

The Chartered Institute of Taxation

Application and Professional Skills

VAT and Other Indirect Taxes

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Suggested solution

REPORT

To: Board of Trustees of Larketon Festivals Ltd (“LFL”)

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Subject: Larketon Courthouse Project: Tax and Related Considerations

Introduction

Further to a letter dated 26 October 2023 from Margaret Robinson, and additional information provided with that letter, we have been asked to prepare a report comparing the two options suggested by the Board for the construction works (“the Project”) at Larketon Courthouse (“the Courthouse”), which are due to commence in January 2024.

This Report is intended for use only by the recipients named above and may not be relied upon by any other party, even for discussion purposes, except where we explicitly agree in writing. Note that the advice provided is based on the legal position as it stands at the date of the Report. Note also that should there be any misunderstanding of fact in the body of the Report we would ask that you bring it to our attention immediately as it may affect our advice.

The Board have asked us to advise on the VAT and other tax implications of the options together with any planning that may be available bearing in mind the Board’s ethical standards.

Executive Summary

1. The Board have suggested the following options for the Project:
 - Option 1: LFL to carry out the Project in its own name
 - Option 2: LFL to set up a wholly-owned trading subsidiary (“Subco”) which would run the Courthouse after completion of the Project. The intention would be for Subco to pay a market rent to LFL for use of the Courthouse
2. The Project is expected to cost £1,588,800, of which £264,800 is VAT.
3. Under either Option the restrictions imposed by the DoC grant on the retention of input VAT are relevant. The DoC must be informed of any input VAT refund, and also be persuaded to allow LFL to retain the refund. Contacting DoC is therefore a priority for the Board.
4. Exemption from VAT will apply to any supplies of admission to cultural performances made by LFL. However, the likely level of taxable sales (i.e.: foodie events, café and bar sales, etc) set out in **EXHIBIT B** suggest that VAT registration will be necessary under either Option.
5. Under both Options the use of the Courthouse seems likely to include a similar degree of non-business use. Non-business input VAT may not be reclaimed and so this would require an apportionment of VAT incurred. **EXHIBIT B** suggests this might be as much as 1/6th of its total use.
6. The expected expenditure on the Courthouse means that it will be a Capital Goods Scheme (“CGS”) item under both Options. This means that any input VAT recovery will need to be adjusted over the CGS period (up to 10 years after “first use”).

7. Option 1 is relatively straightforward to understand and operate but would require LFL to register for VAT. Taxable sales would be subject to VAT. An estimated Input VAT recovery of £140,344 would arise. Option 1 would also mean that LFL could face Corporation Tax (“CT”) on profits earned from foodie events, as well as that share of its café and bar sales which would not be exempt as “primary purpose trading”. However, the projections in **EXHIBIT B** would suggest that CT is not a major driver for the Board in deciding on its course of action. There is no SDLT issue under Option 1.
8. Structures and Building Allowance (“SBA”) at up to 3% of eligible expenditure may be available to LFL as an offset against CT. It will be restricted for any ineligible use. Given the likely level of profits this seems unlikely to be a major issue.
9. Option 2 in its simplest form would not permit any input VAT recovery on the Project at all. This is because the anti-avoidance rule for the option to tax would prevent LFL charging VAT on its rental to Subco.
10. Amending Option 2 to involve the creation of a VAT group would mean that the lease between LFL and Subco was ignored for VAT purposes. This would also mean that input VAT recovery would be calculated based on the VAT group’s overall external sales. Where Subco, which is not an eligible body, was contractually responsible for the sales of the VAT group, then VAT would arise on all sales. Unless this output VAT can be passed on to customers by way of increased ticket prices, this is likely to be commercially disadvantageous. Accordingly, while Option 2 would offer an increased upfront input VAT recovery, this additional input VAT would be “used up” by way of the loss of output VAT having been absorbed on sales within two years.
11. Option 2 would mean Subco would face CT on all of its profits. It is probable that much of these profits could be transferred by Gift Aid to LFL, thus avoiding CT.
12. Structures and Building Allowance (“SBA”) at up to 3% of eligible expenditure may also be available to Subco under Option 2. It will be less restricted than under Option 1 because there would be less ineligible use. Nevertheless, since this is an offset against CT, which can largely be avoided in any event, this seems unlikely to be a major issue.
13. Option 2 would, however, not be permitted under the MoJ lease without payment of an Alteration Fee of £10,000 which may also be subject to VAT. The Board would therefore have to be certain of obtaining permission from the MoJ before proceeding with Option 2.
14. Depending on the NPV of the lease between LFL and Subco, Option 2 would require the filing of an SDLT return to claim group relief which would avoid a charge to SDLT.
15. One further benefit of Option 2 is that it would permit a potential reduction in CT as compared to Option 1. Given that the Board are not expecting to see much in the way of profits, it seems hard to justify Option 2.
16. Assuming that the DoC confirms that the input VAT recovered can be retained, we would recommend Option 1 as offering a good outcome with much less complexity.

Tax Issues Which Apply For Both Options

Based on the intended activities at the Courthouse according to **EXHIBIT A** and **EXHIBIT B**, the following tax points are relevant to both Options.

Note that that the Courthouse is expected to be open 300 days a year under both Options.

VAT

- Performances are expected to take place on 180 days per year. These performances should qualify for the cultural exemption under VATA 1994, Sch 9, Group 13, provided they are made by an “eligible body”. LFL, as a charity, is an eligible body, but Subco would not be. (Note that the exemption rules also require that any income earned from exempt supplies are used to support exempt supplies in future; this seems unlikely to be a problem for LFL.)
- The free-of-charge outreach and educational programmes for underprivileged local children taking place on 50 days per year will be regarded as “non-business” activities for VAT purposes
- The “Foodie” events on 50 days per year will not fall under the cultural exemption for VAT purposes.
- Events with an “open mic” facility to local performers in music, comedy and writing are expected to take place on 20 days per year. Whilst entry to these events will be free, the Board expects to earn money from related bar sales. For VAT purposes, this means that this is likely to be regarded as business activity, although HMRC may challenge such an analysis
- The Courthouse will also have a café and bar which will be open all 300 days that there is some form of organised activity at the site. Bar and café sales will be standard-rated business activities whether carried out by LFL or by Subco

Grant Issue Applying to Both Options

Before looking at the Options in detail, one further important point which arises on review of the evidence provided, particularly **EXHIBIT B**, needs to be considered. Again, it applies whichever Option is applied.

The DoC has stated that it must be informed of any VAT received, and that it may decide to offset the VAT refunded against the grant of £800,000 it is making to LFL. It is therefore important for the Board to understand that any expenses incurred in tax planning may be wasted if the input VAT has to be paid over to DoC in any event. It is therefore vital for the Board to contact the DoC immediately to obtain written confirmation that the grant monies will not be reduced to reflect any input VAT received before proceeding any further.

Option 1

Option 1 is simple: LFL handles the entire Project itself.

In order to reclaim VAT, LFL will need to register for VAT and charge VAT on future earnings which do not benefit from the cultural exemption. These sales are outlined above and based on the projected figures in **EXHIBIT B** will certainly exceed the VAT registration threshold of £85,000 before the end of y/e 30 September 2024.

The Courthouse, being construction works liable to VAT and costing more than £250,000, will amount to a Capital Goods Scheme ("CGS") asset. This means that, over 10 intervals beginning from "first use" (under Option 1 this is likely to be the first day activities take place at the Courthouse), input VAT on the Project will need to be adjusted to reflect changes in both non-business use and in the level of exempt supplies being made at the Courthouse.

Each is addressed in turn, as required by the input tax recovery rules.

Non-business Use

Based on the projected daily use of the Courthouse, it seems likely that ca. 50/300 days, or 1/6th (16.67%), will be used for non-business purposes.

Applying a practical business/non-business apportionment method would mean that 1/6th of the input VAT on the Project (as set out in **EXHIBIT C**) which is £44,133 (£264,800 x 1/6), will simply be irrecoverable as being unrelated to making business supplies.

Exempt Use

Exempt supplies can also only be estimated at the present time, but based on the projections in **EXHIBIT B**, it looks like the exempt element of activities income will be 36.4% in y/e 30 September 2024 (£320,000/£880,000). This percentage drops to 28% in the projections for y/e 30 September 2025 (£425,000/£1,515,000).

Recoverable VAT

Based on the above, business VAT will amount to 5/6th of the total in the first period, which is £220,667 (£264,800 x 5/6). The taxable percentage in the first period is expected to be 63.6%. This would give a refund amount of £140,344 (£220,667 x 63.6%).

This initial VAT recovery will be adjusted by the CGS over the remaining intervals. This may require repayments to HMRC if the level of non-business and/or exempt use increases, or further payments to LFL if that use decreases.

Corporation Tax (“CT”)

As a charity, LFL benefits from exemption from CT on its “primary purpose” trading income. It is clear from **EXHIBIT D** that supplies of performance admissions, which are exempt from VAT will also be exempt from CT, as primary purpose trading. This will mean that income earned on performances will not be subject to CT.

However, other income, such as “foodie” events and café and bar sales, are not exempt from CT. In theory, therefore, LFL could face CT on some of its income. In practice, however, the projections in **EXHIBIT B** do not suggest much if any profits to be taxed.

This is a theoretical disadvantage of Option 1, which will need to be weighed against the CT benefit of Option 2 (see below).

One final point to note is the potential availability of Structures and Buildings Allowance (“SBA”) at up to 3% of eligible expenditure on the Courthouse works. This will require a detailed analysis of the items of expenditure and also the extent of eligible use to calculate the value of SBA.

Given the likely level of profits, however, this does not seem a major issue.

Stamp Duty Land Tax (“SDLT”)

Under Option 1, no supplies of chargeable interests in land are being proposed and so SDLT is not relevant.

Administrative and Commercial Considerations

Option 1 would require administration in the form of a VAT registration with the related compliance obligations. Calculations of non-business use and also of partial exemption and CGS adjustments would be necessary.

However, only one familiar entity is involved. It seems likely that any administration could be managed either by increasing in-house accounts staff or seeking outsourced VAT compliance assistance from LFL’s accountants. This should be quite easy.

Moreover, apart from obtaining permission from the DoC to retain any VAT refunds received, Option 1 is in line with the requirements of the lease from the MoJ and the grant-funding requirements of both the DoC and the NLHF.

Option 2

Option 2 requires the creation of a wholly-owned subsidiary (“Subco”) by LFL. LFL will lease the Courthouse to Subco to allow it to carry on all of the activities at the Courthouse site.

VAT

Because the Courthouse will be a CGS asset with more than 20% exempt use, a lease between LFL and Subco would not be eligible for the option to tax owing to the anti-avoidance rule in VATA 1994, Sch 10, para 12 – 17. Accordingly, any lease would have to be an exempt supply by LFL to Subco.

This would mean LFL could not recover any input VAT at all on the Courthouse. This is a very unattractive outcome and would not justify the expense and time in setting up the structure. Consequently, Option 2 as presented is unlikely to be viable.

However, a more practical and advantageous solution for Option 2 is probably to create a VAT group between Subco and LFL. This would make the Courthouse an asset of the VAT group, and its taxable and business use, which determines the amount of VAT which can be recovered, would depend on the external supplies made by the VAT group. Any lease between Subco and LFL would be disregarded under the VAT grouping rules.

It is important to note that, if “first use” occurred before the date the VAT group is formed, this would require a CGS adjustment period at the date the Courthouse entered the group. Given that there is likely to be very little VAT-able activity in that period, this is likely to be very disadvantageous.

Accordingly, first use should be deferred until after the VAT group is in place. Note that case law has held that the signing of a lease between Subco and LFL could amount to first use.

Increasing VAT Recovery?

The VAT group rules mean that the level of input VAT recovery is dependent on how much of the activity at the Courthouse is actually carried on by Subco. This is because the legislation will deem any external sales made by LFL (rather than *contractually* by Subco) as being both:

- Part of the VAT group’s overall external supplies, and
- Eligible for the cultural exemption because LFL’s “eligible body” status will be deemed to apply to the supplies made *by the VAT group*

However, **EXHIBIT A** suggests that under Option 2 Subco will carry on all of the activities at the Courthouse. On that basis, it is assumed that all sales are made by Subco.

Subco would not qualify as an “eligible body” under VATA 1994, Sch 9, Group 13 and so could not exempt its supplies of “cultural events”, which would be exempt in the hands of LFL. Therefore, the level of taxable activity in the hands of the group would be significantly higher, thus increasing the amount of VAT eligible for recovery by the VAT group.

Accordingly, under this approach, the amount of VAT recovered could be expected to be as high as £220,667, (£264,800 x 5/6, i.e.: excluding only the non-business element) which is clearly much higher than under Options 1 and 2 (£140,344).

Whilst this appears advantageous, the Board will however need to assess the commercial impact of charging VAT on ticket sales for performances. If the cost of output VAT cannot be passed on in the form of higher ticket prices, profits will fall. This would mean £53,333 in y/e 30 Sep 2024, and £70,833 in y/e 30 Sep 2025. Estimated input VAT would be £12,500 and £25,000 respectively, assuming all performers were VAT-registered. This is a net loss of £40,833 and £45,833 respectively, thus eroding the entire saving on the Project VAT in two years. If the equivalent of the VAT on the ticket sales can be passed on to customers, then it would seem more advantageous in the long term to do this VAT exempt and recoup the input tax differential in this way.

Corporation Tax ("CT")

The main advantage of Option 2 is that it offers a means of reducing the CT on the Courthouse activities to nil. This is achieved as follows:

1. By having Subco receive all trading income derived from the Courthouse, LFL will not itself owe any CT on this income.
2. Any residual profits earned by Subco would, in principle, be subject to CT in its hands. However, subject to meeting certain conditions as to time limits and distributable profits, it should be possible to have Subco gift aid those profits to LFL as its charitable parent. These monies would not be taxable in the hands of LFL, and the donation would be a fully deductible amount for CT purposes in Subco's hands.

It would be important to confirm whether the rent paid by Subco to LFL for use of the property would be subject to CT, and if so, whether it could be offset by a management cross-charge which could be deducted in LFL's CT computation.

The result is that it is possible to have LFL benefit from the full profits earned from the Courthouse without suffering CT. It is worth noting the limited profits envisaged.

Note that SBA would also be available to Subco. Subco is likely to have a higher level of eligible activity than LFL would have and so, while a detailed analysis of the expenditure would still be required, this could be more valuable than under Option 1.

Nevertheless, SBA acts to reduce CT and so any increased allowance seems unlikely to be of great value in itself.

Stamp Duty Land Tax (“SDLT”)

SDLT will only be payable where the net present value of the lease between LFL and Subco exceeds £150,000. The NPV of a lease may be checked using HMRC’s SDLT calculator online.

However, it is worth noting that even if the NPV does exceed £150,000, because Subco will be 100% owned by LFL, it should be eligible for a claim for SDLT group relief under FA 2003, Sch 7. Provided the group relief conditions are met for a period of at least three years after the lease has been granted (which seems virtually certain to be the case here), then no SDLT charge will arise. An SDLT form may need to be submitted, however, if the NPV of the lease is in excess of the £150,000 limit.

The potential impact of the anti-avoidance provisions in FA 2003, s 75A should also be borne in mind, as this overrides the group relief conditions where HMRC take the view that the arrangement amounts to artificial avoidance. This seems unlikely to be the case here.

Administrative and Commercial Considerations

The terms of the lease between LFL and the Ministry of Justice (“MoJ”) would prevent Option 2 unless the Alteration Fee of £10,000 is paid. It is not clear if VAT is also due on this Fee (i.e whether it could be classed as a separate supply for consideration by the MoJ), but if so, the input VAT would be recoverable in line with the partial exemption recovery rate in the first period. The Board should therefore contact the MoJ before it goes ahead with Option 2.

The DoC grant requires that the Courthouse expenditure is capitalised in LFL’s accounts but does permit application of the funds for the benefit of a wholly-owned subsidiary. This would seem to permit Option 2, but the Board would be wise to confirm with the DoC that the Option 2 proposals do not constitute a breach of the grant terms. This does not appear to be a problem with the grant funding provided by the National Lottery Heritage Fund (“NLHF”).

Option 2 will mean a greater degree of complexity than either the Board deals with currently, or if it followed Option 1. This is because Subco, as a separate legal entity, will require separate accounts, separate PAYE registration, separate insurance and similar concerns. This will require additional time but will also have an additional cost.

Subco will also need to issue separate invoices from LFL and have separate tills and bank accounts.