VAT focus

What non-VAT practitioners ought to know about VAT

Speed read

VAT is a foreign tongue for many tax practitioners with some aspects of the tax not widely understood. Unexpected outcomes exist in many situations. Two examples are the meaning of business, which brings many charities into the VAT net and the place where cross border transactions happen. The reverse charge rules require the customer to account for VAT on certain cross-border transactions and, despite Brexit, the EU continues to have relevance. Avoiding VAT is difficult with substance over form having more influence nowadays. To provide effective tax advice, a broad understanding of the nuances of VAT is essential.

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What is a business?

VAT must be charged on taxable supplies made in the UK by a 'taxable person' in the course or furtherance of any business carried on by that person. The VAT charged is referred to as 'output tax'. VAT can be recovered on related costs as 'input tax'.

Taxable persons include the whole gambit of vehicles: sole traders, partnerships, corporate bodies, charities, not for profits organisations and so on.

Taxable supplies are supplies made in the UK other than exempt supplies.

VAT cannot be recovered as input tax where attributable to non-business activities. Similarly, VAT cannot generally be recovered on costs relating to exempt supplies.

The legislation specifies the types of supplies qualifying for exemption. The legislation also deems certain activities as being by way of business. These include the provision by clubs of facilities to their members and admission to events for consideration. However, 'business' is not comprehensively defined in the legislation.

The 'old business test'

A couple of cases in the early days of VAT established a six-criteria business test. Is the activity:

- a serious undertaking earnestly pursued;
- pursued with reasonable or recognisable continuity;
- one of substance;
- conducted in a regular manner and on sound and recognised business principles;
- predominantly concerned with making taxable supplies for consideration; and/or
- one generating taxable supplies commonly made with a view to making a profit?

An overall 'yes' weighting would mean a business activity.

In 2018, the Court of Appeal in *Wakefield College* [2018] EWCA Civ 952 departed from the six criteria and applied a two-stage test in concluding that the College was providing education in the course of an economic or business activity.

The 'new business test'

Four years after *Wakefield College*, HMRC announced that the two-stage test should now be used to determine whether an activity constituted a business activity. The two-stages are:

- does the activity result in a supply of goods or services for 'consideration'; and
- is the supply for the purpose of obtaining 'remuneration'?

Both questions need to be answered 'yes' for an activity to constitute a business activity.

'Consideration' is a well-known concept for VAT purposes. It covers anything which might be done, given, or made in exchange for something else.

'Remuneration' did not really feature in UK VAT language until *Wakefield College* when it was stated that 'remuneration' may be said to encapsulate the concept of carrying on an economic activity 'for the purposes of obtaining income therefrom on a continuing basis'.

> When it comes to determining the place of supply of a particular transaction for VAT purposes, it should be noted that the internationally accepted tax residence concept has little bearing on matters

There have been a raft of business/non business cases since *Wakefield College* with the 'old business test' still having an influence on proceedings. HMRC still acknowledge that the old business test 'can be used as a set of tools designed to help identify those factors which should be considered' for the purpose of determining whether an activity is a business activity. This begs the question: what was the point of the 2022 change of policy?

Where is the place of supply?

When it comes to determining the place of supply of a particular transaction for VAT purposes, it should be noted that the internationally accepted tax residence concept has little bearing on matters.

A supply for VAT will either be one of goods or services. The place of supply rules for each are different:

- The place of supply of goods is generally where the goods are when they are removed or made available to the customer.
- The place of supply of services is generally where the customer belongs (for B2B supplies) or by reference to where the supplier belongs (for B2C supplies). There are several variations to this basic position, such as land related supplies which are taxed by reference to where the underlying land is. These variations aside,

the basic point for services is that we normally need to have regard to where the parties belong in order to determine the place of supply.

Place of belonging

The 'belonging' definition applies equally to both the supplier and recipient of a supply.

Business persons

A business 'belongs' where it has its business establishment or some other fixed establishment.

The business establishment is the principal place of business – the head office or 'seat' from which the business is run. Fixed establishments are any other places possessing both the technical and human resources necessary for providing and receiving services on a permanent basis.

If a business does not have a business or fixed establishment anywhere, it belongs where it is legally constituted.

In a situation where a business has a business establishment or some other fixed establishment(s) in more than one country, we need to identify the establishment most directly connected with the supply in question.

A common misconception is that services received in the UK from abroad are not subject to UK VAT

Non-business persons

A private individual belongs in the country in which the person's usual place of residence or permanent address is. The usual place of residence of a private individual is not legally defined but is generally taken to be where the individual spends most of their time.

Corporate bodies and legal persons belong where they are established. This is the place where central administration functions are carried out. Any establishment used for this purpose must have a degree of permanence and have the technical and human resources necessary to receive and use the services supplied to it.

Is this the right way?

A common misconception is that services received in the UK from abroad are not subject to UK VAT. The supplier is not registered for UK VAT and so obviously would not charge UK VAT. However, this does not mean that VAT free services can be sourced from overseas. Such an easy step to avoid VAT is prevented by the reverse charge rules.

Most B2B services received from abroad are subject to the reverse charge. Under the reverse charge procedure, the customer is responsible for accounting for any output tax due on the value of the supply received and can claim input tax to the extent allowed in accordance with the normal rules. The financial effect of the reverse charge is entirely neutral where the cost can be fully attributed to the making of taxable supplies (or supplies that are outside the scope of UK VAT but would be taxable if made in the UK).

The effect of the reverse charge is to put a business in the same position as it would have been had it bought similar services from a UK based business.

The reverse charge does not apply to exempt or zero-rated services. It also does not come into play where taxable services are obtained from overseas suppliers by organisations that are not liable to be registered for VAT.

In terms of VAT registration, it is not widely appreciated that the value of reverse charged services must be counted when considering whether VAT registration is necessary.

A business may be very good at monitoring taxable income against the VAT registration threshold (currently £85k per annum) but many do not realise that taxable supplies include reverse charged services.

At this point, it's worth highlighting where charities, in particular, can come unstuck because of the way in which the reverse charge works.

A charity that is not registered for VAT can receive services from overseas without incurring a VAT cost. However, this is not the case for a VAT registered charity. This is because the reverse charge requires VAT registered persons to account for output tax on supplies received from overseas, regardless of the use to which the services are put. The hit is on VAT recovery entitlement because no VAT can be claimed against non-business activities.

Has the UK escaped the long arm of EU law?

The relevance of EU law for UK VAT purposes has undergone a profound transformation since Brexit.

The implications of the separation of the VAT regulations are significant and the ongoing relationship between the UK and the EU has changed in many areas:

- **Cross-border transactions:** Transactions between the UK and the EU are no longer intra-Community supplies and are subject to new VAT rules and customs procedures.
- **Treatment of supplies:** The treatment of goods and services between the EU and the UK is now subject to each side's domestic regulations.
- **Customs formalities:** Brexit has reintroduced customs formalities for goods moving between the EU and the UK. VAT is now payable on imports (although postponed accounting means that the VAT can be dealt with cost efficiently).
- **Digital services:** Businesses providing such services between the EU and the UK must adhere to the VAT rules of both jurisdictions.

The divergence in VAT regulations between the EU and the UK introduces challenges for businesses.

The Retained EU Law (Revocation and Reform) Act 2023 received royal assent on 29 June 2023.

The Act does not change the Court of Appeal's ability to depart from EU case law (unless it has already endorsed it) if it so wishes. Since 1 January 2024, though, the Court of Appeal needs to consider:

- changes in circumstances having an impact on the retained EU case law; and
- the knock-on effect to the development of domestic law because of the influence of retained EU case law.

The Supreme Court does not need to follow retained EU law and the Act does not change that. Since 1 January 2024, it can ignore previous Supreme Court and House of Lords judgements which applied EU law. It does, though, need to consider:

- the influence of retained EU case law on retained domestic law in situations where the court has departed or intends to depart from the retained EU

case law;
- changes of circumstances having an impact on the retained domestic case law; and
- the knock-on effect to the development of domestic law because of the influence of retained domestic law.

Earlier drafts of the legislation suggested dramatic changes. The final version, though, is not earth shattering from a VAT operational point of view. The VAT system should effectively continue as it has since the end of the Brexit transitional period.

What is actually happening?

In the VAT world, substance over form ensures that VAT is levied in a fair and reasonable manner. There is not always a need to comply with formalities. For example, case law has allowed taxpayers to claim VAT in situations where the purchase invoice has contained errors.

The importance of substance over form for VAT cannot be overstated. The principle serves as a critical safeguard against VAT avoidance and promotes fair and equitable taxation

On the other side of the coin, VAT planning arrangements have fallen foul of the substance over form concept. In the mid-1990s, *Robert Gordon's College* [1995] STC 1093, HL, confirmed that the *Ramsay* principle, the established direct tax anti-avoidance principle, did not apply to VAT. This increased the scope for aggressive VAT planning which came to an end with *Halifax plc (No. 2)* (Case C-255/02) and the recognition that the economic reality of a situation and substance over form cannot be glossed over.

In 2013, the message was driven further home when it was decided in *Newey* (Case C-653/11) that, although contracts were a factor needing to be considered, they were not decisive and could be disregarded if they did not reflect the economic reality of a situation.

More recently, we have *All Answers Ltd* [2023] UKFTT 737 (TC). All Answers Ltd (AAL) provides students with essays written on demand by third party writers. The Upper Tribunal had previously rejected the argument that AAL acted as an agent between the student and the party. To secure the more favourable agent treatment, AAL amended its contracts. This proved unsuccessful, on a return to the First-tier Tribunal, where it was decided that the economic reality was that AAL was still acting as principal. The contractual changes were not reflected in the business model.

The importance of substance over form for VAT cannot be overstated. The principle serves as a critical safeguard against VAT avoidance and promotes fair and equitable taxation. ■

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- VAT and economic activity: from *Longridge* to *Wakefield College* (E Wong, 27.6.18)
- Revocation/reform of retained EU (VAT) law (E Wong, 9.11.23)
- Cases: *All Answers Ltd v HMRC* (19.9.23)