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Indirect tax update

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Summary

Welcome to this week's Indirect Tax Update.

The Court of Justice of the European Union is back in action this week and it has released Advocate General Kokott's opinion in the UK referral involving Kaplan International Colleges UK Ltd v HMRC.

The case relates to the operation of a cost sharing group established in Hong Kong and whether the exemption provided for by the VAT Directive for supplies by a cost sharing group to its members is applicable in the circumstances.

The Advocate General considers that the exemption does not apply where a cost sharing group is established outside the territory of the particular Member State. As such, HMRC's assertion that UK VAT is due on the services provided to Kaplan under the reverse charge mechanism is correct.

The Upper Tribunal has also released its judgment in the case of HMRC v Royal Opera House Covent Garden. This was HMRC's appeal from a decision of the First-tier Tax Tribunal (FTT). The issue is whether production costs (the costs of staging operatic and ballet productions) have a sufficient link with the sale of catering services and the sale of ice creams – (both of which are taxable supplies) which would give rise to a right to recover a proportion of the input VAT incurred.

The FTT agreed with the Royal Opera House. It considered that there was a sufficient link between the production costs and the catering supplies and allowed the appeal.

HMRC appealed to the Upper Tribunal considering that the FTT had made an error of law and the Upper Tribunal has allowed HMRC's appeal.

Finally this week, the European Commission has amended its Notice to Stakeholders dealing with the VAT implications of the UK's 'Brexit' from the European Union at the end of the transitional period on 31 December 2020.

Businesses that trade in goods will need to familiarise themselves with the new VAT rules and procedures.

Court of Justice – Advocate General's opinion – Kaplan International Colleges UK Ltd v HMRC

Whether the services of a cost sharing group established in Hong Kong can benefit from the VAT exemption provided by the VAT Directive

This is yet another case that concerns the operation of a cost sharing group. The issue in this case is relatively straightforward and, essentially, centres around whether or not the cost sharing exemption provided by Article 132(1)(f) of the VAT Directive applies where the cost sharing group is established in a third territory (here Hong Kong).

To put the case into context, Kaplan International Colleges UK Ltd (KIC) is a holding company which holds shares in various subsidiaries. The Kaplan group collectively provide education services and there is no dispute that the group entities are regarded as colleges of a University. Accordingly, the educational services provided to students are exempt from VAT under the provisions of Article 132(1)(i). As the majority of the groups outputs are, thus, exempt from VAT, the group is not entitled to reclaim any associated input VAT on costs. These costs include the cost of paying commission to agents (for locating and placing overseas students) and the cost of marketing and other support services. Up until 2014, these costs were incurred directly by KIC and any VAT incurred on those costs was not reclaimed. From 2014 however, the group incorporated an entity in Hong Kong - Kaplan Partner Services Hong Kong Limited (KPS) which was set up as a cost sharing group and the supply chain was altered so that the agents' recruitment services and the other marketing and support services were routed through KPS. KPS then recharged the costs incurred to KIC and KPS treated the supply of services as exempt from VAT. This meant that KIC did not need to restrict the recovery of input VAT as no VAT was chargeable on the supply by KPS. This created a very substantial VAT saving for KIC.

HMRC took the view that the VAT exemption (for supplies by a cost sharing group to its members) did not apply as the cost sharing group was not established in the UK. HMRC considered that VAT was due on the receipt of the services provided by KPS under the UK's reverse charge mechanism and it issued assessments of almost £6 million. KIC appealed to the First-tier Tax Tribunal which referred a number of questions on the correct interpretation of the VAT Directive to the Court of Justice. The main question from the FTT is whether supplies by a cost sharing group established outside the EU to its members established in the UK qualifies for VAT exemption.

Advocate General Kokott has issued her opinion on 23 April 2020 and has concluded that the VAT exemption does not apply. At first sight, AG Kokott accepts that the wording of Article 132(1)(f) of the VAT Directive does not include any geographical restrictions. The Directive merely allows VAT exemption for supplies by a cost sharing group to its members and does not qualify or limit the provision. However, when the legal provisions are put into context, It must be concluded that the EU legislature did not have in mind cross-border groups — certainly not those in a third state such as Hong Kong. Such an interpretation puts cost sharing groups on exactly the same footing as VAT groups membership of which is restricted to entities established in the same Member State.

Advocate General Kokott concludes that Article 132(1)(f) of the VAT Directive must be interpreted to the effect that the supply of services by a cost sharing group established in a third state is not covered by the exemption. The services supplied by KPS to the international colleges are thus not exempt from VAT.

Comment – this is an opinion from the same Advocate General who argued that the cost sharing exemption was not available for banks and other financial institutions but was intended only for activities that are in the public interest. The full court agreed with the Advocate General in those cases (Aviva and DNB Banka) and there seems to be no reason to suspect that the full court will not do likewise in this case. As the Advocate General points out in this opinion, it would, otherwise, be too easy for 'exempt' entities to avoid the incidence of VAT by establishing a cost sharing group in a ''no-VAT' or 'low-VAT' jurisdiction. The full court will deliver its judgment in the case in due course.

Upper Tribunal – HMRC v Royal Opera House Covent Garden

Whether the FTT had erred in law when it confirmed that production costs had a link to taxable catering supplies

A business that makes exempt supplies for VAT purposes is not entitled to reclaim input VAT that is attributable to those supplies. This is a 'golden' rule of the VAT system. In this case, the Royal Opera House (ROH) made exempt supplies (admissions or 'box-office' in relation to productions of opera and ballet). There was no dispute that these supplies are VAT exempt as they are regarded as cultural services supplied by a not-for-profit entity. ROH incurs significant costs to stage its productions including musicians, actors, set design and props etc and it incurs VAT on these costs. ROH also makes taxable supplies – catering in its theatre restaurants and bars and supplies of ice cream.

ROH argued that it was entitled to reclaim a proportion of the VAT incurred on production costs because there was a clear link between those costs not just with its exempt supplies of tickets to its productions but also with the taxable catering services and sales of ice cream. HMRC disagreed and ROH appealed to the First-tier Tax Tribunal (FTT). The FTT agreed with ROH. It found that there was a sufficient link to justify partial recovery of input VAT. It allowed ROH's appeal.

HMRC was given permission to appeal to the Upper Tribunal which released its judgment on 22 April 2020. The Upper Tribunal has allowed HMRC's appeal. It considers that the FTT erred in law. Whilst accepting that the making of the exempt supplies in this case is promotional of the catering supplies and the ice cream sales and assists in giving the visitor to the ROH "a fully integrated visitor experience", that is not sufficient in itself to enable a conclusion to be reached that the production costs are a cost component of the catering supplies. The link between the production costs and the catering supplies etc is an indirect link which is insufficient to provide any right of recovery.

HMRC's appeal was allowed.

Comment

The Court of Justice has established in a number of leading cases over the years that for input VAT to be reclaimable, there has to be a direct and immediate link with a taxable output. It is a golden rule of the VAT system.

In this case, the ROH tried to argue that its production costs were somehow so linked not only to its staging of productions (VAT exempt) but also with its taxable activities (catering etc).

It managed to convince the First-tier Tribunal of that fact. However, the Upper Tribunal considers that the FTT misguided itself on the law and so made an error of law which it could overturn.

It is not enough to simply show a 'but-for' connection (i.e. but for the production costs, there would be no taxable supplies of catering). VAT law requires a direct and immediate link to justify input VAT recovery. In this case, the production costs were incurred to stage the production and were not cost components of the taxable supplies of catering and ice cream at the theatre on show nights. HMRC's appeal from the FTT decision was allowed.

European Commission

Notice to Stakeholders relating to Brexit

The European Commission has published a Notice to Stakeholders setting out the VAT implications for supplies of goods between the UK and the EU after Brexit. The paper sets out that on 1 January 2021, the current transitional period will expire. The UK will then cease to be subject to or covered by EU VAT law and will be treated just as any other 'third' country.

At the end of the transition period, the EU rules in the field of VAT, and in particular, the Principal VAT Directive and the Refunds Directive will no longer apply to and in the United Kingdom. This will have particular implications for the treatment of transactions in goods and VAT refunds.

The existing rules whereby goods are acquired in the UK from other Member States or are despatched from the UK to other Member States will cease. These will be replaced by rules relating to the import and export of goods which will also mean that the movements will be subject to customs procedures and controls. VAT will become due on the importation of goods into the UK from EU countries and into the EU from the UK. Similarly, export procedures will need to be followed for the movement of goods in the opposite direction and there will be special rules for B2C distance sales of goods into the EU up to a value of €150. The seller of the goods will charge and collect the VAT at the point of sale and will declare and pay that VAT globally to the Member State of identification via a One Stop Shop (similar to MOSS).

Brexit will also mean that UK businesses will no longer be entitled to make a claim for VAT paid in the EU under the EU scheme. Instead, businesses will be required to submit claims under the provisions of the thirteenth Directive which may have more stringent conditions.

There will also be special rules for dealing with the movement of goods to or from Northern Ireland as, under the terms of the withdrawal agreement, Northern Ireland is to be treated as if it remains in the EU for a period of 4 years after the end of the transition period.

Comment

The UK Government has confirmed recently that the transitional period will not be extended and, as a result, the UK will not be subject to EU VAT law after 31 December 2020.

This is only 8 months away and that means that both UK and EU businesses will need to get up to speed and come to terms with the new VAT regime in relation to the cross border supply of goods.

With few exceptions, all movements of goods from the EU to the UK (and vice versa) after the end of the transition period will be subject to customs procedures and customs control. For many businesses this will mean that they will be required to lodge customs declarations – in some cases, for the first time ever.

These procedures are not straightforward and businesses will need to familiarise themselves with the classification and valuation procedures or appoint customs agents to lodge customs entries on their behalf. Either way, time is now of the essence.

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