The Chartered Tax Adviser Examination

November 2020

Application and Professional Skills

VAT and Other Indirect Taxes

Suggested solution

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Dear Rosa

New Offices

Thank you for your letter dated 5 November 2020, with enclosures, explaining the proposed lease and fitting-out of your new offices.

Based on the information you have provided, my advice and recommendations on the tax implications of the proposals are set out in this letter which is for the sole use of Frictionless Trade Association ("FTA") and its subsidiary company FTA (Properties) Ltd ("Properties").

I am not advising Paulton Estates Ltd ("the Landlord") or Shofra Solutions Ltd ("Solutions") although some of my comments may be relevant to their tax positions.

Executive summary

1) As currently structured, the proposals will not entitle deduction of any Value Added Tax ("VAT") either on the fitting-out works or the rent. This is because Properties, the Tenant, is not a taxable person and cannot therefore recover VAT. Although some of the VAT on the works can be passed on to the Landlord as part of its contribution ("the Contribution"), the Landlord is unlikely to be entitled to deduct this VAT.
2) Unfortunately, the suggested alternative invoicing will not secure deduction of input VAT on the works. This is primarily because neither the Landlord, nor FTA, would be the recipient of Solutions' supply.
3) My main recommendation, therefore, is for the lease to be restructured such that FTA is substituted as Tenant in place of Properties and for FTA to undertake the works. This will probably require FTA to convert to corporate status (which indeed you already plan to do). As Tenant, and a taxable person, FTA will be entitled to deduct VAT on the works and on the rent at its residual rate (currently 60%). If, however, Properties remains as the Tenant, a similar result could be achieved if Properties and FTA apply to HM Revenue & Customs ("HMRC") to form a VAT group.
4) VAT grouping is only available if FTA converts to corporate status [*See Examiner's Note below*]. Grouping is beneficial as supplies between FTA and Properties would be disregarded. A single return is made and any supply to, or by, any member of the group, is treated as made to, or by, the group member who has been nominated as the representative member.
5) SDLT will only be chargeable on the VAT-inclusive rent. This is calculated using a net present value calculation and will be £24,747. However, if FTA becomes a charity it can claim SDLT exemption.
6) Some limited relief from corporation tax, in the form of Annual Investment Allowance and Structures and Buildings Allowance, may be available for FTA, but only to the extent expenditure on the works relates to its trading activities and is actually incurred by FTA.
7) FTA will not be liable to VAT or corporation tax on the Contribution.

I will now cover these issues in more detail.

VAT: tests for deduction

As you imply in your letter, the current proposals are VAT-inefficient. They do not enable deduction of VAT incurred on any of the works you propose to carry out or on the rent. For VAT to be deductible, the following four tests must be satisfied:

1) The person claiming input VAT deduction must be a taxable person.
2) The taxable person must be the recipient of the supply on which VAT has been charged.
3) The expenditure must be used, or to be used, by that person for the purposes of transactions which give rise to the right to deduction (generally, taxable supplies).
4) Before deducting VAT, the taxable person must hold a valid VAT invoice issued by the supplier.

I shall consider each in relation to the proposals.

Taxable person

Properties is not VAT-registered, or entitled to be, as it does not currently make any supplies. Therefore, Properties is not a taxable person.

Recipient of supply

Properties will contract with Solutions for a single composite supply of services comprising the Tenant's Ventilation Works and the Tenant's Works. Properties will be the Tenant under the Lease. Properties is the recipient of those supplies and is contractually liable for paying Solutions.

Use of expenditure

As Properties is not a taxable person, the expenditure will not be used for supplies which entitle deduction.

Tax invoice

A supplier is required to issue a VAT invoice for the supply, but only to the recipient, namely Properties.

Accordingly, Properties would satisfy test 4) but not tests 1) to 3).

The Lease enables Properties to claim reimbursement of irrecoverable VAT, but only up to £40,000. This would not, however, include the balance of VAT of £20,000 on Solutions' supply or on the rent.

FTA, of course, is a taxable person. However, under the proposals, FTA is not a party to the contracts with Solutions or the Landlord. As FTA is not the recipient of these supplies, it cannot treat any of the VAT as its deductible input VAT. It may be suggested, based on the old case of *Redrow* that Properties has contracted for FTA to receive the benefit of the supplies and may therefore be treated as the recipient. The facts of *Redrow*, however, were very different and its scope has been limited by later decisions such as *Aimia* and *Airtours*. HMRC are likely to challenge such an approach and I recommend against it. It follows, therefore, that FTA will not satisfy tests 1) to 4) above.

Revised invoicing

You have suggested two possible solutions: either Solutions invoices the Landlord for the total cost of the Tenant's Ventilation Works (and you reimburse the Landlord for any amount exceeding the Contribution); alternatively, Solutions invoices FTA for the cost of such works (and FTA recharges the Landlord up to the amount of the Contribution). Unfortunately, neither of these routes will overcome the problem. I will explain why.

As to the first, Solutions has no contract with the Landlord. The Landlord would not, therefore, be the recipient of a supply for the purposes of its business and would have no entitlement to deduct the VAT charged by Solutions. Tests 2) to 4) above would not be satisfied. If Solutions were to issue a VAT invoice to the Landlord for the Tenant's Ventilation Works (or a part of such works), this would

breach VAT law and could result in penalties. It would not, of course, enable Properties to recover the VAT chargeable for the rest of Solutions' supply and on the rent.

The second alternative, faces similar obstacles, as follows:

1) It would conflict with the Lease which requires Properties to contract, and pay, for the works. HMRC are unlikely, therefore, to accept that FTA is the recipient of Solutions' supply, in particular as FTA is not the Tenant.

2) Even if HMRC were to accept that FTA was the recipient, FTA could only deduct VAT incurred for the purposes of its own taxable business. As occurred in the *Airtours* case, HMRC are likely to challenge this.

3) To enable deduction, FTA's recharge to the Landlord would have to be a taxable supply to which the whole of the costs of the works could be attributed. This would not be the case. The reason for this is that the Contribution is not consideration for any supply to the Landlord. It is outside the scope of VAT. (This treatment is confirmed by HMRC in VAT Notice 742).

4) If FTA were to provide finance in the form of paying for the works, FTA might be regarded as a "development financier" in respect of the building. This would trigger anti-avoidance provisions which would result in the Landlord's option to tax being disapplied. The Landlord would then seek to increase the rent which, although VAT-exempt, would bear "hidden VAT" (none of which could be recovered).

I therefore recommend against your revised invoicing suggestions.

For the sake of completeness, I should mention that Condition 9 in the Heads of Terms (which requires "VAT invoices" to be provided to the Landlord before the Contribution can be drawn down) does not create a supply to the Landlord. It must be interpreted as a reference to invoices issued by the contractor (Solutions), which the Landlord requires as evidence that the Tenant's Ventilation Works have been duly carried out.

<u>Solving the problem</u>

I have considered whether the problem could be solved if Properties were to become a taxable person. Unfortunately, there are difficulties. A landlord's contribution is not a reverse premium since, as noted above, it is not consideration for any supply by the tenant to the landlord, and so is outside the scope of VAT. The same VAT treatment applies to a rent-free period. This would also be outside the scope of VAT unless the tenant performs a distinct service in return (such as helping to market a commercial building, intended for multiple occupation, by agreeing to act as "anchor tenant"), in which case there is a standard rated supply (as the Court suggested in the *Mirror Group* case). This does not appear to be the factual situation here.

If Properties were to grant a formal licence or sub-lease of the building to FTA this would, in principle, create a supply of property letting for VAT purposes. Such a supply would be VAT-exempt. It would not entitle Properties to deduct any related input VAT. If, however, Properties opted to tax the building, this would, in theory, turn it into a taxable supply. Unfortunately, on the facts here, the option would be disapplied by anti-avoidance legislation. This is because Properties would become a "developer" incurring fitting-out costs of not less than £250,000. This would make the building a "capital item" within the meaning of the capital goods adjustment scheme ("CGS"). FTA and Properties are "connected" and the building would become "exempt land" (i.e. FTA would be in occupation of it while unable to deduct input VAT in full), Unfortunately, therefore, it will not be possible for Properties to satisfy test 1) above for VAT deduction.

I have, however, identified a route which will produce a more VAT-efficient result. FTA is a taxable person currently deducting around 60% of its residual input VAT. If FTA is substituted as Tenant, FTA would be entitled to deduct VAT on the rent at its residual rate. FTA, as Tenant, would also be responsible for carrying out the Tenant's Ventilation Works and the Tenant's Works. FTA would be able to deduct VAT on Solutions' invoices for all these works at its residual rate. FTA could claim irrecoverable VAT (which I estimate at £16,000) from the Landlord, which would also reduce the

Landlord's costs (by about £24,000). Substituting FTA as Tenant in place of Properties would require amendment of the Heads of Terms but, as FTA effectively funds Properties, the Landlord is unlikely to refuse. One potential problem is that, currently, FTA is an unincorporated association composed of its members for the time being. I assume the reason for incorporating Properties was to hold office leases. If FTA were substituted as Tenant it would be necessary for its Council to enter into the lease, which may not be possible under the Constitution. I understand, however, that FTA is shortly to convert to corporate status by becoming a company limited by guarantee. This would, of course, overcome the problem. I recommend FTA defers entering into a formal lease until corporate status is achieved. [*Examiner's Note - Candidates will receive appropriate credit for mentioning that new group eligibility rules (which apply from 1 November 2019, see Schedule 18, Finance Act 2019) may enable FTA to remain unincorporated but apply to form a VAT group with Properties*.]

If, however, from a commercial perspective, you wish to retain Properties as the Tenant, a further opportunity arises to achieve VAT savings. If FTA becomes a company limited by guarantee ("F Co"), it would be eligible to apply to HMRC to form a VAT group with Properties. The effect of grouping is as follows:

1) Group members are treated, for VAT purposes, as a single taxable person carrying on business through whichever member is nominated as the representative member.
2) Any supply by a third party to any member of the group is treated as made to the representative member.
3) Any supply by a group member to a third party is treated as supplied by the representative member.
4) Supplies between group members are disregarded.
5) Input VAT is deductible by the representative member to the extent the group's expenditure is used, or to be used, for supplies to third parties which give rise to the right to deduct.
6) A single VAT return is made by the representative member. All group members are jointly and severally liable for VAT due from the representative member.

Suppose, therefore, that F Co was the representative member: VAT on supplies by the Landlord and Solutions would be deductible at the group's residual rate. Consequently, if Properties remained as Tenant, the deduction position would be the same as if FTA had been substituted as Tenant.

Grouping could create further VAT advantages. For example, as transactions between group members are disregarded, this would avoid any potential problems about sub-letting and inter-company charges, assuming you wish Properties to remain in existence. Furthermore, should F Co wish to create new subsidiaries (for example, to ring-fence the supply of merchandise or publications) it could include these within the group.

I recommend, therefore, that FTA presses ahead with converting to corporate status and forming a VAT group.

Two further VAT points arise on the works. First, the works form a composite supply of services. A separate supply is treated as made each time Solutions receives a payment or issues a VAT invoice (to the extent covered by the payment or invoice). The stage payments, spread over nearly three months, are for the works as a whole. Drawdown of the Contribution, however, is based on Certificates and VAT invoices and may occur monthly. I recommend you explore with Solutions whether they are willing to align the payments to avoid this mismatch and reduce any cashflow disadvantage you might otherwise suffer. The second point is that, as already noted, the works will be a CGS item (because works valued at not less than £250,000 have been carried out to a building). Under CGS rules, an annual adjustment to VAT deducted will be required where there is a change in the recovery rate. Assuming you adopt my proposals (FTA becomes Tenant or the parties form a VAT group, or both) and FTA's VAT recovery rate falls, annual CGS adjustments will need to be made as part of your partial exemption calculations. I can advise further on this if required.

SDLT [Note – Scots Law Candidates may answer by reference to LBTT]

As currently structured, SDLT will be chargeable on the lease. This is calculated on the chargeable consideration, at the rate bands applicable for non-residential property, on the effective date the lease is granted.

No premium (which would otherwise be liable to SDLT) is payable and, provided three conditions are satisfied, the fitting-out works do not form part of the chargeable consideration. These are:

1) The works are carried out after completion.
2) The works are on land which the tenant occupies.
3) It is not a condition of the lease that the works are carried out by the Landlord or a person connected with the Landlord.

These conditions will be satisfied here. As the Tenant is responsible for the Tenant's Ventilation Works and merely receives the Contribution, I do not consider the third condition is breached. It would be breached, however, if the Landlord were made contractually liable for those works. The value of the Contribution would have to be included as part of the chargeable consideration, which would increase the SDLT liability.

The rent payable under the lease is substantial. SDLT will be chargeable on the net present value ("NPV") over the term of the lease. As the Landlord will opt to tax, VAT must be added and forms part of the consideration. The NPV is £2,624,727. The SDLT rate bands must then be applied to the NPV, as follows:

NPV	SDLT rate
Up to £150,000	Nil
Over £150,000 up to £5m	1%
Over £5m	2%

Therefore, after deducting the Nil Rate band, SDLT will be £24,747 and will be the liability of the Tenant.

One way of reducing this would be to persuade the Landlord not to opt to tax. However, as noted above, this may be uncommercial (and it would only save £1,500 SDLT). Another way is to offer the Landlord a small premium (up to £150,000, which falls within the SDLT nil rate band) in return for a reduced rent. However, commercially, you may not wish to forego the cashflow advantage of no premium and the rent-free period. Furthermore, the Landlord might wish, for commercial reasons, to maintain the level of the rent.

You mentioned that FTA/F Co may become a charity. This will need careful consideration by a charity law expert and is beyond the scope of this advice. However, assuming (1) this is practicable and the benefits outweigh the compliance costs; (2) it can be achieved before completion; and (3) the Landlord agrees to substitute FTA/F Co as Tenant, this would achieve an outright saving of SDLT since charity exemption can be claimed.

Capital allowances

Capital allowances cannot be claimed in respect of expenditure which relates to your membership activities, as these are non-trading. You will need to agree with HMRC what proportion relates to trading. Expenditure of a capital nature (for example, on acquiring a building) is non-deductible.

Subject to these two points, capital allowances provide some measure of relief, in the form of an approved tax depreciation, for expenditure on plant and machinery. The Tenant's Ventilation Works will, in principle, qualify. To the extent they involve integral features (such as sanitary fittings and hot/cold water systems) they should also qualify. Items which become fixtures and part of the land, however, raise the question of whether the allowance may be claimed by the landlord or the tenant. The legislation provides special rules which look to who has actually incurred the expenditure. The

effect of these rules is that you will not be entitled to claim for any works whose cost is covered by the Contribution.

To the extent you incur expenditure (and subject always to the non-trading point above) you may be entitled to claim capital allowances in the form of Annual Investment Allowance (up to a maximum of £200,000). For expenditure on buildings not eligible for capital allowances (but which relates to trading), a new allowance, known as Structures and Buildings Allowance ("SBA"), is now available. SBA is limited to a flat rate annual depreciation of 2% over 50 years.

Finally, I confirm that the Contribution will not form part of FTA's income for tax purposes.

Conclusion

For the reasons explained above, I recommend that FTA incorporates without delay and is substituted as Tenant. If FTA is not the Tenant, but incorporates, it should apply to HMRC to form a VAT group with Properties. This will produce similar VAT benefits. SDLT will be chargeable unless the Tenant is a charity. There may be limited scope for claiming capital allowances and SBA, but only to the extent the expenditure relates to trading and is actually incurred.

Please do not hesitate to contact me if I can assist further.

Yours sincerely,

David Chin
Tax Manager
Tanith Tax LLP

NOTE:

Credit to be given for the following:

1. Candidates might have covered the extra regulatory aspects if FTA becomes a company limited by guarantee – eg filings at Companies House, yearly confirmation statement, what 'limited by guarantee' means for the members and filing accounts with Charity commission (ie they might have brought some of the content of the Law text book into their answer)

2. They might have mentioned the filing obligations for SDLT on the lease – 14 days for a return and payment

3. They might have talked about 'planning' with moving any taxable business activities down to the Sub so the Sub makes all the income and then expenses/CAs are deducted with the excess gift aided up to the new charity parent (in conjunction with VAT group to cause no VAT recovery issues) and this would then bring in direct tax for notifying for CT and filing returns etc (a common set up with charities is to have the charitable parent and the trading subsidiary)