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Indirect tax update

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Summary

Welcome to this week's Indirect Tax Update.

Our first Indirect Tax Update of the new year covers the momentous step of the UK's departure from the European Union. Whilst technically, the UK left the EU on 31 January 2020, it has been operating for a transitional period as if nothing had, in fact, changed. On Christmas Eve however, the UK's Prime Minister Boris Johnson announced that the EU and the UK had managed to reach an historic agreement (The Trade and Cooperation Agreement) which will govern the future trading relationship between the two parties.

Both sides had briefed that an agreement between them was unlikely and most commentators expected there to be 'no-deal'. In the end, though, agreement was reached. From an indirect tax perspective, the major achievement of the deal was the guarantee that trade in goods between the EU and the UK and vice versa would be on a tariff free basis meaning that no customs duty or quotas will be imposed.

The agreement is very long (1,246 pages) and is enormously complex. It provides a skeleton or framework for the future relationship and it will take all those affected by it considerable time to digest and fully understand. They say that the devil is in the detail and this agreement is no exception. In due course, HMRC will issue further guidance and policy and we will report developments in future editions of this Update.

Whilst the agreement deals mainly with the customs provisions arising from the UK's exit from the EU, there have also been a myriad of changes to UK VAT law that came into force on 1 January 2021.

In other news, the Upper Tribunal has issued an interesting judgment in the case of Colchester Institute Corporation (a college of further education) which examines whether education provided by the college which is paid for wholly by Government funding constitutes a supply for consideration for VAT purposes.

Brexit: United Kingdom and European Union reach historic Trade and Cooperation Agreement

As the transition period comes to an end, the UK and EU agree the terms of the post Brexit deal

Four and a half years after a majority of the people of the United Kingdom voted to leave the European Union and, after what has seemed to be a tortuously long period of political deadlock which saw two Prime Ministers resign and a general election, the UK has now reached the end of the transitional period and is no longer governed by the laws of the EU. Technically, the UK 'Brexited' from the EU on 31 January 2020 but, under the terms of the Withdrawal Agreement, a transitional period, where the UK was treated as if it were still a Member State, was put in place from 1 February 2020 to 31 December 2020. All that remained was for the parties to reach agreement on the future trading relationship. On Christmas Eve 2020, after literally thousands of hours of negotiation and, after having briefed that an agreement was unlikely, the Prime Minister Boris Johnson announced that the UK and EU had, in fact, reached an agreement (known as the Trade and Cooperation Agreement) which, subject to ratification and a Parliamentary vote, would take effect from 1 January 2021. All of this in the midst of the global Coronavirus pandemic.

From an indirect tax perspective, the main feature is the agreement not to impose any tariffs or quotas on the trade in goods between the UK and the EU and vice versa. This is a massive relief to all affected businesses as a 'no deal' scenario would have seen the UK revert to World Trade Organisation tariffs meaning that the cost of trading goods would have been subject to customs and other duties. In simple terms, tariff free trade means that, whilst customs formalities will need to be observed (ie import and export declarations etc), no customs duty will be chargeable on goods arriving from the EU into the UK and there will be no duty payable on goods arriving in the EU from the UK.

Whilst this tariff free trade is, clearly, welcome news, businesses importing and exporting goods will, however, only benefit from tariff free trade if the goods are of UK or EU origin. The origin of goods is a highly complex subject and affected businesses will need to ensure that they understand these rules and apply them correctly going forward. To this end, HMRC has issued a new guidance document entitled "Rules of origin for goods moving between the UK and EU". The document provides detailed guidance on the rules of origin requirements and explains the most important provisions which businesses need to understand and comply with, in order to ensure that they pay zero tariffs when trading with the EU. This applies to both businesses that wish to export goods to the EU at zero tariffs, as well as businesses who wish to import goods from the EU at zero tariffs.

To benefit under the agreement, goods will have to be of UK or EU origin. This means they must meet the UK-EU preferential rules of origin. These rules determine the origin of goods based on where the products or materials (or inputs) used in their production come from (or originate). As an example, where goods originating in the far east are imported into (say) France and are then processed in France before being exported to the UK, it is unlikely that these goods would be regarded as EU origin unless the processing changes the nature of the goods or further goods (with EU origin) are incorporated into the first goods in sufficient quantity. In such a case customs duties are likely to be payable on the importation of these goods into the UK and the goods will not qualify for tariff free importation.

Comment – whilst the agreement on tariff free trade between the EU and the UK is welcome, not all goods moving between the two parties will be covered by zero-tariffs. It will be extremely important for all importers to understand these sophisticated rules of origin to ensure that import declarations are correct and, where necessary, import duties are paid. UK businesses that are new to import procedures need to get to grips with these new rules as soon as possible.

Myriad of VAT changes as a result of Brexit

UK VAT law amended to take account of Brexit

The Trade and Cooperation Agreement highlighted in the lead article of this Update sets out the main details of the customs arrangements that will be in force from 1 January 2021. However, as a result of Brexit, a myriad of VAT changes have also been implemented either through the Taxation (Cross-border Trade) Act 2018 or through regulations amended by a plethora of statutory instruments.

HMRC has published a list of all legislative changes on its website covering changes in UK law relating to customs, excise and VAT. Businesses involved in any way in the supply of goods or services to customers outside the UK will be affected by these changes in the law and need to familiarise themselves with the new regime as soon as possible.

Businesses trading goods with customers in Northern Ireland (or even moving their own goods from GB to NI and vice versa) are subject to a specific set of rules as, under the terms of the Withdrawal agreement between the UK and the EU, NI, whilst remaining part of the UK is, to all intents and purposes from a VAT and customs perspective still to be regarded as being part of the EU.

HMRC has also published a list of amended public notices detailing the particular changes arising from Brexit in particular trades and trading scenarios.

Comment

The end of the Brexit transitional period heralds a new age for the UK's indirect tax regime. The changes to VAT legislation from 1 January 2021 are the most significant and wide ranging since the tax was introduced in 1973.

Application of the new VAT laws in the UK is immediate and businesses will be expected to both know the law and comply with it from day one.

Suffice to say that any business that supplies goods or services (or both) across international boundaries will need to review carefully their current VAT accounting procedures and make any necessary amendments where appropriate.

Upper Tribunal

Colchester Institute Corporation v HMRC

The Upper Tribunal has issued its judgment in this case involving Colchester Institute Corporation (a further education college) and HMRC. The dispute centred around a claim for overpaid output VAT amounting to £1.5 million.

In 2008, the college embarked on a major construction project incurring input VAT of circa £2.25 million. It claimed that VAT in full under a procedure which became known as the Lennartz mechanism (after a Court of Justice case of the same name). The mechanism, which was in common use at the time, allowed for input VAT to be reclaimed provided that the taxpayer accounted for output VAT on the non-business use of the asset in subsequent periods. As the campus buildings were to be used partly for non-business purposes, the college therefore reclaimed all of the input VAT and accounted for output VAT on the non-business use. However, in 2014, the college changed its view that the use of the buildings in question was non-business use. It argued that, in fact, its supply of education to students, which was paid for wholly from government grants, was a business (or economic) activity. Accordingly, it should not have been required to account for any output VAT under the Lennartz mechanism as there had been no non-business use of the buildings. The college therefore submitted its claim for repayment of the output tax it considered had been overpaid to HMRC. HMRC rejected the claim and the college appealed to the First-tier Tax Tribunal (FTT). The FTT dismissed the college's appeal finding that the provision of government funded education was not an economic activity. The college appealed to the Upper Tribunal.

In a surprise judgment issued on 22 December 2020, the Upper Tribunal allowed the college's appeal. It considers that the funding provided by the government is consideration for the supply of education provided by the college to the students (ie third party consideration). As such, the supply of such education should be regarded as a business activity and as a result, no output VAT should have been accounted for by the college. This was not, however, the end of the matter. HMRC argued that, if there was no output VAT due, the college could not have been entitled to the initial deduction of input VAT as, clearly, any input VAT incurred on construction costs was attributable to the college's exempt supplies of education. The college argued that HMRC was out of time (under the 4-year rule) to offset the overclaimed input VAT but the Upper Tribunal disagreed. Even though the four year time limit had expired, HMRC was entitled to offset the overclaimed input tax. As a result, the college's victory was a pyrrhic victory.

Comment

This is a complex case which deals with a VAT accounting mechanism that was popular at the time. The taxpayer in this case sought to reclaim a substantial amount of overpaid output VAT without the need to make a similar adjustment to the amount of input VAT it had overclaimed. The Upper Tribunal's ruling that the output VAT had indeed been overpaid was only half of the equation. The taxpayer clearly hoped to persuade the Tribunal that no adjustment was necessary in relation to the overclaimed input VAT because the four year time limit for HMRC to assess had long expired. However, following the earlier case of Birmingham Hippodrome, the Tribunal was not persuaded. As the overpaid output VAT and overclaimed input VAT arose from the same error, HMRC was entitled to offset the two. Whilst the college won its argument on the output tax issue, it lost on the input tax issue and is now in a worse position. Look out for an appeal.

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