A fresh look at VAT groups

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Punnit Vyas and Kevin Hall consider the impact of the recent changes to VAT for sole traders and partnerships.

The rules on VAT grouping recently underwent some changes as a result of legislation introduced in the Finance Act 2019, effective from 1 November 2019. These changes provided a further dimension for advisers to consider when advising their clients, expanding planning opportunities but also adding to the numerous complex rules already in existence in the area of VAT grouping. In this article, we will consider the impact of the recent changes for sole traders and partnerships and also take a look at the recent case of Melford Capital, which highlights the importance and complexities of VAT groups in the context of financial services.

Extension of VAT grouping to unincorporated businesses

Non-corporate entities, such as individuals, partnerships and Scottish partnerships, are now allowed to join VAT groups, provided they control all their corporate subsidiaries. It should be noted that other types of unincorporated businesses, e.g. clubs and associations, are not included. The relevant legislation is VAT Act 1994 s 43A to D.

The conditions

The pre-1 November 2019 rules allow corporate bodies to form a VAT group if:

- each is established or has a fixed establishment in the UK; and
- they are under common control.

There are some further conditions for 'specified bodies', applicable to larger groups (exceeding £10m turnover). Since 1 November, non-corporates can also join a VAT group if they meet these conditions in respect of control and establishments. A fixed establishment is any establishment which contains 'permanent human and technical resources' of the sole trader or partnership's business.

The control condition is that all members of the group are controlled by one entity, which can be a body corporate, an individual, a partnership or a Scottish partnership. The controlling entity does not have to be a member of the VAT group but now may be so, irrespective of whether or not it is an incorporated body.

This common control test relies on the Companies Act 2006 s 1159 and Sch 6 definitions, which define what is meant by a subsidiary and its holding company. These rules now also apply to an individual or individuals 'if he or they, were he or they a company, would be that body's holding company'. So, an individual as a sole trader or partnership can control a group member in the same way as a parent company of the group member within the definition in s 1159 and Sch 6 to the Companies Act 2006.

It should be also noted that the introduced legislation does not permit a VAT group containing no corporate bodies at all to be formed, i.e. of only sole traders or partners. There is no such restriction on a VAT group containing only corporate bodies.

LLPs are considered to be a body corporate for VAT purposes and can be included in a VAT group. Where the LLP is the holding company and the individual partners of the LLP hold the shares in the subsidiaries of the LLP, this will not normally result in the subsidiary satisfying the control conditions, even if all the partners in the LLP are shareholders. What matters is the named shareholder of the subsidiary company and the exact entity that controls it. It must be the LLP itself that is the controlling body of the subsidiary and not the partners in their capacity as individuals.

Benefits of VAT groups for unincorporated bodies

Assuming the conditions outlined above can be satisfied, advisers should be alert to any opportunities to form a VAT group that would utilise the natural advantages and benefits arising from the formation of the VAT group. Supplies between the members within a VAT group are disregarded for VAT purposes, which is normally a clear benefit of forming a VAT group, particularly where input tax might not be fully recoverable.

However, the benefits arising from VAT group registration are only permissible, as HMRC states, so long as any revenue loss arising as a result of VAT grouping does not go beyond 'the normal operation of grouping'. Unfortunately, this term is not defined any further and so causes some difficulty, as HMRC may prevent a person joining a VAT group and/or remove an existing member from a VAT group where it considers there is revenue loss arising beyond the normal operation of VAT grouping.

There are also some more straightforward benefits of VAT grouping, such as the administrative easing from only having to compile a single VAT return for all the members of the group, although with today's sophisticated accounting software and procedures this might be no more than a marginal benefit.

Consideration of all the benefits of VAT grouping, including any natural VAT savings arising from the intra-group disregard, must be balanced by the disadvantages, potentially the most significant of which is the 'joint and several' liability for the debts of the VAT group. For a sole trader or partnership, the risk of joint and several liability applying to VAT debts may be comparatively greater than it would be for a corporate.

A sole trader or partner should not, however, be deterred from joining a VAT group if there is a clear commercial case for grouping and the 'natural advantages' do not infringe HMRC's perceived notion of revenue loss arising beyond the normal operation of grouping. Indeed, if there were no tangible advantages to the formation of a group, or joining an existing VAT group, VAT grouping for sole traders and partners (or for any other types of entity for that matter) would be a somewhat futile exercise. Below is an example of a scenario that could give rise to natural savings, where the benefits of VAT grouping potentially outweigh the risk. This is followed by a look at an example of VAT groups working in the financial services sector where, partial exemption notwithstanding, VAT grouping is often the most sensible approach.

VAT grouping in practice

A sole trader (or partnership) may wish, at some point in the life of their business, to move the trade to a company. In doing this, there may be non-tax reasons to leave the property, from which the business trades, outside the company. It may be more practical for the sole trader business, and in planning succession of the business and for inheritance purposes, etc., that the ownership of the property is retained with the individual or individuals.

Normally, the transfer of the trade without the property to a new entity can still benefit from the transfer of a going concern rules, so that this is a VAT free transfer of the business assets and trade. This leaves the property needing to be dealt with outside the transfer of a going concern rules. If the corporate transferee is to trade from the same property, a supply is usually made separately of the property by the sole trader to the company by the supply of an interest in the property such as a lease of 21 years or less.

The sole trader would be making an exempt supply of the lease of the property to the company, unless it opts to tax, with the ensuing capital goods scheme input tax adjustments as applicable.

However, a preferable means could be to remove the question of VAT from these transactions and form a VAT group of the sole trader with the company, so that the supplies between the sole trader and the company are disregarded. This provides a more efficient means of extracting profits from the company and removes VAT from the value of the rental charges, without the sole trader personally being tied to a 20 year option to tax on the

property. This approach is not without its risks and does need to be reviewed very carefully, as the movement of the property into the VAT group may cause a VAT charge or input tax clawback depending upon the circumstances. However, if handled correctly this could be a sensible and beneficial use for the new rules extending VAT grouping to non-corporates.

Melford Capital: VAT groups in the context of financial services

The First-tier Tribunal case of Melford Capital General Partner Ltd v HMRC [2020] UKFTT 6 (TC) is interesting, not least because it reminds us of the question of input tax recovery within complex VAT group structures.

Fundamentally, costs bearing VAT which are irrecoverable before the introduction of a VAT group should not become recoverable simply by placing the entity in a VAT group. That certainly seems to be HMRC's guiding principle (or perhaps an unhelpful fixation?) in the approach to VAT grouping and input tax recovery. The Melford Capital decision seems to turn this on its head: input VAT that is recoverable outside a VAT group should not become irrecoverable simply by placing it in a VAT group. The VAT group is, essentially, a single entity after all.

The appellant, Melford Capital, was successful in this case in securing VAT recovery. The facts of the case and structure of the entities involved, and the two VAT groups which were involved in this case, are not straightforward. Essentially, one VAT group was supplying services to the other. The services supplied were akin to management services. The first of the VAT groups included Melford Capital (the general partner of a limited partnership) and the supplies it made were taxable to entities outside the VAT group; i.e. to the special purpose vehicles (SPVs) within the second VAT group.

Melford Capital successfully argued that there was recovery of VAT on the operating and set-up costs which related to the SPVs in the second VAT group but which were incurred by Melford Capital's VAT group. The VAT recovery was justified, to put it simply, on the fact that the Melford Capital's VAT group was providing taxable services externally. As Melford Capital's VAT group made only taxable supplies, it was entitled to full input tax recovery.

HMRC took a less simplistic and more myopic view, arguing in terms of 'cost components'. (This is a well-trodden and previously used argument, that appears to carry more weight in some circumstances and not others – see the recent decision in University of Cambridge (Case C-316/18), and particularly arguments contained in Midland Bank (Case C-98/98) et al.).

HMRC argued that the proper analysis of the VAT on the set-up costs and operating costs that Melford Capital was seeking to recover was to determine whether they were cost components of an economic activity, and not simply to analyse the status of the appellant as a single entity making external taxable supplies from the VAT group. Since Melford Capital also held shares in a holding company, that in turn owned the SPVs, which in turn held the investments, HMRC's view was that the supplies of Melford Capital to the holding company and SPVs (the second VAT group) were partly non-economic as Melford Capital also carried out investment activity, subscription of share capital and interest-free loans to the SPVs within the second VAT group. Input tax was therefore irrecoverable, as HMRC argued that certain costs were incurred by Melford Capital in relation to its purely passive role of holding investments. (See Polysar (Case C-60/90), where the court decided that a business, which did not charge for its involvement in the management of its subsidiaries, could not recover input tax on its costs.)

The tribunal judge disagreed with HMRC's analysis and did not see any separate non-economic activity arising from Melford Capital's activities. It therefore saw the attribution of the costs in question as possible only to the

economic activity of the entire group, which took the form of the taxable services, essentially management charges, that Melford Capital's VAT group supplied to the other VAT group of 'subsidiary' entities. The situation in Melford Capital was akin to a holding company providing management services to its subsidiaries.

The holding company analogy was deployed in this case and useful to an extent for both the appellant and HMRC. However, Melford Capital, the representative member of the VAT group and general partner of the limited partnership, was not a holding company. The holding company in this case was a separate entity (HPH Ltd). Melford Capital in fact supplied its taxable services to the subsidiaries of the holding company (HPH Ltd, the representative member of the second VAT group). Neither Melford Capital nor its direct customers, the SPVs, were holding companies. Despite being an interesting comparison, the holding company analogy was perhaps not the best analysis to apply in this financial services context. Although the judgment contains interesting points from the significant and mounting body of case law on holding companies, it is perhaps misleading for financial structures, and unfortunately this case is unlikely to settle the debate on holding company VAT recovery either.

Final thoughts

It seems that VAT grouping will never be entirely straightforward, particularly in the context of financial services and private equity, where VAT groups are often used in investment structures. Spare a thought too for when cross-border supplies are mixed with VAT groups. Further developments on this area are being awaited with the recent referral of questions to the CJEU in Danske Bank, which has reopened the Skandia debate on how the VAT grouping rules should apply in complex cross-border scenarios across the EU.

What is clear is that VAT grouping, holding companies, together with the extension of VAT grouping to non-corporates, will keep us all busy over the coming months, without even mentioning Brexit for a while!