



# **The Chartered Tax Adviser Examination**

May 2020

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## **Application and Professional Skills**

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**VAT and Other Indirect Taxes**

**SUGGESTED SOLUTION**

## Report to Mr J Wilkinson, Horticulture Technology Ltd

### 1. Scope of report

In accordance with our terms of engagement, this report covers:

1.1 The tax implications of, and our recommendation relating to the construction and fit out of a new laboratory.

1.2 Along with our recommendation, the tax issues concerned with the acquisition of a Triterpene designer from Stanford Panalytical Inc ("SPI").

1.3 The procedures which should be implemented so that the company will meet its responsibilities as importer of the Triterpene designer.

Our report is based exclusively upon the information supplied by you. In accordance with our terms of reference, our report has been prepared solely for the benefit of Horticulture Technology Ltd ("HTL"). Accordingly, its contents shall not be disclosed to a third party without our prior written consent.

### 2. Executive summary

Our findings and recommendations are:

2.1 We consider that the construction of the new laboratory (or a discrete part of it) will not be relieved from VAT given that it will not be used to the extent of at least 95% for publicly funded research. That said, we recommend that the figures supporting its projected use be reviewed critically. Also, subject to practical and commercial considerations, consideration should be given to changing the relative mix of income derived from, or staff deployed in relation to publicly funded research (non-business) and privately funded research to meet the 95% test.

2.2 In relation to the construction of the new laboratory, we prefer Option 3 identified by the working group. Compared to Option 1, it defers VAT of nearly £2.1 million otherwise payable at the outset; the pension fund ("the Fund") assumes the construction risk and, finally, HTL will not incur further debt of £8 million. While Option 2 may appear preferable to Option 3, VAT anti-avoidance legislation will increase the projected cost of the facility by up to £2.3 million, consequently increasing the annual rent payable by HTL to the Fund by perhaps £86,000, with HTL incurring irrecoverable VAT of up to £197,000.

2.3 Since Horticulture Technology Enterprises Ltd's ("HTE") profits chargeable to tax are gift-aided to HTL, with HTL's primary purpose trading activities exempt from tax, the tax benefits attached to capital allowances have no value to HTL but perhaps are valuable to the Fund. Were the Fund to fit-out the new laboratory and fund the preparatory works in return for a small reduction in the premium payable (and SDLT charge), it could secure immediate tax relief of up to say, £200,000 in the form of capital allowances, with HTL saving irrecoverable VAT of say, £184,000 (if the Fund were to increase the annual rent payable, part of the VAT chargeable will be irrecoverable, but we assess it to be relatively insignificant). We strongly recommend that HTL explore this option with the Fund.

2.4 In relation to the acquisition of the Triterpene designer, we calculate that:

a) the Customs Duty payable by HTL on its importation to the UK will be £52,050 which will not be relieved from tax:

b) irrecoverable VAT incurred by HTL over the term of the operating lease will be £296,109 compared to net VAT payable at the outset on its purchase of £274,254. While the irrecoverable VAT under the operating lease is marginally higher, we recommend that you opt to acquire the asset on this basis to secure the cashflow benefit.

In the event of a delay before matters proceed, we recommend that you contact us in case there have been changes in the law which affect our conclusions and advice.

### 3. Procurement of the new laboratory.

Our observations in relation to the options identified by the working group are:

#### 1) Option 1 – HTL constructs the facility using its own resources.

ABC Developments Ltd's ("ABCD") construction services (including the fit-out) will be standard rated unless they are zero-rated on the basis that HTL certifies that the facility (or a discrete part of it) will be used "solely" for non-business purposes.

Publicly funded research is a non-business activity, given that HTL does not provide consideration in return for the funding (in particular, there is no sharing of intellectual property derived from such research). The requirement that HTL account for the application of the funds received by it does not impact upon this analysis.

In practice, to meet the "solely" test, using any fair and reasonable method of apportionment which is not administratively burdensome and is readily auditable by HMRC, HTL must establish that the new laboratory will be used for publicly funded research to the extent of least 95%. You have said that no defined part of the building will be used exclusively for publicly funded research; accordingly, we have assumed that practical considerations preclude reconfiguring the building to secure zero-rating on part of it.

The projected non-business use of the laboratory is 82-89% - see appendix 1 – so the 95% test will not be met. For the avoidance of doubt, you should critically review the projections to satisfy yourself that there is no possibility of meeting this benchmark, for example, by changing the staff deployed in relation to publicly funded research (non-business) and privately funded research. It may also be beneficial overall to forego some of the commercial income in order to satisfy the test. As ever however, the tax considerations should never override HTL's commercial objectives.

Regrettably the 95% test is inflexible – there is no sliding scale; where objective evidence supports non-business use of 95% or more, full VAT relief will be forthcoming, but if it is 94.99%, then VAT is chargeable in full. You should aware that if the 95% test is met at the outset, but broadly within ten years of the facility's occupation, the test no longer holds good, a charge to VAT will arise, based upon the VAT relief initially secured.

Since the works will not be zero-rated, we turn to recovery of VAT chargeable.

The new laboratory is a capital project under the terms of HTL's partial exemption special method ("PESM"). Accordingly, VAT incurred on its construction is recoverable to the extent the facility is used to make supplies chargeable to VAT as a proportion of its whole use. Based on your projections, on a weighted research staff time basis, the laboratory's taxable use will be 18.00%, compared with 10.52% on projected income – see appendix 1. Both methodologies are fair and reasonable, so HTL may adopt the former basis if it is satisfied on the accuracy of the underlying data. Since the building will be a capital item, under the capital goods scheme ("CGS"), VAT initially recovered must be adjusted over, broadly, 10 years to reflect changes in its taxable use.

Based on weighted research staff time, under Option 1 the irrecoverable VAT will be £2,050,000 (£12.5million x 16.4%, with 16.4% representing the standard rate of VAT of 20% discounted by 18% to reflect taxable use). In addition, further VAT liabilities arise:

(a) Irrecoverable VAT of £22,560 (£24,000 x 94%) incurred on the preparatory works (since these works are not a "capital project" in themselves under the terms of HTL's PESM and are not directly connected with the construction of new laboratory, we consider that deductible VAT will be restricted to 6%); and

(b) £10,592 will be repayable to HMRC over 3 years on account of CGS adjustments to £50,000 VAT initially reclaimed on the Research Plot – see appendix 2.

Under this Option, the VAT cost is expensive (£2,083,152); also, HTL assumes the construction risk associated with the project, the administrative cost of overseeing the development, the tax benefits attaching to qualifying capital allowances have no value to HTL given its exempt tax status and finally, the significant cost of funding the construction of the building.

2) Option 2 involves HTL granting a superior lease to the Fund, which grants a 25-year under lease to HTL on the new laboratory.

HTL has opted to tax ("OTT") the Research Plot. For the following reasons, on the grant of the superior lease, we consider that HTL's OTT will be disapplied under anti-avoidance legislation. Accordingly, the grant will be exempt from VAT, rather than standard rated, triggering a CGS adjustment of £10,592 repayable to HMRC - see appendix 2:

(a) the Plot is a capital item subject to the CGS;

(b) HTL, as occupier, will use the building for ineligible purposes, i.e. non-business purposes.

Under this option, we consider that HTL is a "development financier" as defined in the anti-avoidance legislation. "Development financier" is widely defined and covers any person who finances the acquisition of the land or building. This is not confined to monetary funding. HMRC consider, for example, that it covers an end-user who makes a site available to a developer for no charge or less than market value where, on completion of the proposed works, the developer sells or leases back the building to the end-user. Here the consideration for the grant of the superior lease is nil.

Since HTL, as a development financier, will occupy the completed building for ineligible purposes, on the grant of the under lease, the Fund's OTT will be disapplied, thereby increasing the cost of construction from £11.5m to say, £13.8m to reflect irrecoverable VAT borne by the Fund. It is reasonable to assume that the Fund will look to recover this cost by increasing the proposed annual rent from £430,000 to say, £516,000 and/or demanding a premium. In addition, to the VAT liability of £10,592 identified earlier, HTL will incur further VAT liabilities of:

1) Irrecoverable VAT of £22,560 on the preparatory works; and

2) Irrecoverable VAT of £164,000 on the fit-out costs (represented by £1m x 16.4%).

The disapplication of the Fund's OTT makes this option expensive, particularly given that the under lease is limited to 25 years.

3) Option 3 reflects Option 2 with the Fund paying a premium of £400,000 on the grant of the superior lease.

Since the premium of £400,000 reflects the market value of the Research Plot (taking account of the cost of the preparatory works undertaken by HTL), HTL will not be a development financier. Accordingly, the disapplication issue identified under Option 2 insofar as it relates to the Fund's OTT does not apply. However, SDLT of £9,500 will be payable by the Fund on the premium, with it receiving no immediate tax relief. Since HTL's OTT will be disapplied as under Option 2, VAT of £10,592 will be repayable by HTL to HMRC over 3 years to reflect the consequential CGS adjustments. Although the grant of the under lease would normally be chargeable to SDLT, since HTL is a registered charity and the "greater part" i.e. more than 51% of the leasehold interest acquired by it will be used in furtherance of its charitable objectives, HTL may claim the charities' exemption on its SDLT return. The relief will be clawed back if, within three years of the transaction, the building ceases to be used largely for charitable purposes, for example, it is used principally for commercial research.

## Conclusion/advice

Our preferred option is Option 3 as it defers HTL's VAT cost over an extended period, compared to Option 1, with the Fund assuming the construction risk. Further VAT savings will accrue to HTL if the Fund met the fit-out costs and the preparatory works, with the benefit of capital allowances accruing to it. This could be reflected by HTL reducing the premium payable on the grant of the superior lease (reducing SDLT charge which will fall on the Fund), or by the Fund increasing the rent payable on the under lease (although, in the latter case, this would increase HTL's irrecoverable VAT on the rent by say, £7,500 p.a.).

### 4. Capital allowances.

HTL's activities are exempt from corporation tax. Where HTE's trading activities are chargeable to tax, taxable profits are sheltered by the gift aid payments made to HTL (subject to HTE having sufficient distributable reserves and funds to make the payments). Accordingly, the tax relief accruing from capital allowances is academic for the HTL group.

That is not so with the Fund. Since the Fund and HTL are not connected persons, if the Fund met the cost of the fit-out works, it could obtain immediate tax relief in the form of the annual investment allowance of 100% on plant and machinery. The qualifying amount will depend on the accounting period for the Fund. Until December 2020 there is a limit on cost of £1m; from 1 January 2021 the limit is up to a cost of £200,000. The accounting period is split into two periods, with the period post 1 January 2021 time apportioned by the £200,000 limit. The balance of expenditure on plant and machinery is eligible for writing down allowances at the rate of 18% on a reducing balance basis.

### 5. Importation of Triterpene Designer

Under the options put forward by SPI, the triterpene designer's importation into the UK is subject to both Customs Duty and Import VAT. The exemption from duty of scientific instruments and apparatus to be used exclusively for non-commercial purposes have no application here; similarly, nor does the relief on temporarily imported goods given that the equipment will remain in the UK for more than 2 years.

Our conclusions on the Customs Duty and VAT implications of SPI's proposals are:

1) Basis (A): outright purchase of Triterpene designer for \$1.655m (inclusive of freight and insurance of \$5,000), assuming a conversion rate of \$1.00 to £0.85.

We calculate the duty and Import VAT will be:

	<b>£</b>
Agreed price, inclusive of freight & insurance to UK port of entry	1,406,750
Customs duty - £1,406,750 @ 3.70%	52,050
VAT payable - £1,458,800 @ 20%	291,760
Total duty and Import VAT payable	<b>£343,810</b>

Since the Triterpene designer is not a "capital project", HTL will incur irrecoverable VAT of £274,254 (under HTL's PESM, £291,760 falls to be treated as non-attributable input tax, with 6% deductible). Also, since there is no relief for Customs Duty, the duty payable of £52,050 will represent an absolute cost to HTL.

2) Basis (B): an operating lease for a term of 5 years at £24,480 p.m. (£21,607, excluding interest), net of VAT.

As under Basis A, Customs Duty and Import VAT will be chargeable on the importation of the Triterpene designer.

Under this Basis, title to the Triterpene designer will pass to HTL if it exercises its option to make a final payment of \$125,000 at the end of the lease. That being so, we need to establish whether SPI's supply is one of goods or services.

Where possession of goods is transferred under an agreement which expressly contemplates that title to them also will pass at some time in the future, but no later than when the goods are fully paid for, the transaction is considered to be a supply of goods, rather than services, with differing VAT consequences. If the transaction is a supply of goods, SPI is required to register and account for VAT in the UK, with an entitlement to deduct in full VAT chargeable on importation.

Drawing upon caselaw, where a leasing contract contemplates an option to purchase, a supply of goods exists only where the exercise of the option is the sole economic rational choice available to the lessee. If that is not so, the supply is classified as one of services.

Here the option payment is relatively substantial and approximates to the Triterpene designer's market value. Against this background, we consider that exercising the option to purchase is not the only economically rational choice available to HTL; accordingly, the proposed lease represents a supply of services, not goods, with VAT chargeable as and when the monthly lease payments are due. Since SPI does not have an establishment in the UK, under the reverse charge mechanism, the obligation to account to HMRC for output VAT on the lease payments (as well as the option payment of \$125,000 where exercised by HTL) is shifted to HTL, with it recovering as input tax 6% of the output VAT.

Although the parties envisage that HTL will arrange for the Triterpene designer's customs clearance on its importation and to meet the cost of all duties and taxes payable, under this option, HTL cannot recover the import VAT paid since SPI retains title to the equipment and is to use it in furtherance of an economic activity undertaken in the UK. While HMRC allow a person established and registered for VAT in the UK to import and make an onward supply on behalf of its non-EU principal, this facility will not apply here since SPI will be making supplies in the UK.

While SPI expects HTL to meet the "cost of all duties and taxes payable on importation", for Basis (B) to be a workable option, SPI will have to fund the VAT payable on importation and recover it from HMRC under the refund scheme pertaining to business established outside the EU. HMRC's guidance is to be found in sections 5 & 6 of Notice 723A. This is a matter which must be taken up with SPI.

It will facilitate the smooth importation of the Triterpene designer if SPI authorises HTL to act as its agent. In assessing the Customs Duty payable, the valuation of the Triterpene designer is predicated on a hierarchy of 6 methods which normally must be considered in turn. Method 1 will not apply since it is based upon the transaction price on a sale. Given the equipment's specialist nature, it seems improbable that Methods 2-4 apply i.e. the transaction value of identical or similar equipment. Method 5 is based on the Triterpene designer's cost of production, plus SPI's profit and the cost of delivery to the port of entry. It is unlikely that SPI would be willing to disclose this commercially sensitive information to HTL. That being so, the Triterpene designer must be valued under Method 6.

Under Method 6, the Triterpene designer may be valued on any fair and reasonable basis, including the proposed transaction value under Basis A i.e. £1,406,750. Alternatively, and in line with HMRC's published guidance, it could be valued by multiplying the monthly rent payable of £21,607 (net of interest) by its expected economic life of 6 years. That would produce a higher valuation of £1,555,704 (Examiner's note: reasonable alternative calculations will be accepted). Accordingly, the proposed transaction value should be used which produces a Customs Duty liability of £52,050. As agreed, it will be borne by HTL, with SPI meeting the cost of VAT payable of £291,760 on importation but ultimately recovering the tax paid from HMRC. HTL should insure that Import VAT Certificate (C79) is passed to SPI to support its claim for the refund of the tax paid.

Under Basis (B), over 5 years, HTL will incur irrecoverable VAT of £296,109 ( $£[28,800 \times 60 + 125,000 \times .85] \times 20\% \times 94\%$ ) compared with £274,300 under Basis (A). On balance, we consider Basis (B) to be the preferable option as it defers HTL's VAT cost over an extended period.

Finally, turning to matters that should be considered if HTL is the designated importer of the Triterpene designer. Our observations here apply equally to both options put forward by SPI. As importer, you will need an EORI number which may be obtained through an online application. Since HTL will not be importing goods regularly, we recommend that it appoints a customs agent to handle the clearance of the Triterpene designer, providing it with the appropriate commodity code and its import value as detailed above. As the agent will be acting as a 'direct' representative, HTL will be solely liable for underpayments of duty and VAT. As evidence of payment of the VAT due, HTL will receive a C79 certificate which it must pass to SPI. Although HTL could defer the payment of duty and VAT for 14-15 days by setting up a duty deferment account, given that HTL is unlikely to use this facility in the future, it will not be cost effective, but it may secure a small cashflow saving by using its appointed agent's deferment account.

**Pannell & Andrews LLP**

12 May 2020

## Appendix 1

### **Horticulture Technology Ltd**

Construction of new laboratory - the “solely” test.

In accordance with HMRC’s published guidance, the solely test will be met if, on any fair and reasonable basis, the facility will be used to the extent of at least 95% for publicly funded research. Based on the information supplied, the following methodologies have been considered:

1) Income accruing from its use of the facility

Projected non-business income of £1.7m as a proportion of total projected income of £1.9m is 89.48%. For this method to be acceptable, there must be a correlation between the relative proportion of non-business to business income and their associated costs.

2) Weighted research staff time

Time attributable to non-business activity:  $(100 \times 90\%) + (25 \times 50\%) = 102.50$ .  
Non-business weighted time as a proportion of total:  $102.50/125 = 82.00\%$ .

Using either methodology the benchmark of 95% is not met.

## Appendix 2

### **Horticulture Technology Ltd**

Research plot – CGS adjustments:

Input tax	£50,000.
First interval (note 1)	2014/15.

1) Adjustments of £10,592 consequential upon the change in taxable use:

Tax year 2021/22 (note 2)	$\text{£}50,000/10 \times (100 - 18\%) \times 7/12 = \text{£}2,392$ repayable to HMRC on the 30 September 2022 return.
Tax years 2022/23 – 24	$\text{£}50,000/10 \times (100 - 18\%) \times 2 = \text{£}8,200$ (£4,100 repayable on the returns for the periods ending 30 September 2023 & 2024).

2) Adjustment of £10,600 consequential upon the grant of the superior lease (to be reflected in the September 2022 Return).

Notes:

- 1) The first CGS interval of the Commercial Land is 2014/15, with exclusively taxable use until September 2021.
- 2) Under Option 1 (construction of the new laboratory by HTL utilising its own resources), we have assumed that taxable use of the laboratory throughout the CGS period will be 18% (on a weighted research time basis).
- 3) Under Option 2, the grant of the superior lease represents a part disposal of the Commercial Land. No attempt has been made to quantify taxable use of HTL's freehold reversion after September 2021.