3. an unincorporated joint-venture.

A further possibility is to carry out the development through a venture arrangement which does not amount to a partnership. The parties will carry on their business as separate organisations with C&K Residential supplying services to AB Land Holdings Ltd, which would sell the houses.

(1 marks)

The property will remain with the existing owner. On completion, it will make the sale of the new houses which no VAT will be payable because the sales will be zero-rated. However this party will be able to reclaim any VAT on development costs.

(1 mark)

Payment of the profit share to C&K Residential Ltd will be deemed to be in respect of supplies of goods and services to the other venturer. As noted above, new construction work (including design fees as part of the same contract), will be zero-rated. In any case, the other venturer will be able to reclaim any VAT charged to it so there will be no additional cost to the development.

(1 mark)

A further advantage of this arrangement is that C&K Residential Ltd will pay corporate tax on its own share of the profit less its costs.. (1 mark)

For these reasons, we would recommend an unincorporated structure for the housing development under which C&K Residential Ltd supplies its services to AB Land Holdings Ltd.

(1 mark)

If you would like to discuss any of these matters further, please do contact me.

Yours sincerely

Syd Smith

MARKING GUIDE

Overall the marks are allocated as follows:

	Part 1	Part 2	PHS	Total
VAT	51	6		57
Direct Taxes	1	4		5
SDLT		1		1
Customs Duty	6			6
Law / Ethics		9		9
Presentation			22	22
	<u>58</u>	<u>20</u>	<u>22</u>	<u>100</u>

TOPIC	MARKS
Requirement 1	
Mandatory VAT registration limits	1
Intending trader registration & pre-registration VAT	2
Monthly returns	1
Single or Group registration	3
Holding companies	2
Current position	1
Eligibility and composition of VAT group	2
Dividends	<u>1</u>
	<u>13</u>
Customs Tariff	
Duty deferment	1
CT deduction for duty	1
No sale valuation	1
Valuation methods	1
EORI	1
C79	1
AEO	1
Imported software No duty	2
Group single person and no consideration	1
	<u>2</u>
	<u>12</u>
C&K Commercial Ltd	
Novation of contract	2
Rent exempt unless OTT. Input tax	2
Irrevocable effect of option	1
Impact on tenants in retail/commercial	2
Balancing factors	1
Effect of option	2
Option to tax over Office Park	1
Financial district exempt with possible option	2
Concourse 'single building'	1
Partial exemption Direct attribution	2

Overheads	2
No income in development period	1
Use based apportionment in first year	1
Partial exemption projections	2
Impact on budget	2
Special method in subsequent years	1
No retrospective adjustment of residual input tax	2
S106 no supply	1
Input tax treated as residual. No reallocation.	2
Capital Goods Implications	2
Permission/lease terms	1
	<u>33</u>
Requirement 2	
C&K Residential Ltd Joint Venture	
Alternative structures	1
Restriction on advice to any new entity	2
Separate JV company	1
VAT liability of JV	1
Registration of C&K Residential	2
Transfer of property	2
Partnership	1
Provision of goods/services	1
Property ownership – need to grant major interest	1
Joint tenancy	1
Tenants in common	2
Separate supplies by parties	1
Sale of properties zero-rated	1
Payment in respect of services	1
G&K Res pays tax on its own calculated profit and eligible to join VAT group	1
Recommendation	1
	<u>20</u>
Presentation and higher skills	22
Total	100