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Tax Insights

VAT news - November 2017

Input tax incurred by developer on infrastructure works recoverable

The Court of Justice of the European Union (CJEU) has delivered its highly anticipated judgment in the case of Iberdrola Inmobiliaria Real Estate Investments (Iberdrola), overruling Advocate General (AG) Kokott's opinion, and determining that input tax is recoverable by Iberdrola subject to certain conditions. This decision may have implications for businesses such as property developers/builders providing works under planning gain agreements. The decision is also of interest in the context of the developing case law which has to be considered when determining whether input VAT is linked to economic (or business) activities, an area of particular concern to the not for profit sector and charities.

In summary, Iberdrola planned to construct a holiday village on land it owned, which would then be leased out on a taxable basis. However, it transpired that in order to connect the holiday village to the existing municipal waste-water pump station, the pump station had to be extensively renovated. Iberdrola therefore agreed to carry out the repair of the waste-water infrastructure for the local authority at its own expense. Iberdrola sought to recover the related input tax on this work, but it was blocked by the Bulgarian tax authorities. This was on the basis that the work was supplied free of charge to the local authority and so it was alleged that it was not used in connection with an economic activity carried on by Iberdrola. The case was referred to the CJEU after an appeal in the Supreme Court in Bulgaria.

The CJEU disagreed with the AG's opinion which had been that there should be no right of deduction for the works supplied free of charge to the local authority. This was on the basis that without the pump station

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reconstruction, the holiday village could not have been built, and Iberdrola would not have been able to carry out its economic activity. Thus, there was a direct and immediate link between the renovation work and the output tax Iberdrola charged on the lease of the holiday homes. Consequently, Iberdrola was entitled to recover the input VAT as the work on the waste-water pump station was used in the context of its economic activities.

However, the CJEU stated it was for the national court to examine whether the input tax could be recovered in full; if the renovation work on the waste-water pump went beyond the services deemed necessary for this purpose, then the input tax may need to be apportioned.

For further information on the implications of this case, please contact our Indirect Tax Team.

Change in the treatment of pension fund management services by insurance companies

Insurance companies providing pension fund management services may need to adjust their VAT treatment following a recent change in HMRC policy.

HMRC published Brief 3/2017 clarifying the VAT treatment of pension fund management services provided by regulated insurance companies. The change removes an insurance company's entitlement to exempt supplies of pension fund management services provided to Defined Benefit schemes.

To date, HMRC has allowed insurance companies to exempt their supplies of pension fund management services when made to Defined Benefit and Defined Contribution pension schemes. From 1 April 2019, the exemption will only apply to Defined Contribution Schemes which qualify as Special Investment Funds; supplies to Defined Benefit schemes will require VAT to be accounted for on the value of these supplies. This will bring supplies made by insurance companies in-line with non-insurance companies.

Following case law developments in 2013, the CJEU found in *Wheels Common Investment Fund Trustees Ltd* that the service provided in the management of a Defined Benefit scheme was a taxable supply as the pension scheme could not be seen as a Special Investment Fund.

Therefore insurance companies involved with Defined Benefit schemes which have made use of HMRC's exemption policy will need to start preparing for the change. Such insurers will need to consider the VAT liability of their pension fund management services and make any necessary accounting and tax changes.

If you think your business may be affected by this, please contact our Indirect Tax Team who will be able to check whether VAT is being accounted for correctly, and to discuss the options available to minimise any irrecoverable VAT.

Charities will not escape Making Tax Digital plans

In our previous edition we mentioned that charities would be exempt from the forthcoming changes but their trading subsidiaries would not. HMRC has now clarified that this exemption will only apply to Corporation Tax returns.

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Therefore, from April 2019, charities will be required to keep digital VAT records in addition to filing electronic VAT returns. Any VAT adjustments carried out by charities will need to be maintained with their digital records.

As a result of this, charities may find themselves facing extra costs, as it is currently understood that they will be required to purchase specific software to comply with HMRC's new record keeping and filing requirements.

This news is likely to put further strain on charities, many of whom already have to deal with complex VAT calculations. Charities should pay close attention to the proposed changes, further details of which are expected to emerge over the coming months.

Cost Sharing Exemption not applicable for financial services and insurance sectors

Businesses in the financial services and insurance sectors currently making use of the VAT cost sharing exemption (CSE) provisions may be affected by three recent CJEU judgments, which concluded that the exemption should not extend to businesses in these sectors.

The CJEU published its judgments in the following cases: DNB Banka, Aviva and the infraction hearing of EC v Germany. The first two cases concerned whether the application of the CSE rules (contained in Article 132 (f) of the Principal VAT Directive) could include financial services and insurance (contained in Article 135 of the Principal VAT Directive).

Article 132 sets out the exemptions for certain activities in the 'public interest', whereas Article 135 refers to 'other activities'. The Advocate General opined that the exemption for Cost Sharing Groups should only apply to the entities mentioned in Article 132, meaning that financial services and insurance companies would not be able to benefit from the exemption. The CJEU agreed with this decision, interpreting the exemptions strictly.

The final case considered whether Germany unfairly restricted the CSE to members who carry on activities in the health profession, whereas the Principal VAT Directive did not limit the exemption to certain groups but only to entities who were carrying out exempt activities. In line with the DNB Banka and Aviva decisions, the CJEU held that Germany was too restrictive in its application of the CSE rules as these should apply to all activities listed in Article 132; however they could not be expanded to include the activities listed in Article 135.

These decisions may be the final nail in the coffin for the use of the CSE; it is anticipated that going forwards, the CSE will only be used by public or not-for-profit bodies. Although the CSE rules were only implemented in the UK in 2012 and have not been taken up on a large scale, they are more widely used in other EU member states.

Please contact our Indirect Tax Team if you have any questions following these rulings.

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Application of the VAT zero-rating for charitable buildings

Charities looking to construct new buildings for the local community may be able to benefit from the zero-rating provision.

In the case of Eynsham Cricket Club (ECC) the First tier Tribunal (FTT) considered whether the costs associated with the construction of a new pavilion by ECC, a registered community amateur sports club ("CASC"), for the benefit of its members and the local community were subject to zero-rating. The FTT considered whether, firstly, ECC was "established for charitable purposes only" and qualified as a charity for VAT purposes and, secondly, whether the pavilion was intended to be used solely by the club as a village hall or similar.

The FTT found that the Charities Act 2011 set out that a CASC established for charitable purposes is not to be considered a charity. This ultimately meant that ECC failed to qualify for zero-rating for VAT purposes. However, the FTT considered the facts of the case and whether ECC was able to demonstrate that it intended that the pavilion would be a village hall or similar.

ECC submitted that Saturday afternoons during the cricket season were "sacrosanct" for the club and similarly Friday nights were to be used by the club's under 9's team. With the exception of these times the community could hire out the pavilion pending ECC's agreement and the payment of fees, not dissimilar to a village hall. HMRC argued that the pavilion was built principally for the use of the club rather than the wider community and that the village hall within Eynsham would discount the use of the pavilion as a village hall. The FTT disagreed with HMRC's points regarding the construction services, finding that the pavilion was intended to be used as a village hall or similar. However, the appeal ultimately failed as ECC was not a charity.

ECC lost the case due to the complexities of charity law, and not HMRC's argument that sports clubs' facilities available for the wider community do not qualify for zero-rating. Had ECC been established differently, it would have been able to obtain zero-rating on the construction costs of the pavilion. The case shows that charitable organisations looking to construct new buildings to be used by the local community as a village hall or similar can benefit from the VAT provisions for zero-rating.

If you have any questions regarding this case please contact our Indirect Tax or Charity Team who can discuss both VAT and charity regulatory matters.

VAT at standard rate applied to conversion works on mixed use properties

Businesses involved in converting properties should carefully consider the VAT treatment of such conversions, especially where the former properties are used for mixed i.e. commercial and residential purposes.

The joined cases of *Languard New Homes Limited* and *DD & DM MacPherson* at the Upper Tribunal (UT) offered an answer, for now, to a contested question over the last few years as to the correct application of VAT on property conversion projects.

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As background, the first grant of a major interest by a person converting a non-residential building or part of one into a dwelling/s or a building intended for use for a relevant residential purpose is a zero-rated supply. At issue in these cases was the VAT liability of supplies made by a developer converting a mixed-use building into residential units; could the former building be classed as a ‘non-residential building’?

In both of these cases the buildings in question were used before conversion for both commercial and residential purposes. In *Languard* a public house was converted into four maisonettes whereas in *MacPherson* a shop with a residential unit above it was converted into two semi-detached dwellings.

The UT hesitantly agreed with HMRC that where a newly created dwelling contained part of the old residential space then the zero-rating relief will not apply. The UT accepted that the interpretation they favour leads to a curious result where VAT relief would be available if a ground floor of a public house was converted to residential use but not on any works to the first floor; however, the zero-rating relief would not be available at all if the first and second floors were converted vertically to separate residential units; in which case part of the converted building would comprise a part which was previously used as a dwelling.

As a consequence of this joined case, it may be more important than ever to consider the VAT position at the early stages of planning conversion works to ensure that the zero-rating relief can be claimed.

Our Indirect Tax Team have substantial experience in this area and can offer guidance, if required.

Were computer platform services made to investment managers subject to the financial services exemption?

Fund managers involved in Special Investment Funds (SIF’s) may wish to consider whether the services they supply or receive qualify for exemption following the recent ruling by the FTT.

In the case of *BlackRock Investment Management (UK) Ltd*, the appellant (Blackrock) received services from Blackrock Financial Management Inc (BFMI) which were essentially the use of an investment management computer platform.

The case considered whether the supply of use of an investment management computer platform to an investment manager would fall under the financial services VAT exemption. The FTT considered that, in principle, where the platform is being used by the investment manager to manage SIF’s, such a supply falls within the VAT exemption. This is because the platform services formed a distinct whole, and were specific to, and essential for, the management of SIF’s.

The second issue the case looked at was whether it was possible to apportion the consideration received between supplies of SIF’s and non-SIF’s, as the computer platform was used by investment managers to manage both types of funds. The FTT found that the appellant received a single supply of platform use which was standard rated for VAT purposes.

On this basis, the Tribunal found that although the supply of managing a SIF on its own would be considered exempt from VAT, because the services were

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considered a single supply of platform use, it was not possible to apportion the use between exempt and standard rated; since the computer platform was predominantly used to manage non-SIFs, the whole supply was subject to the reverse charge at 20%.

Our Indirect Tax Team can assist in this area if you have any concerns.

European Commission proposes radical changes to the VAT system

On 4 October, the European Commission (EC) announced proposals to amend Directive 2006/112/EC to address some inefficiencies of the VAT system and to tackle VAT fraud. These take the form of some fundamental principles or cornerstones of the VAT system together with a number of quick fixes.

The first step proposed is to change the treatment of B2B cross-border supplies of goods; the European Commission intends to adopt a proposal for a Directive in 2018 providing for the definitive VAT system. These rules will be similar to the current rules for B2C e-services. Under the new rules, the seller will have to charge VAT at the destination country's VAT rates. VAT will be paid in the seller's member state (MS) and a mechanism similar to the Mini One-Stop Shop (MOSS) will be used to account for the VAT. However, this will not apply if the buyer is a certified taxable person (CTP). Instead, a simpler reverse charge system will apply to these businesses.

Among the "quick fixes" there are three other changes being proposed, one of which is to simplify the treatment of call-off stock. The EC is proposing to treat such transactions in the following way: an exempt supply in the MS of departure of goods and an intra-community acquisition in the MS of arrival. Importantly, both parties in the transaction have to be CTP's. The other changes include a modification in requirements to identify a trader and updates to the legislative provisions to simplify ascribing intra-community transportation to a specific transaction in a chain of supplies.

It is hoped that these reforms will simplify the VAT system for those involved in cross-border supplies. If you have any questions on this matter, please contact our Indirect Tax Team.

What is the difference between a hospital and a care home?

HMRC has issued Brief 2/2017 clarifying their policy on the VAT zero-rating for construction of buildings intended for use solely for a relevant residential purpose as care homes, following the FTT decision in the case of *Pennine Care NHS Trust*. This case concerned the construction of a secure mental health unit by an NHS Trust. HMRC denied the application of the zero-rating as it believed the mental health unit was to be used as a hospital or similar institution (in which case it would be a standard rated supply).

The NHS Trust countered that they were constructing a care home rather than a hospital and so could benefit from the zero-rating. The judge was satisfied that the unit was to be mainly used in assisting residents in managing their conditions over a prolonged period. The care provided did not cross the line into medical treatment.

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Following the case, HMRC has set out the two key areas of difference between care homes and hospitals. In their view, hospitals aim to treat patients quickly then discharge them to make space for other patients, as well as dealing with injuries, illnesses and conditions that require clinical intervention and rely on staff with appropriate qualifications to carry out these tasks. Care homes on the other hand, allow lengthy periods of residence for individuals suffering from conditions that require long-term care, and provide personal care that tends to be for the purpose of enabling a person to look after themselves.

HMRC's revised policy accepts that 'personal care' may go beyond a supportive and supervisory role to assist with living. The term may include both therapeutic and clinical treatment that can alleviate or improve the condition of the individual. HMRC will also consider whether there is provision for a resident to be there for a lengthy period.

In addition, a care home may have a treatment centre within the building. If the use of the treatment centre is by 95% or more of the care home residents, then the zero-rating will apply to it. However, if 5% or more of its use is by non-residents, the zero-rating will not apply to the costs associated with the construction of the treatment centre. The use of the treatment centre should also be monitored for the next 10 years otherwise VAT may be repayable to HMRC on a change of its use.

For further guidance on these changes, please contact our Indirect Tax Team.

Is a prefabricated building a temporary or permanent structure for VAT purposes?

Suppliers and customers of prefabricated buildings should carefully consider the VAT implications when leasing these.

In the *Sibcas Limited* case, a developer supplied a temporary structure for use as classrooms to a school. Sibcas treated the supply as a standard rated supply of movable property. HMRC argued the supply was an exempt supply of land and the case was appealed to the UT, with the judge agreeing with HMRC.

The main question in establishing the treatment of the supply in this case was whether the prefabricated building was '*fixed to or in the ground*'. In deciding that it was, the UT took into consideration the large size of the building, its foundations, beams and other fastenings and the degree of movability. It was estimated that it would take 98 days to dismantle and move the whole building – a significant amount of time and effort. It also made clear that a building constructed from prefabricated components is not automatically deemed to be 'movable' for these purposes.

The FTT erred in its decision largely because it focused on components of the building separately, instead of looking at the entire building when determining whether it is fixed to or in the ground. The UT agreed with HMRC that this was a supply of letting of immovable property which should be exempt from VAT.

Businesses concerned about the implications of this decision should contact our Indirect Tax Team for guidance.

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Input VAT recovery by a charity making taxable supplies

Charities and not-for-profit bodies recovering VAT on their purchases should ensure there is a link between the VAT incurred and taxable supplies made in the course of their business activities.

The case of *Will Woodlands* concerned a woodlands charity. It sought to recover VAT incurred while it was carrying out the activity of growing woodlands and then felling and selling on the timber, a taxable supply. HMRC reviewed the charity's objectives at a VAT visit and considered that, as it was a not-for-profit body, the charity should not have reclaimed as much VAT as it did. HMRC considered the apportionment used did not provide a fair and reasonable recovery of input VAT "*because it allowed them too much input VAT credit*".

HMRC contended that in order for the charity to recover the VAT, it must use the land exclusively to make taxable supplies. However, as the charity had non-business/charitable objectives for the land, it was not entitled to reclaim the full VAT sum incurred.

The judge disagreed with HMRC's argument in two respects: firstly, as long as a link existed between VAT incurred and the intention to make a taxable supply, the charity could recover the VAT. Although there was not an *immediate* link between the cost incurred and the eventual sale (i.e. it would take considerable time for a tree to grow), since the charity was acting as a taxable person at the time it incurred the costs it could recover the input VAT. Secondly, HMRC should not consider the intentions or objectives of the taxable person when costs were incurred, and instead should look at the objective character of the transaction.

The Tribunal went further in its judgment and stated that even if it agreed that the income basis of apportionment suggested by HMRC was correct, the charity's method was still more fair and reasonable. This is a useful reminder to taxpayers that unless HMRC are able to provide a more fair and reasonable basis to recover the input VAT than the taxpayer's method, it is likely that the appeal will fail; Tribunals' findings are of fact, and their purpose is not to determine suitable fair and reasonable apportionment calculations.

Please contact our Indirect Tax Team if you are concerned about this ruling.

Littlewoods - compound interest claim rejected

The long-running saga involving *Littlewoods Ltd* (Littlewoods) and HMRC appears to have come to an end, with the Supreme Court ruling in favour of HMRC, in a case which could have cost the Exchequer up to £17 billion.

The issue was whether a taxpayer could apply for compound interest in place of simple interest for repayments of VAT due from HMRC. The Supreme Court overruled the Court of Appeal's decision and considered that the payment of simple interest provided "adequate indemnity" for the taxpayer.

Between 1973 and 2004, HMRC incorrectly charged Littlewoods £205 million of VAT. HMRC subsequently repaid Littlewoods the £205 million together an additional simple interest of £268 million.

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Littlewoods, however, considered the payment of simple interest did not provide adequate commercial restitution and brought a claim against HMRC in the region of £1.25 billion, calculated on a compound basis and on the grounds that such interest was due under the common law of restitution.

The Supreme Court rejected Littlewoods' argument stating that simple interest should be applied in accordance with s.78 of the VAT Act 1994, and that common law claims for compound interest would effectively rule this section redundant.

The Court also considered whether EU law required the payment of compound interest. The CJEU had declared that it was for national law to determine the type of interest that applied, and that the widespread practice of other EU member states' was to award simple interest. Thus the Court did not believe that Littlewoods had been deprived of "adequate indemnity", and rejected the claim for compound interest.

Certainly, had the Supreme Court ruled in favour of Littlewoods there would have been far reaching and potentially detrimental consequences for the HMRC as we understand there were approximately 5,000 additional cases behind Littlewoods. HMRC can now breathe easy as, after around 10 years of litigation, this appears to be the end of the road for compound interest claims.

Please contact our Indirect Tax Team if you have any queries in relation to this decision.

What is a 'college of a university' for the purposes of VAT exemption?

The Court of Appeal considered this question and found that the provider of education, SAE Education Limited (SAE), failed to fall within the definition of a 'college of a university' for VAT purposes so its supplies were not subject to exemption and instead were standard rated.

The Court set out its basis for considering whether an entity is a 'college of a university', and stated the following must be established:

- It is a constituent part of the university with all the rights and privileges for its students and other members which that entails;
- As part of this it must demonstrate some legal relationship between the university and college which establishes and confirms the status of the latter;
- The arrangement must be one which in a real sense makes the college a part of the university and not simply a suitable educational provider to whom the university has outsourced the courses which it has been unable for whatever reason to provide itself.

Although SAE provided a myriad of arguments that it was a college of a university, the Court rejected the arguments on the basis that it was not able to fulfil *all* of the above factors.

For-profit educational providers may need to look at their relationship and integration with universities when considering if their supplies are exempt or standard rated. This ruling by the Court of Appeal may mean they need to review their VAT position in light of this judgment.

Our Indirect Tax Team can assist if you have any questions concerning this.

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VAT recoverable when supplying customers with rewards in exchange for points

This case concerned Tesco Clubcard vouchers and services exchanged (some in the form of 'Reward Tokens') when points were redeemed by Clubcard members. The 'Reward Tokens' allowed Clubcard members to purchase goods/services from a third party, known as a 'Deal Partner' (for example, the purchase of a restaurant meal from a designated Deal Partner).

The issue at stake was whether Tesco Freetime Limited (Tesco) was entitled to recover the input tax it paid to the Deal Partners for running the scheme.

HMRC argued that Tesco provided points to customers for free and these points were exchanged for experiences in which the customer was the recipient of the supply. On this basis, Tesco would not be able to recover the input VAT as, although it paid for the supply, it was the customer who received and enjoyed the supply. Effectively, HMRC believed Clubcard members got 'something for nothing'.

The FTT rejected this notion, stating that the flaw in HMRC's argument was that it did not reflect the economic reality. Moreover, the idea that the Clubcard members received "something for nothing" and that there was an "untaxed consumption" were "demonstrably false".

On this basis, the FTT ruled that the Deal Partners were supplying redemption services to Tesco, necessary to operate the loyalty scheme, and so the VAT incurred on this was recoverable by Tesco.

Please contact our Indirect Tax Team if your business is affected by this decision.

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