Three party transactions: output tax issues

Indirect Tax

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In the first of a two-part series, we analyse the output tax issues of three-party deals. The second part will consider input tax challenges.

Key Points

What is the issue?

The recent FTT case of *All Answers Ltd* was lost by the taxpayer, with the judge agreeing with HMRC that the company was acting as principal rather than agent when selling completed essays to students that had been written by self-employed authors.

What does it mean for me?

The increase in the number of website businesses that link suppliers and customers means that VAT should be considered as soon as a new venture is started to decide whether the host is making a supply of goods or services or only receiving a commission.

What can I take away?

In deciding the agent vs principal issue, you must consider the terms of written contracts between the various parties and the commercial reality of a deal. The absence of a contract between the authors and students in the *All Answers* case was significant.

Party ‘A’ sells standard rated goods or services to ‘B’. ‘B’ makes a profit and sells to ‘C’. ‘B’ is registered for VAT and ‘A’ is not. ‘C’ is a private individual or any party which cannot claim input tax.

When you have digested the VAT issues of the previous sentence, and thought of the main way of reducing the tax payable on this deal, you will appreciate why three-party transactions have always produced so many VAT headaches, controversial tribunal decisions and – in some cases – bankrupt businesses. Bankruptcy could happen if HMRC uses its power to assess underpaid output tax for the previous four years by issuing a ‘best judgment’ assessment in accordance with Value Added Tax Act 1994 s 73(1).

The multi-million-pound VAT saving question – in some cases – is as follows:

- Can the deal be restructured so that ‘A’ directly sells to ‘C’ (no output tax); and then ‘B’ charges a commission to ‘A’? (Some output tax will be charged by ‘B’ but on its profit margin rather than the full selling price.)

The potential VAT savings can be massive, as shown by the recent First-tier Tribunal case of *All Answers Ltd*, which I will consider in this article.

Agent vs principal

An important VAT challenge is to always consider the question: who is supplying what and to whom? If this answer is clearcut, the VAT outcomes are usually straightforward. There are two important issues to consider for all three-party deals:

- **Commercial reality:** Which business does the final customer think they are dealing with? For example, if goods or services are faulty or sub-standard, who will the customer complain to for compensation or a replacement?
- **Contracts:** The contractual reality of a deal will usually establish who is acting as, say, the principal and who is the agent. A contract can be a simple one-page agreement; it does not need to match the word count of Tolstoy's *War and Peace*.

In most cases, the commercial reality of a deal and the written terms of a contract will produce the same VAT outcome. However, in cases where there is a difference – hopefully very few – it is the commercial reality that will take priority. For example, if I issue a letter of engagement which states that I will supply hairdressing services to a firm of accountants but I actually provide tax consultancy work, it is the VAT rate for tax consultancy services that will be relevant.

Essays for students

The recent case of *All Answers Ltd* [2023] UKFTT 00737 considered whether the company was supplying online essays and written coursework to students and other customers for a fee, rather than the self-employed writers used by All Answers to produce the work. The agent vs principal issue for All Answers was considered by both the First-tier Tribunal and Upper Tribunal in 2018 and 2020 respectively, and both courts ruled in favour of HMRC, concluding that All Answers was the principal.

In summary,All Answers retains two-thirds of the fees paid by students, with the writers keeping one third. All Answers argued in its earlier appeals that the writers were supplying services to the students and it provided an agency service to the writers. The tax at stake was a massive £904,168.

So, what made the third run of the litigation process in 2023 different to the previous two failed attempts? The answer is that All Answers revised the contracts with the writers which, it claimed, completely changed the legal relationship of the arrangement and also the commercial reality of the deal.

All Answers argued that the revised contract clearly stated that the writer retained the copyright of all work supplied to students and therefore All Answers could only be acting as agent. In other words, output tax was payable by All Answers on two-thirds of the fee. The contract included a specific paragraph stating that it was the job of the writer 'to provide the work to the customer'.

The tribunal agreed with HMRC that the contractual change did not affect the commercial reality; namely, that All Answers supplied essays to the students and the writers provided essays to All Answers. Job done.

An important factor was the absence of any contract between the writers and the students. Even though All Answers implied that a contract existed because of clauses in the contract between the writer and All Answers, these clauses were not sufficient to change the VAT position: 'All Answers delivered the academic works and not the writer.' The appeal was dismissed.

In summary, the most important learning point is that contracts are needed between all parties involved in a three-party arrangement.

Website trading

The All Answers decision is a timely reminder of the need to regularly review the VAT position for all website arrangements where a site links a supplier and a customer. In many cases, the website host is making direct supplies as a principal rather than an agent.

I previously wrote an article for *Tax Adviser* ('Shark infested waters', October 2017) about three-party transactions – and shared a VAT tale from my private practice about a website that linked owners of expensive handbags with people who wanted to hire – yes, you've guessed it – an expensive handbag. Have a look at the article for more analysis of the VAT dilemmas (see tinyurl.com/mr2v52hu).

It is important to consider VAT as soon as a new website is launched, to avoid doubt about which party is liable to account for output tax. If HMRC decides that the host has been selling goods or services – rather than earning a commission – this could mean either a backdated registration or a big output tax assessment. See ***Hire of goods: who is the principal?***

Hire of goods: who is the principal?

Oscar is VAT registered and owns a website which links theatre groups looking to hire props with other groups who have a stock of props. Oscar retains 25% of the fee charged by the groups that own the props.

The terms and conditions on the website clearly state: 'If you are unable to resolve any complaint with the owner of the goods, then contact us and we will raise it on your behalf.' The phrase 'on your behalf' is an indicator that Oscar is acting as an agent.

Note: It is irrelevant for VAT purposes whether a commission is earned from a buyer or seller. The key factor is the service carried out by the website, which – in Oscar's case – is to act as an intermediary in bringing together two theatre groups.

Brexit: the end of ‘triangulation’

An outcome of the UK’s departure from the EU on 31 December 2020 was the loss of a concession known in VAT speak as ‘triangulation’, which is relevant when ‘A’ sells goods to ‘B’ and ‘B’ sells them to ‘C’. Each party in the supply chain is VAT registered but in different EU countries and the goods are shipped directly from ‘A’ to ‘C’. The outcome of this EU simplification measure is that it avoids the need for intermediary ‘B’ having to register for VAT in the state of either the supplier or customer. See ***Triangulation post-Brexit***.

Triangulation post Brexit

Mike is VAT registered in the UK. He buys steel for £20,000 per month from a Polish supplier and sells it to a German manufacturer for £30,000. The goods are shipped directly from Poland to Germany.

Until 31 December 2020, the invoices from the Polish supplier to Mike were zero-rated, as were Mike’s invoices to the German manufacturer. The latter business accounted for acquisition tax – and claimed input tax – on its German VAT returns, based on the VAT rate for steel in Germany.

Since 1 January 2021, Mike has three options:

- Mike could register for VAT in Poland or Germany, depending on where he legally takes ownership of the goods. This could prove costly because many EU countries require a non-EU business to appoint an EU based accountant or agent to act as their representative with the tax authorities. There can also be lengthy delays getting a VAT number in some countries.
- He could change the nature of the contract so that the Polish business directly supplies goods to the German manufacturer for £30,000 and Mike issues a commission invoice to the Polish supplier for £10,000. There is no need for Mike to register for VAT in Poland because the supplier will deal with the VAT on their own return by doing a reverse charge calculation.
- Mike could rent premises in another EU country (creating a fixed or business establishment there) and register for VAT so that triangulation is again an option for three-party deals. Ireland and the Netherlands are the natural choices.

Note: The problem with the second option is that Mike will be disclosing his profit margin and the two parties might seek to exclude him from future deals.

Backdated registration

In the First-tier Tribunal case of *Bryn Williams* [2019] UKFTT 79, the taxpayer traded as a taxi control business and was not VAT registered because his net commission from account customers meant that his income was below the threshold. However, the tribunal and HMRC agreed that Mr Williams was acting as principal for the rides, rather than the self-employed drivers he used to do the work. He should have registered in 2009. Don’t forget that HMRC has the power to correct a late registration by going back up to 20 years.

It is worth noting the reasons why HMRC decided that Mr Williams was acting as the principal:

- He negotiated contracts with the customers as his own deal.
- The cars bore his business logo.
- He received money directly from the customers and paid the drivers.
- There was a shared risk with bad debts, rather than the driver taking all of the bad debt.
- At the time of the customer booking a ride, Mr Williams did not know which driver would carry it out.