

VAT ON INTERCOMPANY TRANSACTIONS AND MANAGEMENT CHARGES



**Cutting through the confusion on transactions
with associated businesses, other day to day
transactions and much more**

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Marie Stein has worked in VAT since 1982, starting as a VAT officer with HM Customs & Excise. She moved to become a VAT consultant in the accountancy profession in 1986, and has run her own successful consultancy business since 2010 through her website "vatexchange.co.uk".

Marie's aim is to make the subject of VAT more accessible to businesses, accountants and anyone who needs to know about VAT. She has published three books on the subject:

- VAT for residential property developers and contractors
- VAT for DIY property developers
- VAT on intercompany transactions and management charges

VAT mistakes can have a significant effect on the financial viability of transactions, whether it's sharing out the office insurance or a major property development. And because VAT is a transaction tax, it's usually impossible to change things after the event. Marie explains the complex rules in everyday English (as far as possible) and discusses commercial issues in practical terms to show how VAT applies to everyday transactions.

If you need help with any VAT issue, you can contact Marie at marie@vatexchange.co.uk.

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And finally, the answer to the question:

Can we claim VAT on our office costs and legal bills if we raise a management charge to our associated company?

Disclaimer

This book is a guide about the way that the VAT rules apply to transactions between associated businesses, based on my interpretation of the legislation and HMRC guidance at the date of publication. It DOES NOT cover every possible scenario nor does it replace formal advice on specific situations. Please take proper advice to be certain about the VAT implications of transactions between your business and any related parties, including sole proprietors, limited companies or partnerships and avoid unexpected VAT issues along the way. The author is not liable for any errors or costs arising as a result of relying on information in this book.

The main VAT rules are summarized for the purposes of this book and their relevance to transactions with associated businesses. Links to HMRC's guidance on the subjects discussed in this book are included throughout the book and you must refer to their guidance for full and detailed information about any subject.

Marie Stein

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Marie Stein

June 2018

Preface

Can we claim VAT on our office costs and legal bills if we raise a management charge to our associated company?

When I first started writing this book, it was a response to the many queries I receive about transactions between associated businesses. The queries can be as simple as the one above, or much more detailed, concerning a range of complicated commercial business arrangements and complex VAT issues.

The common thread is that in most cases, the parties themselves aren't sure what the transactions represent and there is no written agreement between the parties.

In one case, HMRC refused to make a repayment to a company for VAT on supplies of services from associated companies. HMRC disputed whether the services were actually been made, despite the provision of timesheets for the individuals concerned, the existence of an intra-group agreement and other evidence.

In that case, one of the main problems was that the parties could not specifically identify the services that had been provided. There was no doubt that work had been carried out, but neither the supplying nor recipient company were able to specify exactly which services had been performed or reconcile the work done with the amounts charged on individual invoices.

It's therefore essential that arrangements between associated businesses are as robust and commercially viable as any similar arrangements with third parties AND that you can demonstrate that services have been provided.

You don't have to pay a solicitor to draw up detailed contracts for all transactions with associated businesses - although if the amounts involved are significant, it's probably a good investment. If all you're doing is sharing out the telephone bill according to the proportion of use by two or three associated companies, then you probably don't need a contract, but you should keep a record of usage to support the amounts charged. Either way, if you want to avoid the cost and hassle caused by HMRC rejecting a claim for VAT charged on supplies between your businesses, I'd strongly recommend that you review your current arrangements and consider whether you need to invest time and money in formal agreements.

Either way, before you raise any sort of charge to associated businesses, issue a VAT invoice or claim VAT on related costs, you must establish whether or not the payment is for a supply of goods or services and whether the charge is liable to VAT.

I don't expect any significant changes to the current UK rules in the foreseeable future even allowing for Brexit, for the simple reason that the collection and administration of VAT is a very efficient way of collecting revenue. If the UK wishes to retain a strong trading relationship with the EC, I suspect that we will retain the same VAT system in the long term.

Please read the Introduction which introduces the important technical issues and explains how the book works.

Introduction

Most businesses are pretty good at dealing with VAT on their main business activity; knowing when to charge VAT to customers and when they can claim VAT on costs. But it's those non-core issues that often cause problems.

HMRC VAT officers often find errors in the VAT accounting of such transactions, meaning that the business owners have to spend a disproportionate amount of time (and sometimes professional costs) sorting out non-core VAT issues, sometimes where the amount of money involved is a tiny fraction of the VAT on their core business activities.

I've run www.vatexchange.co.uk since 2008. EVERY SINGLE MONTH the most commonly visited page on the site is an article about VAT and management charges/intra-company payments and reimbursements. The VAT liability of such payments is also the most common sources of the queries I receive from clients and on the website forums, e.g. "do I add VAT when I charge for a share of staff costs?" or "I need to invoice for some telephone bills and directors costs - is it okay to call it a management charge and add VAT?".

To answer the question you need to satisfy two criteria:

- You can only charge for services if the payment; or consideration, is for a supply of goods or services that are liable to VAT.
- You can only claim VAT on costs if you're using the goods and/or services to make taxable supplies and if the goods and/or services are cost components in making those supplies.

I appreciate that the above clauses include technical terminology, but there's really no other way of explaining the criteria without losing something in the translation. I'll discuss these terms in the context of transactions with associated businesses throughout the book.

There is one other very important point: the act of "**raising a management charge**" *doesn't mean that services have been provided*. And issuing a VAT invoice for such "charges" could be fraudulent if services have not been provided or if the value of the services is misrepresented.

Payments between associated parties can be made for a number of reasons; including payment for supplies, contributions towards costs, reimbursements for goods or services bought on behalf of the other party or even a profit share.

Either way, if the businesses are separate legal entities, you MUST define the VAT liability of any payments made between the parties before issuing a VAT invoice.

Once you're certain that the payment IS consideration for a supply of goods or services, THEN you have to consider a number of issues:

- Is the charge made in the course or furtherance of a business? Charges made by holding companies to subsidiaries may not be regarded as being made "in the course of business".
- What is the nature of that supply; e.g. management services, consultancy services or administration services?

- Can you provide evidence of the work carried out?
- Is there a written agreement? Does the agreement CORRECTLY represent the arrangements?

HMRC are increasingly vigilant about situations where associated businesses issue invoices and the effect of the transactions gives a cashflow benefit due to the timing of VAT returns. You can understand why HMRC pay attention to these situations when you consider that the businesses are owned or controlled by the same individual or company. So it's important that the parties can demonstrate that services have been supplied as though the transactions were between independent third parties.

Terminology: Supplier Co and Recipient Co.

In this book, the reference to "associated businesses" means transactions between separate legal entities who are connected or related in some way, whether sole proprietors, partnership, companies, limited liability partnerships, trusts etc. I've discussed this concept in more detail on page 19.

For ease of reference I'll use the following references to the example question throughout the book:

- the business that wants to raise a charge and claim VAT on office costs and legal bills is "Supplier Co"; and
- the associated business, that would pay the charge, is "Recipient Co".

VAT liability?

Once you've established that supplies have been made, you then follow normal VAT rules to establish whether the service is liable to VAT at 20%, 5%, 0% or exempt under VAT law, which apply whether the parties are related or not.

You might assume that the easiest approach is to charge VAT in any situation - you avoid the risk of under-declaring VAT and HMRC don't usually complain if they get overpaid! But unfortunately, it's not that simple. ***If you don't establish the correct VAT liability right from the start, you can end up with unexpected VAT assessments or irrecoverable VAT that could have been avoided.***

This book explains when such payments are liable to VAT and discusses practical ways to avoid mistakes so that you can concentrate on generating profit on your core business activities. It also explains when special rules apply to payments - such as property costs, staff costs, motoring costs and cross-border transactions, as discussed in [Chapters 7 to 12](#).

What's a contract?

I'm not a solicitor, but I think it's important to consider the concept of "contract" in the context of transactions between associated businesses.

My Oxford dictionary defines contract as: "a written or spoken agreement intended to be enforceable by law". We'll discuss this issue throughout the book and [Chapter 15](#) discusses in more detail what you might include in a contract for VAT purposes.

As I said in the Preface, you're not legally required to have written contracts for VAT purposes. But the reason that solicitors, accountants, VAT consultants and other professionals usually recommend having written contracts is to properly establish the arrangements for transactions between separate legal entities, whether associated parties or third parties and prevent confusion when dealing with HMRC or other third parties.

The difference between "intra" and "inter"

As I've discussed in Chapter 3, there's often confusion about relations between associated businesses and sometimes this is because people get their terminology mixed up.

"Inter-company" means between separate companies; e.g. parent company to subsidiary.

"Intra-company" means within a single company; e.g. the sharing of head office costs between separate divisions of the company.

Supplier Co and VAT recovery

The answer to the question: *"Can we claim VAT on our office costs and legal bills if we raise a management charge to our associated company?"* depends on whether Supplier Co is providing taxable services to Recipient Co. However Supplier Co can also claim VAT if it uses the services to make any other taxable supplies to third parties.

This means that you can't just look at the arrangements between Supplier Co and Recipient Co in isolation; Supplier Co's entitlement to claim VAT on its costs depends on whether and to what extent it makes taxable supplies to BOTH Recipient Co and any other parties, whether associated businesses or third parties. We'll discuss the main principles in [Chapters 1 - 4](#) of the book.

We'll also consider whether Recipient Co can claim VAT on charges from Supplier Co. If Recipient Co makes exempt supplies or carries out non-business activities, then it may not be able to claim VAT charged by Supplier Co and therefore the VAT is simply an additional cost, so it's also important to consider Recipient Co's VAT recovery situation.

How does the book work?

The book is in three main parts as follows:

PART 1: INTRODUCTION TO VAT: IS IT CONSIDERATION FOR A TAXABLE SUPPLY?

To begin with, you need to understand the basic concepts of VAT, which are explained in [Chapter 1](#).

Please take the time to read [Chapter 1](#) even if you're an accountant or otherwise familiar with the main VAT rules. It's important to know the basic principles to understand how they apply in specific circumstances.

In [Chapter 2](#), I've discussed the concept of supplies of services, when they occur and how to demonstrate that services have been supplied. In [Chapter 3](#), I've discussed different reasons for making payments that don't represent payment for a supply. [Chapter 4](#) discusses what to do when you have established that taxable supplies have been made, with more practical information about

issuing VAT invoices, when to charge VAT and answers to some of the most frequently asked questions.

[Chapter 5](#) explains when income from such transactions counts towards VAT registration limit and certain other VAT registration issues that can affect the VAT liability of these payments. [Chapter 6](#) explains some practical cashflow planning ideas for dealing VAT on supplies between associated businesses. It also discusses the implications that can arise if HMRC do not accept that supplies have been made.

[Chapters 5](#) and [6](#) also discuss the benefits of VAT group registrations for connected companies and how this is a practical way to minimize administration AND VAT on inter-company transactions.

PART 2: VAT LIABILITY OF SPECIFIC CHARGES

In [Chapters 7](#) and [8](#), I discuss the types of services that are often defined in contracts as business services and management services, where the value is often based on costs plus a mark-up, including specific reference to holding companies.

[Chapters 9 – 11](#) discuss specific rules that can apply to people costs, motoring costs and property costs. These chapters discuss a range of issues from dealing with day to day staff expenses, director's costs and when charges for the use of property are exempt from VAT.

International transactions

[Chapter 12](#) discusses the VAT liability of cross-border payments. This is one of most complex areas of VAT, because it involves a whole new set of rules and terminology. I've also discussed the potential VAT implications from a typical query involving a set of transactions between associated businesses in the UK, the USA and various EU countries.

PART 3: PLANNING TO MINIMIZE VAT COSTS AND WHEN IT'S AVOIDANCE

[Chapter 13](#) explains how to minimize the VAT on charges to recipients who can't claim VAT because their business is exempt or partly exempt; or they're not registered for VAT. The chapter doesn't include any clever schemes or arrangements; it simply summarizes the most common ways of keeping VAT cost low using normal VAT accounting arrangements.

[Chapter 14](#) explains when anti-avoidance rules can affect apply to transactions; which is often when they are between associated businesses and where Recipient Co of the service can't recover any or all of the VAT charged.

[Chapter 15](#) discusses whether or not you should have written contracts and the information that you'd need to include for VAT purposes.

Isn't the simplest thing to charge VAT on everything?

No, because the payer can only ever claim VAT that is "correctly charged", as explained in [Chapter 2](#). HMRC do not ignore such situations even when the "supplying" party has included the VAT charged on its VAT return.

Worked examples

There are two worked examples after this introduction which show how the VAT liability of day to day charges can apply in three scenarios;

- implications for a sole trader providing office and administration services whose income is just below the VAT registration limit;
- the supply of management services between associated companies with separate VAT registrations; and
- the supply of management services between associated companies registered in a VAT group registration.

The examples ***demonstrate the effect of adding VAT to charges for supplies which consume VAT free "cost components", including staff costs, insurance and exempt property costs.***

I've discussed the implications of these scenarios in a little more detail in Chapter 5, which deals with the implications for transactions according to the VAT registration status of the parties involved.

I have come across similar situations on many occasions, so the examples deal with the most common issues.

Do you have to add a markup for VAT purposes?

No, not in principle. However, HMRC normally expect that the value of services is at least *at cost* to demonstrate that the activities are carried out "in the course or furtherance of a business".

Generally speaking, if the value of services is based on cost plus a mark-up, then this should be satisfactory for VAT purposes, but of course you should take advice from your accountant to be sure that the VAT treatment doesn't affect other tax or commercial issues.

Appealing against HMRC's decisions

I must also mention the ***difficulty and cost of dealing with HMRC decisions.***

You probably know that you can ask HMRC to carry out an internal review of their decision and; if the original decision is upheld, that you can appeal to the Tax Tribunal.

You can also consider the "Alternative Disputes Resolution" where the formal appeals process is put on hold while you try to resolve the issue by negotiation, which can help if you think that HMRC hasn't fully understood the facts or if there is some genuine misunderstanding between the parties.

Either way, these procedures are time-consuming and it's frustrating waiting for decisions. And if the internal review and/or ADR isn't successful, then you have to appeal to the Tribunal. The timescale for getting a listing at the Tribunal is around six months and you may have to wait another month or so for the Tribunal's decision.

And as if this isn't bad enough, **you have to fund your own costs EVEN IF THE TRIBUNAL RULES IN YOUR FAVOUR.**

You DO NOT want to end up in this situation because you haven't taken the time or care to arrange transactions with associated businesses correctly. So please take the time to review your existing arrangements and make whatever changes are necessary to ensure that you don't have to appeal against a decision against HMRC in the first place.

Further information

There are links to HMRC's guidance throughout the book if you want to look for more information about specific subjects and you can always contact HMRC's VAT helpline <http://tinyurl.com/nj59f4j> if you want help about a specific issue.

Finally, you may see certain subjects discussed in two or more chapters; for example the subject of proving that services have been supplied; VAT group registrations, single or multiple supply; anti-avoidance rules. I've tried to avoid repetition as much as possible; but often particular technical issues arise in a number of commercial situations so I have to explain the technical issue in each context. I'd also rather include too much information than too little so that you don't have to keep referring back to different sections of the book.

Either way, please remember that this is a practical guide to the subject. It's not a detailed textbook, nor does it replace formal advice about specific situations.

But if you understand the principles explained in this book, they will help you to identify and avoid potential problems when dealing with transactions between associated businesses so that you can focus your time and effort on making money through your main business activities.

Marie

June, 2018

What's an associated business?

In the context of this book, the term "associated business" refers to separate legal entities that are owned or controlled by one single person or company or other legal entity. The terms "related business" or "connected parties" could also be used, but the term "associated business" seems to come up more often in queries from clients or accountants.

Either one refers to any situation where legal entities are related or connected or linked through common ownership or any other way that means that the affairs of any two or more legal entities are controlled by or under the primary influence of a single person, or group of people.

Companies

There are various definitions in tax law about "related persons" or "connected parties". The control criteria that must be fulfilled for **connected companies** to register in the same group are based on the definition of holding company and subsidiary in Companies Act 2006, s1159 and Schedule 6. See VAT Notice 700/2: Group and divisional registration section 1.2 <http://tinyurl.com/pcejzeo>.

Partnerships, sole proprietors and others

But what about other legal entities? Many SMEs are not limited companies, but could be owned by the same individual, who may traded as a sole proprietor and also be a partner in a partnership which have separate VAT registrations. It may be a family concern, where the parents have ultimate control over separate legal entities which are run by the children and operate separate businesses; a husband and wife, siblings, or individuals in their role as trustees.

When does this cause problems for VAT purposes?

Most of the anti-avoidance legislation is aimed at larger limited companies, but HMRC can and do challenge other types of legal entities with smaller businesses if they think that any sort of abuse, avoidance or evasion has been or will be carried out. This often happens as a result of transactions with associated businesses, where HMRC believe that the transaction is affected by the relationship between the businesses and the VAT rules have been abused in some way.

That's why it's important to make sure that any transactions between legal entities that are related in any way are carried out in a proper commercial manner, as with any third party transaction. And as that applies whether you're just charging for a share of the telephone bill or issuing a management charge for on-going services.

The starting point is to establish exactly what the payer is receiving for their money and whether the payment is consideration for a taxable supply.

The case studies

These case studies represent three typical scenarios that arise when management services or office services are valued by reference to overhead costs, directors' and employee costs. The examples show the effect of different VAT registration arrangements on the VAT charged to recipients and the significant effect of charging VAT on fees calculated by reference to VAT free cost components; particularly directors/employees costs and VAT exempt rent.

The examples also show the significant benefit for limited companies who are able to register for VAT in group registrations, while partnerships and sole proprietors are not able to take advantage of similar arrangements.

Example 1: This is for a company providing management and consultancy services to associated companies which have separate VAT registrations.

Example 2: This is for a holding company which provides management and consultancy services to associated companies who are in a single VAT group registration.

Example 3: A sole proprietor provides office and administration services to a number of businesses.

In each case, the supplier incurs similar types of expenditure (see pp 24 - 25). The same annual calculations are used in Examples 1 and 2 but the results show how being in a VAT group registration can help to reduce VAT costs for the recipients of the services. Example 3 shows how fees charged to clients can be significantly affected by whether or not the supplier is registered for VAT.

Calculating the charges

In all cases, the supplier's costs are cost components of the services provided to the recipient businesses.

The value of the service charges is based on three elements:

1. The cost of goods and services which are liable to VAT. However if registered for VAT, Supplier Co claims this VAT from HMRC, so the value on which the charge is based doesn't include irrecoverable VAT. If not registered, the supplier calculates the service charges by reference to the VAT inclusive costs.
2. The cost of goods and services which don't bear VAT. These include salaries, insurance and rent.
3. A mark up. For the purposes of the examples, I've added a mark-up of 12% to costs to arrive at the value of the annual charge.

Net VAT cost

The "net VAT cost" is the overall VAT cost of the transactions.

It's the difference between the VAT claimed on expenditure by the supplying business and the VAT charged on supplies to recipients. If the recipients of the services are registered for VAT and can claim all of their input tax, the "net VAT cost" is zero.

However the VAT charged on supplies affects the recipients of the supplies who can't claim any or all of the VAT charged either because they aren't registered for VAT; or they can't claim all of their input tax because they make exempt supplies or carry out non-business activities.

What do the examples show us?

Example 1: Adding VAT to VAT-free costs creates additional VAT on charges to clients.

Example 1 shows a typical calculation for separately registered businesses.

Suppliers and recipients of services have separate VAT registrations

Net costs: £203,800

Mark-up @12%: £24,456

Annual fee: £228,256

VAT@20%: £45,651.20

Total: £273,907

Additional VAT may not be a cost if Recipient Co of the services is able to recover all of its input tax.

VAT charged on fees: £45,651.20

Less VAT on costs: £7,420

Net VAT cost: £38,231.20

In this example, the total VAT charged to clients is £45,651.20. After claiming VAT of £7,420 as input tax, the net VAT cost is £38,231.20 and Supplier Co will pay this amount to HMRC.

Most of the difference is because the largest components of Supplier Co's net costs are "people costs"; i.e. salaries and other employment costs; are VAT free. However by including these costs as "cost components" of the standard rated services, the effect is to create additional VAT of £38,231.20 on the fees charged to associated companies.

If the recipients use the services to make only taxable supplies, then they can claim all of the £45,651.20 charged by Supplier Co. But if the recipients' business is exempt or partly exempt and the recipient can't claim all of the VAT on their expenditure, the VAT is an added cost.

Example 2: There's a significant VAT advantage for the recipient if registered for VAT in the same VAT group as the supplier of the services.

This is because transactions between members of the same VAT group aren't liable to VAT.

Supplier Co and recipient Co are in the same VAT group registration.

Net costs: £203,800

Mark-up @12%: £24,456

Annual fee: £228,256,

VAT: NIL

Total: £228,256

The charges made to Recipient Co are not liable to VAT because the companies are registered in the same VAT group.

VAT charged on fees: NIL

Less VAT claimed on costs: £7420

Net VAT cost: (£7420)*

In this example, the fees charged to Recipient Co are VAT free because the companies are registered for VAT in the same group registration. *That's why there is a significant VAT benefit for exempt or partly exempt companies by registering in a VAT group with related companies from whom they purchase services.* See [Chapters 6](#) and [8](#) for more information about VAT group registrations.

****However this only applies if Recipient Co uses the services to make taxable supplies to separately registered customers. If Recipient Co uses the services to make exempt supplies or for non-business purposes, the VAT recovery rules mean that Supplier Co would not be able to claim VAT on its costs.*** See Chapter 1, Annex II for more information about partial exemption; i.e. when making exempt supplies means that the supplier (in this case the VAT group) can't claim VAT on related costs.

This puts businesses trading as partnerships or sole proprietors at a disadvantage for VAT purposes because they can't take advantage of the same arrangements with related businesses.

Example 3: When turnover is below the VAT registration limit, businesses must work out whether it's more VAT efficient register for VAT or stay unregistered. This generally means weighing up whether it's more economical for her to bear irrecoverable VAT on costs or add VAT to sales income and therefore increase her fees.

In this case, the proprietor's net turnover is just below the VAT registration limit. Her income from fees for office services is £78,310 and she has incurred £1,920 irrecoverable VAT on her costs. The difference between the output tax of £15,232 and the input tax £1,920 is primarily because of adding VAT to marked-up VAT free cost components, primarily salaries and property costs; an additional net VAT cost of £13,312.

If any or all of the recipients of her services are not registered for VAT, then the effect of the SP registering for VAT would, in this situation, increase the cost of her services by 16.7%.

Not VAT registered

Net costs: £68,000 + irrecoverable VAT: £1,920 = £69,920

Mark-up @12%: £8,390.04

Annual income: £78,310.04

NO VAT charged

Total: £78,310.04

VAT charged on fees: NIL

Less VAT not claimed on costs: £1,920

Net VAT cost: £1,920.

VAT registered

Net costs: £68,000

Mark-up @12%: £8,160

Annual fees: £7,160

VAT@20%: £15,232

Total: £91,391

VAT charged on fees: £15,232

Less VAT claimed on costs: £1,920

Net VAT cost: £13,312.

Case Studies: Example 1 and 2: Example annual costs

	Net	VAT	Gross
Office rent	15000	3000	18000
Service charge	1500	300	1800
Rates	3000	NIL	3000
Utilities	4000	800	4800
Telephone/internet	2500	500	3000
Office insurance	1200	NIL	1200
Vehicle hire	5000	1000	6000
Vehicle insurance	1000	NIL	1000
Office equipment	1500	300	1800
Consumables	1100	220	1320
IT support Self employed consultant	10000	NIL	10000
Professional fees	8000	1600	9600
Directors' costs Salaries, pension etc	80000	NIL	80000
3 employees Salaries, pension etc	70000	NIL	70000
Total	203,880	7,720	211,520

Case Studies: Example 3

Example annual costs

	Net	VAT	Gross
Office rent	5000	NIL	5000
Service charge	500	NIL	500
Rates	2500	NIL	2500
Utilities	3000	600	3600
Telephone/internet	2500	500	3000
Office insurance	400	NIL	400
Vehicle hire (includes insurance)	1000	200	1200
Vehicle insurance	NIL	NIL	NIL
Office equipment	600	120	720
Consumables	500	100	600
IT support Self employed consultant	4000	NIL	4000
Professional fees	2000	400	2400
Directors' costs Salaries, pension etc	32000	NIL	32000
2 Part time employees	14000	NIL	14000
Total	68,000	1,920	69920

Chapter 1

What is VAT and how does it work?

VAT is a complicated tax. HMRC's main VAT publication, VAT Notice 700; The VAT Guide <http://tinyurl.com/n2kcg3> is over 200 pages long. Then there are dozens of individual notices about specific VAT issues; such as registering for VAT or the VAT liability of certain goods or services, such as staff costs or rent. There are links to the relevant sections of VAT Notice 700 and other HMRC publications as we go along. The notices provide much more detailed guidance about specific issues that apply to the subjects discussed in this book.

If you're an accountant or book-keeper, you'll already know the basic rules. But you might want to spend a couple of minutes reading this chapter to remind yourself, just in case you've forgotten anything.

- What is VAT?
- VAT registration
- VAT returns
- VAT rates and exemption
 - Taxable supplies
 - Exempt supplies
 - The difference between taxable and exempt
- Claiming VAT on costs
- VAT invoices
 - VAT inclusive
 - VAT exclusive
 - How is VAT calculated on VAT inclusive values?
- When do I pay the VAT: tax points
 - Normal rules
 - Tax points
 - Basic tax point
 - Actual tax point
 - Continuous supplies of services
 - Anti-avoidance rules
- Multiple and composite supplies

Annexes

- Contents of a VAT invoice
- Introduction to partial exemption
- VAT and agents

There are 2 HMRC publications that explain the main principles of VAT:

HMRC's "Introduction to VAT" <http://tinyurl.com/nqtcmy> is a brief guide to VAT and good place to start.

VAT Notice 700: The VAT Guide: <http://tinyurl.com/9ykqw> is HMRC's main reference book which explains the main principles of VAT in some depth.

What is VAT?

VAT is a sales tax. It's charged on the sale of goods and services.

Here are the most important technical terms

- A supply is the sale of goods or services in the course or furtherance of a business.
- This includes sales in the traditional sense; i.e. where the ownership is transferred from seller to buyer; and services such as builders and other trades, professional services, and leases or licences to use or occupy a property.
- VAT is charged on sales of goods and services done or given for a consideration.
- Consideration is generally any sort of payment, usually cash, but sometimes it might be in the form of goods or services given in return in a barter transaction.

Sales of goods and services are "outputs" and the VAT charged is "output tax".

Purchases of goods and services are "inputs" and the VAT paid is "input tax".

VAT registered businesses pay the difference between their output tax and input tax to HMRC.

N.B. I'll avoid technical jargon as much as possible in this book, but I'll have to use certain technical terms; particularly supply and consideration when explaining some technical issues.

VAT Registration

The business owner is registered for VAT; whether it's a limited company, a partnership, sole proprietor or any other legal entity

The VAT registration covers all of the business activities of the business owner.

Business owners must apply to register for VAT if the value of their taxable sales in any past 12 month or future thirty day period exceeds the VAT registration limit, which is currently £82,000. See HMRC website for details of current and historic registration limits
<http://tinyurl.com/qxjci8a>

Business owners who are required to register for VAT, or who are registered for VAT, are called taxable persons.

The VAT registration limit is increased each year, usually in line with inflation, so check the HMRC website for current limits. There are penalties for failing to notify HMRC that you're liable to register at the right time.

You can also register for VAT on a voluntary basis if the value of your taxable sales is below this limit.

VAT Returns

VAT registered businesses submit VAT returns and payments, usually every three months. HMRC can issue penalties if either returns or payments are submitted late.

VAT registered businesses include VAT on sales and expenditure made in the period covered by the VAT return and pay the difference to HMRC. If the input tax is higher than output tax, businesses submit a repayment return and HMRC will refund the difference.

VAT rates and exemption

There are two classes of "supply" for VAT purposes: taxable and exempt

Taxable sales

Most sales of goods and services are liable to VAT at one of three rates currently in force:

- Standard rate: 20%
- Reduced rate: 5%. These include domestic gas and electricity and certain construction services for converting commercial properties to residential use.
- Zero rate: 0%. These include most groceries, children's clothes, books and magazines, the construction and sale of new homes and certain goods and services for the disabled and elderly.

Exempt supplies

EXEMPT supplies are not liable to VAT. These include most property rentals and sales, insurance and banking services, health and education.

ALL sales of goods and services in the UK are liable to VAT at 20%, unless the law specifically says otherwise.

There is detailed guidance about the VAT liability of specific goods and services on HMRC's website, including separate notices and leaflets for different business sectors, e.g. property, food, insurance, children's clothing etc: <http://tinyurl.com/owymcbo>

What's the difference between zero-rated and exempt supplies?

You might assume that being "zero-rated" or "exempt" is the same, because income from both of these types of sales is VAT free. But there is a very important difference between the two about VAT on related costs.

- Businesses making taxable supplies (at 20%, 5% or 0%) can in principle recover input tax on goods and services used to make those supplies, subject to the "normal rules" about VAT on certain "blocked" expenditure (see below)
- Businesses making exempt supplies can't normally recover input tax on goods and services used to make those supplies. This VAT is called "exempt input tax". Businesses that make both taxable and exempt supplies and can't recover their "exempt input tax" are called "partly exempt" - see Annex III to this chapter for more information about partial exemption.

N.B. If all your income is taxable, you can claim most or all of your input tax VAT from HMRC. However you can only claim VAT that has been correctly charged, even if the supplier has paid the VAT on his VAT return. So make sure that you don't pay more VAT than you should; e.g. on zero-rated books or exempt property rent.

Claiming VAT on costs: "Subject to the normal rules".

One of the most commonly used phrases in VAT is : "subject to the normal rules"

What are the normal rules?

Is the expenditure for business purposes? You can't claim VAT on goods or services used for non-business, such as private use or charity use. If the goods and/or services are used for both business/non-business, then you may have to pay VAT on their use to HMRC. I've explained the main principles of this in Annex to Chapter 9.

You must have evidence of the expenditure in the form of a VAT invoice from Supplier Co. If the value of the expenditure is below £250 - for example petrol, subsistence costs - a less detailed or modified VAT invoice is acceptable - see below for more information about VAT invoices.

People often use the terms "VAT exempt" or "VAT free" or "VAT zero-rated" without understanding what they mean. Because the distinction between zero-rated and exempt is very important, I've made a point of using the correct terminology throughout the book to avoid any confusion.

"Blocked input tax": VAT registered businesses can't claim VAT on certain specified costs, which include:

- Buying a car
- Entertaining third parties
- Director's domestic accommodation
- Certain building materials, generally used by developers in construction work.
- The resale of certain travel and accommodation services, including hotel accommodation and aeroplane and rail travel that fall within the Tour Operator Margin Scheme. See [Chapter 9](#); People costs.

- Buying a business as a going concern.

VAT on these costs is called blocked input tax

A full list of these items is in VAT Notice 700, s10.3 <http://tinyurl.com/kk92jgg>.

I've discussed the subject of claiming VAT on costs in [Annex II](#) to this chapter and [Chapter 2](#).

VAT invoices

A VAT invoice is the legal document issued when a taxable supply has been made.

The VAT legislation specifies a list of information that must be included on a VAT invoice, including basic facts such as name and address of seller and purchaser, description of the goods or services sold and the value. A full list is shown at the annex to this chapter.

In certain circumstances, a less detailed or modified VAT invoice can be issued, for example when value is £250 or less (VAT inclusive) and for retail sales. See VAT Notice 700, section 16 <http://tinyurl.com/nflzxt> for details.

Annex 1 to this chapter shows a full list of information to be shown on a VAT invoice.

Value

Value for VAT is the consideration received for any supply of goods or services. That usually means cash payment, but can also include goods or services given or done in return; i.e. barter transactions.

For example: if you charge £200 plus VAT, then the value for VAT is £200 and you charge VAT @20% = £40.

The other important factor is the difference between "VAT inclusive" and "VAT exclusive" values.

Most people assume that to calculate VAT, you simply multiply the value of the sale by 20% or 5%, depending on the VAT rate. However the calculation depends on whether the amount is VAT inclusive or VAT exclusive and therefore affects the amount of VAT that the seller has to pay to HMRC.

How is the VAT calculated?

If the value is VAT exclusive: VAT is calculated at 20% or 5% (according to the VAT rate) of the net price. If the net price is £100 @ 20%, the VAT is £20; if it's £100 @ 5%, the VAT is £5.

However if the value is VAT inclusive, the VAT is calculated by multiplying the price by the "VAT fraction". This is because the VAT inclusive price includes both the "net" amount AND the VAT.

When the VAT rate is 20%, this means that the VAT inclusive price is made up of the 100% of the net value plus 20% VAT; i.e. 120% of the net value.

The VAT is calculated as 20/120, or 1/6 x the VAT inclusive price.

If the VAT inclusive price is £100, the VAT is:
 $£100 \times \frac{1}{6} = £16.67$.

If the supply is reduced rated, the VAT is $5/105 = 1/21$ the VAT inclusive price

If the VAT inclusive price is £100, the VAT is:
 $£100 \times 1/21 = £4.61$.

This is why it's important to define whether the value of charges are VAT inclusive or VAT exclusive.

Special rules

But what if you don't charge anything or only a minimal amount? The VAT Act 1994 contains a schedule which explains how to value different types of such transactions for VAT purposes; such as personal use of business assets; petrol provided by the business (the VAT fuel scale charges) gifts, imported goods and services. Most of you will be familiar with the rules about VAT on fuel and gifts.

One other area which often causes confusion is dealing with VAT when goods or services are used for non-business purposes, e.g. charity, and/or personal use, e.g. if an employee uses a computer for both personal and business purposes. I've discussed this in more detail in the Annex to Chapter 9.

More detailed guidance on the subject of value for VAT purposes can be found in VAT Notice 700, section 7.2 <http://tinyurl.com/nvuros3>

Timing: when do you pay the VAT to HMRC?

Time of supply: tax point

The "time of supply" or "tax point" is the date on which a supply of goods or services is deemed to take place. If, for example, you sell goods on 1 November, then the tax point is 1 November and you include the VAT on that sale on the VAT return which includes the month of November and pay the VAT to HMRC.

Basic tax point

If your VAT return covers the period 1 November 2014 to 31 January 2015 (01/15), then you would include the VAT on this sale on the 01/15 return.

- The basic tax point for sales of goods is when the goods are made available or delivered to customers.
- The basic tax point for sales of services is when the services are completed.

Actual tax point

However these basic tax points can be over-ridden by other commercial events, in particular if the customer pays in advance, or the supplier issues a VAT invoice before the basic tax point. This becomes the actual tax point.

So in the above example, if you were paid on 31 October, you would have to include the VAT on the VAT return for the period 1 August to 31 October (10/14).

The other commonly used rule is the 14 day rule. Suppose you deliver goods to a customer on 31 October, but weren't paid until 30 November. Under the 14 day rule, then you can defer the tax point until the date on which the invoice is issued, as long as it's issued within 14 days of the basic taxpoint. So in this example, as long as you issue the invoice by 14 November, you include the VAT on the 01/15 VAT return, not the 10/14 VAT return.

This means that you get the cash flow benefit of receiving the VAT payment at the end of November, but not paying to HMRC until 7 March, the due date for your online 01/15 return.

Special rules

There are also special rules for certain industry sectors, e.g. long term hire of goods where invoices are issued on an annual basis; or certain land and property rental income.

See VAT Notice 700, section 14 <http://tinyurl.com/n9ysdj9>. I've also discussed certain issues in more detail where necessary throughout the book.

Continuous supplies of services

One of the main topics of this book is management services, or other services supplied continuously, including administrative or office services, or consultancy services, it's important to understand how the tax point rules apply for these services.

The basic rule for "continuous supplies of services" is that a "tax point" is created at the earlier of :

- the date of payment; or
- the date on which a VAT invoice is issued.

See VAT Notice 700 s14.3 <http://tinyurl.com/n9ysdj9> for more information about this rule:

Payments between associated businesses

Sometimes, payments for supplies between associated businesses aren't made in cash form but by some accounting adjustment whereby mutual debts between the businesses concerned. This doesn't apply simply by recording the value of services in the profit and loss account as having been made/received; or by recognising the value of services in the balance sheet of the businesses concerned.

Payment is deemed to occur when the accounting treatment has the effect of writing off mutual debts between the parties.

The actual timing of this will depend on the circumstances, but ***often the value of the services provided is calculated when the annual accounts are drawn up by reference to the costs incurred in providing the services. The set off of mutual debts is formalised when the accounts of the businesses concerned are approved.*** It can also occur when the adjustments create credit and debit adjustments in the accounting records which have the effect of setting off debts between the businesses.

Either way, if the adjustments are made before a VAT invoice has been issued, these accounting events which set off mutual debts are regarded as payment and therefore the tax point for the services. The supplying business must issue a VAT invoice to the recipient showing the time of supply as the date of the set off.

See VAT Notice 700, s14.2.2 <http://tinyurl.com/n9ysdj9> for further information about tax points created by accounting events.

Anti avoidance provisions: the twelve month rule

There is a specific anti-avoidance provision which applies to supplies of services between associated businesses, where the recipient of the supply is partly exempt so can't recover all of the VAT charged by the supplier. The provision is known as the twelve month rule.

One way of avoiding or deferring such irrecoverable VAT is to defer the issue of a tax invoice or payment for the supplies concerned, whether in cash, barter transactions or by set-off of mutual debts as explained above.

In these cases, the supply of the services is made annually under the twelve month rule, so that the tax point occurs each year and the supplier must issue a VAT invoice at that time. The main exception to this is the supplier issues a VAT invoice or a payment is made within 6 months of the end of the twelve month period.

Single supply and multiple supply

What happens if you sell 2 or more items, which individually have different VAT rates, for a single price?

Before you can work out the VAT liability, you have to decide whether the sale is a single or composite supply; or a mixed or multiple supply. What does this mean?

Here are the basic principles:

A single or composite supply is when one individual item is the most important and the parts are ancillary to, or "for the better enjoyment" of the main item. A good example is a washing machine and the instruction leaflet. If sold separately, the leaflet would probably qualify for zero-rating as printed matter. However, when it's sold with the washing machine, it's clearly ancillary to and "for the better enjoyment of" the washing machine. So the sale is regarded as a single supply which is liable to VAT at 20%.

A mixed supply or "multiple" supply is when two or more goods or services are billed for a single price but each component is liable to VAT at different rates. A good example is when a magazine, which is normally zero-rated as printed matter, comes with a free CD, which is standard rated.

The important factor is that, unlike single supplies, no one single element is more important or necessary to the others. Each part is independently necessary and not ancillary to other elements.

A good example of this is the **provision of office services**. We'll look at this subject in more detail later in the book (see [Chapter 7](#)), but for now let's consider an example where an invoice includes two main elements: office costs; including staff services, office consumables, telephone and internet access; and the provision of a dedicated office. The office costs are standard rated and in this case, the rent for the office is VAT exempt.

Supplier Co can apportion the cost between the standard rated services and the office rent, as long as the charges are separately identified on the invoice.

If Supplier Co can't or doesn't itemize the different elements properly, then everything covered by the invoice is liable to VAT at the standard rate. So if the invoice shows a single charge to cover both the standard rated and exempt services, then Supplier Co has to charge VAT at 20% on the whole charge.

The issue of single and multiple supplies is important because many transactions involve more than one type of service or goods, including some of the transactions discussed in this book, so it's important to be aware of the principles involved.

HMRC's guidance about apportionment for SINGLE or MULTIPLE supplies is in VAT Notice 700, section 8.1 <http://tinyurl.com/9ykqw> which explains how suppliers can apportion their invoices when making mixed supplies.

Whether a supply is a single or mixed supply isn't always obvious, but if you're unsure, go back to the basic principle of whether there is any one main element and whether the other components are "for the better enjoyment of that component. The washing machine/instruction book and book/CD examples provide very good examples, but if you're in any doubt, then you can ask HMRC for a ruling.

Chapter One: Checklist

- ✚ There are two classes of supplies – or sales – for VAT purposes: taxable and exempt. VAT is charged on taxable sales of goods or services by VAT registered businesses at 20%, 5% or zero-rated.
- ✚ Sales of goods and services are “outputs” and VAT charged is “output tax”.
- ✚ Purchases of goods and services are “inputs” and VAT on them is “input tax.”
- ✚ Businesses making taxable supplies can recover VAT on expenditure.
- ✚ Businesses making exempt supplies normally can't recover VAT on related expenditure, unless it falls within certain de minimis limits.
- ✚ VAT on certain "blocked" costs can never be recovered.
- ✚ VAT invoices must be issued by the supplier and the customer must have the VAT invoice to claim VAT as input tax.
- ✚ The value is the consideration, or payment received.
- ✚ Special "tax point" rules determine on which VAT return you declare VAT on sales to HMRC.
- ✚ “Composite” and “mixed” supplies both include two or more elements that have different VAT liabilities. Composite supplies have one primary element while mixed supplies contain a number of equally important parts.

Annex 1

Contents of a VAT invoice

VAT invoices must show the following information:

- an identifying number, which is from a series that is unique and sequential;
- your name, address and VAT registration number;
- the time of supply (tax point);
- date of issue (if different to the time of supply);
- your customer's name (or trading name) and address;
- a description which identifies the goods or services supplied; and
- the unit price (see paragraph 16.3.2).
- For each description, you must show the:
 - quantity of goods or extent of the services;
 - charge made, excluding VAT;
 - rate of VAT;
 - total charge made, excluding VAT;
 - rate of any cash discount offered; and
 - total amount charged including VAT shown in sterling

See VAT Notice 700 section 16 <http://tinyurl.com/ghlgxxq> for more detailed information about VAT invoices.

Annex II

Introduction to VAT recovery and partial exemption

One of the main principles of VAT recovery is that you normally can't claim VAT on goods or services if they relate to income that is EXEMPT from VAT. This VAT is called "**exempt input tax**". However if you also make taxable supplies, you may be able to claim exempt input tax if the exempt input tax falls within certain "de minimis" limits, which are:

- £7,500 per VAT year: and
- 50% of all VAT incurred in that year.

This is referred to as "**partial exemption**".

For example, an estate agent might incur £10,000 VAT on costs of running the business, mainly office and vehicle costs. However the owner also owns a couple of houses which he rents out. His exempt input VAT on related costs is £8,000. Can he recover his exempt input tax?

No. Even though £8,000 is below 50% of his total input tax, it exceeds the maximum figure of £7,500.

However if the exempt input tax is £7,400, then it can be claimed because it falls within both the 50% percentage limit and the £7,400 value limit.

Exempt input tax is calculated under a two stage process:

- **Direct attribution:** the business must directly attribute specific costs to either taxable or exempt supplies.
- **Overhead VAT:** VAT on costs that can't be directly attributed to taxable or exempt supplies must be apportioned between the two, using either the standard method, which is based on the proportion of taxable and exempt income, or by using a special method with agreement from HMRC.

HMRC's VAT Notice 706 explains the partial exemption rules in more detail:

<http://tinyurl.com/mvetpps>

"Use" in VAT

The word "use" is one of the most common in the English language. Whether it's describing how we're going to "use" our week off work to decorate the house or whether we'll be "using" our newly converted property as an investment property or to sell. It's a commonly used word, whether as a verb or a noun.

Other "uses"

The word "use" also comes up in respect of other VAT issues such as whether properties will be put to "qualifying" use; i.e. residential or charitable use. If so, the construction work may qualify for zero-rating or the reduced rate of VAT.

For the most part in this book, we'll be concerned whether goods or services will be used in the context of transactions involving connected parties and "non-core" income and expenditure by other businesses.

What's your "intention"?

The word "intention" is also important. When a business owner incurs VAT on expenditure used for business purposes, he has to identify whether he intends to use the goods or services to generate taxable or exempt sales. The income might be generated in the same week, month, year or even later, particularly in the case of property developments. However the business owner has to define his intention at the time the cost is incurred so that he can determine whether or not he can recover the VAT.

There are also rules that require the business to adjust the amount of VAT originally recovered in future years. They apply if the actual use is different to the original intention or the actual use changes from the initial use over time, for example, to developers renting properties instead of selling them. They are called the "change of intention or use" rules and the "capital goods scheme".

I've explained these rules in a little more detail in [Chapter 14](#), but you can also find more information in HMRC VAT Notice 706: Partial exemption and 706/2: Capital goods scheme: <http://tinyurl.com/nzyz8ms>.

Annex III

VAT and agents

My Compact Oxford Dictionary defines the word “agent” as any of the following:

- “A person who provides a particular service”
- “A spy”
- “A person or thing that takes an active role or produces a particular effect”

The word that can take on quite a different meaning depending on the context.

It’s also one of those words that’s used quite a lot in the world of commerce, meaning different things depending on the contractual or legal arrangements. And because there is no definitive meaning of the word, you have to understand the contractual and legal arrangements to define the VAT position.

So how does it work for VAT?

I thought that the best place to start discussing this would be to start with the everyday meaning of the word, which I’d define as follows:

An “agent” is someone who arranges for his client to buy or sell goods or services by/to a third party. The agent's service is usually in return for a fee or commission payment. If the agent arranges a sale of goods or services for his client, he’s called a “sales agent”. If he arranges a purchase of goods or services, he’s called “buying agent”

- This means that the agent provides services to his principal.
- The principal buys or sells goods or services directly from/to a third party

Therefore there are 2 separate transactions for VAT purposes:

- the sale of goods or services from one principle to another; and
- the provision of agency services by the agent to his principle.

Suppose that the transaction involved the sale of goods from A Ltd to B Ltd for £200 plus VAT. The agent, C Ltd, has arranged the sale for its client, A Ltd, in return for a fee or commission of 10% of the net value; i.e. £20. A Ltd, B Ltd and C Ltd are registered for VAT. The VAT accounting is as follows:

- A Ltd issues a VAT invoice to B Ltd for £200 plus VAT @ £40.
 - A Ltd includes £40 as output tax on its VAT return.
 - B Ltd includes £40 as input tax on its VAT return.
- C Ltd issues a VAT invoice to A Ltd for £20 plus VAT @ £4.
 - C Ltd includes £4 as output tax on his return
 - A Ltd includes £4 as input tax on its VAT return.

This is what I’d classify as a “traditional” agency arrangement and we’re probably all familiar with this sort of fee structures.

Other agency situations

However the term “agency” is used in other situations which have different VAT treatments. I’ve summarised 3 of the most common situations as follows:

- Agents acting as principal – undisclosed agency
- When an agent isn’t an agent – particularly in the case of staff agencies
- Sales of goods or services involving EU parties.

Agents acting as principal

In some situations, agents are treated as principal. This normally happens if their client wants to remain anonymous. This often happens when goods are sold at auctions. This is how the VAT works in situations where the agent is acting on behalf of someone buying at auction:

- the vendor would issue a VAT invoice for the full value to the agent for the item concerned and the agent would claim the VAT back on his VAT return as input tax;
- the agent would issue a VAT invoice to his client for the full value of the item and include the VAT as output tax on his VAT return; and
- the agent would also issue a VAT invoice for his agency fee and include the VAT as output tax on his VAT return.

Even though the agent doesn’t take title to the goods concerned, he is treated as both “receiving and making the supply” of the goods for VAT purposes because he acts as principal.

HMRC’s guidance on this subject is VAT Notice 700, section 23.2.2 <http://tinyurl.com/keusk28>. There is also information about agents acting as principal when invoicing for second hand goods or works of art that are eligible for the margin scheme.

When an agent isn’t an agent

Sometimes the word “agent” is used in a broader sense, when somebody buys or sells something “on behalf” of a “client” but in legal terms is a principal in the transaction. The VAT invoices are the same as any other sale or purchase because the “agent” is buying and selling as principal, taking “title” to the goods and services concerned.

Employment agencies

One industry that commonly uses the term “agent” where the arrangements aren’t always as an agent is that of employment agencies; businesses that provide staff on a permanent or interim basis. In this case, it’s all to do with the employment arrangements of the individuals. For legal and tax purposes, in most cases, the individuals actually enter into a contract of service with the staff agency. This is important for the individuals because it gives them rights such as holiday and sickness benefits and legal protection if the agency tries to dismiss them unfairly. For VAT purposes, it means that the “agency” has to charge VAT on the full value of the amount charged to the client, not just the “agency” charge.

It’s still traditional for businesses that provide staff in this way to define themselves as “employment agencies” or “staff bureaux”, but each situation will depend on the contractual arrangements

involved. HMRC explain the correct treatment for such arrangements in VAT Notice 701/34: Staff, section 5: <http://tinyurl.com/oqdbapd>. There are some situations where the “agent” doesn’t engage individuals as employees and these arrangements can help business customers who can’t recover VAT because they are partly exempt, because VAT is only charged on the agency fee. However some of these arrangements may be regarded by HMRC as avoidance so it’s important to take proper advice in such situations.

Sales of goods or services involving EU parties

The concept of “agency” is different in most EU countries. This is because their law is based upon Roman law concepts where “agents” are treated as though they buy and sell goods under arrangements referred to as “commissionaire” arrangements. In this case, the law doesn’t recognise any separate supply of agency services to the principal.

This actually caused certain problems for UK businesses and therefore since July 2000, all such transactions are treated as made to and by the agents for VAT purposes only. This means that:

- the agent receives an invoice for the goods/services from the original supplier in the agent’s name:
- the agent issues a VAT invoice for the full value of the goods/services to the customer.

This doesn’t change the legal arrangements and only applies for supplies involving EU and non-EU parties. It doesn’t affect UK-UK transactions at all.

Further information is in VAT Notice 700, section 24 <http://tinyurl.com/keusk28>.

It all depends on the contract!

The subject of agency and whether or not someone is an agent or a principal can be very messy and can cause a real hassle for UK businesses. I’ve only been able to explain the main principles in this annex and you should read HMRC’s guidance, especially that in Notice 700, if you’re at all unsure about whether or not an agency arrangement exists and how it might affect your VAT liability.

Chances are that if you’re buying goods or services for a number of businesses and you’re going to share out the costs between the other parties, then you’re buying and selling as principal. But remember that in any situation, you should always check the details of any contract or other agreement with the other parties to establish whether you’re buying/selling as principal or you’re acting as agent.

And if you don’t have anything written down about the arrangements, you might want to consider setting up some sort of business services agreement to establish who is doing/buying/selling what for whom and avoid confusion for VAT purposes.

Chapter 2

Does raising a charge mean that you've made a supply?

Question: Is it okay to claim VAT on our office costs and legal bills if we raise a management charge to our associated company?

The act of "raising a management charge" - by which I assume issuing a VAT invoice - on its own doesn't create a supply. And in fact, issuing a VAT invoice when no supply has been made is an offence; plus the VAT charged remains a debt due to the crown even if the invoice has been issued in error.

I explained the main principles of VAT in Chapter 1 and they apply whether you're making supplies to associated businesses or third parties. In this chapter, I'm going to discuss why you have to make a "supply" - in particular a supply of services - to any customer before you can claim VAT on your own costs.

- What is a supply of services?
 - What is a supply of services?
 - Direct and immediate link
 - The cost component issue
- Transactions between associated businesses
 - Why is all this necessary?
 - Interest free loans
- So how do you know if you've made a supply of services?
 - Is there a direct link between the payment and goods/services?
 - Is there anything in writing to explain the reasons for payments?

Terminology

Remember that in this book, I'm using the following terms:

- The business that wants to raise the management charge to claim VAT on office costs and legal bills is "Supplier Co"; and
- The associated business, that would receive the management charge, is "Recipient Co".

What is a supply of services?

In this chapter, I'll be discussing the concept of supply of services between associated businesses, not goods. The reason for this is quite logical: goods are tangible assets and you can clearly demonstrate that goods have been supplied because the ownership of the goods transfers from one person to another.

What is a supply of services?

But it's much more difficult when it relates to services, because it's not always possible to demonstrate that services have been supplied because they can be intangible.

So what is a supply of services?

VAT Act 1994, s5(2)(b) says:

"anything which is not a supply of goods but is done for a consideration (including, if so done, the granting, assignment or surrender of any right) is a supply of services."

In their internal guidance, HMRC explain this in the following terms:

"A supply of services is made when a person does something or agrees to do something for a consideration. Certain supplies may at first appear to be vague enough not to be thought of as supplies of services for example someone may agree to refrain from doing something or may give up a right. However, if the person has agreed to carry out an act of this nature for a consideration then there is a supply of services. "

So Supplier Co can only claim VAT on its costs if the goods and services have been used to make taxable supplies (and remember we're talking about services here) to Recipient Co AND if the goods and services - in this case the telephone and legal services - are COST COMPONENTS of the supplies made to Recipient Co.

Direct and immediate link

There must also be a "direct and immediate" link between the goods and services bought by the business and the supplies made by the business. This means that the goods and services must be cost components of the supplies made by the business as explained below.

The cost component issue

To be a cost component, Supplier Co must have USED the telephone/legal services in the course of providing services, whether to Recipient Co or a third party.

For example, the services of an architect are used by a housebuilder to design new houses, so the architect's services are a "cost component" of the housebuilder's business of building and selling new houses.

But what about less specialized services; e.g. the costs of running an office, or employing staff or property costs?

The term "cost component" can mean two different things:

Used to make a specific supply as either of the following:

- the goods or services can be used to make onward supply of the same goods and/or services; or goods or services used to make specific supplies. For example, Supplier Co's costs of telephone services and legal services could be supplied to the associated business unaltered. Supplier Co purchased the telephone services and legal services from the service provider and made an onward supply of those services to Recipient Co who used the telephone services and legal services in its own business.

- the goods/services are component parts of a different supply to Recipient Co. For example, Supplier Co provides management services to Recipient Co and calculates the cost of the management services by reference to its (i.e. Supplier Co's) costs, including telephone and legal costs. You could think of this as *altering the nature of the goods/service*; i.e. Supplier Co is changing the nature of the telephone/legal services to provide management services. This is demonstrated in the worked examples on pages 20 - 25. where I've shown how the value of services is calculated by reference to the costs incurred by Supplier Co.

So if Supplier Co provides management services to Recipient Co and uses those telephone services and legal work in the course of providing those services, then the telephone and legal costs are "cost components" of the management services.

In these situations, there is a direct and immediate link between the goods and services bought by the business and the supplies made by the business.

Overhead costs

If the goods/services are not used in making a specific supply, then they may be regarded as being overhead costs which are directly and immediately linked to the business as a whole and the supplies made by the business.

What does this mean?

Suppose Supplier Co provides management services to Recipient Co but its main business activity is as a software designer. The legal services are used purely to provide management services to Recipient Co, but the telephone services are used in both business activities; i.e. both in the design business and in providing management services to Recipient Co. In this case, the telephone service is an overhead cost and linked to the supplies made the business as a whole.

In this case, because Supplier Co makes only taxable supplies, it can claim all of the VAT on its overhead costs (subject to the normal rules). However if its main business activity was as an insurance agent making exempt supplies, then the overhead costs would be linked to both business activities; i.e. taxable and exempt. Supplier Co would have to calculate the amount of VAT it can claim on the telephone bill and other overhead costs under the partial exemption rules, explained in [Annex II](#) to Chapter 1.

Transactions between associated businesses

Regardless of the type of service, or how you decide to value the services, **you MUST be able to demonstrate that services have been supplied and evidence the work performed**. And, this is even MORE important when we're talking about transactions between associated businesses.

And to do that, you need, at the very least:

- Agreements or contracts outlining the services to be supplied, the charges to be made and when invoices will be issued.
- Charges should always be AT LEAST at cost, preferably at third party rates.

- Retain proper evidence of work done to confirm the value of the services; whether in the form of timesheets, that services as described in the timesheet have been carried out showing the number of hours worked and the services carried out that day.
- If possible, be ready to show HMRC the work that has been or is being done, whether it's day to day administration services, answering the telephone or running an office, or, if the work is of a more technical nature, copies of reports or correspondence.

Why is all this necessary?

Why indeed?

HMRC have always said that business owners are free to set up and run their businesses as they see fit, subject to anti-avoidance legislation. Historically, anti-avoidance legislation in the UK has been designed to prevent arrangements that would enable larger partly exempt businesses to reduce, avoid or defer irrecoverable VAT. I've discussed this subject in more detail in [Chapter 14](#) and have referred to certain anti-avoidance rules in other places throughout the book.

However, in more recent years, HMRC have started to pay more attention to arrangements between FULLY TAXABLE associated businesses; i.e. businesses who only make taxable sales (i.e. at 20%, 5% or 0%) so can claim all of the VAT on their costs (with the normal exclusions - see Chapter 1, [Appendix II](#)).

So why is this? One of the main reasons is cashflow. The way the VAT system works provides a number of ways whereby the recipient can claim input tax before the supplier has to pay the output tax. And it's a very easy way of getting an interest free loan.

How to get an interest free loan by claiming VAT:

The simplest way is to take advantage of various VAT accounting facilities:

- Maximizing cashflow benefit by combined use of monthly and quarterly returns.
- Combined use of invoice and cash accounting to generate a cashflow benefit.

These practices are wholly legal and usually acceptable to HMRC. They are regularly used in certain business sectors; e.g. export companies and housebuilders, as discussed in [Chapter 6](#).

Historically, arrangements for supplies of services between associated businesses have often been informal; i.e. services have been provided, but there's no formal agreement and charges are only raised if the recipient business has made enough profit to pay.

A good example of this practice is when a "management charge" is raised at the end of the financial year, by raising an entries in the accounts of the Supplying Co and Recipient Co, where the debt for the value of the services is recognised and payment is made by writing off mutual debts. It's only in more recent years that HMRC have started to look more closely at the subject of supplies of services between FULLY TAXABLE associated businesses, particularly where the amounts are large, the pattern of transactions is unusual or there is any obvious cashflow benefit.

HMRC are now challenging properly documented and valid VAT repayment claims for VAT on supplies of services between associated businesses if they don't believe that the supplies have not been made.

New businesses often use monthly returns to enable them to claim VAT charged on supplies quickly during their start up phase. Supplier Co (on quarterly returns using cash accounting) can provide services to Recipient Co, which is on monthly returns and claiming under normal VAT accounting rules. The cashflow benefit Could provide Recipient Co with interest free financing for several months.

I can only assume that HMRC is starting to challenge such arrangements because they are looking for ways to minimize VAT costs for the government and discouraging associated businesses from using such cashflow arrangements is one way of protecting VAT revenue. But remember that HMRC can also withdraw the use of the cash accounting scheme or the monthly VAT returns. See Chapter 6 where I've discussed such situation which have been challenged by HMRC and the implications for the businesses concerned.

Either way, these developments only serve to remind us of the increasing importance of setting up robust and transparent arrangements when making supplies of services between associated companies.

So, how do you know whether you've made a supply of services?

Sometimes it's very obvious that services are being supplied. Whether it's construction services, or a lease in a property, or professional services such as architects or accountants, you know what you're getting in return for your money.

When it comes to arrangements between related businesses, HMRC expect that any such transactions are made in a commercial manner and that the payments are clearly linked to a particular event or action.

A formal agreement between two or more associated businesses, for the provision of management services, administration services or office services, which are valued on the basis of third party costs - such as telephone or legal costs - is a good indication that services are being supplied. However it doesn't prove that the work has been done.

This is why HMRC ask for evidence of the work carried out, so **it's essential to provide evidence that services have been performed**. I'll discuss this in the context of business services and management services in [Chapters 5](#) and [6](#).

Is there a direct link between the payment and goods/services?

Earlier in the chapter, I discussed the concept of "cost component" and the fact that the supplier must be able to show that there is a direct and immediate link between the goods and services it purchases and the goods and services that it sell.

There is a further aspect to the issue of "direct link".

There must be a **direct link between any payment made by Recipient Co and the goods and/or services made by Supplier Co for the payment to be "consideration" for a supply**. This means that the supplier will only provide services to the recipient if it (i.e. Supplier Co) receives payment of some kind in return for those specific services.

What does this mean? Well, suppose Recipient Co has made a large profit and wants to share the profit with Supplier Co. The fact that Recipient Co has made a payment to Supplier Co doesn't mean that the payment is consideration for a supply of services by Supplier Co. This concept is supported by the decisions of the European Court of Justice ("ECJ") in many cases and has been followed by HMRC and UK tribunals and courts, so it's a fundamental concept in VAT.

There are also situations where a third party may undertake to pay for a supply of goods or services on behalf of the actual recipient, so payment isn't for a supply, but is reimbursement of the cost. A good example of this would be when a house builder pays for the legal services for the house buyers - the payment by the house builder and the supply of services by the solicitor are clearly linked and the payment is "consideration for a supply". However, payments can be made for many other reasons that are not linked to the receipt of supplies of goods or services. I've discussed the most common of these situations in [Chapter 3](#).

Is there anything in writing to explain the reasons for payments?

It isn't essential to have a written agreement to prove that payment is "consideration for a supply". If you buy something in a shop, it's rare that you'll have to sign any legal document setting out the terms and conditions of the transactions. However by the act of paying money to purchase groceries or pay for haircut, there's implicit agreement by both parties that they've entered into a contract. Some retailers have written terms and conditions which can be seen on their website; but in any situation, most transactions are covered by basic principles in UK law that require the supplier to provide the goods and services as shown/described and the purchaser to pay for those goods or services.

Most business to business transactions are defined in a written agreement of some sort, but, the fact that there is an agreement doesn't mean that there is a supply between the parties. Nor does it always correctly reflect the actual legal arrangements. Some of the most common types of payments between associated aren't consideration for a supply, so you must establish the nature of the payment to help you determine the correct VAT position, as discussed in [Chapter 3](#).

Chapter 2: Checklist

- You can only claim VAT on costs if the goods and/or services of a taxable supply, whether made to a third party or associated business.
- A supply of goods is when the title to something passes from one person to another in return for a payment.
- A supply of services is when you do something for someone else in return for a payment.
- There has to be a direct link between the services supplied and any payment made to create a supply for VAT purposes.
- You can arrange your VAT affairs to minimize your VAT costs.
- You can arrange your VAT affairs to generate interest free cashflow funding from HMRC.
- Either way, you can only claim VAT on costs if you can demonstrate that that you have made taxable supplies and you also must be able to prove that supplies have been made.

Chapter 3

How do you know if the payment is "consideration for a supply?"

So we've now thought about what is meant by a "supply of services" and whether services have been carried out. The next step is to establish whether payments made between associated business represent "consideration for a supply" and the practical steps that you need to take to confirm whether a taxable supply has been made.

I've discussed each of the scenarios in the context of our question about claiming VAT on telephone bills and legal costs to demonstrate the main principles.

- Is there a contract?
 - Do you have to have a contract?
 - The fact that there's a contract doesn't mean a supply has been made
 - The written agreement must correctly reflect the arrangements
- If it's not consideration for a supply, then what is it?
 - Disbursements
 - Transactions by agents
 - Profit share or loan
- Is the charge made in the course or furtherance of a business?
 - Holding companies
 - Free supplies of services or below cost
- Are the parties separate legal entities?
 - Don't confuse your "inters" and "intras"!
- VAT group registration and VAT divisional registration

Is there a written agreement

An obvious starting place to establish whether a supply of services has been made is a written agreement, or contract. We wouldn't normally do business with a third party without a contract.

However, transactions involving associated businesses are often less formal and queries often arise because the parties don't know what payments or transactions represent. As we go through the book, we'll discuss a range of typical scenarios between associated businesses and whether related payments are liable to VAT.

But it's now more than ever essential to put such arrangements in writing to avoid disagreements and uncertainty about the VAT liability.

Do you have to have a contract?

No, there's nothing in the VAT legislation that says that a contract or other written agreement is compulsory.

It's common for associated businesses to have group agreements setting out how the separate businesses will interact each other. Sometimes there is one single group agreement which sets out

the criteria for all transactions between group members, effectively allowing the sole shareholder and/or director to decide how and when transactions will be carried out.

However, a lot of these agreements have been in place for a long time and may no longer reflect the current arrangements between the businesses. And remember that a written agreement doesn't prove that supplies of services have been or are being made between associated businesses: it simply sets out the arrangements for how such transactions will take place.

If there are supplies between individual companies, I would strongly recommend that individual agreements are put in place properly describing the arrangement between each separate legal entity; clearly describing the nature of the supplies made payments arrangements etc, in exactly the same way that arrangements with third parties are documented.

You wouldn't have a group agreement with a third party, so why do this with associated businesses?

Whether the supplies will be made by a holding company to subsidiary companies, or between subsidiary companies, each arrangement should be properly documented.

The fact that there's an agreement doesn't mean a supply has been made

Having an agreement is not proof that supplies have taken place. HMRC will examine the agreement in detail and may choose to ignore the agreement if they believe that it does not represent the real facts. **You must be able to demonstrate that services have been supplied** as defined in the agreement and that the agreement is a true reflection of the arrangements between the businesses concerned.

The written agreement must correctly reflect the arrangements

It's important that any existing agreements are properly reviewed to make sure that they correctly reflect the actual arrangements; to reflect changes in practice over the years.

HMRC will also expect that the agreement is followed by the parties concerned and may query if there are any deviations from the agreement, e.g. if payments are delayed, charges don't reflect the agreed formulae or if VAT invoices are not issued as stated in the agreement. Of course there will be genuine situations that cause payments to be late, or other circumstances mean that there is some deviation from the agreement, but make sure that you're able to provide reasons if HMRC query such situations arise.

If it's not consideration for a supply, then what is it?

Payments between associated can be made for a number of reasons. Sometimes payments are simply contributions towards costs, reimbursements for goods or services bought on behalf of the other party; sometimes payments are a way of sharing profit or income.

Is the payment a disbursement?

A disbursement is when one person pays a bill on behalf of a third party and collects the amount from the third party. A common arrangement between associated businesses is that of a

"paymaster" situation, where one of the parties pays for all third party goods and services and collects a share of the cost from the other businesses.

A good everyday example of a disbursement is stamp duty land tax, which is payable on certain property purchases. The solicitor will typically pay the tax and then charge to the client as a VAT-free disbursement on the invoice, along with their fee for services which is liable to VAT at 20%.

But what about arrangements between associated businesses, where one party holds accounts with all third party suppliers and collects the relevant share of the cost from the other businesses?

Let's illustrate the distinction with an everyday example: the telephone bill.

In this scenario, Supplier Co and Recipient Co share the same premises and Supplier Co has the account with the telecoms provider.

When there is a disbursement:

Each company has a separate contract with a single telecoms provider and receive a separate invoice for their respective service; Co A's invoice is for £40 plus VAT i.e. £48; Co B's invoice is for £30 plus VAT; i.e. £36.

Supplier Co makes a single payment to cover both invoices to the telecoms provider and bills Recipient Co for its part of the cost; i.e. £36.

This is a disbursement. Co A is acting as a "paymaster" and simply recouping the cost of the payment from Co B. The VAT invoice is issued to each company individually by the telecoms company. Co A cannot claim any of the VAT charged on the invoice issued to Co B, nor should it charge VAT on the payment it receives from Co B.

Not a disbursement:

In this scenario, only Co A has a contract with the telecoms provider, covering the costs of its service and that to Co B. Co A receives a single invoice for the total cost; £70 plus VAT; i.e. £84. Co A makes a single payment to the telecoms provider and bills Co B for its share of the cost.

This is not a disbursement. Co A has received the supply of services from the telecoms provider, as Co B has no direct relationship with the telecoms provider.

Co A can recover all £48 of the VAT on the invoice from the telecoms provider. The VAT that relates to its own usage can be recovered subject to the normal rules. Co A can also claim the VAT that relates to the proportion used by Co B and issues an invoice to Co B for the telecoms service for £30 plus £6 VAT because it is charging Co B for the supply of the telecoms service.

If you want more detailed guidance about disbursements, see HMRC's guidance about disbursements in VAT Notice 700; s25.1 <http://tinyurl.com/kfcv7iz>.

Transactions by agents

The subject of agent and principal can be difficult and the VAT accounting can be somewhat confusing, as explained in [Annex III](#) to Chapter 1.

One typical example is where a business uses an associated business to act as "undisclosed principal" when buying goods or services from third parties, because they want to keep their identity private.

Profit share or loan to fund associated businesses

It's not uncommon for associated businesses to provide loans or pay a share of profit under the guise of a payment for services; or to inflate the value of services as a way of passing funds to associated businesses. The reasons for this often have very little to do with VAT and in the past, HMRC may not have been too concerned about such arrangements in the past, especially if both parties were "fully taxable", so there was no VAT loss to the revenue.

However for the reasons discussed in [Chapter 2](#), I'd strongly recommend that you DON'T use management charges as a way of moving money or providing between different legal entities. The VAT on the invoice can't be claimed as input tax because the payment isn't consideration for a supply. However the supplier must pay the VAT shown on the invoice as a debt due to the crown.

Issuing incorrect invoices is both a civil and criminal offence so do NOT use this as a way to move money between businesses. Remember also that you could be committing other, non-VAT related offences by such actions.

Is the charge made in the course or furtherance of a business

The other main requirement is that the "supply" is made "in the course or furtherance of a business".

Holding companies

The role of holding companies is quite unique in these situations, because some of their activities are NOT regarded as being in the course or furtherance of a business.

In most cases, some or all of the function of a holding company is to manage or oversee the activities of the subsidiaries on behalf of the shareholders, sometimes in return for payment from the subsidiaries, sometimes not. This is usually not regarded as a business activity by tax authorities, which means that holding companies can't always register for VAT nor can they claim VAT on costs that relate to their "non-business" activity.

The best example of such situations are when company directors perform "directors' functions"; i.e. their services are made to protect the investment of shareholders in such activities as board meetings, reporting on and managing the performance of subsidiary companies for shareholders.

I've discussed this issue in more detail in [Chapters 6](#) and [8](#), which deal with management services agreements and a recent decision by the European Court of Justice about VAT on costs incurred by holding companies.

See VAT also Notice 700, section 4.6: <http://tinyurl.com/lxuf57o>

Free supplies of services or below cost

The other "non-business" aspect to this is when associated businesses provide goods or services to each other either at no charge or below cost. HMRC normally regard this as "non-business",

because the transaction is not made on a commercial basis, particularly if the recipient is partly exempt, so benefits by not paying irrecoverable VAT.

The effect of this is that Supplier Co would not be able to claim VAT on the related part of the telephone bills, legal costs or other VAT bearing expenditure. Also, under the anti-avoidance rules, HMRC can direct that such transactions between associated parties are invalid or direct Supplier Co to charge VAT at the normal market rate.

Of course, there may be a good commercial reason for providing goods or services free or charge, or below cost, for example if Supplier Co is entitled to a share of Recipient Co's profits from other sales at a later date. Either way, Supplier Co would have to issue a VAT invoice for the deferred payment or for the barter goods or services as and when any further payment is received.

See VAT Notice 700: The VAT Guide, section 4.6 <http://tinyurl.com/qbaoq5x> for more information about business/non-business activities.

Are the parties separate legal entities?

For VAT purposes, a “supply” is normally only made between separate legal entities.

For example, this could include the provision of shared office services between limited companies which have separate VAT registrations. Alternatively, an individual partner, acting as a sole proprietor, could charge a partnership for the use of property or other assets owned by him.

See Chapter 5 where I’ve discussed how being registered for VAT increases VAT costs and when income from such arrangements counts towards the VAT registration limits.

But it may not be clear who is supplying whom, especially in the case of associated businesses who use refer to related businesses in less formal terms; for example referring to partners as directors; or using the term “company” when referring to a partnership.

However one of the most common areas of confusion is “inter” and “intra”

People often confuse the terms “intra-company” transactions and “inter-company” transactions.

My Compact Oxford dictionary gives the following definitions:

- “Inter” means among other things; between.
- “Intra” means on the inside; within.

So please remember the distinction:

“Inter-company” means between separate companies; e.g. parent company to subsidiary.

“Intra-company” means within a single company; e.g. the sharing of head office costs between separate divisions of the company.

VAT group registrations and divisional registrations

Finally, there are two specific scenarios when transactions involving limited companies are not supplies for VAT purposes.

The first is when associated companies are registered in a VAT group registration, where the member companies share a single registration number. The group registers as a single entity under the name of the representative company of the group and submits one VAT for all group members, which includes VAT on supplies made by members of the group to third parties or non-members and VAT on expenditure.

Transactions between different members of the group are normally "disregarded", which means that normally, VAT is not charged on such transactions, although there are some anti-avoidance provisions that can apply particularly if any of the companies parties are partly exempt (see [Chapters 6 and 14](#)).

Group registrations are very useful arrangements for transactions involving associated companies and can generate significant savings on transactions between the companies.

However the anti-avoidance rules are very complicated and I would always recommend that you take professional advice when dealing with transactions involving VAT groups, particularly involving land and property and international transactions, even if the companies involved are no longer part of the VAT group.

The second situation when transactions are NOT supplies is when companies have divisional registrations, so that separate divisions have separate VAT registration numbers and submit separate returns. Any transactions between the separate divisions aren't supplies for VAT purposes.

See VAT Notice 700/2: Group and Divisional registration: <http://tinyurl.com/ozee6cu> for more information.

I've explained a little more about group and divisional registration in [Chapter 5](#).

Chapter 3: Checklist

- You do not have to have a written contract to prove that you've supplied goods or services.
- Payments are made between associated businesses for a number of reasons; including profit shares or repayment of costs.
- Your supplies must be made "in the course or furtherance of a business activity".
- Don't confuse "inter" (i.e. between) and "intra" (i.e. within).
- Transactions between separate parts of the same legal entity - e.g. between divisions of a company or different offices of a partnership - are not normally liable to VAT.
- Connected companies can register for VAT in a single VAT group registration. VAT is not usually charged on transactions between group members.
- Limited companies may also set up separate registrations for separate divisions, but the divisions still do not charge VAT on intra-company transactions.

Chapter 4

If you're sure it's payment for a taxable supply

If you're sure the payment is for a supply of goods and/or services, this chapter explains the basic VAT principles for issuing invoices, making payments and when special rules apply.

- VAT accounting: payment and invoices
 - Payments
 - Invoices
 - Barter transactions
- What is the VAT liability?
 - What sort of special rules might apply?
- Is it a single or multiple supply?
- Frequently asked questions
 - Isn't it easier to add VAT to everything?
 - What if the bill includes costs that weren't liable to VAT; e.g. office rent, staff salaries and insurance?
 - Do we have to add a mark-up on supplies to associated businesses?
 - Changing the nature of the services and cost components?

VAT accounting for supplies: payment and invoices

Payments

As I explained in [Chapter 2](#), the act of making a payment or issuing a VAT invoice doesn't mean that there is a supply of services. So "raising a management charge" doesn't mean that services have been supplied.

But, conversely, associated businesses often make "payment" for the supply of goods or services to each other in return for something other than money, such as barter transactions and writing off mutual debts, as explained in [Chapter 1](#). Either way, the supplier must charge VAT for the taxable supplies even if the payment isn't made in money.

Invoices

Supplier Co has to issue a VAT invoice to Recipient Co in the same way as any transaction with a third party, as explained in [Chapter 1](#).

Barter transactions

If Supplier Co provides services to Recipient Co in return for a supply of services or goods instead of cash, then there is a supply by both parties. This means that both parties have to issue a VAT invoice for their respective side of the barter; i.e. for the value of goods or services supplied to each other; and pay VAT charged to HMRC the same as VAT on any other sales. Each party can claim the VAT charged by the other party on their VAT return as input tax subject to the normal rules.

See VAT Notice 700, The VAT Guide, <http://tinyurl.com/p2p7gqf>:

- section 8.7 for more information about barter transactions;
- section 7.4 explains when non-monetary payment is made and how to calculate the value for VAT purpose

If the payment is consideration for a taxable supply, what is the liability?

The basic principle is that supplies are liable to VAT at 20%, unless they are specifically listed for VAT relief at the reduced rate of 5%; the zero-rate or VAT exemption.

Where do you find this information?

The first place to look is HMRC's website <http://tinyurl.com/mqwua6e> which summarises the supplies that qualify for the reduced rate of 5%, the zero-rate or VAT exemption. It also tells you where to find more detailed information about VAT liability in specific business sectors, e.g. construction, financial services, printed matter, food etc.

If you're providing office services, administration services or management services, then your services will almost certainly be liable to VAT. However I've explained more about the VAT liability of most common services between associated businesses in [Chapters 7 to 10](#).

Is it a single supply or a multiple supply?

I explained the difference between single (or composite) and mixed (or multiple) supplies in [Chapter 1](#).

Let's think about this in the context of a bill to cover the cost of standard rated elements; e.g. the use of the telephone and exempt office rent and staff costs. Recipient Co is paying for the right to use Supplier Co's office premises (e.g. use a desk or meeting room as and when needed), use the telephone and administration services from various staff, as and when needed.

As explained in [Chapter 1](#), you have to establish whether component parts of the supply are for the "better enjoyment" of one specific element, then the VAT liability of the supply would be dictated by the VAT liability of that element.

Alternatively if there is a mixed supply of different services at different rates, then you can itemize them on your invoice and apportion the amount you charge between the separate services, only charging VAT where necessary.

However if any one of the elements is liable to VAT and none of the VAT free or reduced rated elements are separately identified and valued, then the whole charge is liable to VAT at 20%.

We'll look at some more specific issues relating to typical single or multiple supplies between associated businesses in [Chapters 7 - 10](#).

What sort of special rules might apply?

There are some important special rules that apply to certain types of supply, including property and personnel/staff costs, which in certain circumstances are not liable to VAT. I've talked about these in more detail in [Chapters 7-10](#).

Frequently asked questions

Finally, here are answers to some FAQs:

Isn't the simplest solution just to always add VAT to everything?

No. Ever since I've worked in VAT, I've met a lot of people whose approach to VAT has been "if it moves, add VAT". Now in some respects, that sounds quite logical because if you always charge VAT, then HMRC can't assess you for undercharged VAT. If you add VAT to something that isn't liable to VAT (e.g. disbursements which I discussed in Chapter 3), you still have to pay the VAT charged on the invoice to HMRC. The VAT is a "debt due to the crown" because it's shown on a document that purports to be a "VAT invoice".

But there are two other very good reasons this isn't a good idea:

- First, if the payer can't recover all of their VAT because they are partly exempt, or maybe not even registered for VAT, then the added VAT is simply an additional cost.
- Second, under the VAT rules, the payer can't recover VAT which has been "incorrectly charged". So even if the payer is a "fully taxable" VAT registered business, they are not entitled to recover such VAT.

If you've overcharged VAT or paid VAT that you think was charged incorrectly, you must amend the error within the normal 4 year adjustment period. The supplier must issue a credit note for the overcharged VAT, as explained in VAT Notice 700, section 18 <http://tinyurl.com/q9r37e8>.

See VAT Notice 700/46: How to correct VAT errors and make adjustments and claims <http://tinyurl.com/nplc9oc> which explains how to include such adjustments on your VAT return.

What if the bill includes cost components that aren't liable to VAT; e.g. the office insurance, staff salaries or exempt property rent. Do I have to add VAT on to that element of the charge?

The fact that some of the costs don't bear VAT doesn't affect whether you add VAT to your charge. Just because your costs include rent, or insurance, or staff salaries, doesn't mean you're providing these same services to your associated business.

The first thing you have to do is to establish whether you're making a single or multiple supply, as discussed in [Chapter 1](#). If you're making a single supply of management services, or administration services, or office facilities, then there is only one VAT liability, regardless of whether any of the cost components are VAT free.

However, if you're making a multiple supply and identifying different values for each supply on the invoice, then you have to look at each individual element to decide the liability.

Certain supplies are zero-rated or exempt from VAT. These **might** include rent or insurance; and the recharge of certain staff costs and disbursements may not be liable to VAT. Note I've used the word **might** when referring to these charges, because like everything else it depends on the contractual arrangements between the parties and what the payer is receiving for the payment.

A good example is insurance. Assume that Supplier Co has an insurance policy for the office which is also used by Recipient Co. The policy is in Supplier Co's name.

The supply of insurance is only exempt from VAT when made by an authorised insurer, which is why Supplier Co doesn't pay VAT on the insurance premiums. However if Supplier Co charges Recipient Co for a supply of insurance, then Supplier Co would have to add VAT to the charge because the supply of insurance would be standard rated.

Cost components

Alternatively, the insurance premiums may simply be a "cost component" in the provision of management services or administration services. In this case, your charge to Recipient Co would be liable to VAT at 20%, even though one or more of the cost components is exempt or zero-rated.

See [Chapters 7-10](#) for more information about specific types of income that aren't consideration for a taxable supply.

Do I have to add a mark-up if I'm charging an associated business?

No, you don't have to add a mark-up specifically for VAT purposes. However, as discussed earlier, it's important that Supplier Co of the services (or goods) is carrying out their activities "in the course or furtherance of a business". This normally means that HMRC would expect to see supplies to associated businesses charged at normal market rate; i.e. the same rate charged to third parties.

HMRC can also direct that the value of transactions is made at an open market value under anti-avoidance rules if services are undervalued and the payer/recipient of the goods or services can't recover all of their input VAT, as I've discussed in [Chapter 14](#).

Supplier Co and VAT recovery

There's one further issue to consider.

There may be another answer to the question " *Can we claim VAT on our office costs and legal bills if we raise a management charge to our associated company?* ".

Supplier Co may be entitled to claim some or all of the VAT on the office costs and legal bills if those services are used to make OTHER taxable supplies. This means that you have to consider whether Supplier Co can claim VAT on costs in the context of its overall business activities and not only the services supplied to Recipient Co.

Suppose Supplier Co is an estate agency which also provides management services to Recipient Co. If the office costs and legal services are used in the estate agency business, then Supplier Co can claim the VAT under the normal rules.

If the services to Recipient Co are exempt, or non-business (e.g. because they are provided free of charge or below cost), then Supplier Co would not be able to claim VAT on the proportion of the office costs and legal services used for non-business activities. For example, if 60% of the costs were used in the estate agency and 40% used to provide free supplies to Recipient Co, then Supplier Co would, in principle, only be entitled to claim VAT on 60% of its costs.

As always, it all depends on the exact circumstances of the situation.

"Can we claim VAT on our office costs and legal bills if we raise a management charge to our associated company?" depends not only on whether Supplier Co uses the office costs and legal services to provide taxable services to Recipient Co, but also whether Supplier Co is using the services to make any other taxable supplies to third parties.

Chapter 4: Checklist

- You have to issue VAT invoices for payments for supplies of services with associated business under the normal rules.
- Payments can be cash, or barter transactions, or when accounting entries have the effect of setting off mutual debts between supplier and recipient.
- Special rules apply to certain property transaction, cross border transactions, directors' costs and staff costs.
- Remember to consider whether the service is a single supply liable to VAT at 20%, or if it's a mixed supply where different VAT liabilities can apply to individually itemized component parts.
- Don't add VAT to everything because the customer can't claim VAT if it has been incorrectly charged.
- You don't have to add a mark-up on charges to associated businesses, but you must be able to show that the transaction is subject to the same conditions as any third party transaction.

Chapter 5

VAT registration issues

This book mostly deals with payments made to VAT registered businesses and whether or not such payments are liable to VAT. However in this chapter, I'll be considering the implications when suppliers aren't registered for VAT and showing how much VAT is saved on their sales.

I'll also be showing how the VAT cost of supplies of services between associated companies is affected by whether or not the companies are registered for VAT in a group registration.

- Unregistered suppliers
 - VAT registration limits
 - Comparison of VAT costs between registered and unregistered Supplier Co
- Disaggregation: artificial separation of business activities
- Group registration:
 - How does this affect VAT costs?
 - Worked examples
 - What if the group makes exempt supplies?
 - Anti-avoidance provisions for VAT groups
- Divisional registration

There are three case studies in this book. The first two concerns a supplier (Supplier Co) which is already registered for VAT; in the first example separately registered and in the second example in a VAT group registration with Recipient Co. The third concerns a sole proprietor who is trading just under the VAT registration limit.

I'll be referring to the worked examples on pp 20-25.

Unregistered suppliers

It's particularly important to consider the implications for unregistered businesses services to associated businesses because income from services to associated businesses counts towards VAT registration limits in the same way as any other income from taxable supplies.

Sometimes being registered for VAT is actually useful because it means that you can claim VAT as input tax on all of your costs and IF your clients can claim the VAT that you charge on your supplies.

However, if your clients are partly exempt or not registered for VAT, then being registered for VAT means that your services are more expensive **because of the effect of adding VAT to the cost components that aren't liable to VAT; i.e. rent, insurance, salary costs.**

As you can see from the example earlier in the book, the effect of being registered for VAT is to **increase the potential VAT cost to the recipients significantly, because of having to add VAT to charges based on VAT free costs components.**

VAT registration limits

The sole proprietor example is based on a situation I came across several years ago concerned a lady who ran an office, providing administration and office services to a related business and some unrelated building contractors, as well as more limited services for a number of other business clients. The building contractors each had their own mobile telephone accounts and worked independently of each other, occasionally sharing a van and a few other pieces of equipment between them.

What had originally started as a small, part time operation run from her home providing services to her brother's company. Over the years, it developed into a full time operation with the added cost of business office premises. Her income from the business started at around £10,000 per annum, but once the operation grew, her income increased and exceeded the VAT registration limit.

The cost components included the usual overhead costs of rent, rates, insurance, her salary, office equipment and consumables. The owner also dealt with their suppliers and customers and provided a messaging service. Also, the contractors used the office when they needed to meet clients away from the building site.

The issue of the proprietor's own VAT registration status came up when a VAT officer was carrying out an inspection of one of the contractors at the office. The proprietor assumed that because her income was made up of recharged office costs (exempt rent and insurance) and her own salary (which wasn't liable to VAT), this part of her charges wouldn't be liable to VAT. Unfortunately, that wasn't correct and in fact she should have been registered for VAT three years earlier. So not only did she have to start charging VAT on the income from the contractors, she also had to pay VAT on her income from the previous three years.

Comparison of VAT costs between registered and unregistered Supplier Co

After taking into account some input tax on her costs, her total VAT bill for the previous was around £19,000. She also had to pay a fine for not notifying her liability to register for VAT at the correct time.

Thankfully because two of the contractors were registered for VAT and were able to claim VAT on their costs, they agreed that she could issue them with a VAT invoice for VAT on her charges for the previous four years. This meant that instead of having to fund £19,000 out of her own pocket, she only had to find about £4,000, to cover the cost of services to her unregistered clients.

Of course, every situation is different but the same principles apply:

Recharges of office and people costs usually represent consideration for a taxable supply and the income counts as income for VAT registration purposes

If you're in any doubt about whether you need to register, have a look at HMRC's VAT Notice 700/1: "Should I be registered for VAT?" <http://tinyurl.com/396kxa> or contact HMRC's VAT helpline to speak to someone. If you're still not sure, I'd suggest that you speak to an accountant or VAT consultant. Either way, it's best to err on the side of caution in these situations.

I appreciate that being registered for VAT puts small businesses at a disadvantage can because you have to increase your prices by adding VAT. But you don't want to end up paying a substantial VAT bill out of your own pocket because you haven't registered at the right time. Your accountant should be able to help you work out if you can reduce your VAT bills by using the VAT Flat Rate Scheme or make sure that you're claiming as much VAT on costs as possible.

Disaggregation: artificially separating business activities to keep turnover below the VAT registration limit.

The subject of VAT registration brings us to the subject of “disaggregation”, or separating activities to avoid VAT registration. It applies in situations where HMRC believes that two or more businesses, which aren't registered for VAT because their individual turnover is below the limit, should be regarded as a single business or single legal entity. This means that HMRC can direct that such businesses register for VAT and pay VAT on their combined income, usually from the current date but sometimes from an earlier date.

Let's consider this in the context of our office manager and building contractors. Suppose the office manager is married to the contractor who isn't registered for VAT. She's always acted as his office manager and took on the other contractors as clients to help generate a bit more income. When she took on the other contractors as clients and started to rent office premises, she started to allocate her costs between the three contractors so she knew how much to charge the other two contractors.

Her husband's income from contracting and he earns about £55,000 per annum from this activity. Suppose his wife earns £30,000 each year from the services she provides to the other contractors working from home.

HMRC may take the view that the husband and wife are actually trading as partners and look at their combined income as coming from a single partnership, even if this wasn't the reason for treating the businesses separately. But HMRC believes that her role in managing his business affairs means that there is a single business entity and issue a direction that the separate entities - i.e. the two sole proprietors - should be regarded as a single "taxable person" for VAT purposes.

This means that both parties would have to pay VAT on his income, from as far back as the date their combined income exceeded the VAT registration limit and would have to charge VAT on future income.

The principle can apply whenever having separate businesses or different legal entities gives rise to a VAT advantage by “artificial separation of business activities” or “disaggregation”. It can apply even if the VAT advantage isn't even INTENTIONAL, so there's no onus on HMRC to prove that the motive for separate businesses is to save VAT.

To minimize the risk that HMRC would regard your arrangements as “artificial splitting of businesses”, it's important to take sensible practical steps such as keeping separate proper records and accounts for each business, use separate premises where possible and make sure that you charge for the provision of goods or services between the separate businesses at the normal market rate.

See VAT Notice 700/8: VAT avoidance schemes, sections 4.3.2 and 5.1.5 for further information
<http://tinyurl.com/okrrvtx>

Group registration

In [Chapter 2](#), I explained the distinction between “inter-company” and “intra-company” transactions for VAT purposes. In this section, I’ll be looking at transactions between separate limited companies; i.e. inter-company transactions.

There is one specific situation when VAT registered companies don’t have to charge VAT on inter-company charges. And that’s **when the companies are registered for VAT as part of the same VAT group registration.**

Limited companies can normally register for VAT as a VAT group in the following situations if they are established in the UK or have a UK establishment AND they satisfy the control criteria. This generally means that all of the companies are controlled as though for tax purposes; i.e. one member of the group controls all the other members of the group or another person who isn’t a member of the VAT group (including a company, partnership or an individual) controls all of the members. The primary control conditions are in VAT Notice 700/2: Group and divisional registration, section 2.9: <http://tinyurl.com/qj34kbb>

VAT group registrations are a very useful facility for associated companies that closely operate, with several shared costs and/or profit sharing arrangements to cover common expenses. It means that you don’t have to identify the nature of payments between the companies so that VAT accounting doesn’t get in the way of day to day operations.

As I’ve previously mentioned, there are some anti-avoidance provisions that apply to VAT groups. ***I’d strongly recommend that you read VAT Notice 700/2: Group and divisional registration:*** <http://tinyurl.com/pbyfvdu> ***in detail if you are considering applying to set up or include new members in VAT groups.*** It contains important information for members of group registrations.

How does a group registration affect VAT costs?

Because transactions between group members aren’t liable to VAT, the effect of being in a VAT group registration is particularly useful for partly exempt businesses, because there’s no VAT added to charges made that are based on VAT-free cost components, predominantly rent, insurance and employment costs.

HMRC usually regard such situations as acceptable VAT savings; i.e. they are a “normal consequence of VAT grouping”. The anti-avoidance arrangements are intended to prevent situations where partly exempt companies are able to reduce or avoid or defer VAT in other situations, e.g. purchases of goods or services from third parties or other associated companies that are not registered in the same VAT group.

VAT group registrations are very useful arrangements to help minimize administration AND to help minimize VAT on costs between associated businesses.

Worked examples

On pages 20 - 25, I've shown worked examples based on charges made between two associated companies. The figures are for illustration only, but clearly show the benefit of being in a group registration for Recipient Co.

Examples 1 and 2 are based on Supplier Co incurring net costs of £203,880 in providing management services to Recipient Co, of which £165,200 are "VAT free" cost components, predominantly personnel costs for directors and employees. In these examples, over 80% of the costs of providing services are vat free.

In that scenario, with a modest 12% mark-up and the annual management services valued at £228,256, the additional VAT cost that would arise if the companies were separately registered is £38,231. This would be additional cost to Recipient Co if it is partly exempt.

If both Supplier Co and Recipient Co are fully taxable, i.e. they can claim all of the VAT on their costs (subject to the normal rules), then any VAT charged by Supplier Co to Recipient Co isn't actually a cost because Recipient Co will be able to claim all of the VAT charged as input tax.

What if Recipient Co is partly exempt?

But the scenario is quite different if Recipient Co is partly exempt because, while being in a group registration would avoid incurring additional VAT costs on "VAT free" elements of services from Supplier Co, ***the fact that Recipient Co makes exempt supplies also means that Supplier Co could not claim all of the VAT incurred on its third party costs used to provide goods and/or services to Recipient Co.***

For example, if only 5% of the sales made to recipients who are separately registered (whether associated business or third parties) by group members are liable to VAT, then in principle the group can only claim 5% of the VAT on its overhead costs.

Again, the situation will depend on the actual arrangements, but being in a VAT group registration will almost always result in savings for the partly exempt recipients of supplies of services from other group members.

However, partly exempt VAT groups have to deal with some of the most complex areas of VAT; including partial exemption VAT recovery methods and anti-avoidance legislation.

If you're in any doubt, I'd strongly recommend that you ask your accountant to run some numbers to calculate the effects of being in a VAT group and take specialist advice if you need advice about setting up practical planning arrangements, taking into account any anti-avoidance legislation that could apply.

Further information

HMRC's guidance about both group registration and divisional registration is in VAT Notice 700/2: Group and divisional registration <http://tinyurl.com/o5ag25s>.

VAT group anti-avoidance provisions

There are two specific anti-avoidance provisions that apply in the case of VAT group registrations:

The "specified body" conditions. This rule applies two additional conditions to companies who are members of or apply to join VAT group registrations and is designed to "*prevent partly exempt purchasers of services setting up joint ventures within their VAT group, in order to buy in services without incurring irrecoverable VAT. The joint venture companies are in reality run by and for the benefit of third party suppliers, who exercise control of them*" (VAT Notice 700/2: VAT group and divisional registration, s3: <http://tinyurl.com/pbyfvdu>)

This provision applies if and when the consolidated turnover of the group to third parties exceeded £10m in the past year or is expected to exceed £10m in the following year.

These provisions are complex but include a range of conditions, including involvement of limited liability partnerships and how the £10m turnover is affected by the group consolidated accounts.

One of the benefits that is included in this list is the provision of management services, including:

"any charges being made by anyone for managing the business activity that involves making intra-group supplies, or for providing staff or managing it. This does not include remuneration of businesses paid to directors or employees of the body" VAT Notice 700/2; section 3.11.2.

HMRC go on to explain that this is because management charges normally represent a reward for the business's performance AND it is normally difficult to establish a genuine open market value for such transactions.

These rules are particularly complicated so take special care if they apply to your business.

Cross-border transactions

There are two other specific anti-avoidance provisions for VAT groups.

The first concerns imported services and prevent a partly exempt UK company from obtaining VAT free services by obtaining them from non-UK suppliers.

The other provision relates to land and property in the UK, where the owner is a member of the VAT group which belongs outside the group (presumably also "belongs" in the UK) and has opted to tax the property.

In these situations, the recipient of the service has to pay VAT on the "imported service" under a procedure known as the "reverse charge" .

See VAT Notice 700/2, section 5 <http://tinyurl.com/pbyfvdu> for further information about the above provisions and [Chapter 14](#) for information about other anti-avoidance rules.

Divisional registration

It is possible for limited companies to be registered in separate divisions, with separate VAT registration numbers and each division submitting separate VAT returns. The provisions are explained in VAT Notice 700/2: section 8 <http://tinyurl.com/mw4ensv>.

The normal rule is that payments between different parts of the same legal entity aren't "consideration for supplies" for VAT purposes, so there's no need to charge VAT on such payments. This makes life a lot easier for companies or partnerships or other organisations when sharing costs or profits.

Notice 700/2: Section 8.13 confirms that intra-company payments aren't liable to VAT. It says:

"Do I need to issue separate tax invoices for transactions between divisions of the same corporate body?"

No. You must not issue tax invoices for transactions made between divisions of the same corporate body. These are not considered to be supplies for VAT purposes."

The main reason for having divisional registrations is to enable individual divisions to submit VAT returns where the divisions use different accounting methods or software. But transactions between different divisions aren't liable to VAT.

Chapter 5: Checklist

- Income from administration charges, cost sharing or other taxable supplies counts towards the recipient's VAT registration limit, even if the value includes VAT free cost components.
- The addition of VAT to payments for services that are based on VAT free cost components makes a significant difference to charges made according to whether the supplier is VAT registered or not registered.
- Combined income from separate businesses could also require associated businesses to register as a single entity even if individually they aren't liable to register for VAT.
- "Inter-company" payments between companies who are registered in the same VAT group registration are not liable to VAT, except in the case of certain businesses affected by anti-avoidance provisions.
- "Intra-company" payments, or payments between separate parts of the same legal entity, are not liable to VAT, except in the case of certain businesses affected by anti-avoidance provisions.

Chapter 6

VAT planning for transactions between associated businesses

VAT returns and VAT accounting

It is possible to arrange your transactions with associated businesses to get a VAT cashflow advantage using the various VAT accounting facilities that are available. In this chapter, I'll be explaining how this can be done in certain situations.

However you decide to arrange our VAT affairs, remember that HMRC may regard the way you use such facilities as abusive and can withdraw the use of certain VAT accounting facilities at any time.

- VAT returns
- Monthly returns
 - Start up businesses
- VAT accounting schemes:
 - Cash accounting
 - The flat rate scheme
 - Getting it wrong in practice
- Supplies of services
 - Is it fraudulent?
 - Worst case scenario?
- Making your arrangements robust

However you chose to set up your arrangements, ensure that arrangements with associated businesses are set up properly to help avoid problems with VAT claims. It's difficult to identify every possible vulnerable area, but you'll be minimizing the chances of things going wrong if you spend some time setting things up properly from the start. You might have to invest in some professional help to set up contracts and taking advice about the VAT accounting arrangements, but it's money well spent if it saves you the hassle of dealing with unexpected problems with HMRC further down the line.

VAT returns

VAT returns are normally submitted for three monthly periods; i.e. four VAT each year, but that businesses can ask to submit monthly returns if they will normally be claiming VAT refunds (i.e. "repayment traders").

HMRC will normally allow businesses to have VAT returns that fit their accounting years, otherwise businesses are allocated return periods (or "staggered") by rote as they apply.

I'll discuss monthly returns later in this chapter, but I wanted to show how it's also possible for businesses to arrange their affairs to obtain a VAT cashflow advantage even if they're on quarterly returns.

Normal VAT accounting vs cash accounting: Normal VAT accounting is often referred to as "invoice accounting" because for most transactions, the tax point is the date on which the VAT invoice is issued to the customer or client. Cash accounting can be used under certain VAT accounting

schemes to delay the payment to HMRC until the customer has paid the bill. To avoid any confusion, I'll use the term "normal VAT accounting" during this book to distinguish from cash accounting.

Consider the associated businesses in our example at the front of the book. Suppose that both Supplier Co and Recipient Co submit VAT returns for the same three monthly periods, in this case calendar quarters. Their VAT returns for the three month period to 31 March must be submitted and paid by 7 May, or 10 May if paying electronically.

Supplier Co issues monthly invoices for supplies of management and administration services to Recipient Co, which makes zero-rated supplies of books and magazines.

Recipient Co submits its VAT return on 1 April. It's a repayment claim and the business receives the claim from HMRC on 20 April. Supplier Co, on the other hand, doesn't have to pay the VAT charged to Recipient Co until it submits its return on 7 May. Therefore the businesses together have the benefit of the VAT cashflow for seventeen days.

And if the businesses are on different VAT quarterly periods (or "staggered" to use HMRC terminology), the cashflow benefits could be even more beneficial:

- If Supplier Co's VAT return is for 1 February to 30 April, its VAT return would not be due until 7 June, giving a potential cashflow advantage of over five weeks.
- If Supplier Co's VAT return is for 1 March to 31 May, its VAT return would not be due until 7 July, giving a potential cashflow advantage of over nine weeks.

Of course, you can't rely on this because the extent of the cashflow benefit always depends on the length of time between when the repayment claim is submitted and when it is paid by HMRC.

HMRC often review repayment returns, especially if the amounts are large or if a repayment claim is different to normal trading patterns. Sometimes their reviews can take several weeks or even months, basically wiping out the benefit of such cashflow benefits.

But once they understand the businesses concerned and are satisfied that the any supplies from associated businesses are valid supplies for VAT purposes, HMRC often make routine repayments without review. Unfortunately, you can never guarantee this, which is why it's not a good idea to rely on VAT repayments to help fund your business, albeit often you don't have a choice!

Monthly returns

Having Recipient Co submit **monthly returns** can provide even better cashflow benefits, because Recipient Co can claim monthly repayments while Supplier Co can take up some two to three months before having to pay VAT on the supplies to Recipient Co.

Regular repayment situations are not uncommon in certain business sectors. Two very good examples are construction and export businesses.

Contractors making zero-rated construction services. Construction groups often have a purchasing company which has accounts with builders' merchants, ensuring they get large discounts available for bulk purchasing. These companies are on normal quarterly returns. They sell the goods/materials purchased from the merchants to the development companies. The development

companies carrying out zero-rated construction work are on monthly VAT returns, enabling them to claim VAT on the goods purchased from the purchasing companies each month.

Export companies. Similar arrangements are normal with UK manufacturing businesses who set up export companies on monthly VAT returns to claim VAT on goods manufactured for export.

HMRC don't normally have any problems with the use of monthly returns in these types of situations, because the companies making zero-rated supplies are making supplies of goods or construction services, both of which are tangible and can be demonstrated.

Start up businesses

The combination of monthly and quarterly returns can be particularly helpful for new businesses, with separately registered companies, partnerships etc making supplies to each other, but it puts the repayment company at risk of delays, particularly if HMRC take time to review the claim.

HMRC say that businesses shouldn't RELY ON VAT REPAYMENTS TO FUND THEIR BUSINESS and in an ideal world, nobody would ever put themselves in that situation. Who wants to be in a situation where their business is effectively hostage to decisions made by the government department which has strong legal powers to administer and collect tax in the UK?

But we all know that the world isn't that simple and many new businesses DO rely on VAT repayments to help them in their start up phases. And in many cases, any VAT claimed will be paid as output tax by the associated supplier. I appreciate that HMRC has to protect the revenue, which includes reviewing VAT claims, especially if they believe that VAT has been incorrectly claimed.

I just hope that, given their current inclination to challenge arrangements between associated parties, **HMRC's over-zealous desire to protect the revenue doesn't cause businesses with limited options for funding to close down, especially in an economy when SMEs are one of the main sources of new jobs and additional tax revenue for the government.**

VAT accounting schemes

It's also possible to generate VAT cashflow benefits - and even some outright savings - by using certain other VAT accounting schemes, such as cash accounting; see VAT Notice 731: Cash Accounting <http://tinyurl.com/p2whvpa> and the VAT flat rate scheme; see VAT Notice 733: VAT Flat Rate Scheme for small businesses <http://tinyurl.com/nxwvbmf>.

- Cash accounting

Cash accounting is particularly useful because it enables the supplier of the goods or services to delay paying the VAT to HMRC until the recipient pays the invoice, while the recipient can use normal accounting and claim VAT as soon as it receives the invoice from the supplier.

- Flat rate scheme

The flat rate scheme allows businesses whose net turnover is less than £150,000 to calculate their VAT liability by applying a flat rate of VAT, which is less than 20%, to their gross turnover and sometimes make a significant saving on the amount of tax payable to HMRC. I've seen

situations where associated business take advantage of savings produced when the supplier uses the flat rate scheme but the recipient claims all of the VAT charged using invoice accounting. I've shown how the scheme works in more detail in [Chapter 13](#).

Accountants and VAT consultants often come up with other inventive arrangements to generate cashflow savings and actual VAT savings. Such arrangements might not be illegal or avoidance, but could certainly be regarded as abusive.

HMRC is increasingly vigilant about such arrangements. My normal "rule of thumb" is that if the arrangement gives rise to any significant ongoing VAT saving OR cashflow benefits arising from supplies of services between associated businesses when compared with arrangements with third parties, it should be "handled with care".

And there is one other particularly important factor that can cause such arrangements to go wrong:

Getting it wrong in practice There's no point in spending money to get advice and set up arrangements to get a cashflow benefit unless you actually follow the instructions. Over the years, I've seen many situations where businesses spend a lot of money and time setting up such arrangements, but ***don't implement them properly***; for example they continue to issue invoices on a quarterly basis instead of issuing invoices on a monthly basis.

Arrangement may also fail because of other VAT rules. A good example is the bad debt relief scheme, where the recipient of supplies is required to repay to HMRC any VAT claimed on unpaid invoices within the six months VAT relief payment period. I've seen situations where HMRC are still in the process of reviewing a repayment VAT return when the six month period ends and refuse to pay the claim because the recipient has not paid for the services. See the VAT Notice 700/18: Relief from VAT on bad debts: <http://tinyurl.com/ox723j7> for more information about the scheme.

Supplies of services

In [Chapters 2 - 4](#), I explained why it's so important to set up arrangements between associated businesses correctly; i.e. with individual contracts or agreements between the parties, supplies being made a commercial rate and the issue of VAT invoices as though the supplies are between third parties.

I also explained why it's essential to retain robust evidence to demonstrate that such services have been provided, in case HMRC query whether such services have been supplied. I wanted to talk about this scenario in a bit more detail and some of the broader issues that can arise.

At the start of the book, I mentioned that HMRC recently challenged the validity of invoices issued by one of our clients to an associated business for the provision of consultancy services. The reasons given by HMRC reasons for their decision covered a number of different technical aspects including whether the contractual arrangement between companies were valid and various other things including whether the individuals involved were ***physically capable of working all the hours recorded on their timesheets***.

This is not the first time when HMRC have chosen to disregard the validity of a written contract or agreement between associated businesses and I worry that this is part of a trend; to challenge the

validity of agreements when the content of the agreements doesn't agree with HMRC's interpretation of the events.

HMRC's current approach to such arrangements seems to be that unless the supplying business can provide detailed and robust of work carried out, to at least the standard one would expect if the services were provided by a third party, if not more so, then HMRC won't accept that the services have been supplied.

Does this mean that the business has committed fraud?

Another way of looking at this scenario is that by challenging the validity of the invoices, HMRC is accusing the supply company of issuing fraudulent invoices and the recipient of making fraudulent claims for VAT on their services.

If HMRC genuinely believes that businesses are issuing invoices to associated businesses for services that have not been carried out, then surely this is a matter of fraud and should be dealt with as such. So does their decision mean that they accept that services have been carried out, but they are simply trying to find a way to prevent the recipient claiming VAT charged on the invoice and benefiting from the cashflow advantage.

The whole situation seems ridiculous when you consider that any VAT claimed by the recipient will be paid to HMRC as output tax by the supplying business. The only cost to the revenue is the cash flow and it would be far simpler for HMRC to withdraw the use of monthly returns from such businesses if they think that the facility is being reduced.

Many businesses, particularly in the start-up phase, rely on regular VAT repayments to help with their cash flow. If you are setting up a business with a long development time before making any sales, you have to be able to pay staff, suppliers, rent, rates and all of the other costs even though you don't have any income. A lot of new businesses struggle to get bank loans or overdraft facilities, so they have to rely on any other sources of income, including VAT payments, to survive.

Worst case scenario?

Suppose a married couple sell their house and move to rented accommodation with their children, using the £250,000 profit from the sale of their house to set up a business. The business won't make any sales or at least 12 months, because it would take this time to develop and manufacture products.

In the meantime, they set up separate companies to carry out different parts of the development process, with an intra-group administration agreement setting out detailed arrangements for the supply of goods and services between the companies. Any variations to the arrangements set out in the agreement can be changed at the directors' discretion.

The directors, who are also sole-shareholders, are employed by separate companies, which raise consultancy fees (at market rates) for their work in developing the products of to the sales company. The companies carrying out the development work also employ a small number of staff. The development companies are on quarterly returns and will use cash accounting, while the sales

company is on monthly returns and submits claims for the VAT charged. The director and staff record the of each project on their timesheets, but don't record details of specific work carried out.

When the sales company starts operations, it has anticipated sales of £1m in year two, it will employ upwards of 15 fulltime staff and generate further VAT revenue in on-going sales.

Unfortunately, this never happens. HMRC does not believe that supplies have been made by the development companies and refuse to pay the VAT claim made by the sales company

The directors are unable to raise finance from the banks or any other third party and their plans to develop the business which could eventually employ hundreds of people and generates hundreds of thousands of pounds for the UK revenue come to a halt because HMRC don't believe that supplies of services have been made between the companies.

What started out as a properly costed, well planned business falls apart within the first year because of HMRC decision not to make the VAT repayments.

The directors do not even know if they can afford to challenge HMRC's decision - HMRC no longer have to pay the costs of appeals where the appellant is successful, and we all know that these affairs can be expensive. Plus it can take several months for a case to get to the Tribunal. And even if the appellant wins, HMRC always have the option of appealing. And in addition to this, the effects on the directors' family and domestic life are significant - they have lost their original home and their financial security.

The directors are forced to declare themselves and their business bankrupt before making any sales.

Believe it or not, this isn't really the worst case scenario I can imagine - in fact I've seen similar situations where the whole affair has become even more messy and difficult to manage. But this is bad enough and that's why it's so important that you get things right from day one.

N.B. In the case I mentioned above, my client was advised by leading tax counsel that they have a very good chance of winning at Tribunal. However the directors did not know whether they could wait the several months to get to the Tribunal - and possibly losing - never mind the ongoing uncertainty about whether HMRC would challenge the Tribunal's decision.

So it's head HMRC wins, tails the taxpayer loses.

My concern about these situations is that HMRC are only tasked with considering one side of the picture; i.e. to protect the revenue at the point of tax collection, without any concern for the broader picture.

If HMRC was asked to make a comment about the above scenario, they'd probably say that regardless of the bigger picture, they are required to make decisions about VAT repayments based on the specific facts of any case for the protection of the revenue. And, of course, that is correct.

But HMRC don't exist in the real world. If you're at the mercy of a decision made by a single VAT officer, it seems as though HMRC exists in a bubble where taxpayers are nothing more than resources of revenue while human beings, who are the business owners who generate the business and pay the tax, are completely vulnerable against the power of the government's income generating machine.

Making a your arrangements robust

The situations discussed in this chapter failed on two main criteria:

- HMRC believe that that the contracts don't reflect the real facts; and
- the businesses couldn't provide SPECIFIC evidence of the work done to support the time charged on the invoices.

So, as I explained earlier in the book, it's ESSENTIAL that your arrangements are AT LEAST as robust as those with any third party, which means:

- Set up individual contracts/ agreements between ANY businesses who are making/receiving supplies to/from each other and make sure that the agreements/contracts correctly reflect the day to day activities and interactions between the parties involved.
- Make sure the employment status of all individuals involved is clear so there's no ambiguity about the direction of supplies.
- The contracts should specify the work to be done, with clauses to deal with situations that don't go to plan, such as work not done on time, or errors.
- The contracts should explain how charges for the work will be calculated.
- The contracts should set out the timing for the invoices and payment arrangements.
- Detailed daily records of work done should be maintained. This doesn't have to be on an hour by hour basis, but at least to the level of detail that you'd see on your accountants' or solicitors' timesheets, e.g. time spent on telephone calls, reviewing reports, writing letters, in meetings etc.
- Probably the most important is to be able to show HMRC the work that has been done. Ensure that timesheets show not only the name of the project, but also some description of the actual of work done e.g. drafting viability report; reviewing product testing results. Be able to show the physical evidence, e.g. the finished report or product testing data.

It might seem like a lot of hassle for charges between associated businesses, but it's better than not being able to get the cashflow benefit of the VAT repayment and A LOT better than having your business fold because you were relying on a VAT repayment to pay bills.

Chapter 6: Checklist

- It is possible for recipients of services to get interest free cashflow funding by submitting returns before the supplier submits their return.
- Submitting monthly returns can mean up to 3 months cashflow benefit.
- However you can't rely on VAT repayments because HMRC may take time to review the claim and make the repayment.
- Setting up contracts and using HMRC's VAT accounting schemes to help minimize VAT liability or avoid delays in repayment claims will only work if the arrangements are correctly implemented.
- HMRC may take the view that the arrangements are being abused and withdraw permission for use of the schemes.
- It is essential to be able to demonstrate to HMRC that services have been supplied between associated parties.
- Arrangements between associated businesses should be at least as robust as those between unrelated businesses.

Chapter 7

Office costs and day to day business services

The majority of queries about recharges and cost sharing relate to office costs; the practical day to day routine activities.

As we've already discussed, the liability depends on the type of service involved and the contractual arrangement between the parties.

- Business services
- What's an office cost?
 - Disbursements
 - Is it payment for a specific service
 - What if we don't pay VAT on the cost?
- Is it a single (composite) or multiple (mixed) supply?
- Is it in writing?

N.B. The sections headed in blue are also relevant to [Chapters 6 to 8](#), where we discuss the VAT liability of other costs; i.e. people costs, motoring costs and property costs.

Business services

Business services cover a range of services. For the purpose of this book, I'll make a distinction between business services and management services.

Business services typically include a range of day to day activities, including the provision of office facilities and a range of routine office services. The amount charged by the supplier is based primarily on the cost of goods/services; or "office costs" and a share of staff costs.

Management services typically include the provision of services carried out by directors or senior staff members; e.g. in the form of consulting or advisory services. While part of the cost may be based on office costs, salaries and other support services, the actual service provided consists of the management or consultancy services, by the individuals concerned.

I'll be looking at management services and people costs in more detail in [Chapters 8](#) and [9](#) respectively. However in this chapter, we'll be concentrating on the provision of routine business services.

What's an office cost?

I use the term "office cost" to include any and all expenses in running an office. These include some or all of the following:

- Telephone/internet services based on a proportion of the bills.
- Rent for office space.
- Use of office facilities including computers, printer etc.
- Office consumables, including stationery, tea, coffee etc..

- Staff salaries
- Buildings and business insurance.
- Other office services, including cleaning and property maintenance.

Some of these costs are liable to VAT at the standard rate, but as we've already discussed, certain expenditure doesn't usually bear VAT, including insurance premiums, staff salaries and sometimes rent.

When the costs are "recharged" or "shared" with associated businesses, or even third parties who use the facilities, you have to [establish whether you're charging for a specific service \(e.g. telephone services or designated office space - see Chapter 11](#) about property) or whether the charges are a way of obtaining payment for a service that includes a number of components, usually called office facilities or administration services.

There are a few steps that will help you determine this:

Is the payment to reimburse you for a disbursement, as discussed in [Chapter 3](#)? Remember that this is when the goods/services were never owned by/consumed by and legally are the responsibility of the payer.

Is it payment for a specific service such as the provision of telephone/internet services? In that situation, the contracting party is charging the other companies for the use of the facilities, which is liable to VAT at 20%.

What if we don't pay VAT on the cost, e.g. exempt insurance? In [Chapter 4](#), I explained that the supplier may have to add VAT on charges to cover "VAT free" cost components, such as salaries, rent and insurance. This is because if you make a single supply of office or administration or management services and the value is based on costs including employee costs and property, then the whole service is a single supply at the standard rate of VAT.

Insurance

Insurance is a good example of something that is normally exempt from VAT. However only insurance companies who underwrite the insurance risk can exempt insurance premiums. If you're not an insurance Supplier Cos defined in the VAT legislation, any charge you make you make for insurance to a UK customer is standard rated. So if Supplier Co makes a specific charge for providing office insurance, then they would have to charge VAT.

However, if the payer is specifically named in the policy, then payment is reimbursement for their share of the insurance premium and not liable to VAT.

Zero-rated food and drink

If you buy zero-rated food and drink, any charge made for consumption on the premises is standard rated.

Staff costs

The other main VAT free expense is staff salaries. Charging for the use of staff or their services is usually standard rated. I've explained when certain charges for employee costs and property are VAT free in [Chapters 8](#) and [10](#).

Is it a single supply or multiple supply?

What if you want to invoice for a number of office costs at once, rather than billing for separate identifiable costs?

In Chapter 1, I explained the distinction between making a single supply - where the supply includes a number of components, where one is predominant and the others are for the "better enjoyment" of the main component - or a mixed supply of services – where there is no one predominant part

As I've explained below, which ever way you define things, the charge is almost certain to be liable to VAT at 20%, so in practice it really doesn't matter. But it's important to understand the implications.

Single or "composite" supply

In most cases, you'll be providing a range of office services for a single charge

Or there is one main service and the others are "for the better enjoyment" e.g. you might provide an receptionist service where the other aspects are just incidental to the main element, but the value of the charge is based on both the cost of the telephone service and other amenities, e.g. office consumables, employee time. This would be a taxable supply of receptionist services and the whole amount of the charge will be liable to VAT.

Mixed or "multiple" supply

This is where you invoice for a number of services, each of which is independently important to the client.

In this case you can charge VAT at the correct rate for each individual element; assuming any are exempt or zero-rated; otherwise if you don't identify elements that have different rates of VAT, you have to charge VAT at 20% on the total value of the invoice.

Is it in writing?

In [Chapters 3](#) and [4](#), I explained why it's not only helpful but important to put such arrangements in writing, to avoid confusion about both the commercial arrangements and the VAT implications. I know this may seem a bit over the top for arrangements between small associated businesses, but actually this is one of the most common areas where HMRC find problems.

In Chapter 5, I discussed the concept of "Disaggregation" and whether businesses are artificially separated so that their individual turnover is below the VAT registration limit.

HMRC may regard the provision of services or sharing of facilities between associated businesses without a commercial arrangement as an important factor that indicates that businesses are connected and should be registered for VAT as a single business.

Everybody knows of businesses which "get away" with VAT registration without any formal arrangements, so you might assume that you're okay as long as you have separate bank accounts or use separate rooms and keep separate accounting records. Unfortunately, if HMRC decides to review your VAT affairs and challenge your VAT registration status (or lack of!), this might not be enough to persuade HMRC that the businesses are separate entities for VAT purposes.

The existence of an agreement which clearly defines the arrangements between the businesses and the arrangements are made on a third party basis is usually an important factor in demonstrating to HMRC that the businesses have not been "artificially separated".

Chapter 7: Checklist

- There's no formal definition of the term, but business services are usually day to day practical services.
- Office costs typically include property rent, staff salaries, telephone costs, office consumables.
- You have to establish whether you're making a single supply, e.g. office support services or administration services where the primary element is based on staff services and the other elements are incidental to the main element.
- If you provide a "mixed supply"; i.e. a range of equally important services, e.g. staff services and office space, and separately identify the charges on the invoice, you need only charge VAT on the taxable charges.
- You don't have to have a written contract but it's a good idea to have one in place for each business to confirm the arrangements and avoid confusion.

Chapter 8

Management services

In this chapter, we'll be looking at specific charges made for the services of directors, senior or specialists staff, whether or not there is a formal "management services agreement".

- What's a management charge?
- Claiming VAT on head office costs
- Is it written down?
 - Director's services
 - International transactions
- Is there a payment?
- Value
- VAT invoices
- Timing
- Evidence that services have been supplied
- Anti-avoidance
- Holding company costs
 - Business/non-business activities
 - Calculating how much VAT can be claimed

N.B. The subject of directors services and costs is covered partly in this chapter and [Chapter 9: People costs](#).

What's a management charge?

The term "management charge" is a widely used term but there is no formal definition of the term for VAT purposes. Usually management services agreements are between related businesses that set out the terms and conditions whereby one party provides services to the other party(ies), for example holding companies providing services to subsidiaries.

Remember the question from the Preface?

Can we claim VAT on our office costs and legal bills if we raise a management charge to our associated company?

I've since explained that you can only claim VAT on office costs and legal bills if those services are used to make taxable supplies and that you can only "raise a management charge" (i.e. issue a VAT invoice) to request payment for a supply of goods or services.

The term "management charge" comes up a lot and I want to emphasise that it isn't a technical term for VAT purposes. In practice, I've seen the term used on invoices for administration services, staff services, directors' services, sharing office space and a whole lot of other stuff. The most important thing is, as explained in [Chapters 1-4](#), that whether you call it a management charge or

administration charge or office services charge, you can only issue a VAT invoice if there has been a supply of services.

Claiming VAT on head office costs

One of the most common reasons for raising management charges is to enable the "supplier" to claim VAT on costs. A typical situation is when a management company needs to recover salary costs, professional fees, property costs incurred and recover the cost from the subsidiary companies.

Before I go any further, it's important to clarify the meaning of "head office" and "holding company" because they are often confused in practice.

- A "head office" does NOT just refer to the "head office" of a company; it could be the head office of a partnership or sole proprietor or any other legal entity.
- A "holding company" is a company that owns (or "holds") the shares in subsidiary companies. Among corporate groups, it's common to refer to the holding company as "head office".

Either way, make sure that you know whether you're discussing a head office or holding company. Charges to and from head office and other parts of a company, partnership etc, don't represent supplies for VAT purposes, so aren't liable to VAT.

So if we're looking at a holding company, what exactly is the subsidiary getting in return for their payment? Usually the subsidiary receives a combination of strategic advice, consultancy services, legal advice or other professional services in return for their payment, under the heading of "management services" which is liable to VAT at 20%. The important thing is that both parties agree on the reason for the payment.

The main exception to this concerns holding companies which incur costs relating to non-business activities of providing services of *looking after investments* for shareholders, where services are not made in the course of business as discussed in [Chapters 1-4](#) and in more detail later in this chapter.

Is it written down?

Management service agreements or administration agreements are normally written to formalise arrangements between separate organisations where payments and/or the provision of goods and services are involved.

VAT officers often ask to see MSAs to review the VAT liability of payments between associated businesses.

The content of an MSA is up to the businesses concerned. They usually state the nature of the services that will be provided. Charges are often based on the value of specific costs, such as senior management/directors salary and pension payments, plus other costs of running the head office. There's usually a mark-up to establish that the services are a genuine supply made on a third party basis.

Supplies made under such arrangements are usually a single supply of services which is liable to VAT at the standard rate.

There are two specific situations which have different VAT treatments, even if they are specifically defined in a MSA.

- Directors' non-business activities

The first concerns the activities of directors in respect of subsidiary companies. Because the role of directors in such situations does not always constitute a business activity for VAT purposes, any charges (e.g. a share of their costs) made for these services is not "consideration" for a taxable supply.

The issue of VAT on holding company costs is discussed in a little more detail at the end of this chapter. There is more also more information about directors' costs in Chapter 9: People costs.

- International supplies of services

The VAT treatment of services between associated business is particularly difficult if either party is an overseas business. This is because international services are only VAT free if certain criteria are met. One of these is that the services must fall within certain definitions. A good example is that consultancy services or similar professional or technical services, are not liable to UK VAT (the technical term is "outside the scope of UK VAT") while management services are liable to UK VAT. Therefore it's particularly important that MSAs or other agreements clearly define the nature of the services provided.

The subject of international services is particularly complex and even more so in the context of VAT groups and partly exempt businesses. The subject is explained in more detail in Chapter [12: International Transactions](#) and [Chapter 14: Anti-avoidance](#).

Is there a payment?

Payments for services between associated business, including companies that ARE NOT registered in VAT group registrations, is often made by the set-off of mutual debts which are calculated at the year end. In some case, this can be regarded as "payment" for VAT purposes. See [Chapter 1](#), "Time of supply" for further information about this subject.

Chapter 1 also explains the twelve month anti-avoidance rule for continuous supplies of services between associated businesses to ensure that VAT isn't avoided or deferred.

Value

The value of any supply is the amount charged, net of VAT. If payment is not made in money, this is a barter transaction and the value is based on the monetary value; i.e. the amount the customer would have to pay if the payment was wholly in money.. HMRC explains this in VAT Notice 700, section 7.4 <http://tinyurl.com/l4jdh3d>.

See also VAT Notice 700, section 8.7 which explains a little more about barter transactions <http://preview.tinyurl.com/ock2ec6>.

Do we have to add a mark-up?

As explained earlier in the book, it's not necessary to add a mark-up to any charges for management services or similar supplies.. But it's important to remember that HMRC may challenge the validity of the agreements and related invoices if they have reason to query whether supplies have been made.

See [Chapters 2-4](#) and [6](#) where I've discussed the importance of demonstrating that arrangements between associated businesses represent "supplies" for VAT purposes, including that such arrangements are on the same basis or similar to contracts or agreements between third parties. There's no one specific criterion that determines this, but adding a mark-up to the cost of good/services is normal for transactions between third parties, so it's a good idea to add a mark-up, even a modest one, for supplies made to associated business. In the worked examples shown at the front of the book, I've added a 12% mark up.

But it's equally important that the value of services is not artificially inflated. In [Chapter 6](#), I discussed situations where cash-flow benefits can be obtained on supplies between associated businesses, if Recipient Co submits monthly VAT returns and Supplier Co submits quarterly returns. Recipient Co could have a cashflow benefit of up to three months. HMRC would almost certainly challenge such claims if they believed that the value had been artificially inflated to give Recipient Co an excessive VAT benefit.

HMRC may query the value charged for supplies in such situations where the high value of the services has seemed to be based on some criteria that could be manipulated, e.g. time costs for staff where the numbers of hours worked or the daily/hourly charge out rate seem abnormally high.

In one case, HMRC disputed that a director could have worked 13 or even 16 hour days because of the director's domestic circumstances, even though the director concerned was an unusual individual in only requiring 2 - 3 hours sleep each night. In other cases, HMRC have challenged the amount of hours charged over several months based on their assumption of an average working day of 8 - 9 hours, clearly the officers concerned did not appreciate that a 12 hour day for business owners is not at all unusual!

Finally, HMRC may ask the supplying businesses concerned to justify the level of mark-up, even if the recipient is fully taxable and could claim all of the VAT charged. In those situations, the best way of justifying the level of mark-up is to show that the same sort of mark-up is applied to similar services supplied to third parties.

Evidence that services have been provided

I've already discussed the need to *provide evidence of the work done to at least the same level of detail as in a third party situation* and the type of evidence that should be available.

What do I mean by this?

Think of a couple of situations involving services and the evidence that work has been carried out and there is clear evidence of work done:

- Construction services, evidenced by the construction of a building, extension, repairs, maintenance etc.

- Legal services, evidenced by correspondence, attendance at meetings, preparation of reports.

In my own case, I usually provide clients with extracts from my daily time sheets, showing the time spent and a summary of the work carried out; including writing letters or reports; telephone conversations; reviews of contracts etc.

The best approach is to ensure that there is AT LEAST this level of evidence when services are provided between associated businesses.

VAT invoices

If the payment is received before the invoice is issued, Supplier Co MUST issue the invoice within 30 days so that the Recipient Co can claim the VAT on his VAT return. See VAT Notice 700, s16.2.3:

<http://tinyurl.com/p97npe7>.

Avoidance

There are a range of anti-avoidance provisions, which I've discussed in [Chapter 14: Anti-avoidance](#). These include certain schemes and arrangements that contain certain listed "hallmarks" including certain arrangements between connected parties. It is mandatory for larger businesses to notify HMRC of the use of such schemes, as explained in Chapter 14. They include certain arrangements for services between connected companies.

But remember that HMRC can challenge the validity of any arrangements, regardless of the size of the business, even if the business isn't required to notify HMRC of the use of the arrangements.

Holding company costs

I've explained that one of the criteria that services have been supplied is that the supply is made "in the course or furtherance of a business".

Business or non-business activities

Holding companies, they can only register for VAT if their activities are "in the course or furtherance of a business", so if their only activity is to monitor and guide the activities of the subsidiaries on behalf of the shareholders, the company can't register for VAT, which means that it can't recover VAT on its costs.. I'll come back to this issue later in this chapter (see "VAT on holding company costs" below) and in [Chapter 9: People costs](#).

If, however, the holding company is also making taxable supplies, perhaps under a MSA, there it can claim VAT on the proportion of its costs used to make those taxable supplies.

I discussed above the VAT implications for holding companies who don't carry out any "business activities" for VAT purposes, including the fact that they cannot register for VAT or recover VAT on their costs. The issue of VAT recovery on holding company costs has been fiercely challenged by HMRC over the years and the issue referred to the European Court of Justice ("ECJ") for clarification. HMRC's policy has recently been upheld by the ECJ following the ruling in the case of the British Airways Authority ("BAA") and their policy is confirmed in their Revenue & Customs Brief 32/14 <http://tinyurl.com/plcjinj3>.

It is, however, one of those issues that is challenged by businesses and there are currently two other cases about VAT on holding company costs awaiting judgements at the ECJ, which could affect HMRC's policy. Either way, I think that HMRC won't be easily convinced to change their policy, so for the time being they will follow their stated policy.

Calculating how much VAT can be recovered

If a holding company business carries out non-business activities but also makes taxable supplies, it can only claim VAT on the proportion of its costs that are used to make the taxable supplies. This is explained in VAT Notice 706: Partial Exemption, section 2.2: <http://tinyurl.com/n9suubr>. There is no specified method for this in the VAT legislation, only that the method used should be "fair and reasonable". A common method is based on the proportion of directors' time used on shareholder (i.e. non-business) activities.

If the holding company also makes exempt supplies; or is registered as part of a VAT group that is partly exempt; then it can only claim VAT on costs used to make taxable supplies. This means that there will be two steps to the calculation:

- calculating how much VAT on costs is used for business activities; and
- calculating how much VAT on the business costs is used to make taxable supplies.

I explained the main principles of VAT recovery and partial exemption in [Appendix II](#) to Chapter 1. If a VAT registered business carries out non-business activities (for example as a holding company or carrying out charitable activities) it must apply to HMRC for approval to use a method of calculating how much VAT on its costs is used for business activities.

Businesses carrying out both non-business activities and making exempt supplies have to submit a proposal to HMRC for a combined business/non-business and partial exemption method to calculate how much VAT they can recover. This is explained in VAT Notice 706: Partial Exemption: <http://tinyurl.com/mvetpps>. This can be a very time-consuming process and it can take several months to reach agreement with HMRC, so the best advice is to make the application as soon as possible. It may also be worth investing in professional advice about the structure of any such method, in all but the most simple situations, to ensure that you're claiming as much VAT as possible while the method is practical and easy to administer.

Chapter 8: Checklist

- Services provided by directors and/or senior management to associated businesses are often formalized in management services agreements (“MSAs”).
- Such services are typically defined as “management” services or “consultancy” services and are a way of sharing out head office costs between associated businesses or subsidiary companies. These services are liable to VAT at the standard rate.
- The services are usually carried out on an ongoing basis and are defined as “continuous supplies of services” for VAT purposes.
- It's essential to retain evidence of services provided to associated businesses to support claims for VAT charged.
- Remember the distinction between inter-company transactions (i.e. between) and intra-company transactions (i.e. within the company - e.g. head office to branches).
- A holding company owns the shares in subsidiary companies. A head office is usually part of a company or partnership or other entity and manages the business carried out by branches or other offices of the business.
- Payment can be made by accounting entries that have the effect of writing off mutual debts between the parties.
- Certain services carried out by directors are for the benefit of shareholders and are not a “business activity” for VAT purposes. This means that payments aren’t liable to VAT and that holding companies are not entitled to register for VAT or claim VAT on its costs, unless it is carrying out business activities and making taxable supplies.
- Free supplies of services or services made below cost may also be regarded as non-business activities by HMRC.
- Businesses carrying out both non-business and business activities (e.g. holding companies) must seek agreement from HMRC for a method to calculate how much VAT they can claim on expenditure.

Chapter 9

People costs

One of the most common shared costs among associated companies are “people costs”; i.e. the cost of employing staff who carry out work for two or more of the businesses.

In principle, the supply of staff to UK recipients is liable to VAT at the standard rate. If included as part of a single supply of business services or management services, as discussed in [Chapters 7 and 8](#), then the liability follows that of those services; i.e. liable to VAT at the standard rate.

However there are some specific situations where the VAT liability is different, as which I’ve discussed in this chapter.

- When do you charge VAT on income for staff or directors?
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- Staff provided by employment agencies and staff bureaux
- Supplies to non-UK recipients
- Travel, subsistence, training, conferences etc
 - How does this apply to transactions between associated businesses: The Tour Operators Margin Scheme
 - When TOMS services used by directors and employee are "materially altered"
 - Day to day subsistence

HMRC’s main notice on this subject is VAT Notice 700/34: Staff <http://tinyurl.com/p88d7n6>.

When do you charge VAT on payments for staff or directors services?

Providing "people", whether employees or directors, in return for consideration, is normally a supply for VAT purposes and generally liable to VAT at the standard rate. There are certain exceptions, including supplies of staff in the medical or welfare sectors, and certain situations involving government and other public bodies, which I've summarized later in this chapter.

Arrangements involving associated businesses

Like many other transactions between associated businesses, arrangements regarding individual directors or employees are often informal and/or not written down. So if you're charging associated businesses for staff costs, it's not always clear whether you're making a supply of staff or a supply of services performed by the individuals. Also, in many cases, charging for staff costs might actually be a reimbursement, rather than payment for a supply of staff or other services.

Terminology

It all depends on employment and/or contractual status of the individual(s) involved.

- An employee is someone who is employed under a contract of service for an employer. This normally includes directors, except for certain limited situations as explained later in this chapter.

In this situation, the individuals enter into a contract of employment with and are under the control and direction of the employer, who is responsible for paying their wages, tax, NIC and pension contributions (where part of the employee's contract of employment)

If the individuals come under the control and direction of a separate legal entity, whether an associated business or third party, but their employment contract is still with the original employer, then this is regarded as a supply of staff by the employer.

- People who aren't employees usually provide their services under a contract for services for a client.

In this scenario, the individuals provide services which do not create a contract of employment, for example to carry out a specific task or provide certain services over a period of time, even if the contract stipulates that the individuals concerned must be in attendance on certain days and meet certain performance criteria.

For the purposes of this chapter, I'll use the following additional terms to avoid confusion:

- Original employer: Business which engages the individuals under a contract of service.
- Secondment: Arrangement whereby employee is assigned to different duties, either for their employer (e.g. temporary relocation to another office or division) or is made available to a separate legal entity (whether an associated business or a third party) and the individual comes under the day to day control and direction of the third party.
- Recipient or temporary employer: Business which obtains a supply of staff; or "secondees" from original employer.

The subject causes a lot of confusion because the payment arrangements don't always follow the actual contractual arrangement. For example in a group of companies, one company may pay all of the staff salaries, tax, NI, etc and then request reimbursement from the employing company. Such payments aren't liable to VAT because they are not payment for a supply of staff, but usually reimbursements for costs as explained below.

Employment situations

As well as the traditional "secondment" arrangements, there are certain other employment situations which have unique VAT treatments.

Joint contracts of employment

Joint contracts of employment exist when a contract stipulates that the individual works for two or more employers. In this case, any sharing of costs of employment between the employers concerned is usually a disbursement for VAT purposes, as explained below.

However, if the contract of employment says that the individual may have to carry out services at the discretion of the employer for other businesses, there is not a joint contract and any payments made to the employer are payment for services and liable to VAT. A good example would be a receptionist who runs the reception area for a number of associated companies, but is employed by just one of the companies. In these situations, any charges made towards the cost of the employee's salary or other employment costs are liable to VAT (unless the businesses are in the same group registration – see [Chapters 1](#) and [5](#))

See HMRC VAT Notice 700/34, s3.2: <http://tinyurl.com/nymqx7b>.

Paymaster arrangements/disbursements

The term "paymaster" is used to describe situations when one person pays on behalf of someone else and then requests reimbursement of the cost as in joint contracts and payments for the arrangements mentioned above.

In the case of joint contracts of employment, the employee's salary, tax etc are paid by one of the employers and the costs shared between all of the employers.

Paymaster arrangements are often used in groups of companies where one of the companies is responsible for running the payroll for all group employees. In this situation, the company operating the payroll pays the salaries and employment costs of all group employees as a disbursement on behalf of the employer. The employer then reimburses the payroll company for the amounts paid on its behalf.

In these situations, the reimbursements are not payment for a service, so are not liable to VAT.

However, if the payroll/paymaster company charges any additional amount for providing the payroll service, this amount is liable to VAT, unless the companies are registered in the same VAT group registration.

See VAT Notice 700/34, s3.3: <http://tinyurl.com/nymqx7b>.

Employees arranging their own secondment: temporary suspension of an employment contract

One exception to the normal rules is when an employee arranges to take on a temporary post for a separate business, whether an associated business or third party and the original employer agrees that the employee can return to his/her original position when the temporary post is over.

This could include situations where an employee decides to take “time off” to do volunteer work, or wants some work experience at a different organisation. The original employer would typically suspend the employee’s employment contract either for a fixed period or for an open period of time.

HMRC accepts that there is no “supply of staff” to the temporary employer as long as the following conditions are met:

- The temporary employer issues a new contract or letter of employment to the employee; and
- The temporary position has been arranged at the employee’s own initiative.

The original employer would have no involvement with the employee’s temporary activities. The temporary employer and employee would agree the terms and conditions of the employment, and the employee would work under the control and direction of the temporary employer.

In these situations, the original employer is not providing any services to the new employer. See VAT Notice 700/34, section 3.1 <http://tinyurl.com/nymqx7b>.

Business sector specific situations

There are certain situations when supplies of staff aren't liable to VAT because the arrangements aren't regarded as a "business activity". These would include certain secondments of staff between certain government departments and other public organisations.

There are also special rules for the provision of staff in the medical and welfare sectors. The supplies may qualify for exemption as the provision of medical services or care services.

- Most medical services that are provided by medical practitioners who are enrolled on statutory professional registers are exempt from VAT. The exemption also applies to certain services provided by staff who are working under the direct supervision of medical practitioners. See VAT Notice 701/57, Health Professionals, section 5 for further information: <http://tinyurl.com/nmc93fq>.
- Exemption can also apply to welfare services e.g. domiciliary care services provided to final consumers, or residential care services in certain circumstances as explained in VAT Notice 701/2: Welfare, section 5: <http://tinyurl.com/pjfro5r>.

The VAT exemption rules are complicated and it's important to understand the contractual provisions to define the correct VAT liability. Make sure that you check out HMRC's guidance or take professional advice to avoid unexpected VAT liabilities and to ensure that any such arrangements satisfy the criteria for exemption as much as possible.

Sole proprietors and partners providing professional services

If you are a sole proprietor of your own business, or a partner in a partnership, you may also hold other appointments because of your specific expertise; e.g, an accountant who takes on the role as treasurer of a local charity, to carry out or oversee the accounting affairs of the charity; or a solicitor appointed as company director because of his legal expertise.

If you become an employee, whether under a part-time appointment, or temporary employee, of the organisation concerned and receive any payments personally, then the payments are not liable to VAT because they are made under a contract of service, like any normal salaried position.

If, however, you provide those services in your normal business capacity as a partner (e.g. accountancy services by a partner) and any payments are retained as payment for services by your business, then the income is liable to VAT under the normal rules. The arrangement is a supply of services by your business to the recipient organisation.

See HMRC Notice 700/34, section 3.4 for further details: <http://tinyurl.com/nymqx7b>.

Directors

The role of directors is unique in that they are primarily responsible to the owners of a company; i.e. the shareholders. As discussed in [Chapters 4](#) and [8](#), this means that for VAT purposes, the activities of holding companies may be regarded as “non-business” in certain situations because their primary concern is to safeguard the shareholders’ investments; not carrying out day to day activities of running the business.

In this chapter, we'll be looking at the VAT liability of payments between associated companies for directors' services, or payments made to the directors individually.

I've discussed the most common scenarios where payments are made between associated businesses relating to directors' services below.

HMRC distinguishes between two different types of directors' appointment:

- Where one company is legally or contractually entitled to appoint a director to another; for example in the case of a holding company appointing a director to the board of a subsidiary company and whose role is to oversee the company's performance without carrying out any other services. In this case, any payment made to the appointing company is not payment for a supply for VAT purposes and isn't liable to VAT.
- When a director is appointed because of having expert knowledge and is appointed to give advice and be actively involved in the running of the recipient company, the director's services are normally regarded as supplies for VAT purposes and any payment made to the appointing company is liable to VAT.

There are also situations when individual directors have a dual role, in which case any payments would have to be apportioned between payment for services from the holding company to the subsidiary which are liable to VAT and directors' fees for acting on behalf of the shareholders, which are not.

Directors are normally treated as employees for tax and VAT purposes. So if, for example, your company is asked for the services of an employee or director to act as director of another company, then this is regarded as a supply of staff and liable to VAT in the same way as any other employee.

If, however, the appointment is organised by the director as a personal appointment and doesn't require or enable his employing company to provide services, such as management or advisory services, then this is a personal appointment and payments made to the director are not liable to VAT.

- Acting as a common director

An individual may be a director of a number of companies and is paid a fee for his services, which include attending board meetings or approving certain business decisions on behalf of the shareholders.

In these situations, the individual is not acting on behalf of any one company, but on his/her own behalf. If one company pays all of the director's fees and then asks the other companies to pay their appropriate share, then this is not liable to VAT as such payments are to reimburse the paying company for meeting the director's fees.

- VAT on directors' domestic accommodation

HMRC are particularly vigilant about VAT on director's domestic accommodation (also sole proprietors, partners and other business owners). This VAT cannot be claimed as input tax, unless the property or part of the property has a specific business use: see VAT Notice 700: The VAT Guide, section 12.2.2: <http://tinyurl.com/lsebnc9>.

Charging for time and keeping records

One of the most common ways of charging for director, management or staff services is by reference to the amount of time spent. Sometimes this is based on the actual hourly cost to the supplying business (i.e. salary, NI, tax, pension etc), sometimes the hourly rate is marked up as a way of moving value from one business to another.

As discussed in earlier chapters, it's important to retain records showing the hours worked in case HMRC ask for evidence that services have been provided. If the individual works on a number of separate projects for the "customer" and charges are raised by reference to the individual projects, then the supplying business should retain records of the different projects involved and the actual work carried out, as discussed in [Chapter 8](#) to demonstrate that work has been done.

Agreements between the parties may allow Supplier Co to calculate the charge based on other criteria, or make adjustments to the charge out rates or charge for more or less hours. However it is important to demonstrate that work has been carried out and that there is a logical basis for calculating the value charged for the services.

This is particularly important if Supplier Co wants to claim VAT on costs incurred in making the supplies concerned and must be able to demonstrate that the costs are "cost components" of the services; e.g. VAT on employment agency fees, which would be a cost component of the provision of services of employees or of services performed.

What's the value of the supply?

The value of the supply of staff depends on the contractual arrangements between the supplier and the recipient. Normally, if you're the original employer and you continue to pay the salary/NIC/tax/pension contributions of the employee during the length of the "secondment" then the value of these payments would normally represent the "value" of your supply, so you would charge VAT at the standard rate on this amount.

If the recipient pays salary to the staff concerned and/or pays any NIC, tax or pension contributions, the value of these payments is also part of the value of your service, because, as their employer, these payments are your cost components in making the service to the recipient. This means that you would include these payments as part of the net value for the services on the invoice issued to Recipient Co, even though Recipient Co has made these payments to the employee, HMRC or the pension fund directly.

If you make any additional charges, e.g. a "placement" fee or "arrangement" fee or any other amount, this is also part of the value of your service.

See HMRC VAT Notice 700/34, section 2.3 <http://tinyurl.com/nymqx7b>.

Pension costs

It's common for associated businesses to have a single funded pension scheme which employees of all businesses are entitled to join, with costs shared among all of the employers involved.

HMRC's VAT Notice 700/17: Funded Pension Schemes <http://tinyurl.com/ps9jabk> explains when employers can claim VAT on pension costs. The main principle is that employers can recover VAT on the administration costs of the fund, whereas the trustees of the fund can recover VAT on investment costs, subject to the normal rules; i.e. depending on whether the fund's investments generate taxable or exempt supplies; e.g. from sales of shares or interest from UK deposits.

Payments made to employers by the trustees towards the management of the scheme are not normally liable to VAT – see Notice 700/17, s2.6 <http://tinyurl.com/njed4ps>

Sometimes, the trustee acts as a paymaster, paying all of the management costs and recharging each employer with their relevant share. The trustee must charge VAT on the recharge of the management costs, because the trustee is treated as both having received and made the supply of management services, as explained in Notice 700/17, s2.8 <http://tinyurl.com/ps9jabk>.

In some cases, there is a single corporate trustee for a pension fund which can be included in a VAT group registration with the employing companies. In this case, the recharge of management costs to the employers isn't liable to VAT as transactions between group members are disregarded for VAT purposes. Each of the employing companies can claim VAT on their share of the management and administration costs, while the trustee can treat VAT on investment costs as input tax and claim subject to the normal VAT recovery rules;

- the proportion of VAT that can be claimed on management costs is based on whether and to what extent the employer(s) make taxable supplies in the course of their normal business activities; and

- the proportion of VAT that can be claimed on investment costs depends on whether the investments generate taxable or exempt supplies, e.g. UK financial investments or property rental/sales.

Staff provided by employment agencies or staff bureaux

The VAT liability of staff provided by employment agencies, or staff bureaux, or similar organisations, depends on the employment arrangements of the individuals concerned. In some cases, agencies have to charge VAT on the full value of their services, including the employee's salary plus their commission or arrangement fee. In other cases, the agency only has to charge VAT on their commission or arrangement fee, not on the value of the employee's salary.

If you share the cost of an employee provided by an agency, e.g. splitting the cost 50:50 with an associated business to reflect the fact that the individual will split their time equally between the businesses, then the normal VAT procedure would be that the business which contracts with the agency will claim VAT on the agency's fee and recharge 50% of the value to the other business, charging VAT on the recharged amount.

Travel, subsistence, training, conferences etc

There is a special scheme called the "Tour Operators Margin Scheme"; or the "TOMS" for short that applies to all EU businesses for dealing with VAT on the sale of travel and accommodation services.

The main principle of the scheme is similar to that for the sale of second hand cars; i.e. the supplier can't claim VAT on the cost of the services but must only pay VAT on any profit made on the sale of the services. It normally applies to **services that include travel or accommodation and certain other services, such as theatre trips or restaurant meals.**

The main principles are that the services are supplied **without material alteration** and are for the **"direct benefit of the traveller"**.

The best example is a tour operator who buys hotel accommodation and travel and sells the services as a holiday package.

The scheme applies to the sale of holidays to the public, business trips and can also apply to business conferences or training courses which include the cost of travel, accommodation or other "TOMS" services, whether in the UK or abroad.

VAT is only payable on the standard or reduced rated proportion of the margin, so if the amount charged includes zero-rated costs, such as U.K. rail fares or air fares, then this proportion of the margin is zero-rated.

How does this apply to transactions between associated businesses?

The "TOMS" scheme usually also applies to business to business transactions. This could include the cost of attending conferences or training courses.

Example

Suppose Supplier Co pays the bill for a number of staff from its own company and Recipient Co to attend a training conference. Supplier Co holds the account with the conference organiser and the VAT invoice for all attendees is issued to Supplier Co. The cost includes accommodation and meals for the duration of the conference. The conference organiser has charged VAT on the cost.

This is a typical scenario that can trigger the TOMS between businesses.

- Supplier Co can claim the proportion of the VAT on the invoice that relates to its own employees.
- The charge to Recipient Co is regarded as a TOMS supply. This means that Supplier Co cannot claim VAT on the proportion of the cost that relates to Recipient Co's employees, but must only pay VAT on any profit margin on the amount charged to Recipient Co.

If, however, Recipient Co had its own account with the conference organiser, it would receive its own VAT invoice and could claim the VAT on the cost of the conference under the normal rules.

Is the TOMS compulsory?

Yes, you are required to use the TOMS unless your business falls within the narrow category of situations where business to business transactions can be treated under normal VAT rules. This would mean that in the above example, Supplier Co would claim VAT on the total cost and charge VAT on the amount invoiced to Recipient Co.

VAT Notice 709/5, s3.6 <http://tinyurl.com/q9owp3f> explains the circumstances when business to business transactions can be treated under normal VAT rules:

What if my TOMS supplies form only an incidental part of my business?

You need not use the TOMS if you:

- *do not buy-in any supplies of accommodation or passenger transport for resale (a definition of passenger transport can be found in Notice 744A Passenger Transport), and*
- *buy-in for resale some other supplies which are normally margin scheme supplies, and*
- *do not expect your gross total turnover from these supplies to be more than 1 per cent of your total gross turnover*

The TOMS applies to a wide range of supplies. For example, simply buying hotel accommodation and charging another business for their share of the cost would also come under the TOMS. HMRC are normally very strict about applying the rules, so don't assume that they would overlook even occasional transactions that aren't treated correctly.

When are directors' and employees' TOMS costs "materially altered"?

As I've explained in the previous chapters, employee and directors' costs are often included as a cost component in the supply of business services or management services, or similar supplies. **In these situations, the TOMS doesn't apply because the services, whether hotel accommodation or train**

fares, are used in the course of providing those services so are "materially altered". In other words, the supplier isn't re-selling hotel accommodation or train travel.

The TOMS rules are complicated and you should read HMRC's guidance in VAT Notice 709/5 if you're involved with any such transactions: <http://tinyurl.com/q9owp3f>

Day to day subsistence costs

Many employers operate their staff expenses system alongside the salary system, sometimes reimbursing staff costs at the same time as paying salaries. In many cases, employee costs are paid for by the same business which operates the payroll, paying for such costs as travel, accommodation and re-imbursing employees and directors for costs they incur on a day to day basis, e.g. car parking or the cost of meals away from the office.

What are the VAT implications if one business pays subsistence costs for other businesses?

- Is it a disbursement?

If Supplier Co pays for expenses for costs which it receives as principal, e.g. it has an account with a hotel chain or travel agency, for services used by its own employees, then Supplier Co will receive a VAT invoice and can claim VAT on the costs and issue a VAT invoice to Receiver Co and any other associated businesses.

If the supplies are made directly to Recipient Co and the invoice is issued directly to Recipient Co, but paid by Supplier Co, then the payment made by Recipient Co to cover the cost would simply be a disbursement. This means that Supplier Co is not entitled to claim the VAT and it does not have to add any VAT to the amount charged.

However if Supplier Co makes a charge for administering the expenses, this would represent a taxable supply to Recipient Co and Supplier Co would charge VAT, subject to the normal rules.

- What if we add a mark-up to the cost?

By definition, a disbursement only occurs when the exact value of the goods/services is reimbursed, so if you add a mark-up to costs where the supply has been made directly to an associated business or any other person, the charge wouldn't be a disbursement for VAT purposes.

Remember that disbursements are only free from VAT when certain criteria are fulfilled, including that only the original cost of the goods or services is recharged and clearly itemised on the invoice. If you don't do this, then the payment you receive is not a disbursement for VAT purposes, because it doesn't fall within the criteria to be treated as a disbursement. This means that you must charge VAT on the full value of the amount charged, not just the mark-up. See VAT Notice 700: The VAT Guide, section 25.1 for full details of the criteria for disbursements: <http://tinyurl.com/keusk28>.

Any separate administration charge will be liable to VAT.

- Claiming VAT on subsistence costs

The rules about VAT recovery on subsistence costs are the same as those for any other type of expenditure. Under the normal rules, employers may be entitled to claim VAT on the basis of less detailed VAT invoices if the VAT inclusive cost is less than £250 - see VAT Notice 700: The VAT Guide, section 16.6 <http://tinyurl.com/p97npe7>. If you incur the costs and charge the amounts to the employing business, the VAT liability of the recharges will depend on whether the charge is a disbursement or payment for a taxable supply, as discussed above.

Either way, remember that you can only claim VAT if your business has a VAT invoice issued in its name for the costs incurred.

Supplies to non-UK recipients

The supply of staff to businesses belonging outside the UK is normally not liable to VAT.

However as I mentioned earlier, the rules about international services are complicated - don't assume that recharges of costs are VAT free just because the recipient is an overseas business. Please read [Chapter 12](#) for further information.

Chapter 9: Checklist

- There are various types of employment arrangements and it's important to understand the arrangements to get the VAT accounting correct.
- Arrangements between associated businesses can be very informal, but it's important to understand what's going on.
- A supply of staff usually occurs when the employee comes under the day to day control of the recipient business, even if their contract of employment is with their original employer.
- A supply of services occurs when the individual provides services for the recipient but remains under day to day control of his/her employer.
- If there is a joint contract of employment, recharges for staff salaries are usually disbursements.
- Paymaster arrangements often arise when one business runs the payroll for a group of associated businesses and the employing businesses reimburse the paymaster for the salary and other staff costs.
- The Tour Operators Margin Scheme can apply to payments for certain travel and accommodation costs that are "for the benefit of travellers" and are not materially altered.
- Businesses recharging such costs may not be entitled to claim VAT, so it may be more VAT efficient for each separate business to purchase such services directly if they are used within the business and not resold.

Annex

VAT on private use of goods and services

I've explained how to deal with VAT on the cost of goods and services used for non-business activities, particularly in the context of holding companies and directors' costs.

The other situations which gives rise to "non-business" use are when goods or services are used for private use, whether by the business owner or employees, or for charity purposes. This doesn't necessarily fall within the main topic of this book; i.e. transactions with associated businesses, but it's worth mentioning because these scenarios often occur in SMEs when individual proprietors, family owners or partners use goods or services in one or other of their businesses on an informal basis.

The main VAT rules are in VAT Notice 700, The VAT Guide; s9.3: <http://tinyurl.com/n2kcqg3> where HMRC provide examples of situations they regard as "non-business" use. The non-business use of fuel has its own special rules; including the fuel scale charge, which is explained in Chapter 10: Motoring costs.

Apportioning input tax

I've explained in previous chapters that if, when you purchase goods or services, you know that they will be used for non-business purposes or a mix of business/non-business, then you can only claim the VAT that relates to the business use, subject to the partial exemption rules.

However if the goods or services have already been purchased and used in the business, then you have to pay output tax on the non-business use. There are different rules for dealing with VAT on goods and services:

Goods

If you use goods only for non-business purposes, i.e. you remove them from the business entirely, then you have to pay output VAT on the cost of the goods or their value at that time.

If you only use the goods occasionally, but the goods are still the property of the business, this is regarded as a supply of services. You pay VAT on any charge made, or the cost of the services.

Services

If you use business services, for example computer software, or you have construction work done at your home by your employees for domestic purposes, then you must pay VAT on the value of the services.

Value

The amount of output tax must normally be based on the commercial value of the goods or services and there is guidance about how to calculate this in VAT Notice 700, s9.3 <http://tinyurl.com/qbaoq5x>

Chapter 10

Motoring costs

VAT Notices 700/64: VAT and motoring expenses <http://tinyurl.com/ovbmqpf> explains how VAT applies to petrol and motor vehicles. In this chapter, I'll only discuss situations that involve payments between businesses that have separate VAT registrations for the use of cars.

The rules discussed in this chapter apply only to cars and not other types of motor vehicles, e.g. motor cycles or vans. See VAT Notice 700/64, s2 for the definition of a motor car for VAT purposes.

Most of you will know that there are special VAT rules relating to the purchase and/or use of cars, which are explained comprehensively in HMRC's VAT notice. I've summarised the most important rules below, with links to the more detailed information in the VAT leaflet for reference.

- VAT and cars: the main rules
 - Partly exempt businesses
- Company cars
- What is it you're actually paying for?
 - Use of a car: in-house leasing
 - Fuel
- Provision of a car as cost component of a supply of management services or a supply of staff
- Private use of cars: charges to employees
- Cross border arrangements

VAT and cars: the main rules

These are the main rules relating to VAT and motoring costs and the relevant sections in Notice 700/64 <http://tinyurl.com/ovbmqpf>.

- Businesses can't recover VAT on the purchase of a car unless it's a "qualifying car" which includes new cars purchased for resale, for use as a taxi, by a driving instructor, for self-drive hire or exclusively for business purposes. See VAT Notice 700/64, s3.
- You can't claim VAT on car accessories purchased at the same time as a non-qualifying car - see VAT Notice 700/64, s5.2.
- You can claim VAT on the cost of repairs and maintenance if the car is used for business purposes - see VAT Notice 700/64, s5.1.
- There are special rules about VAT recovery on petrol to deal with non-business use of a vehicle, including the fuel scale charges - see VAT Notice 700/64, s8.
- You can normally only claim 50% on the cost of leasing cars and in some cases daily rental cars - see VAT Notice 700/64.
- If a car is sold and no VAT was claimed on its purchase, then the sale is exempt from VAT - see VAT Notice/64, s7.2.

- If you sell a car but didn't pay any VAT on the purchase, then you only pay VAT on any profit margin under the second hand scheme - see VAT Notice 718/1: The VAT Margin Scheme on second hand cars and other vehicles: <http://tinyurl.com/oj9ohcl>
- The restrictions on VAT recovery are designed to cover the non-business use of cars, for example the 50% block on car leasing charges and fuel scale charges.

This chapter deals with payments between associated businesses for the use of cars and fuel.

Partly exempt businesses

Remember that if your business is partly exempt and can only claim part of its input tax (as explained in Chapter 1, Annex II), you can only claim the proportion of the VAT on motoring costs that relates to your taxable supplies.

So if you normally only claim 8% of your input tax, you would only be able to claim 4% of the VAT on car leasing costs; i.e.

- 50% block on VAT on leasing charges to represent non-business use;
- Of the 50% that relates to business use, the business can only claim 4%; i.e. $8\% \times 50\% = 4\%$.

Company cars

VAT on the cost of "company cars" can't be recovered, unless it "will be used exclusively for the **purposes of your business** and would not be made available for the private use of anyone" - see VAT Notice 700/64, s3.1 <http://tinyurl.com/ovrwghb%20>.

This is a very well known rule and very strictly enforced by HMRC. For example, if the car is kept at an employee's house overnight, then this is regarded as non-business use. Pool cars are "made available" if the car is allocated to any one specific individual.

There may be situations when VAT has been claimed on a car purchase because, at the time it was purchased, the owner anticipated that it would only be used for business purposes, but circumstances change and the car is at some point used or made available for non-business purposes. In this situation, the business has to repay some of the VAT claimed on the purchase to HMRC as output tax, based on the value of the car at the time the use of the car changes from business to non-business - see VAT Notice 700/64, s3.10 <http://tinyurl.com/ovrwghb%20>.

As a general rule, if you're a sole proprietor, partner, or company director, HMRC will expect you to prove that the car is not made available for private use if you claim VAT on the purchase. If you work from home and keep the car at home overnight, you'll have to provide very robust evidence that the car is not used for anything other than business, e.g. that it is only insured for business use and you maintain meticulous mileage records.

Even then, HMRC may take the view that the car is "made available" for non-business purposes simply because it's permanently parked at a domestic address.

What is it you're actually paying for?

So if you're making/receiving inter-company/business payments relating to the use of a car, the first thing you need to do is to work out exactly why the payment is being made?

It will normally fall into one of the following categories:

- Payment for the use of the car.
- Payment for the cost of petrol.
- Part of the cost of management services where the value of motoring costs is a cost component of the value of the management charge.

As discussed earlier in the book, arrangements between associated businesses are often informal, particularly with smaller businesses. I've seen many situations where vehicles are owned by one VAT registered business and made available to other businesses in return for a share of the costs, usually without any written agreement.

A good example would be where an individual trades as a sole proprietor and is also a partner in a partnership, each with separate VAT registrations. The car may be owned by the sole proprietor and used by employees of the partnership.

To avoid problems with VAT accounting, it's important to document such arrangements. I've explained the VAT accounting for the 3 common scenarios mentioned above.

For the purposes of this chapter, I've assumed that the supplier (whether a sole proprietor, partnership, limited company etc) either owns the cars in question; or leases them from third party leasing companies. It also purchases the petrol (through a fuel card or company credit/debit card) and pays for any repairs and maintenance and insurance. It receives payments from other group companies towards the costs.

Payment for the use of the car.

If Supplier Co charges associated companies for the use of a car, then the charge made for the supply is liable to VAT at 20%.

If Supplier Co has claimed VAT on the purchase of the car, on the basis that the vehicle will be used for in-house leasing, then the leasing charges must be at a commercial rate. This is to prevent associated businesses minimise the 50% VAT cost on leasing charges that would arise if the charges were made at lower rates - see VAT Notice 700/64, s3.9. For example if the charges are calculated by reference to the running costs of the car, i.e. insurance, repairs and maintenance, then this wouldn't normally qualify as a commercial rate because the charges don't include anything to represent the actual cost of the car or funding costs.

If you're considering setting up any such arrangements for the provision of cars between associated businesses, then I'd strongly recommend taking professional advice to ensure that the VAT accounting is correct.

Fuel

VAT Notice 700/64, s8 <http://tinyurl.com/ovrwghb> explains the rules for calculating the amount of VAT that can be claimed on road fuel. There are four different methods, designed to ensure proper VAT accounting for the purchase of road fuel and making it available for non-business use, of which the most common is the fuel scale charge. In this case, the business treats all of the VAT on the cost

of the fuel as input tax and pays VAT as output tax to cover non-business use based on the fuel scale rates.

However, if one business purchases fuel used by the other businesses, then it can claim back the VAT paid on the fuel but must charge VAT on the amount charged to the associated businesses. This is a common scenario among associated businesses, where one VAT registered business operates a fuel card or group credit/debit card for fuel purchases.

Provision of car as a cost component of management services or a supply of staff

Often the use of or access to a car falls within inter-company agreements, particularly management services agreements where the use of the car by the individuals (usually directors or senior staff) forms part of the service. In this case, the cost of providing the car is a cost component of providing the business or management service and forms part of the standard rated service charge.

Private use of cars: charges to employees

See VAT Notice 700/64, s6 <http://tinyurl.com/ovrwghb> for information about when VAT on the private use of cars by employees.

Cross border arrangements

The VAT liability for the use of cars in different countries in the EU is covered by special "place of supply" rules, as explained in [Chapter 14: International Services](#).

Chapter 10: Checklist

- The VAT rules relating to cars and fuel costs are designed to prevent businesses claiming VAT on non-business use.
- VAT on the purchase of cars can only be claimed if the car will be used EXCLUSIVELY for business purposes and not made available for non-business use.
- Charges for leasing cars between associated businesses must be made at commercial rates.
- If your business purchases fuel to supply to associated businesses, it can claim the VAT on the purchase but must be able to demonstrate that the fuel has only been supplied (i.e. sold) or otherwise used only for business purposes.
- If you recharge the cost of car hire with other TOMS services (i.e. travel or accommodation) then the cost of the car hire may also fall within the TOMS accounting scheme.
- There are special VAT accounting rules for cross-border leasing of cars.

Chapter 11

Property costs

Most of you know that the rules about VAT and property are a very complicated. For the purposes of this chapter, I'll only be talking about commercial property; i.e. any property that isn't a dwelling, residential property or property for charitable purposes. If you want to know the full definitions of these types of property, see VAT Notice 708: Buildings and Construction, section 14:

<http://tinyurl.com/otedchh>

Usually, income from the sale or rent of commercial property is exempt from VAT, apart from the situations explained below. Payments between associated businesses for the use of property normally depend on whether the arrangement allows the exclusive use of property, or is simply a charge for shared facilities as discussed in this chapter.

- VAT liability
- When it's exempt
 - Managed office space
- When you can't claim VAT on costs
- When it's standard rated
 - Shared space and facilities
- The option to tax

Annex:

- The option to tax: main principles

The other important notices that apply to property are:

VAT Notice 742: Land and buildings <http://tinyurl.com/nl7vuwe>

VAT Notice 742a: Opting to tax land and buildings <http://tinyurl.com/q7jsndg>

VAT liability

Income from the sale or lease of most commercial property is exempt from VAT. There are three main types of income from commercial property which are summarised below:

1. Rental and sales income is normally exempt from VAT except:
 - Freehold sales of new commercial property.
 - Properties which are subject to the option to tax.
 - Supplies which are "excluded" from exemption.
2. The construction of and any type of building work on commercial property is standard rated. The only exception is work on dwellings used for holiday accommodation, where certain reliefs may apply.

3. There are three situations when income from commercial property is liable to VAT at the standard rate:
- Sales of new freehold commercial property – i.e. up to 3 years old.
 - Exclusions from exemption, such as car parking, holiday accommodation, certain sporting rights.
 - Opted property – where the landlord opts to charge VAT on income from the property so that he can recover VAT on related costs.

When is it exempt

The legal definition of a supply of property includes a grant of an interest in, right over or licence to occupy land in return for a payment or consideration, including includes an assignment or surrender.

Most of the above terms are legal definitions. The best place to find an explanation of the terms is VAT Notice 742, Land and Property: <http://tinyurl.com/nl7vuwe>. Section 2 explains the main criteria.

What's relevant for our purposes is whether income for the use of office space falls within the exemption.

Even if there is no formal agreement, HMRC state that a licence to occupy exists if the occupant is entitled to use property with the following criteria:

- “a defined area of land (land includes buildings - see paragraph 2.1)
- for an agreed duration
- in return for payment, and
- has the right to occupy that area as owner and to exclude others from enjoying that right”

VAT Notice 742, section 2.5 <http://tinyurl.com/nl7vuwe>

Managed office space

A good example of a single supply, which includes facilities that are for the "better enjoyment" of the main component is managed office space. HMRC say that a licence to occupy land exists in the following situations:

- “ the provision of a specific area of office accommodation, such as a bay, room or floor, together with the right to use shared areas such as reception, lifts, restaurant, rest rooms, leisure facilities and so on
- the provision of a serviced office but only where the use of phones, computer systems, photocopiers etc. is incidental to the provision of office space”

VAT Notice 742, section 2.6 <http://tinyurl.com/nl7vuwe>

This means that the income for the use of the office space is exempt, unless the landlord has opted to tax the property.

When the landlord can't recover VAT on costs

But the main implication of rental income being exempt is that the "landlord" may not be able to recover VAT on related costs because of the VAT recovery rules.

Chapter 1 [Annex I](#) explains the main rules about VAT recovery. If the landlord has no other VAT exempt income, then it's possible that the landlord can recover all of the VAT on related costs if it falls within the partial exemption "de minimis" limit, which is currently £7,500 per VAT year and 50% of all input tax.

Therefore in the above examples, any VAT incurred on standard rated costs used in those offices, such as incidental telephone facilities, computers or photocopiers, cleaning costs, property management costs, would be "exempt input tax". You have to calculate the proportion of these costs that are used for making the exempt supplies and only claim this VAT if it falls within the partial exemption "de minimis" limit.

When it's standard rated

Shared space and facilities

However, arrangements between associated businesses are often quite informal and sometimes "rental income" isn't exempt because there's no clearly defined boundaries and each of the occupants has access to and can use any part of the property.

In Chapters 7 and 8, I discussed the concepts of "business service agreements" and "management services agreements" and how the value of income from such arrangements is usually calculated. In practice the provision of office accommodation is typically part of or similar to these arrangements. Suppose you have a head office which carries out all of the administrative functions for 3 or 4 different companies. This could be done as follows:

- a parent company employs all of the admin staff and provides services to the subsidiaries under a business services agreement; or
- admin staff are employed under joint contracts of employment; or
- each company has its own admin staff who all work in the same office.

In either case, the charge for the services will include the relevant proportion of office costs; i.e. rent, utilities, rates, services charges as part of a standard rated service of business, administrative, management or consultancy services. So unless the legal arrangements for the services specifically provide the exclusive right to use a specified part of a property as defined in HMRC notice 742, sections 2.5 and 2.6 <http://tinyurl.com/q7jsndg> any charge made for the use of the office is not rent but is almost certainly part of a single standard rated supply.

As with any supply, the VAT liability in your case will depend on the exact circumstances, but HMRC's guidance in Notice 742 <http://tinyurl.com/q7jsndg> covers most situations.

The option to tax

As I explained at the beginning of the chapter, the option to tax is a procedure whereby anybody with an interest in a commercial property can "opt to tax" the property. This means that any sales or rental income from that property by that person is liable to VAT at the standard rate AND the property owner/leaseholder can claim VAT on related costs.

Therefore if you've opted to tax a property and are subletting it or providing managed office space, your income will be standard rated, not exempt AND you can claim VAT on related costs.

The option to tax is simple in principle, but the procedure of making the option and notifying HMRC can be confusing but you must follow the specific guidance, as explained in VAT Notice 742a: Opting to tax land and buildings: <http://tinyurl.com/q7jsndg>. Otherwise, your option to tax may not be valid.

There are anti-avoidance provisions to prevent abuse of the option where the tenant or purchaser is partly exempt; i.e. can't recover all of the VAT on their costs. These normally apply if the property or any construction work on the property costs £250,000 net of VAT. They can even apply if the parties are NOT CONNECTED in any way; i.e. to third party transactions. These rules are complicated so you must read the information in VAT Notice 742a and consider taking professional advice if you think that they could apply in your situation.

I've summarized the main rules in the Annex to the chapter.

Chapter 11: Checklist

- Commercial property rent is normally exempt from VAT.
- You have to consider the actual arrangements to establish whether you're making a supply of property to an associated business, especially if there is no written agreement.
- The supply of property includes situations when the associated business has the exclusive use of a specified area of a property, e.g. a dedicated floor with shared reception and common areas including incidental components such as telephone services, use of office equipment and office insurance.
- Informal arrangements which don't provide any dedicated or exclusive availability of property are usually not supplies of property and are therefore standard rated.
- If you make exempt supplies of property to associated businesses, you may not be able to claim all of the VAT on related expenditure.
- Alternatively you can opt to tax the property which means that you charge VAT on rental income but you can claim VAT on costs. See the Annex to this chapter for further information.

Annex

The option to tax

The option to tax

The option to tax allows anyone with an interest in commercial property to change the VAT liability of income from their properties from exempt to standard rated. This means that they have to charge VAT @ 20% on any subsequent sales or rental income.

It also means that the property owners can recover VAT on related expenditure.

Main features of the option to tax:

- The option to tax never applies to dwellings or properties for relevant residential or relevant charitable use.
- Anybody (i.e. sole proprietor, partnership, limited company etc) who has an interest in property can opt to tax the property concerned.
- The option to tax is specific to the property concerned and does not normally extend to other properties owned by the opter, usually only where the properties are physically linked.
- The option to tax is “personal”; i.e. the option only applies to the person making the option. It doesn’t transfer to the new owner if the property is sold, nor does it apply to others who have an interest in the property.
- There are 2 steps to make a valid option to tax : first the property owner must make an option to tax, second, the property owner must notify HMRC of making the option within thirty days.
- If the property owner has already received exempt income from any leases, licences or other use of the property, they may have to request permission from HMRC to opt to tax.
- The option can only be revoked in two circumstances:
 - Within six months of being made; or
 - After twenty years.

It’s therefore important to consider whether to opt to tax a property carefully because the option can’t easily be withdrawn.

- A special rule called a “Real Estate Election” or “REE” allows businesses to make a formal decision to opt all properties which they acquire in the future. This is normally only used by businesses with large property portfolios.
- Anti-avoidance provisions include special rules for selling an opted property as a going concern. See VAT Notice 700/9: Transfer of business as a going concern [LINK](#)
- There are also special VAT accounting rules called the capital goods scheme and the clawback/payback provisions that require adjustments to the VAT claimed on certain property expenditure. See [Chapter 14](#) for further information.

Further information about the option to tax is in Notice 742A: Opting to tax land and buildings, <http://tinyurl.com/q7jsndg>.

Chapter 12: Introduction

International transactions

One of the most complex areas of VAT is the VAT liability of international supplies of services. Because of that, this chapter has a couple of additional sections.

The main contents of this chapter begin on p115.

Example query

On p 130 there is an example of a typical query asking for advice about the VAT treatment of intra-group charges involving cross-border transactions.

Terminology

The second additional feature is on pp 131-133. It's a short section explaining some technical terminology that will help you understand the "place of supply" rules.

International services example

I've amalgamated and simplified certain facts from a number of separate queries, the intention being to demonstrate the complexity of dealing with cross-border charges between associated businesses.

The issues are so complex that it isn't possible to give a comprehensive answer in this book. However, this chapter introduces the main principles that apply to cross-border transactions and at the end of the chapter, I will summarize the main issues that apply in the example scenario.

To find an answer for all parts of the question, we have to consider the different issues relating to each and every different payment, including with the main UK VAT rules explained in previous chapters, then the complex international VAT issues that are introduced in this chapter.

Example

A UK company wants to raise charges to its US holding company to recover costs incurred in the UK, so that it can claim VAT on some of the costs incurred by the London office, which carries out a range of activities for the group as a whole. These include employing directors and senior staff, tax and regulatory compliance and group marketing. The senior executives based in London perform work for other group companies outside the UK, such as acting as directors and providing management services.

The European companies each employ local HR and compliance people, but the head of each department is employed in London by the UK company.

The US parent co also charges London for certain expenditure, including a share of the PII insurance, IT licences to manufacture products and a proportion of the cost of management time for senior executives employed offshore. All of these costs are incurred by non-UK group members, including the US parent company.

The final issue concerns group accountancy and legal costs. The US parent engages accountants for the group under a world-wide contract and contracts with various legal firms in different countries and charges a proportion of the costs to the UK company. The UK company recharges a share of these costs to other group companies in Europe.

Terminology

The VAT liability of services supplied to and received from overseas businesses is based on a principle called the "place of supply". This is normally the country in which the VAT liability arises - a bit like the concept of residence for tax purposes.

There is one particular phrase that comes up in the context of place of supply and when we're discussing whether non-UK business can claim VAT incurred on costs in the UK:

"making supplies outside the UK that would be taxable if made in the UK".

What does this mean?

In Chapter 1, I explained that there are two classes of "supply" for VAT purposes: taxable, at 20%, 5% or the zero-rate; i.e. "0"; or exempt. The main difference between the two is that businesses making taxable supplies can claim VAT on their costs, while businesses making exempt supplies can't normally recover VAT on their costs. If you make both taxable and exempt supplies, you can only claim the VAT on costs used to make the taxable supplies, in which case you're defined as a "partly exempt" business.

So what does this mean in the context of international services and claiming VAT on costs?

The best way to explain this is with a simple example, showing the difference between say a clothes retailer and a bank.

- The sale of clothes in the UK and other EU countries is taxable. In the UK, the rates are either 20% for adults' clothes or 0% for most children's clothes. This means that clothing retailers can claim VAT on their costs.
- The provision of banking facilities in the UK is exempt, so you don't pay VAT on bank interest or bank charges. However banks can't claim VAT on their costs.

Suppose a French retailer or German bank incurs VAT on certain UK costs, for example hotel bills for employees or car hire/petrol costs. Can they claim this VAT from HMRC?

- The French retailer can claim the VAT because although the retailer makes no sales in the UK, if the retailer were to open a shop in the UK, then its sales would be taxable.
- The German bank, on the other hand, can't claim the VAT. This is because if it opened a branch in the UK to service UK customers, then its' services would be exempt from VAT.

The same principles would apply to UK businesses who incur VAT on costs in other EU countries. For example, if a UK clothing retailer pays VAT on costs in Italy, the retailer could claim the VAT from the Italian tax authority because the sale of clothes in Italy is taxable.

However if a UK bank pays VAT on costs in Spain, then it can't recover any VAT because the provision of banking facilities in Spain is exempt.

When is exempt not exempt?

One other issue that causes confusion is the use of the terms exempt, zero-rated and exempt with credit. The terms are used commonly throughout the EU but sometimes to mean different things. I've summarised below the most common uses.

Exempt

In both EU and UK VAT law, the term “exempt” means that supplies, i.e. sales of goods and services, are not liable to VAT. “Taxable” supplies are liable to VAT.

UK law

This is how the terms are used in the UK:

TAXABLE supplies are those charged at 20%, 5% or 0%. Businesses making taxable supplies can claim VAT on goods and services used to make those supplies, with certain exceptions such as buying cars, staff entertainment etc.

Some other EU countries also apply the zero-rate of VAT to certain supplies.

EXEMPT supplies are not liable to VAT. Businesses making exempt supplies cannot normally claim VAT on goods and services used to make those supplies.

Businesses which make both taxable and exempt supplies can normally only recover VAT on expenditure used to make the taxable supplies, unless the VAT on costs used to make exempt supplies falls within certain “de minimis” limits. These businesses are “partly exempt” for VAT purposes.

The important thing to remember is the difference between zero-rated supplies and exempt supplies. You don't have to charge VAT on either type of income, but you can normally only recover VAT on goods and services used to generate zero-rated sales BECAUSE ZERO-RATED INCOME IS TAXABLE INCOME.

EU law

The EU VAT Directive also uses the term “exempt with credit”.

This normally means that the business doesn't charge VAT on the income but can claim VAT on the expenditure, so in practice it's the same as “zero-rated”.

However, as with all things European, every member state has different ways of using these terms in their own legislation. Some will use the term “exempt with credit”; others will have a “zero-rate” of taxable supplies as we do in the UK. So check out the guidance on the EU Commission Europa website: <http://tinyurl.com/nr9l9o>.

Chapter 12

International services: the place of supply of services

International transactions are subject to a specific principle called the “place of supply of services”. The rule defines in which country the VAT liability arises; i.e. if Supplier Co is in France and the customer is in Germany, whether the VAT should be paid in France or Germany.

And not only are the rules complicated, but they involve a whole new set of definitions, explained on pages 131-133.

In this chapter, I'll explain the main principles below with special reference to transactions between associated businesses.

- The general rule
- Is the customer a business?
- B2B services
- Where does the customer belong?
- Accounting for VAT on imported services: the reverse charge
- Services not covered by the general rule:
 - Do you have to register for VAT in other EU countries?
 - When you can use the reverse charge
- Charges between associated businesses
 - Is it payment for a supply of services?
 - Anti-avoidance reverse charges and VAT group registrations
 - What is the service?
- Single or multiple supply?
- Travel and accommodation costs
- VAT accounting requirements
 - VAT invoices
 - European Sales Lists
- How to claim VAT charged in other EU countries
- Dealing with tax authorities in different countries

HMRC's guidance about the subject is in VAT Notice 741a: Place of supply of services <http://tinyurl.com/mm5647o>. It's a long notice as the VAT rules relating to international services are complicated. I can only explain the main rules here, with links to the most relevant sections in the notice as they apply to business to business (or “B2B”) transactions that are typically made between associated businesses/companies.

The principles apply to all countries in the EU. ***The rules have been designed to enable EU businesses to reduce administration so that they don't have to register for VAT in every country where their customers are based.*** Using the accounting rule called the “reverse charge” enables the customer to pay VAT on the services to their local tax authorities instead.

There are different rules for different types of services which makes dealing with international services particularly difficult. Plus each EU country has some latitude when it comes to interpreting

the rules, so you can't assume that the Germans or the Swedes or the Romanians will apply the rules in the same way as in the UK. This also means that in some cases, you could end up with double taxation; i.e. where both parties have to pay VAT in their own country, or no tax because neither party has to pay VAT.

The other aspect is defining where the supplier of a service and the customer "belongs". This concept of "belonging" is as critical to EU VAT rules as is the concept of "residence" or "domicile" for tax purposes.

For example your company may provide services to a French subsidiary which has a branch in London. How do you know whether your services are being supplied to the customer in France or in London? The first place to start is the "general rule".

The general rule

There are different rules for supplies of services to businesses ("B2B") and supplies to consumers; i.e. private individuals ("B2C").

- B2B supplies: the place of supply is normally where the customer belongs. So if you supply services to a business in Italy, you don't charge UK VAT but the customer pays Italian VAT on your services by including the VAT on his Italian VAT return.
- B2C supplies: the place of supply is normally where Supplier Co belongs. So if you provide services to a private individual in Spain, then you charge UK VAT and include that on your UK VAT return. The main exception is the recently introduced rules for certain broadcasting and digital services, where the place of supply is where the customer belongs and suppliers must either register for VAT in their customer's country or opt to register under the "mini one-stop shop" ("MOSS") rules where they register in their own country for their broadcasting and digital sales (in addition to their normal UK VAT registration) but charge VAT in the country where their customer belongs. See HMRC's guidance to the MOSS scheme <http://tinyurl.com/p2nwr7a>

For the purposes of this book, we're really only concerned with B2B transactions, so that is the subject of this chapter.

Is the customer a business?

If you're assuming that the "general rule" applies because your client is a business in another EU country, you have to be sure that your services are provided to the customer for the purposes of the customer's business. You can normally verify this by ensuring that Recipient Co is registered for VAT in their own country and quoting the VAT registration number on your invoice. If the customer is not registered for VAT, e.g. because the value of their supplies is below the VAT registration rate for their country, you will have to obtain alternative evidence.

See VAT Notice 741a section 2.7 <http://tinyurl.com/osgwdtx> for more information.

B2B services

The basic rule is that if you supply services covered by the general rule to a business in another EC country or outside the EC, then the “place of supply” is where the customer belongs. The technical definition is that the service “would be taxable if made in the UK but is made outside the UK”.

There are three important aspects to this:

- As stated above, it means that you don’t charge UK VAT to your customer.
- Even though the services are “made outside the UK”, you can still claim VAT on your costs under the normal rules because the services would be taxable (i.e. liable to VAT at 20%, 5% or the zero-rate) if made in the UK
- The customer is responsible for paying VAT at the rate chargeable in their country on the services on their VAT return under the reverse charge rule as explained below.

The rule also applies to UK businesses who receive services covered by the general rule from non-UK suppliers. So if you receive legal services from a solicitor in say Germany, the solicitor won’t charge German VAT but you will include VAT on the services at 20% on your UK VAT return using the reverse charge, as explained in more detail on p 138.

If the place of supply is the UK, then you add VAT to your invoice. If the place of supply is the customer’s country, then they pay reverse charge VAT.

The services covered by the general rule are as follows:

- Transfers and assignments of copyright, patents, licences, trademarks and similar rights
- Acceptance of any obligation to refrain from pursuing or exercising, in whole or part, any business activity or any such rights as are referred to in paragraph 16(2)(a) above
- Advertising services
- Services of consultants, engineers, consultancy bureaux, lawyers, accountants, and other similar services; data processing and provision of information, other than any services relating to land
- Banking, financial and insurance services (including reinsurance), other than the provision of safe deposit facilities
- The provision of access to, and transport or transmission through, natural gas and electricity distribution systems and the provision of other directly linked services
- The supply of staff
- The letting on hire of goods other than means of transport
- Telecommunications services
- Radio and television broadcasting services
- Electronically supplied services
- Emissions allowances

Where does the customer belong?

Usually, the situation is simple enough; you simply establish the country in which the customer belongs, which is usually where it is established and has consumed the services.

But what if Recipient Co has establishments in more than one country? In that case, you have to identify which establishment is "most directly concerned with receiving the supply". This normally means where the services are consumed or used.

For example, the scenario mentioned in the example on page 130 where Supplier Co is based in the UK, Recipient Co is based in France, but also has a branch in London.

Let's assume that Supplier Co has supplied consultancy services to Recipient Co.

You might assume that the services are supplied to the company in France, therefore the "place of supply" is in France. Recipient Co is a French company and therefore "belongs" in France. This would mean that Supplier Co would not add UK VAT to its invoice, but the French Co would account for reverse charge French VAT on its VAT return.

However, if the services were for the purposes of the business carried on by the French Co in the UK, then the London office is probably the "establishment most directly concerned" with receiving the supplies.

In this example, because the recipient of the supply belongs in the UK, the place of supply is the UK. This means that Supplier Co must charge UK VAT at 20% on the invoice and French Co does not have to account for reverse charge VAT.

This is a complex subject and I can only explain the main principles in this book. HMRC VAT Notice 741a: Place of supply of services; section 3: <http://tinyurl.com/osgwdtx> discusses the concept of belonging in more detail and gives several more examples.

The reverse charge

The reverse charge is the name given to the mechanism whereby the recipient of the supply of services pays the VAT on the services, instead of the supplier. It's like paying import VAT or acquisition VAT on goods.

It's also called the "tax shift mechanism" because it reflects the fact that the liability to pay VAT on the supply is shifted from the supplier to the recipient of the supply.

How is the reverse charge applied?

Reverse charge VAT must be included as output tax on the recipient's VAT return, normally the earlier of the date of payment or when the services are finished. If the services are a continuous supply with periodic payments, the tax point is normally the date on which the payment is made - see VAT Notice 741a: Place of supply of services, [section http://tinyurl.com/pzdo5ts](http://tinyurl.com/pzdo5ts)

The VAT can be claimed as input tax on the same return, subject to the normal rules; i.e. if the services have been or will be used to make taxable supplies in the UK. Alternatively if the services are used to make **supplies made outside the UK that would be taxable if made in the UK**, the reverse charge VAT can be claimed as input tax. So if your business only makes taxable supplies, the reverse charge VAT is only an accounting entry.

If the recipient uses or will use the services for non-business activities, or to make exempt supplies, then the recipient can only claim VAT to the extent that the services are used to make any taxable

supplies, or supplies made outside the UK that would be taxable if made in the UK. The amount of the reverse charge VAT that can be claimed is calculated by using the business's business/non-business and partial exemption method.

See VAT Notice 741a, Place of supply of services, section 18 <http://tinyurl.com/pzdo5ts> for more information about the reverse charge.

What about services that ARE NOT covered by the general rule?

In principle, services that aren't covered by the B2B general rule USUALLY mean that the supplier of the services is required to register for VAT in the country concerned and charge VAT in that country. This is because **the place of supply of the service is where the services are performed OR where the supplier belongs or where the service is "used and enjoyed"**.

These services not covered by the general rule include the following:

- Services relating to land and buildings.
- Entertainment and educational services.
- Travel and holiday services.
- Passenger and freight transport.
- Agency services.
- Hire of goods and vehicles.
- Telecommunications services.
- Any other service NOT covered by the general rule.

There are special rules for the above services; for example the place of supply in respect of land is where the land or property is located; entertainment and educational services is where the service is performed. So in principle, if I carry out training for a client in France, I would, in principle, have to register for VAT in France and charge French VAT to my client.

However even in these cases, the rules often allow the customer to pay the VAT using the reverse charge procedure because one of the main principles of EU VAT law is to minimize situations where Supplier Co has to charge VAT. However this isn't always the case and in many situations, the supplying business may have to register for VAT in the country concerned.

There is a lot of detailed information in VAT Notice 741a, Place of supply of services <http://tinyurl.com/nlu3wwh>. It is a long notice and the rules are complicated so you must take time to read the notice and take advice if you're at all unsure about how the rules apply, whether to transactions with associated businesses or third parties.

Further information about the rules in other EU countries can be found on the EC commission website - see p118 for links.

Charges between associated businesses

Is it a “supply” for VAT purposes?

In Chapter 1, I explained that charges between different parts of the same legal entity aren't NORMALLY regarded as “supplies” for VAT purposes. This is because supplies only exist when the transaction is made between different legal entities, e.g. parent and subsidiary company; sole proprietor and limited company; or between two separate partnerships. This means that normally, payments between e.g. divisions or branches of the same company in different countries aren't supplies for VAT purposes, so neither party pays VAT on the services.

This also normally applies to transactions between companies registered for VAT in a single VAT group registration.

However this isn't always the case, because different EU countries apply different rules in these situations. A good example was a recent ECJ case which dealt with payments between 2 divisions of the same company where one was based in Sweden and the other in the US. Under Swedish law, payments between different parts of the same company in different countries can be regarded as consideration for a supply for VAT purposes. In that case, the Swedish branch had to pay reverse charge Swedish VAT on payments made to its head office in the US.

For more information about this issue, see Revenue & Customs Brief 02/15 about intra company supplies and VAT group registrations: <http://tinyurl.com/o6w6wjn>

The case discussed in the R&B Brief concerns the specific VAT grouping rules in Sweden and whether in that scenario, services from a US branch were liable to reverse charge VAT in Sweden.

The facts of this case are a very good example of why you must be very careful when arranging transactions with overseas associated businesses, whether separate legal entities or overseas offices or branches. Not only do you have to consider how the UK VAT rules apply, but you have to understand how the VAT rules of the country(ies) in which the other businesses are based.

HMRC give some examples of how the UK applies this rule in VAT Notice 741a, section 3 <http://tinyurl.com/osgwdtx>

So if you're involved in such transactions, it's important for the payer/recipient to understand how the rules apply in their own country and establish the correct VAT accounting for such transactions in their country.

What is the service?

You must decide whether the service falls within the “general rule” or one of the other types of services covered by special place of supply rules mentioned above.

HMRC give detailed guidance about the services covered by the general rule in VAT Notice 741a, section 15 <http://tinyurl.com/oakhr5v>.

They explain that the services covered by this rule as follows:

“their place of performance can be indeterminate or variable and they are easily undertaken in a different place to where a supplier has established a business. They are often intangible in nature.”

Notice 741a, section 15.1.

So how does all of this apply to services provided to associated businesses in other EU countries?

In [Chapters 7](#) and [8](#), I discussed when that certain types of services could be categorized as either business services or management services.

In order to fall within the B2B general rule, HMRC usually make the distinction between the two by saying that to fall within the B2B rule, the services would have to be consultancy or advisory in nature. Managing an office in the UK or managing staff would normally be regarded as supplied in the UK and liable to UK VAT. See VAT Notice 742a, Place of supply of services, 15.5.3

<http://tinyurl.com/nlu3wwh>

Another commonly supplied service between associated businesses is the supply of staff. This is included in the services covered by the general rule and therefore the recipient of the service accounts for VAT under the reverse charge.

Anti-avoidance: Intra-group reverse charges

In Chapter 6, I explained that transactions between group members are not normally supplies for VAT purposes. However there are two specific anti-avoidance provisions that are exceptions to the normal rule, relating to certain cross border services supplied to members of UK VAT groups.

- The reverse charge applies for certain transactions between COMPANIES THAT ARE IN A UK VAT GROUP REGISTRATION AND WHERE THE UK RECIPIENT OF THE SERVICES IS PARTLY EXEMPT. The effect of this is to generate additional VAT liability for partly exempt recipients so removes any VAT advantage that would be obtained by sourcing these supplies overseas.

See VAT Notice 700/2, section 5 <http://tinyurl.com/mpdrhbf> for further information.

- The other provision relates to land and property in the UK, where the owner is a member of the VAT group which belongs outside the UK and has opted to tax the property. In this situation, the reverse charge also applies to rent or other charges for the use of the property.

See VAT Notice 741a: Place of supply of services, section 18.10.5 <http://tinyurl.com/pzdo5ts> for further information

Cross-border intra-company transactions when the company is not part of a UK VAT group registration

Transactions between branches and/or head office or other establishments of the same company are not normally regarded as "supplies" for VAT purposes. This also applies if the transactions are cross border; for example charges from a head office in France to a UK branch **IF THE COMPANY IS NOT PART OF A UK VAT GROUP REGISTRATION.**

This means that, if the "services" would fall within the general rule (e.g. consultancy, legal services) the UK branch doesn't have to apply the reverse charge because the transactions is within the same legal entity.

However one scenario that might trigger a reverse charge is if the French head office buys in such services from a French solicitor, but the services are for the benefit of the UK branch. For example if the UK branch needed legal advice about French trading standards. In this situation, the branch may have to account for VAT under the reverse charge on the services from the French supplier. This would be because under the place of supply rule, the recipient of the services from the French solicitor is deemed to be the UK branch, not the French head office.

However as explained earlier in the chapter, not all EU countries follow this principle so it's important to check the tax rules in other EU countries if you are charging for services to overseas branches or head offices.

Single or multiple supply?

If you "raise a management charge", you have to establish whether it's a single supply or a mix of supplies.

For example, part of the charge might be for advisory services of directors and senior staff, which would fall under the B2B rule, while part is for managing the day to day operations of the UK office, which would not fall under the B2B rule.

Payments for travel and accommodation: the Tour Operators' Margin Scheme ("TOMS")

I explained the principles of the TOMS in Chapter 9. If your invoices for charges to associated businesses for travel, accommodation and similar costs, then remember that you can't claim VAT on the purchase of such expenses and you only pay VAT on any profit margin where you buy in and resell such services "without material alteration".

Also, if you're buying and charging for services covered by the TOMS, then you **can't include them on a VAT invoice**, even if part of the amount charged for other goods or services, such as management services.

Finally, remember that the TOMS doesn't apply if the cost of such facilities is simply a cost component used to calculate the value of your principal services; e.g. management services, staff services or consultancy services. In that case, you claim the VAT on the costs under the normal rules. See VAT Notice 709/5, section 3.6 <http://tinyurl.com/obe7dav> for further information.

VAT accounting requirements

VAT invoices

The best way to confirm that you are providing services to an overseas business is to quote that business's VAT registration number on your invoice. Alternatively ensure that you have alternative evidence that your client is a business should HMRC ask for confirmation.

ESLs

If you supply services to VAT registered businesses in other EU countries who must account for reverse charge VAT on those services, you may be required to submit a "European Sales List" or "ESL" for services each month. See VAT Notice 725, The Single Market, section 17 for further information: <http://tinyurl.com/lvgrdn3>.

How do businesses claim VAT incurred in other EU countries if it is not registered for VAT in that country?

You may be able to recover the VAT using the "EC VAT refund scheme".

This normally applies in the following circumstances:

- If the business incurring the costs can't register for VAT in the country where the VAT has been charged; and
- If the services have been used by the customer for the purposes of making supplies outside the country that would be taxable if made in the country.

EU businesses may submit claims for VAT paid in other EU countries for each calendar year, while non-EU businesses may submit claims for VAT paid in any EU country for the 12 month period from 1 July to the following 30 September. Claims must be made using the online claim system and must be submitted within 6 months of the end of the year month period concerned.

HMRC's guidance to this scheme is in VAT Notice 723a: Refunds of VAT in the European Community for EC and non-EC businesses <http://tinyurl.com/p82ebrf>.

Dealing with tax authorities in other EU countries

The other aspect of doing business with any businesses which belong in different EU countries, is that you may have to liaise with tax authorities in those countries and/or have some knowledge of VAT or other tax rules in those countries.

As I've explained at the start of this chapter, the main principles of VAT are common to all EU countries. However, member states of the EU have certain latitude when it comes to the interpretation of some of those rules, so the Greek or the Swedish or the Dutch application of the same VAT rule could each be quite different to the UK application.

It means that sometimes, you have to contact the tax authorities in the countries concerned. You may have to find out if you have to register for VAT in that country or the VAT liability of certain goods or services. This can be difficult if you don't speak that language; or if their application of the rules is not familiar. If you think you may be liable to register for VAT in that country or if you owe VAT or any other tax, then you might assume that your best option is to ignore it! However this could cause problems in the future, both in terms of dealing with the relevant tax offices and/or incurring penalties.

So how do you deal with this?

This can be a frustrating and time-consuming process. But there are a few other ways of dealing with VAT in other EU countries:

Ask your associated business, client or supplier for information about VAT in their country and perhaps to liaise with the local tax office on your behalf. Of course you may not wish to do this if it means disclosing commercially sensitive information to third parties, but they may at least be able to help with the main principles, especially if it will help their commercial relationship with you. I've seen this done several times over the years and it's saved a lot of time, cost and hassle for all of the parties involved.

Alternatively, you can obtain a lot of information about VAT in other EU countries from the EC website <http://tinyurl.com/nr9l9o>, including contact details of national tax offices. There is specific information about VAT rates and registration limits <http://ow.ly/F4tDG> in all EU countries. Check out the main VAT information pages on the EC website. There is also a lot of general information about international VAT on HMRC's website, although it's not so country specific: <http://tinyurl.com/ndpnegk>.

Finally, if you still need help resolving your VAT issue and you may have to engage an accountancy firm to take advantage of their EU network, hopefully it will be a useful investment and help you avoid problems in the future.

Chapter 12: Checklist

- The "place of supply" means the country where the VAT liability arises.
- Certain B2B services are covered by the "general rule", which means that the "place of supply" is the country where the customer belongs.
- Customers account for reverse charge VAT on their VAT returns on "general rule" services from suppliers in other countries.
- This means that suppliers don't have to register for VAT in every EU country.
- There are special rules for other services that are not covered by the general rule, which sometimes mean that the supplier has to register for VAT where his customer belongs.
- It's therefore important to define the nature of services in writing and be able to evidence the nature of the work done so that VAT is accounted for in the correct country.
- Although the same principles apply to all EU countries, each country has its own interpretation of the place of supply rules though the same principles apply e.g. see information on Swedish VAT on intra-company transactions.
- There is no supply for intra-company payments under UK rules.
- There are anti-avoidance provisions for certain cross border supplies between members of VAT group registrations.
- You may be entitled to claim VAT incurred in other EU countries under the refund scheme.

Chapter 12: Appendix

And back to our case-study:

So how do we go about analyzing the VAT issues in the case study at the start of the chapter?

As with any situation, we can only establish the full VAT implications when we have seen any agreements relating to the transactions. However to start with, I've summarized the most important VAT issues below.

A UK company must raise charges to its US holding company for costs incurred in the UK, so that it can claim VAT on some of the costs incurred by the London office, which carries out a range of activities for the group as a whole.

- The initial issue is whether or not the UK company is making supplies to the US company for VAT purposes; is there a written agreement specifying the nature of service is made between the companies and the amounts charged? See [Chapters 2 and 3](#) for further information about whether charges represent supplies for VAT purposes.
- The UK company must be able to demonstrate that it has "made a supply of services" to the US company. See [Chapters 2 and 3](#).
- The UK company can only recover its VAT and the goods and services used to make supplies that are liable to VAT in the UK; for supplies remain outside the UK that would be taxable if made in the UK. See the place of supply rules in [Chapter 12](#).
- The supply to the US company may be liable to UK VAT unless the services are either exempt from UK VAT or are treated as made "outside of the UK" under the place of supply rules.
- The goods and services must be cost components of the goods and services of the supply. See [Chapter 2](#).

The costs include employing directors and senior staff, tax and regulatory compliance and group marketing. The senior executives based in London perform work for other group companies outside the UK, such as acting as directors and providing management services.

- The activities of directors are not always regarded as "business activities" if their services are for the principle benefit of the shareholders; rather than for the purposes of the business making supplies. See [Chapter 9: People costs](#).
- VAT cannot be recovered on costs relating to "non-business activities".
- The provision of "management services" is not, normally, free from UK VAT under the "place of supply" rules. In order to be outside the scope of UK VAT, the services must fall within the category of advisory, consultancy or similar nature that fall within the "general rule".

All EU companies employ local HR and compliance people but the head of each department is employed in London by the UK company.

- Charges made for services supplied by any individual are only free from UK VAT if supplied "outside the UK".

- The charges are only outside the scope of UK if the services fall within the "general rule".

The parent company also charges London for certain expenditure, including a share of the PII insurance, IT licences to manufacture products and a proportion of the cost of management time for senior executives employed offshore. All of these costs are incurred by non-UK group members, including the US parent company.

- In this case, the payments are made to the US parent company and we start by considering whether the UK business has to pay "reverse charge" VAT on those payments.
- The issue here is whether the charges made from the parent company are consideration for a supply for VAT purposes. This will depend on the contractual arrangements between the UK and the parent company. If the services are the type that are covered by the general rule, then the UK company must account for reverse charge VAT on the amount paid to the US parent company.
- Insurance is normally exempt from UK VAT if it is supplied by an authorised insurance company. Therefore the charge made for the cost of insurance by the US parent company will not be exempt from VAT and will probably be liable to reverse charge VAT. Alternatively it could simply be a cost component in the provision of management consultancy or advisory services.
- If the charges for the IT licences represent consideration for a supply of a licence from the US to the UK company, the UK company must account for reverse charge VAT on the amount paid.

The US parent engages accountants for the group under a world-wide contract and contracts with various legal firms in different countries. It charges a proportion of the costs to the UK company. The UK company recharges a share of these costs to other group companies in Europe.

- The amounts charged for accountancy and legal services would be liable to reverse charge VAT if they are payment for the provision of the services by US company to the UK company. The client would have to confirm if the nature of the arrangement is that the services are supplied to the UK company and then by the UK company to the EU subsidiaries. Accountancy and legal services normally fall within the general B2B rule.
- The VAT liability of charges made to the European subsidiaries for their share of the legal and accountancy services may be "outside the scope" of UK VAT and the place of supply rule.
- In principle, this would only apply if the UK company imports the services from the US company and makes an onward supply to the European companies. This is why it's important to clarify the arrangements for any payments between associated businesses in writing.
- The European companies would also have to pay reverse charge VAT on any payments made for accountancy or legal services.

Finally, the UK company has paid for various UK hotel, travel costs and car hire for the directors whose costs are being charged to the US parent.

- If the UK company is charging for these services "without material alteration", then they would probably fall within the Tour Operators Margin Scheme.
- However if they are cost components in the provision of services by the UK company to the US company, then the charge made to the US company would follow the VAT liability of the services concerned.

As you can see, the VAT implications for transactions between businesses in different countries are particularly complicated. It's therefore even more important that there are proper arrangements between the companies that define the nature of any services and/or any payments.

Also, even though all EC member states follow the same VAT principles and rules as set out in the EC VAT Directive, each country has its own interpretation of the rules and how VAT is applied to international services. This means that you need to confirm VAT liability of any payment made between businesses in different EC countries, as well as establishing the UK VAT position.

Finally, although we've focused on EU VAT rules in this chapter, it's important to remember that most non-EU countries have their own version of VAT or other sales taxes, so you may also need to consider the national tax rules if you're involved in transactions with businesses in those countries.

If your business is involved in any way with making receiving services to or from non-UK businesses, I strongly recommend that you take professional advice about the VAT issues before claiming VAT on any UK costs, preferably before any services are carried out and particularly before any payments are made or received. At the very least, read VAT Notice 742a <http://tinyurl.com/nlu3wwh> to learn more about the main principles.

Chapter 13

What if the recipient can't claim the VAT charged?

As a business owner, one of the most frustrating things is when tax rules actually increase your costs. And one of the most common situations is when you have to charge VAT to an associated business which they can't claim, either because they aren't registered for VAT or because their sales income is VAT exempt.

So in this chapter, I'll be explaining how and when it's possible to minimize charges to associated businesses, including charges between non-corporate businesses (i.e. sole proprietors, partnerships) and limited companies. Everything in this chapter is sensible VAT planning and HMRC should not object as long as the VAT arrangements follows the commercial situation and the arrangements are not used in an abusive way.

EXAMPLES

One of the worked examples discussed in [Chapter 5](#) was about a sole proprietor provided services to separate construction businesses, one of which was her husband who ran his own contracting business. If he was a VAT registered contractor, he would be able to reclaim VAT charged on her costs, but because most of his work is for non-business customers, he doesn't want to register and add 20% to his costs. So we'll consider how and if it's possible for the office manager to reduce the VAT charged on her charges.

- Basic VAT recovery principles
- Is it more VAT efficient effective for the recipient to register for VAT to claim VAT?
- Is it more VAT efficient if the supplier is registered?
- Don't charge VAT if not needed.
- Make sure that separate exempt, zero-rated and reduced rated elements of mixed supplies are properly identified
- Staff costs
- Unregistered suppliers
- Valuation
- The Flat Rate Scheme
- Group registration and partial exemption
- If the customer can reclaim all their VAT, surely the simplest thing is to add VAT to everything?

Basic VAT recovery principles

Let's start by reviewing the basic VAT recovery rules and make sure that VAT registered recipients of the services can increase VAT recovery.

In Chapter 1, I explained the basic principles of VAT recovery. For the purposes of this chapter, here are the important principles:

- Businesses making taxable supplies at any rate can recover input tax on goods and services used to make those supplies apart from certain specific costs (“blocked input tax”).
- Businesses making exempt supplies can’t normally recover input tax on goods and services used to make those supplies. This VAT is called “exempt input tax”.
- Businesses who make both taxable and exempt supplies can normally only recover the VAT on costs used to make the taxable supplies. These businesses are known as “partly exempt” businesses.
- Partly exempt businesses can recover “exempt input tax” if it falls within certain “de minimis” limits, which are currently:
 - £625 per month or £7,500 per VAT year; and
 - 50% of all their input tax.
- The “de minimis” limit includes VAT on costs that are “directly attributable” to exempt supplies; for example the costs of maintaining houses that generate exempt rental income; plus a proportion of VAT on the business’s overhead costs.
- The method of calculating how much VAT can be recovered is set out in the VAT legislation and there is a “standard method”, based on the values of taxable and exempt income, that can be used to do this.

HMRC’s guidance on VAT recovery and partial exemption is in VAT Notice 706: Partial Exemption <http://tinyurl.com/qjbzgif>.

The VAT recovery rules can be very complicated and often partly exempt businesses have to apply to HMRC for permission to use a “special method”. There are also several other special rules, so if you’re new to the subject, you might want to invest in some specialist advice to make sure that you’re claiming as much VAT as possible and also getting things right. Designing and applying for permission to use a special method can be time-consuming and expensive.

Under the “de minimis” rule, business can claim VAT on net costs up to £37,500 if the VAT is charged at 20% during the twelve month “VAT year”, as long as it’s no more than 50% of the business’s total input VAT.

So if you're a partly exempt recipient, here are some initial ways of making sure that you claim as much VAT as possible:

- Make sure that you directly attribute costs to taxable business activities wherever possible.
- Consider whether the “standard” partial exemption method is “fair and reasonable” or whether you’d be better off asking for permission to use a special method. For example, if you're a contractor, most of your time and effort and costs may be spent on taxable business activities, but you may also have a few houses from which you receive VAT exempt rent, which is routinely more than your taxable income. In that case, the standard method would probably give you an unfair VAT recovery rate because of the disproportionate value of the rental income and it would be worth changing to a more reasonable and fair method.
- If you’re considering any large value expenditure relating to the exempt business, consider whether you can split the expenditure over two or more “partial exemption years” to take full advantage of each year’s de minimis limit.

Many large businesses have devised complex special partial exemption methods, designed to maximize their VAT recovery. If you think that the standard method doesn't give you fair results, then I'd suggest that you talk to your accountant and consider investing in specialist VAT advice to see if it's cost effective to make such a change and whether HMRC would agree to your proposal.

Is it more VAT efficient effective for the recipient to register for VAT to claim VAT?

I use the term "VAT efficient" to consider a range of issues; for example whether certain arrangements mean that being registered for VAT, or not registered for VAT, is more VAT efficient in the sense of reducing the overall VAT cost; or even if effect of being registered means that the business as a whole will suffer because adding VAT to sales income could mean that the business loses a lot of customers.

Many small business owners don't want to register for VAT if their customers are non-business, probably private individuals, because adding VAT to income would could make his business uncompetitive. This is especially true for any businesses whose costs are mainly VAT free – for example any service based industry, such as a hairdresser or painters and decorators whose main client base are private individuals.

But ***there may be situations when the benefit of registering for VAT can actually outweigh any disadvantages.*** Additional savings by claiming VAT on costs may outweigh the potential disadvantage of losing a few customers. For example, if a building contractor was bidding for higher value contracts for VAT registered contractors, he might find that it's worth registering for VAT even if his income is still below the VAT registration limit.

Either way the only way of deciding whether it's cost effective to register for VAT is to work out the figures. And you may still decide that not being registered for VAT is still the best option, even if it means that you can't claim VAT on costs.

Is it more VAT efficient if the supplier is registered?

I considered the VAT efficiency in the context of a business whose turnover is just below the VAT registration limits in the example on pages 20-25. As the calculation shows, being registered for VAT always means that your charges increase because you have to add VAT to the VAT free cost components elements of your income.

Don't charge VAT if not needed.

If you are already registered for VAT, then make sure that you are able to minimize the VAT that you charge to associated business or third party clients.

First of all, remember that reimbursements are not normally liable to VAT:

This includes the following:

- Goods or services provided by an unregistered business where the invoice is made out to the associated business.
- Reimbursements of tax or other statutory payments that the associated business is legally required to pay are not liable to VAT.

- Reimbursements for exempt or zero-rated supplies where the supply is made direct to the associated business, particularly insurance services where the AB is the insured person, or zero-rated supplies invoiced to the AB such as printed matter or certain construction services.

N.B. Although you should not add VAT to reimbursements, if you make any additional charge for administration in addition to the actual cost, then these charges are liable to VAT and you would charge VAT at 20% for any such services. Make sure that you follow HMRC's guidance in VAT Notice 700, The VAT Guide: s25.1: <http://tinyurl.com/lvgrdn3>.

Charges for separate supplies of reduced rated, zero-rated or exempt goods or services.

There are very few aspects of business, administration services that are liable to the reduced rate of VAT, the zero-rate or exempt from VAT. We've discussed earlier in the book the concept of single and mixed supplies and, depending on the nature of the arrangement between you and your associated business, it is possible that your service is a mixed supply and certain elements can be charged free from VAT. For example, if the agreement with your associated business specifies a particular area a office space, separate supplies of zero-rated printed matter, shared employment costs, then the following charges could be VAT free:

- Rent. Charges for the provision of allocated office space may be exempt from VAT. See [Chapter 11](#) for more information about this subject.
- Printed matter, much of which can be zero-rated. You may print leaflets or brochures for you associated businesses - see HMRC VAT notice 700/10: Zero-rating of books and other forms of printed matter <http://tinyurl.com/olv3k3o> for information about when such supplies can be zero-rated.
- If the office insurance shows both parties on the certificate, then any charge to recover the relevant share from your associated business is a reimbursement and not liable to VAT.

Ensure that you itemize the value of such charges clearly on the invoice and specify the VAT liability of the individual charges.

Staff costs

If all or part of your charge to an associated business is to cover your own employment cost and that of any other of your employees, these charges are liable to VAT. However there are certain "people costs" that can be VAT free.

- Joint contracts of employment: Payments towards the employment costs of staff members who are employed under joint contracts of employment are normally not liable to VAT, as explained in [Chapter 9](#).
- Certain director's fees are not liable to VAT if they are not payment for services to associated businesses, but to share out director's costs for their services to shareholders.

Unregistered third party suppliers

You can also minimize VAT on the cost of independent contractors, who aren't registered for VAT.

Suppose you engage the services of an unregistered book-keeper who looks after the accounting side of things for you and a number of associated businesses. If the contract with the book-keeper is with your company and you provide the book-keeping service under your contract for business services to the associated businesses, then you'll have to charge VAT on this portion of your invoice.

However, if the book-keeper contracts directly with the associated businesses, the service is made to each business directly. If you pay the book-keepers invoices on behalf of the associated businesses, then the payments will be disbursements and not liable to VAT if you follow the criteria set out in VAT Notice 700, s25.1 <http://tinyurl.com/lvgrdn3>.

Valuation

The issue of valuation for VAT purposes is important, because HMRC have the power to direct that the value of supplies to customers/clients who can't recover the VAT can be changed to the normal market value. There are also specific anti-avoidance rules to prevent manipulation of the valuation for certain transactions, including property.

But that doesn't prevent you from charging a normal commercial rate for exempt or zero-rated supplies made to associated businesses.

If all or part of your invoice is for goods or services that are not liable to VAT, then make sure that you fully value these elements.

For example, if you make separate supplies of office accommodation which is exempt from VAT, then this is exempt from VAT (unless you've opted to tax, as explained in [Chapter 11: Annex](#)). You may also make a separate service charge for services relating to their specific offices, such as maintenance, cleaning etc. These can normally also be exempt from VAT on the basis that they are additional rent for the property; see Notice 742: Land and property, section 11 <http://tinyurl.com/qfvuxcc>.

So if your monthly rent for a property is £1,000 and you lease 25% each to three separate tenants, one of which is an associated businesses, your cost for each lease is £250. However if the normal market rent for such properties is £350 per month, then you would charge this market rent to all of your tenants.

However it's also important that you don't overvalue the value of supplies to associated businesses - depending on the circumstances, this could be regarded as abusive by HMRC. See [Chapter 6](#) where I've discussed practical arrangements with associated businesses in more detail.

The Flat Rate Scheme

It may also be possible to reduce costs overall by the use of the flat rate scheme.

This scheme can help to reduce the amount of VAT payable to HMRC by the supplier while the associated business claims back all of the VAT charged on Supplier Co's invoices, therefore benefitting the group of associated as a whole, so it's worth considering.

Here's how it works: You issue normal VAT invoices adding VAT at 20% for your services and your client claims back the VAT under the normal rules.

However, although you've charged 20% VAT on your invoice, under the flat rate scheme, you may be able to pay a lower amount of VAT to HMRC. Under the scheme, you can't claim any VAT on your costs, but the corollary is that you can benefit by charging VAT at 20% to customers, while paying VAT to HMRC at a lower rate.

You can normally only apply to use the scheme if you expect that your VAT exclusive annual turnover will be below £150,000 in the next 12 months.

See VAT Notice 733: The VAT Flat rate scheme for further details about the scheme
<http://tinyurl.com/plsxqmc>.

The rate of VAT that you pay to HMRC is set at different levels for different types of business, but always lower than 20%. See the rates for different businesses: <http://tinyurl.com/qx9m9yb>.

Example

So how does it work in practice? Let's take an example of somebody providing secretarial services.

Suppose the supplier issues VAT invoices for £3000 per month, plus VAT @20%. This would mean that the total bill for the quarter is £9,000 and the output tax for that VAT return period is £1800.

The supplier's only VAT bearing costs are telephone, office equipment/consumables and heating, lighting. Suppose the VAT on these costs is £250 per quarter.

The customer pays £10,800 gross for the work done during the period.

The normal VAT calculation would be:

- VAT on sales: £1800
- Less VAT on purchases and expenses: £250
- Net payable to HMRC: £1550

However the flat rate for secretarial services is 13%.

Under the scheme, the supplier calculates the VAT inclusive value of sales in that period by 13%; i.e. $£10800 \times 13\% = £1,404$.

This is a saving of (£1550 - £1404) = £146.

Remember, the supplier can't claim any VAT on costs if using the flat rate scheme.

The reasons for the scheme are primarily to help smaller businesses to reduce administration and sometimes it can generate quite significant savings from normal VAT accounting. However I've seen situations where it is actually more expensive for a business to use the flat rate scheme, so it's not always the best option.

The best advice is to check the rates for the services concerned and work out whether it's more beneficial to apply to use the scheme or use normal VAT accounting. You have to apply to HMRC for permission to use the scheme and leave the scheme, so consider the implications carefully before deciding whether to apply.

Group registration and partial exemption

I explained the implications of VAT group registration in [Chapter 5](#) and how this can benefit partly exempt companies because VAT is not added to salary costs and other "VAT free" cost components. So this is an obvious option to consider if you have limited companies and one or more is partly exempt.

HMRC is normally happy for VAT group registrations to be used in this way and that's one of the most common uses of the VAT group facility. This is what they would normally define as a "normal consequence of VAT grouping".

However, there are a number of anti-avoidance provisions that apply to certain transactions involving partly exempt businesses and VAT groups, so be careful about using any sort of arrangements that are designed to save VAT on other costs, particularly property costs, or those on imported services.

I've explained the main anti-avoidance provisions in [Chapter 14](#) and where to find more information. Despite the anti-avoidance rules, there is always somebody who will come up with a clever - and usually complex way of saving VAT. But usually the old adage is true: if it sounds too good to be true, it usually isn't true. And with HMRC being more and more experienced at identifying avoidance in practice, I'd always advise against any arrangement that could be regarded as avoidance.

If the customer can reclaim all their VAT, surely the simplest thing is to add VAT to everything?

No. One of the main principles of VAT is that ***VAT registered businesses can only claim VAT that has been correctly charged.*** If VAT is charged for a supply that is exempt or zero-rated, the recipient is not entitled to claim the VAT. However the supplier must include any VAT charged on its VAT return, as the VAT charged is a debt due to the crown.

The only way to cancel the VAT charged is for the supplier to issue a credit note and make an adjustment on his VAT return under the procedure in VAT Notice 700/45: How to correct errors and make adjustments or claims <http://tinyurl.com/nplc9oc>

Also, remember that HMRC issue assessments for VAT that has been claimed incorrectly, even if the claimant is a fully taxable business and the supplier has included the VAT on its return. So make a point of verifying that VAT has been correctly charged before including it on your VAT return.

Chapter 13: Checklist

- Do the sums to work out whether it's more VAT efficient for either supplier or recipient of supplies to register for VAT if they're not liable to register for VAT.
- If your contract is for a mixed supply, ensure that you correctly identify the value of components that are exempt zero-rated or reduced rated.
- Charge commercial rates for zero-rated and exempt supplies.
- Consider if you can reduce VAT on staff costs by setting up joint contracts of employment.
- Arrange separate contracts with third party unregistered suppliers.
- Consider the use of the flat rate scheme to minimize costs for the group as a whole.
- Make sure that partly exempt businesses use VAT efficient partial exemption methods.
- **DO NOT ADD VAT TO EVERYTHING EVEN IF THE RECIPIENT MAKES ONLY TAXABLE SUPPLIES.** VAT registered businesses can only claim VAT on services that has been "correctly charged".

Chapter 14

VAT avoidance

- What are you allowed to do?
- Who do the avoidance rules affect?
- Planning, avoidance, evasion: what's the difference?
- The main principles of anti-avoidance
- VAT avoidance and when you have to notify HMRC
 - Arrangements to save or defer VAT: Listed schemes and hallmarks
- Other types of avoidance
 - VAT accounting rules
 - Capital Goods Scheme
 - Clawback/payback provisions
 - Property related avoidance
 - Non-property related
- It doesn't just apply to large businesses!

What are you allowed to do?

HMRC say that businesses are allowed to organise their VAT affairs to minimize your VAT costs. For the most part, this normally means that you can organise things as you like as long as it's within both the letter and the spirit of the legislation. However, there are several rules that identify specific transactions or arrangements that HMRC consider to be abusive or **avoidance** and are not acceptable. I've summarised the main ones in this chapter.

This book is about transactions between associated businesses and I've focused on very common situations, particularly management charges and business services. In the first part of the book, I discussed in some detail the potential problems that can arise when making supplies of services between associated businesses, including situations where transactions are arranged to obtain a cashflow benefit. In these situations, HMRC may be prompted to take action if they believe that certain VAT accounting arrangements, such as monthly returns and cash accounting, are being abused.

However in this chapter, I'll be explaining the specific anti-avoidance provisions that apply in more specific situations, typically involving partly exempt businesses. You may not encounter such arrangements then on a regular basis - if at all - but it's useful to be aware of the avoidance rules. Your business may not make any exempt supplies at the moment, but this can change if, for example, you decide to lease a property or carry out any other exempt businesses which incur large value VAT bearing costs.

Who do the avoidance rules affect?

There are two main types of avoidance:

Small businesses who arrange their affairs to avoid being registered for VAT.

Partly exempt businesses who arrange their affairs to artificially minimize their VAT costs.

The anti-avoidance provisions generally apply whether or not the "avoidance" is intentional.

Larger partly businesses are required to notify HMRC if they enter into certain arrangements/transactions which reduce their VAT liability. But HMRC are allowed to take action in respect of businesses of any size if they believe that avoidance has taken place.

Evasion, avoidance and planning: what's the difference?

You often come across the terms **planning, evasion and avoidance** in the context of reducing or managing VAT costs, but they mean quite different things.

Here's how I understand them to apply:

Evasion is when you try to evade tax liabilities by obvious disobedience of the law; e.g. underdeclaring VAT on returns; or issuing a VAT1614D certificate to purchase a property VAT exempt when it doesn't apply.

Avoidance is when your actions fall within the letter of the law but not within the intention of the law. An example would be when you manipulate values of certain transactions to maximize VAT savings or carry out transactions that are legal but artificially reduce VAT liabilities. HMRC have issued specific guidance explaining the situations they consider to be avoidance and the law now requires business owners to notify HMRC if they implement such arrangements.

Planning is when you're managing your VAT affairs to be VAT efficient and falling within both the intention and the letter of the law. Although depending on how you plan your affairs, HMRC may consider your practices abusive as I've discussed in [Chapter 6](#).

The main principles of anti-avoidance

HMRC started to introduce specific anti-avoidance rules, including those relating to property transactions, group registrations and avoidance of VAT registration by separating business activities, in the 1980s and 1990s. But what they really needed was a precedent that would allow them to expand their pursuit of avoidance on a broader basis.

The precedents were established following the decision of the European Court of Justice ("ECJ") in the case of Halifax Plc. The company invested several £millions in a new property, which would normally have given rise to a large irrecoverable VAT bill. To avoid this VAT cost, the property was acquired via a number of transactions that, while legal, had the effect of reducing the VAT cost to a very small fraction of what it should have been.

HMRC argued that the effect of the transactions was to generate an artificial VAT advantage and the ECJ agreed.

The 2006 ruling established two important principles:

- Avoidance occurs when the effect of "artificial" or "abusive" transactions creates a tax advantage for the business that runs counter to the meaning of the legislation.
- The tax authority (in this case HMRC) was entitled to recover the avoided tax by calculating the VAT liability if the "abusive" transactions hadn't occurred.

This established the principles that allowed HMRC to introduce a range of anti-avoidance measures, as explained below.

The other very important issue is that under the general disclosure requirements for any VAT errors, and the new VAT avoidance disclosure provisions, it's now clear that the onus is on the taxpayer/business owner to NOTIFY HMRC any VAT avoidance.

The rules are primarily aimed at medium and large businesses who are partly exempt. They are not intended to prevent any business from implementing normal VAT planning to help keep their VAT costs down.

VAT avoidance and when you have to notify HMRC

The main anti-avoidance rules are explained in VAT notice 700/8: <http://tinyurl.com/p4rmfje>

Arrangements to save or defer VAT: Listed schemes and hallmarks

The notice explains when business owners who are putting in place arrangements to save or defer VAT must notify HMRC. The aim is to ensure that business owners are required to notify HMRC if they do anything which enables them "to obtain a VAT advantage". This means either not paying enough VAT on their sales or recovering too much VAT on their expenditure.

The anti-avoidance provisions allow HMRC to disregard certain transactions that they believe have given a VAT advantage - either by paying too little VAT or claiming too much VAT - to the business. In effect, HMRC can assess the VAT liability on the basis of how they believe the transactions would normally have been carried out.

HMRC say that businesses are allowed to structure their affairs to gain a tax advantage; for example using VAT group registrations. The disclosure requirements apply to those situations where arrangements have been put in place that could be defined as artificial.

There are 2 main approaches:

- The listed schemes. These are specific schemes that generate savings from one particular type of arrangements; for example certain types of property transactions or value-shifting.
- Hallmarked schemes. This applies to any arrangements that are put in place and have certain "hallmarks of avoidance", such as paying fees to advisors based on the amount of VAT savings, confidentiality agreements and transactions involving connected persons.

See HMRC Notice 700/8 sections 3.4 and 3.6 for lists of the schemes and hallmarks <http://tinyurl.com/olmxxop>. They include some relating to commercial property and one relating to residential conversions .

Businesses who enter into any of the schemes or any other arrangements that include one or more "hallmarks" must notify HMRC, in the format given in the notice.

If HMRC agrees that the arrangements constitute avoidance, they will issue an assessment for VAT that has been underpaid or overclaimed by the businesses concerned.

When do you have to notify HMRC?

You're required to notify HMRC that you're using a scheme when certain events occur. This is usually when you have submitted a VAT return where the amount of VAT you declare as output tax or claim as input tax means that you are paying too little VAT or claiming more VAT as a result of the arrangements.

The specific circumstances are listed in Notice 700/8:

- For listed schemes: section 4.1 <http://tinyurl.com/ocffz7p>
- For schemes involving hallmarks: section 7.1 <http://tinyurl.com/ocffz7p>.

If you're in any doubt, it's best to notify HMRC. If they discover any arrangement which you should have disclosed, they will not only assess you for the underdeclared/overclaimed VAT, but almost certainly penalties as well.

Notification thresholds

The rules are primarily aimed at medium and large businesses who are partly exempt, and put arrangements in place to reduce their VAT expenditure and or reduce the VAT they pay on sales.

However you don't have to notify unless your turnover exceeds certain thresholds in the year before or VAT period before the VAT period in which you're required to notify HMRC, as follows:

Annual turnover

- Listed schemes: £600,000
- Hallmarks: £10,000,000

Quarterly or monthly turnover

- Listed schemes:
 - 3 month returns: £150,000
 - Monthly returns: £50,000
- Hallmarks:
 - 3 month returns: £2.5m
 - Monthly returns: £833,334

The threshold applies to your business plus – if a company - that of all members of any corporate group to which it belongs.

- See Notice 700/8, section 4.3.1 for HMRC's guidance about the threshold for listed schemes: <http://tinyurl.com/ohbopuh>.
- See Notice 700/8, section 7.6 for HMRC's guidance about the threshold for hallmarks: <http://tinyurl.com/py6xmcz>.

The thresholds mean that many smaller businesses don't have to notify HMRC of the use of such schemes, but it doesn't prevent HMRC challenging their arrangements at a later time.

And even though your turnover may be below the "notification thresholds" doesn't mean that you can use such arrangements without HMRC considering them as avoidance.

And as I discussed in [Chapter 6](#), HMRC are now withdrawing the use of certain VAT accounting facilities if they believe that they are being abused.

Other anti-avoidance measures

In addition to the anti-avoidance measures explained above, there are a number of other measures that apply to specific types of transactions; including certain payments between members of VAT group registrations. And don't assume that they will only apply to situations that are designed to avoid, reduce or defer VAT - *most of these measures apply to normal commercial transactions, whether or not the parties involved are related in any way.*

I've listed the most important below with links to the HMRC VAT Notice that contains information about them:

General partial exemption provisions relating to VAT recovery

In addition to specific anti-avoidance provisions, there are two specific VAT accounting rules that apply to VAT on certain expenditure to ensure that VAT can only be claimed if the goods/services are used to make taxable supplies.

The normal partial exemption calculations apply to VAT incurred in each "partial exemption year". However what if you've claimed VAT in one year because you intend to make taxable supplies but either decide to use the goods/services to make exempt supplies or you change the use of the goods/services in later years?

That's where two general anti-avoidance provisions apply:

- **The Capital items scheme (usually referred to as the "capital goods scheme" or "CGS").** This applies to certain properties, construction costing £250k or more net of VAT and certain other assets, including computers, boats, aeroplanes, costing £50k or more net of VAT. Under the scheme, businesses are required to adjust the amount of VAT claimed on the initial expenditure if they change whether they use the assets from taxable to exempt, or exempt to taxable, or any mixture of the two, in the following 10 years for property and construction and 5 years for the other assets.
- See VAT Notice 706/2: Capital goods scheme for further information <http://tinyurl.com/nzyz8ms>.
- The other scheme is known as the "change of use" provisions, or the "payback" or "clawback" provisions. It is similar to the CGS in that it requires businesses to adjust the amount of VAT claimed according to whether the goods/services are used to make taxable or exempt supplies or any mixture of the two.
- The main difference is that The clawback/payback provisions apply if goods/services have NOT YET BEEN USED to make any supplies, but are used to make a different class of supply before the original supply is made. A good example would be a housebuilder who planned to sell new houses as zero-rated supplies so claimed VAT on costs, but had to rent the property first, which

is exempt from VAT. Under the clawback rule, the house-builder would have to repay some of the VAT originally claimed.

- The provisions apply to expenditure of any type. Adjustments must be made up to 6 years after the expenditure occurs.
- See VAT Notice 706: Partial exemption, section 13 <http://tinyurl.com/o2jl7my> for further information.

Specific anti-avoidance provisions

This first section includes provisions relating to property transactions:

- To prevent the purchase of a new commercial property without paying VAT by purchasing new zero-rated residential or charitable use properties and changing its use to non-residential/charitable use: see VAT Notice 708: Buildings and construction; section 19 <http://tinyurl.com/q6n3ueo>
- To prevent the VAT free sale of capital items - including buildings costing £250k net of VAT - by selling a property as a going concern: see VAT Notice 700/9: Transfer of a business as a going concern: <http://tinyurl.com/pbwvq45> The rules about selling a commercial property are particularly complicated.
- There are particularly complex anti-avoidance rules to prevent abuse of the "option to tax" for properties that are subject to the CGS. Information about this is included in VAT Notice 742a: Opting to tax land and buildings, section 13 <http://tinyurl.com/plsxqmc>.
- VAT grouping provisions: see [Chapter 8](#) for information about specific anti-avoidance provisions for charges for the use of UK commercial property by overseas members of UK VAT groups.

Remember that most of these provisions apply to transactions with third parties as well as associated businesses.

Additional provisions not specifically linked to property

- VAT grouping provisions: see [Chapter 8](#) for information about specific anti-avoidance provisions for VAT groups involving the purchase of VAT free services from overseas members of VAT groups.
- Disaggregation. Separating business activities between different legal entities which means that the separate parties are trading beneath the VAT limit can be challenged by HMRC. See Chapter 5 for more information.
- Valuation. The anti-avoidance rules enable HMRC to direct that transactions are valued at a "open market value"; i.e. the price that would be expected between non-related parties.

While the anti-avoidance provisions are a very helpful tool to prevent avoidance or evasions, remember that HMRC are increasingly alert for abusive use of normal VAT accounting schemes, whether by large businesses or SMEs.

Chapter 14: Checklist

- HMRC say that you are allowed to arrange your VAT affairs to minimize VAT on your costs.
- Sensible VAT planning can help to manage and minimize VAT.
- However HMRC are increasingly vigilant about the use of normal VAT accounting facilities that have been abused to generate a VAT advantage.
- The anti-avoidance provisions mean that HMRC can decide that existing arrangements give rise to an unacceptable VAT benefit and HMRC can assess for the amount of VAT they believe should have been paid if the avoidance arrangements were not put in place.
- Although only large businesses must disclose the use of the listed schemes and arrangements involving hallmarks, HMRC can challenge SMEs if they believe that their arrangements constitute avoidance, e.g. smaller businesses who are not registered for VAT because of separating business activities.

Chapter 15

So what should an agreement between associated businesses include?

And what's the answer to the question?

In this book, we've considered a lot of detailed information about the VAT liability of transactions between associated businesses. To round off the book, I'll discuss whether you need a written contract, and if so, what sort of information should be included in it.

- Do you need a contract?
- Should a solicitor write it?
- What should be in it?
- Implementation
- What do you do if HMRC refuse a claim for VAT on services from an associated business?
- And finally.....

Do you need a contract?

Throughout this book, I've stressed the importance of having written agreements that confirm the arrangements for supplies between associated businesses, particularly in the case of services. I've also recommended that any such business arrangements should be carried out in the same way as any similar arrangements with third parties.

Of course not every business transaction or arrangement is defined in writing; particularly those of an informal or occasional nature. For example, you wouldn't normally have a written agreement if you decide to charge someone for the use of your business telephone once in a while; nor if someone borrowed an office for a couple of hours or if one of your employees occasionally helps an associated business to work on some urgent spreadsheets for the afternoon.

In these situations, you might not even charge for the service, but if you do, simply issuing a VAT invoice for the services which includes a description of the services is normally sufficient for VAT purposes.

So when would I recommend that a written contract is set up? Certainly when one or more of the following situations arise:

- There is a continuous supply of services, even if the amount/value is not consistent.
- When specific cost components are used to provide services to an associated business, whether specific services or as an overhead cost.
- Any situation where charges are based on one or more of Supplier Co's costs; i.e. the value is calculated by reference to cost components of the suppliers expenditure.
- Where payments are made on a regular basis or VAT invoices issued on a regular basis.
- Where there is more than one type of services involved.
- When the charges are based on the amount of time spent by directors and/or employees.

Should a solicitor write it?

There's nothing in VAT law that says what must be included in a contract or agreement, so it's actually up to you and/or your customers, whether associated businesses or third parties. You can find example sales agreements on the internet which you can download and tailor to your own requirements. A good place to start looking is websites for professional organisations, such as the Federation of Small Business; or your industry websites e.g. for the construction industry. Alternatively, you can write something on the back of an envelope. As long as both parties agree (and preferably show this by signing the agreement), you have a contract.

I've seen many situations where large businesses have copied and pasted documents from other places and used that as an intra-group agreement and HMRC have not challenged the arrangements.

I guess that my rule of thumb would be that if your transactions are regular and of a significant value, and you rely on certain VAT accounting facilities - such as monthly VAT returns or cash accounting, it's worth investing in the services of a solicitor to ensure that everything is written down as it should be and that your arrangements are commercially robust.

What should be in it?

So what should be in any agreement/contract?

Think of any contract or terms & conditions of business and you'll come up with a list of common subjects. Here's my starter list:

- Description of goods and/or services
- Amounts of work/goods, hours to be worked
- Pricing information
- When payments are required
- When invoices are issued
- Proof of work done/services carried out
- Starting date for agreement and when it will end
- What to do if there's a disagreement; e.g.
 - quality of services
 - amount of hours worked
 - staff issues
 - disputes with HMRC
- Sign and date the document, showing the identity of the signatories.

Most of this stuff is every day, common sense stuff that you'll include in any contract/agreement with a third party. However every situation is different and you'll want to cover any specific issues that might be important; for example what happens if a designated employee is unavailable.

Implementation

The most important thing is to implement what it says in the contract. There's no point in spending time or paying a solicitor to draft a contract which is signed and stuck in a drawer and forgotten about. Any such documents reflect part of your business activities and it's important that the provisions are implemented on a day to day basis.

Remember that it's precisely BECAUSE of the fact that the businesses are associated that HMRC closely scrutinize their VAT affairs. It might seem unfair that associated businesses have to be whiter than white in their business dealings, but you can understand why when you think of some of the individuals who have been involved with business frauds and scams over the years and the amounts of money lost to HM Treasury, or missing from employee pension funds.

Dealing with HMRC in these situations can sometimes be a matter of balance rather than black and white. However much you intend that such transactions are done on a commercial basis, there are times when things won't go to plan, or there may be simple human error that would have been spotted if the customer was a third party. But it's important that any written agreement and the day to day implementation are as good as possible.

The best advice I can give to any associated businesses is to carry out transactions in the same way as you would with any third parties, as far as possible; and to retain evidence that services have been supplied; both in the written form and by proving that services have actually been carried out. **What do you do if HMRC refuse a claim for VAT on services from an associated business?**

So what do you do if HMRC refuses your VAT claim?

It's easy to say that the best way to avoid this situation is to get things right in the first place, but that's very patronising and we all know that despite our best efforts and intentions, we make mistakes and don't prioritise things properly.

The first thing is to ask yourself whether HMRC are correct. They have to provide a written explanation for their decision and you may see that their decision is quite logical - perhaps you have an agreement but have forgotten to issue proper invoices, or you haven't retained evidence of the work carried out.

It's at this stage I would strongly recommend that you take professional advice from your accountant or VAT consultant. Your accountant should be able to help out if the paperwork is missing or incomplete, or can help you locate evidence of work performed. A VAT consultant will be able to deal with the more esoteric aspects - for example even if you've issued VAT invoices, have you made a supply of services?

HMRC internal procedures

The normal procedure is to ask for an internal review of HMRC's decision, which they must complete within 45 days. If they uphold their original decision, then you can appeal to the TAX tribunal.

An alternative and, in principle, less formal approach is HMRC's Alternative Dispute Resolution. I've never used this facility but I understand that it can be particularly helpful if the issues are factual - for example you think that HMRC doesn't correctly understand the situation, or you want to discuss/present evidence that services have been performed.

Both of the above procedures are carried out by HMRC personnel who have no previous involvement with the case, so they aren't exactly neutral. But they are quicker than going direct to Tribunal.

Appealing to the tax tribunal

If HMRC have upheld their original decision, your only option is to appeal to the tax tribunal. This is both expensive and time consuming. The normal waiting time is currently about 6 months and HMRC DON'T pay your costs, even if you win. Plus HMRC can appeal to the High Court if they disagree with the tribunal's decision.

Either way, it's a horrible situation to be in. I believe that most HMRC officers are honest and dedicated professionals who do their best to reach the correct decision. But **their job is primarily to protect the revenue** even if the business is genuinely damaged by their decision. I know of VAT officers (thankfully the exception to the rule) who seem to get real satisfaction from issuing assessments, even if they know that their decisions will force a business into bankruptcy. On the other hand, I've seen situations where business owners are abusive and un-co-operative and this makes the whole situation much worse.

There's no simple way of dealing with this situation. But if you take some time now to understand the principles involved and ensure that your business arrangements, whether with associated businesses or third parties, are properly managed, it could save you a lot of time, money and distress.

And finally: what's the answer to the question:

Can we claim VAT on our office costs and legal bills if we raise a management charge to our associated company?

The answer depends on a number of things:

- You can only claim VAT on any costs if they are cost components of taxable supplies that you have made to your associated business or any third party customer.
- The costs can be cost component of specific services or the business's overhead costs.
- Raising a management charge" usually means "issuing a VAT invoice for management services". But you can only issue a VAT invoice if you have made a supply of services; i.e. the services have actually been performed.
- If you have supplied services to an associated business, it's particularly important to demonstrate that the services have been performed or HMRC may not believe that services have been supplied and disallow any VAT claimed by the associated business.

It's more important than ever that transactions with associated businesses are at least as robust as those with third parties AND that you can prove to HMRC that services have been supplied.