Briefing

The VAT review for October

Speed read

August and September have seen limited development from a VAT perspective, though there have been a number of recent tribunal decisions, of which perhaps the most interesting is the *Pertemps* case. The idea that an employer was providing a service to an employee by offering an alternative remuneration structure may, at first glance seem a little outlandish, but care is needed in distinguishing this situation from that considered by the CJEU in *Astra Zeneca*. At a European level, the AG's opinion in joined Hungarian cases may re-open the question whether compound interest should be a necessary part of the compensation due to a taxpayer in relation to VAT levied in breach of EU law, whilst a number of member states are cooperating in trial of cross-border VAT rulings for complex cases.

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VAT and salary sacrifice

In *HMRC v Pertemps Ltd* [2019] UKUT 234, the Upper Tribunal (UT) has held that salary sacrifice arrangements put in place by an employer did not involve any supply of services by that employer to its employees.

Pertemps was an employment business that provided permanent and temporary workers to clients. It offered its employees an optional alternative salary sacrifice scheme (MAP) pursuant to which its workers could give up part of their salary (out of which they would normally have to meet their own travel and subsistence expenses) in return for receiving direct payments of travel and subsistence expenses from Pertemps (as employer) without deduction of tax under an HMRC dispensation.

The benefit of MAP was that employees obtained a cashflow advantage over receiving taxed wages and then having to reclaim tax on their end of year tax return for their expenses. However, payments under the MAP were subject to a small MAP adjustment which reduced the amount of the payment to employees. HMRC contended that Pertemps was supplying services to its employees in return for the MAP adjustment and was liable to VAT on those amounts.

The UT noted the recent decision of the Court of Appeal in *Wakefield College v HMRC* [2018] EWCA 952 on the correct approach to the question whether a taxable supply of services took place. It was necessary to separate this issue into two questions: was there a supply of services for a consideration within article 2 of the Principal VAT Directive; and, if so, whether the supply was part of an economic activity carried out by the supplier within the meaning of article 9.

HMRC argued that the supply made by Pertemps was the operation of the MAP which provided the employees with a cash flow benefit in return for the MAP adjustment. In particular, HMRC relied on the CJEU decision in *Astra Zeneca UK Ltd v HMRC* [2010] STC 2298, in which the CJEU held that there was a supply for a consideration where an employee sacrificed salary in return for receiving a voucher. The UT rejected this analysis.

In this case, there was merely a payment of expenses by Pertemps without deduction of tax due to the HMRC dispensation. Pertemps was simply paying employees in one (tax efficient) way rather than another. This was not the provision of an administration service. The reality was that Pertemps offered its employees a contract of employment under which they could be remunerated in two alternative ways: one included the MAP and a reduced salary. This did not involve any supply of administration services and nor did it involve any service of 'exchanging' one method of remuneration with another.

Had it been necessary to do so, the UT would also have held that any supplies made by Pertemps were not made as part of any economic activity by Pertemps. In particular, it was not the type of activity that could have been provided by a third party supplier and nor was Pertemps operating the MAP for the purpose of obtaining income.

Why it matters

From a VAT perspective, it may be tempting for HMRC to see supplies wherever there is any form of discount or adjusted payment. Reciprocal terms in contracts can all too easily take on the form of a phantom supply. Distinguishing between the situation where a true supply exists and simple reciprocal rights and obligation under a contract can be difficult. In this case, it was clear that the MAP was merely one option for remunerating employees, rather than a separate supply being made available by an employer to its employees.

Input VAT on debt enforcement action

In *Newmafruit Farms v HMRC* [2019] UKFTT 401, the First-tier Tribunal (FTT) has held that VAT on professional fees incurred by a lender in obtaining repayment of loans was not deductible. The FTT considered that the input VAT had a direct and immediate link with the exempt supply of loans and could not be recovered as a residual cost component of the business as a whole.

The taxpayer company in this case, a fruit farming business, had lent monies to a property developer as a way of investing its significant cash reserves. In 2016, however, the taxpayer took High Court action to enforce repayment of the loans.

The taxpayer sought to deduct the input VAT it incurred in the High Court proceedings. It argued that there was a direct and immediate link between the fees it had incurred and its economic activity as a whole. HMRC, in contrast, argued that in making loans, the taxpayer had made exempt supplies and the input VAT was solely and directly attributable to those exempt supplies. The taxpayer sought to distance the input VAT from the supply of the loans by pointing to the fact that the legal fees were incurred years after the loans were made, and so argued that there was a 'temporal disconnect' between the two.

The FTT has rejected the taxpayer's argument. When a lender supplies a loan, the lender will need to administer the loan until it is discharged, including bringing proceedings in cases of default. All of the administration is clearly a cost component of the supply of the loan, and the expected costs would typically be factored into the rate of interest (which is the consideration for the supply). Therefore, the taxpayer's legal costs in enforcing the loan against a borrower was a cost component of the original supply of the loan and, as such, there was a clear direct and immediate link. The FTT went on to reject the argument that it made any difference that the taxpayer was not normally in the business of making loans.

Why it matters

The FTT's approach in this case appears eminently sensible. A lender can expect to have a range of administrative functions to carry out in relation to loans it makes and these administrative tasks must be factored into the cost of (and therefore the consideration charged for) making those loans. Unlike in cases such as *Midland Bank plc v HMRC* [2000] STC 501, costs incurred in administration were foreseeable cost components, even though they may have been incurred subsequent to the relevant output transaction.

Pre-incorporation input VAT

In *Koolmove Ltd v HMRC* [2019] UKFTT 502, the FTT has held that a company set up to exploit software was entitled to recover input VAT on legal expenses incurred by its founder to protect the intellectual property in that software. The situation fell within the circumstances contemplated by reg 111 of the VAT Regulations, SI 1995/2518, to the extent that the legal services were supplied within six months of the VAT registration of the company.

The software concerned was originally developed by Mr McKee. However, his former employer brought an action against him for infringement of copyright, breach of confidence and an injunction on use of the software. Mr McKee incurred costs in successfully defending himself against these proceedings. Having done so, he set up a company, Koolmove Ltd, to exploit the software he had developed. Koolmove then registered for VAT and sought to recover, as input VAT, the VAT incurred by Mr McKee on legal fees.

HMRC rejected this claim on the basis that the legal fees were one step removed from demonstrating a direct and immediate link between the court case and the business of Koolmove.

The FTT, however, reached the 'clear conclusion' that the appellant was entitled to rely on reg 111 to claim input VAT recovery. It was clear that Mr McKee always intended to exploit the software through a company and he had set up the company as soon as reasonably practicable after the litigation had been concluded in his favour. Until that point, there would have been no point setting up the company. Furthermore, Mr McKee satisfied all the conditions in reg 111: the legal services were for the benefit of the company; the company had reimbursed Mr McKee for the costs; Mr McKee was not himself registered for VAT; the expenses were incurred for the purposes of the business to be carried on by the company; and the services were, at least for the most part, provided within six months of the company's registration for VAT.

Why it matters

The FTT was critical of HMRC's case, describing it as 'somewhat confused'. Much of HMRC's argument simply focused on the fact that the supplies were made to Mr McKee rather than the company and the FTT considered that HMRC had 'lost sight' of the fact that the whole point of reg 111 is to allow recovery of input VAT on services supplied to an incorporator prior to the incorporation of the company where the relevant business is to be carried on by it.

The decision is an important reminder of the availability of this relief, but also of the strict conditions necessary to be fulfilled in order to take advantage of it.

VAT and compound interest (again)

In joined cases *Sole-Mizo* (Case C-13/18) and *Dalmandi* (Case C126/18), the advocate general (AG) has again opened up the issue of whether compound interest is necessary in order to provide full or adequate compensation for the damage caused by demanding payment of VAT contrary to EU law. The AG has opined that EU law will normally require full compensation to be made to a person who has suffered from a breach of EU law and that full compensation requires the payment of interest both at a rate which is commercial and which recognises the erosion to the value of money by the effluxion of time, by providing some form of compounding.

The issue of compound interest was, of course, considered by the Supreme Court in *Littlewoods v HMRC* [2017] UKSC 70. Following a referral to the CJEU, the Supreme Court held that EU law did not require UK law to provide for compound interest on repayments of overpaid VAT in order to provide the taxpayer with an 'adequate indemnity'. The Supreme Court considered that, read as a whole, the CJEU had not indicated that a full indemnity for the loss of the use of money over time was a necessary component of an 'effective remedy' and, as such, the exclusive statutory right to simple interest in UK law was compliant with EU law.

The latest joined Hungarian cases concern provisions of Hungarian law that illegally restricted and delayed VAT deductions for input VAT. These provisions were held incompatible with EU law and the Hungarian tax authorities paid interest on the late deduction of the VAT based on the base rate of the central bank (under provisions of domestic Hungarian law dealing with situations where a settled practice had been overturned). The two Hungarian taxpayers in this new case submitted claims for compound interest on the input VAT which had been restricted.

The case raises a number of issues over the EU principles of effectiveness and equivalence, but the general issue of most interest is the question whether the simple rate of interest was sufficient to provide an 'adequate indemnity'.

On this issue, the AG noted that some earlier CJEU judgments referred to a taxpayer's right to 'full compensation' and in other judgments (particularly in tax matters where substantial amounts are at stake) reference is made to 'adequate compensation'. Despite the differences in wording, the AG suggests that there is no conflict in the two formulations. Rather the use of the term 'adequate' indicates that in some circumstances the right to 'full compensation' for damage caused by breach of EU law may have to be qualified due to considerations of 'practicability and general expediency'.

Commenting specifically on the *Littlewoods* case, the AG states that 'the intention of the Court was not to depart from the principle of full reparation, but rather to refer to the fact that the precise rate to be applied — the one amounting to full compensation — depends on the situation currently prevailing in each Member State'.

The AG has suggested, however, that apart from in such situations, the grant of something at least close to full compensation is necessary to ensure the full effectiveness of EU law. In particular, the AG's opinion goes on to suggest that basing the rate on that of the central bank would not comply with that requirement as such a rate would not be a rate in practice available to an ordinary taxpayer to borrow the necessary funds to offset the late repayment of VAT. Moreover, the AG went on to say that compensating the taxpayer also required the tax authority to compensate for the 'monetary erosion caused by the effluxion of time' by further interest. In essence, therefore, the AG suggested that some form of compound interest is necessary to meet the requirements of EU law, though this should be one based on the rate of inflation (rather than a rate charged by a bank).

Why it matters

This is only an AG's opinion, and it does not fully explain why the AG considered that the CJEU thought simple interest acceptable in the *Littlewoods* case by way of departure from the general principle. However, if followed by the CJEU, it will potentially shine the spotlight back on arguments for compound interest and potentially cast doubt on the Supreme Court judgment in *Littlewoods*.

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Cross-border VAT rulings

The European Commission has published an information notice providing details of a trial for private VAT ruling requests relating to cross-border situations (see bit.ly/2rOj3UX). Eighteen member states are currently participating in the project, including the UK, Spain, France, Italy and the Netherlands.

Under the project, taxable persons planning a cross-border transaction in one or more of these member states may request a ruling on the VAT treatment from the tax authority in the member state where they are registered. The request should, in principle, be submitted in the normal form for a national VAT ruling.

A cross-border VAT ruling can only be requested if the transaction envisaged is complex and has a cross-border aspect involving two or more member states participating in the project. Applicants should provide a detailed and clear description of their situation/transaction and of their opinion and/or doubts with regard to the applicable VAT treatment. In addition, the applicant should explicitly request that the member state to whom the request is made should enter into consultations with other affected member states.

Once a request is made, the member states concerned will consult each other. However, the cross-border ruling process does not guarantee that the member states will agree on the VAT treatment of the transactions envisaged or will issue an agreed cross-border ruling.

The intention is that decisions should be taken as soon as possible, but national rules on reply deadlines will not automatically apply to these cross-border ruling requests.

Why it matters

The trial procedure offers taxpayers little in the way of rights or guarantees at this stage. Nevertheless, if it can be successfully implemented and broadened, then it holds out the prospect for an efficient means for taxpayers to obtain clarity and certainty on complex cross-border transactions from a VAT perspective.

Implementation of VAT reverse charge on construction services delayed

The government has announced that the implementation date for the reverse charge on construction services will be delayed until 1 October 2020.

Earlier this year, the government enacted legislation to introduce a reverse charge on certain supplies of construction services with effect from 1 October 2019. The Value Added Tax (Section 55A) (Specified Services and Excepted Supplies) Order, SI 2019/892, will, in general terms, introduce a VAT reverse charge on supplies of construction services to which the provisions of the construction industry scheme (CIS) also apply. However, since the purpose of the legislation is to prevent missing trader fraud opportunities within the construction industry, the legislation includes a number of exceptions for low risk situations, such as where the supply is made to the final consumer.

On 6 September 2019, the government announced that the reverse charge will now be implemented a year later, on 1 October 2020. This is in part to allow businesses more time to prepare for the introduction of the reverse charge, since the government had received representations from the Industry that some businesses were not yet prepared to operate the charge.

Why it matters

The delay will be welcomed by many businesses in the construction industry. However, the announcement of the delay has been left very late and some businesses will have prepared for the introduction of the reverse charge and may now have to delay or reverse any planned changes to their systems. HMRC states that it will take into account the fact the implementation date has been changed where genuine errors occur as a result of the delay.

What to look out for

- We understand that HMRC has indicated that it will be issuing guidance as to the procedure that a recipient of a supply should follow to reclaim overcharged VAT directly from HMRC where it is impossible or excessively difficult to reclaim that VAT from its supplier.
- On 17 October, the AG's opinion is due to be published in *KrakVet Marek Batko* (Case C-276/18). This Hungarian referral concerns whether the VAT regime should be interpreted as preventing tax authorities from one member state from attributing to a transaction a qualification differing from that of another member state in a way that gives rise to double taxation of the taxable person. ■

For related reading visit www.taxjournal.com

- Cases: *HMRC v Pertemps* (18.9.19)
- Cases: *Koolmove v HMRC* (18.9.19)
- Supreme Court ruling in *Littlewoods* (Nick Skerrett, 9.11.17)