

The Chartered Institute of Taxation

Application and Professional Skills

VAT and Other Indirect Taxes

May 2022

Suggested solution

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[] May 2022

Dear Debbie,

New Business Opportunity

Thank you for your letter dated [] May 2022 outlining these exciting new proposals for the Personal Care Suite ("PCS") at "Wychwood".

Based on the information you have provided my advice and recommendations are set out in this letter. No doubt, you will wish to share it with Joanne, but otherwise it is intended for your personal use. I note that Joanne is not currently one of our clients. However, subject to the usual rules, my firm would be pleased to act for her too.

Overview

An initial consideration is whether, given the increase in your fixed costs and overheads, you will continue to be able to trade profitably through the agreement with Curabimus plc. I recommend preparing cashflow projections based on various scenarios. I should be happy to assist. Subject to this, your choice of business structure will depend upon a number of factors:

1. Foremost, is what you wish to achieve commercially with Joanne.
2. Merle's position is also relevant, in particular whether she is to operate her own business or become your employee.
3. Tax and commercial considerations will influence these decisions, including how, and in what form, you each wish to receive income/extract profits.
4. At present, neither you nor Joanne are VAT-registered. The new venture will increase turnover. Accordingly, depending on what business structure you choose, registration will at some stage become an issue. If advantageous, voluntary registration can be considered. The proposed lease with Curabimus plc also gives rise to VAT and other tax issues.

I will now consider these matters in more detail, concluding with my advice and recommendations.

Business structure

Three possible structures should be considered. You and Joanne could:

- a) continue to operate separately as sole traders.
- b) form a partnership, or limited liability partnership ("LLP").
- c) incorporate a limited company.

If Merle operates the second chair in the salon, she could either do so as a sole trader or as an employee. I assume you are not considering Merle as a partner/shareholder at this stage. But if this is incorrect, please let me know.

a) Sole traders

Currently, both you and Joanne carry on separate businesses. Your profits, after deduction of allowable expenses and capital allowances, are chargeable to income tax. You must also pay National Insurance Contributions ("NICs") under Class 2 and Class 4. For VAT purposes, hairdressing and beautician services are, in principle, taxable supplies chargeable at the standard rate of 20%.

However, VAT is not currently an issue as your turnover is below the annual registration threshold (currently £85,000). Once you begin operating the PCS, however, you expect turnover to increase significantly. Should you continue as sole traders, however, it may be some time before either of you exceeds the threshold. This is important because your customers are private individuals for whom VAT is a cost. Pricing, therefore, may well be an issue if you are to compete in the market and maintain margins.

Currently, your two businesses are distinct. This may become less clear-cut once you begin trading at the PCS. If, therefore, your businesses are to remain separate, this must be reflected by the arrangements you put in place and supported by appropriate documentation. Joanne would need to exercise control over the beauty treatment room (“BTR”) and operate it as an independent business. From the income tax perspective, it is important to avoid challenge from HM Revenue and Customs (“HMRC”) that, for example, Joanne is your employee. The consequence would be your having to operate PAYE as respects her income. You would also be liable to collect employee NICs under PAYE. The BTR takings would be treated as part of your turnover.

From the VAT perspective, a special “disaggregation” rule is also relevant. This is aimed to prevent the contrived splitting of a business to avoid VAT. Where two or more businesses are closely linked to one another by financial, economic or organisational links, HMRC may issue a direction treating those businesses as a single business. A common example is where spouses run a pub together (one claiming to supply drink, the other food, both apparently trading below the VAT threshold). HMRC cannot issue a retrospective direction. However, it is important not to run the risk of such challenges.

Steps to support the existence of separate businesses would include entering into a formal agreement with Joanne granting her exclusive use of the BTR, and charging a market rent, together with appropriate charges for the use of any shared facilities and services.

Similar considerations (income tax, NICs and VAT) apply to Merle, which I consider below in relation to the second chair.

b) Partnership

An ordinary partnership is used when two or more persons wish to pool their skills and carry on their business in common. Partners’ rights and obligations should be set out in a written agreement. You can agree that partners contribute different amounts of capital and share differently in profits and losses. The liability for debts of the partnership is unlimited unless an LLP is used. An LLP is constituted as a body corporate and may involve increased set-up and compliance costs. Moreover, accounts must be filed as public documents at Companies House. Liability to third parties, however, is limited. This protection needs to be balanced against the administrative and other burdens.

Each type of partnership is “transparent” for income tax purposes: namely, one looks through the partnership to tax the partners as individuals. Accordingly, each partner must file her own self-assessment return. Each partner is liable for income tax on her profit share (after deduction of allowable expenses and capital allowances) with payments being made in January and July each year as you do at present. Class 2 and Class 4 NICs are chargeable. A partner may, by agreement, take periodic drawings on account of her estimated profits (topped-up by a further profit distribution based on the accounts). A separate partnership return is required for compliance purposes.

A partnership may employ staff. Wages and employee NICs are an allowable expense. The partnership must operate PAYE to collect and account for income tax and Class 1 NICs. In addition to paying employer NICs, employers must also offer provide certain protections imposed by employment law (e.g., minimum wage, sick and holiday pay and a workplace pension). These may add considerably to the cost of employing staff.

Where VAT registration applies (see below), registration is in the name of the partnership. VAT returns must be made, declaring the amount of VAT charged on taxable supplies (“output VAT”).

From this you may deduct VAT on expenditure (“input VAT”). The net VAT is paid to, or repaid by, HMRC. All partners are jointly and severally liable for any VAT due.

If you and Joanne form a partnership, you would not suffer any adverse tax consequences on transferring the assets of your existing business into the partnership, or when contributing any additional partnership capital. Interest on loans taken out for this purpose is allowable against income tax. In general, for VAT purposes, partners are not treated as making any supply to each other when using partnership property in the course of the business.

c) Limited Company

A limited company is a separate legal person from its shareholders. On a winding-up, liability to third parties is limited to the capital invested. Except in cases of fraud, directors are not liable for its debts. Incorporation would involve certain administrative and tax costs and, for larger companies, the costs of an annual audit.

A company is chargeable to corporation tax on its trading profits, currently at the rate of 19%. As directors, you could take income either in the form of salary, or dividends, or a combination of the two. Income taken as salary is chargeable to income tax and Class 1 employee NICs. Newco would be required to file P11Ds, operate PAYE and would also be chargeable to employer NICs (currently the rate is 13.8% on salaries over the secondary threshold of £8,844). Employment costs, however, are an allowable deduction against corporation tax.

Newco may pay dividends to its shareholders out of net profit after corporation tax. Dividends are not chargeable to employer or employee NICs. An annual allowance of £2,000 is given to each shareholder receiving a dividend. The dividend is then subject to income tax, but this is at the dividend rate, namely 7.5% on dividends falling within your basic rate band, or 32.5% on dividends within your higher rate band. The dividend rate, therefore, is lower than normal income tax rates. However, as dividends are paid out of Newco’s profit after corporation tax, the effective rates are actually higher although, to an extent, this is offset by the saving of NICs. It is generally more tax efficient, where the profit is sufficient, to take profits by way of dividend rather than as salary.

The second chair

If Merle is not to be a partner/shareholder in the venture, there are three options for operating the second chair. Merle could be:

- a) an employee.
- b) an independent contractor, supplying her services to the salon;
- c) a self-employed hairstylist, supplying her services direct to customers.

Under a), Merle would be employed by you, the partnership or the company (depending on which structure you choose). Takings from the second chair would form part of salon turnover. Income tax, NICs and other employment issues would be as described above.

Under b), in principle Merle would not be an employee. Instead, she would take income in the form of a service fee. As in a) above, takings from the second chair would form part of salon turnover. Merle would be liable to income tax and Class 2 and Class 4 NICs as a self-employed person. However, the arrangements would have to be robust enough and suitably documented to withstand an HMRC challenge. HMRC have regard to a number of factors, e.g., whether Merle has autonomy, bears business risk, insures against third party liability, provides her own tools, has other potential sources of business income. If, in substance, the relationship between you is one of employer/employee, HMRC are likely to challenge it, particularly if they consider the aim is to avoid employer NICs.

The effect of option c) is that Merle is self-employed. She would pay a rental to the salon for use of the second chair but its takings are her own turnover. Historically, such arrangements have generated much caselaw, where HMRC have alleged that the aim is to avoid VAT. Pursuant to an Agreement with the National Federation of Hairdressers, HMRC now accept these arrangements are permissible

provided the chair renter has control over all aspects of her business, is responsible for all risks, tax and regulatory compliance and is free to set her own prices. This must be evidenced by a written agreement. The VAT legislation provides that chair rentals now count as taxable supplies for VAT purposes. As already stated, however VAT is not an issue while your business is unregistered, though if you adopt option c), any chair rental charged to Merle would count towards the VAT threshold.

I will now look in more detail at VAT and its relevance to the proposed lease.

VAT

A business (whether sole trader, partnership or company) is required to register where the value of its taxable supplies in any period of twelve months then ending has exceeded £85,000. As already noted, supplies of hairdressing and beautician services (including sale of products) are taxable supplies. The grant of exclusive occupation of a defined area in a building is VAT-exempt. If the grantor waives exemption (opts to tax) the supply is taxable, in a similar way to the chair rental in a salon, or where an agreement is for shared use of facilities. Taxable supplies are widely defined and can include, for example, an agreement to undertake works in return for payment in money or money's worth.

Where a business is VAT-registered, it must charge and account for VAT on its taxable supplies but is entitled to deduct VAT on expenditure used, or to be used, for the purpose of making taxable supplies. I note from your 2021/22 Accounts your allowable expenses totalled £14,405. If these all bore VAT (except for £240 bank charges which are exempt) and you had been VAT registered, input VAT of £2,360 would have been deductible, increasing your net profit. The downside of VAT registration, of course, is the need to account for VAT on supplies. This means increasing prices if margins are to be maintained. Setting prices is a commercial decision, taking account of a number of factors such as the existence of any competition and what the market will bear.

If you and Joanne form a partnership, or incorporate a company, I think it likely you will cross the VAT threshold sooner or later and the issue will need to be addressed. A business already making taxable supplies but below the threshold is entitled to apply to HMRC for voluntary registration. This is often done where the business incurs significant input VAT and/or the addition of VAT to prices will not damage its competitive position. In addition, when a business registers, there are reliefs allowing reclaim of certain pre-registration VAT (e.g., on goods in stock which were purchased within 4 years and on services purchased within 6 months before registration).

The issue of VAT recovery is relevant for the lease, to which I now turn.

The proposed lease

You are responsible for fitting-out works, estimated to cost £20,000. These are likely to be VAT-able (£4,000). From June 2024, rent and service charges become payable. As Curabimus plc has opted to tax, these will also be VAT-able. The rent-free period and contribution are inducements to enter into the lease. HMRC generally disregard rent-free periods unless some specific service is provided in return. I do not consider there is such a service here. Where, however, a landlord makes a contribution to a tenant for the purpose of undertaking fitting-out, this is treated as a supply of services by the tenant to the landlord. It follows, in my view, that the £15,000 contribution will form part of your turnover and count towards the VAT threshold. Accordingly, you should seek the agreement of Curabimus plc that if VAT is applicable this may be added (£3,000) to the contribution. Curabimus plc should be entitled to deduct this as input VAT.

Depending on their nature, fitting-out works may qualify for 100% capital allowances. When a landlord makes a contribution, as here, the landlord normally reserves the right to claim allowances. However, Curabimus plc may be willing to agree to your claiming capital allowances and this should be discussed as part of negotiations. In any event, you should be entitled to claim such part of your own costs (c. £5,000) as relates to qualifying expenditure. I can advise further on this if I have details of the works.

A couple of other points are worth mentioning. In principle, a tenant is liable for stamp duty land tax ("SDLT") on the premium (if any) and the net present value of the rent including VAT. However, no SDLT is chargeable here as the transaction falls within the 'Nil' rate band for non-residential property.

There are some commercial points regarding the lease: e.g., responsibility for repairs and maintenance; insurance; what is covered by the service charge; access and security; car parking. These are matters for negotiation. Importantly, you should also ensure that Curabimus plc are agreeable to grant, or assign, the lease to any new entity you and Joanne decide to form.

Advice and recommendations

The decision about which business structure to adopt involves balancing commercial considerations, including how much you wish to draw as regular income or defer for later distribution, as well as comparing the impact of the various taxes in play.

I understand your wish to pool your talents with Joanne and undertake the new venture together. This points in favour of immediately forming a partnership, or alternatively, becoming shareholders and directors in a company. Remaining as sole traders, of course, would not achieve your aspirations in any meaningful way. However, if your respective services are price-sensitive, it is desirable to put-off VAT registration as long as possible in order to preserve margins. The downside is the inability to recover input VAT (in particular on the start-up costs, fitting-out and, in due course, the rent and service charge).

For the reasons explained above, however, it is essential to put in place robust and well-documented arrangements if the continuance of sole trader status is to be credible and avoid HMRC challenge.

I recommend we undertake a cost/benefit analysis, taking account of the timing of expenditure and when the VAT threshold is likely to be crossed, to decide whether this option is worth pursuing. You can easily convert to a partnership or company at a later date.

The position of Merle is also relevant. She has never operated her own business. Given the modest level of her earnings, she may be unwilling to embark on this and meet the stringent conditions (which also increase the risks of HMRC scrutinising the arrangements). Importantly, you may not wish to give Merle the freedom to set her own prices. On balance, therefore, I recommend you take on Merle as an employee. This will entail the costs already described, but these are allowable deductions against tax.

Using a partnership or company will better achieve your and Joanne's aspirations, and if this is a very major factor, you may wish, therefore, to consider this immediately. Your combined turnover will make compulsory VAT registration more imminent. If pricing is not a concern, an immediate voluntary registration would entitle recovery of all related input VAT and this is an important factor to be weighed in the balance.

As regards the choice of structure, I consider an LLP to be preferable to an ordinary partnership as you would benefit from limited liability. Newco would also have limited liability. The choice between an LLP and company depends mainly on whether you wish to extract profits as partner drawings or as shareholder director remuneration. The impact of taxation is different.

If you use a company, it is most tax-efficient to draw a salary below the NI threshold and top it up with dividends. This could give you a slightly higher income overall than an LLP. However, the higher the salary drawn, the higher the tax burden and there will come a point when, overall, an LLP is likely to yield a higher income. Another factor is the increased compliance burdens of using a company. I attach an illustration based on a number of assumptions, which you may find helpful.

Finally, in relation to VAT, I should mention the Flat Rate Scheme ("FRS"). The FRS is a simplification measure benefitting businesses whose annual turnover is below £150,000. For hairdressing and

beautician services the flat rate is 13% (12% in the first year), thus you would pay less VAT on your sales.. The downside is that no input VAT is deductible. There is an exception for “capital expenditure”. We should need to consider whether the fitting-out qualifies, and if so, I would recommend that we adopt this when we apply for VAT registration.

I hope I have covered all your questions, but please do not hesitate to contact me if I can assist further.

Yours sincerely,

Derya Tarhan
Tax Manager

Enc.

EXAMPLE CALCULATION COMPARING LLP WITH A LIMITED COMPANY

Two partners, sharing 50/50

Net profits: £100,000

Personal allowance: £12,570

Income tax (basic rate) 20%

NICs: Class 2, £158 pa; Class 4, 9% of annual profits over £9,568

Tax charge per partner

	£
Income tax (£50,000 - £12,570) = £37,430 @ 20%:	7,486
NICs, Class 2:	158
NICs, Class 4 (£50,000 - £9,568) = £40,432 @ 9%:	3,639
Total tax	11,283

Partner take-home pay (£50,000 - £11,283) = £38,717

Assumptions (Company):

Two director shareholders. Each draw £12,570 salary plus dividends

Taxable profit (excluding directors' remuneration): £100,000

Corporation tax rate: 19%

Dividend allowance: £2,000 pa

Dividend rate: 7.5%

Personal allowance and basic rate as above

NICs (Class 1 employer): 13.8% on earnings over £8,844

NICs (Class 1 employee): 12% on earnings over £9,568

Tax charge (Company)

Profit:		£	100,000
		£	
Less:			
2 x director salaries:	25,140		
Employer NICs (£25,140 - £17,688) = £7,452 @ 13.8%:	1,028		
	26,168		<u>(26,168)</u>
			73,832

Less corporation tax @ 19% = £14,028 (14,028)

Amount available for distribution 59,804

Tax charge per director

	£
Income tax on salary:	Nil
NICs, Class 1 (£12,570 - £9,568) = £3,002 @ 12%:	360
Dividend tax (£29,902 - £2,000) = £27,902 @ 7.5%:	<u>2,093</u>
Total tax	2,453

Director take-home pay (£12,570 + £29,902 = £42,472 - £2,453) = £40,019

Note: will become less tax-efficient as salary increases, due to increased employer NICs and reduced profit available for distribution as dividends.