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Indirect tax update

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Summary

Welcome to this week's Indirect Tax Update.

This is the first edition of the ITU since the end of July. Having reviewed the output from the Courts and Tribunals there is little to report of any great interest for UK businesses. However, HMRC has been busy and, has published a number of Revenue & Customs Briefs during August.

The first is an update to Revenue & Customs Brief 08/2020 relating to partial exemption methods operated by businesses that sell goods on hire purchase (HP) terms. The Brief confirms how the partial exemption calculation should work where the amount of credit is less than the value of the asset being sold.

The second Revenue & Customs Brief is 12/2020 which relates to a change to HMRC's policy in relation to termination payments and certain compensation payments. The change of policy reflects the judgments of the Court of Justice in the recent cases of Meo Telecoms and Vodafone Portugal where the Court determined that termination payments should be treated as part of the consideration paid by the customer for the underlying telecoms services.

It had been HMRC's established policy to treat such payments to UK businesses as being compensatory in nature and not as consideration for any supply and, accordingly, from a VAT perspective, the payments were outside the scope of VAT. The Revenue & Customs Brief now confirms that this treatment was wrong and goes on to say, somewhat surprisingly, that HMRC expects UK businesses to correct the 'error' for the past four years.

With Brexit on the horizon, we also take a look at the rules that will come into play in the UK at the end of the transitional period in relation to the movement of postal packets into the United Kingdom containing goods with a value not exceeding £135.

These new rules will require overseas suppliers to register for and pay UK VAT or to appoint a UK established postal operator to do so on their behalf. The rules introduce new concepts of 'qualifying' and 'excepted' imports and, typically, there will be penalties for any lack of compliance with the new regime.

Revenue & Customs Brief 12/2020

Termination and compensation payments

There are many reasons why a customer might terminate a contract with a supplier. In many cases, the terms of the contract may stipulate that the customer must pay a sum of money to the supplier. This may simply be the amount to be paid by the customer over the remaining term of the contract or may just be a fixed amount determined at the outset or by reference to an agreed formula. Either way, historically, the payment made by the customer has been treated for VAT purposes in the UK as being outside the scope of VAT such that the supplier is not required to account for any VAT on the payment received. The reason for this treatment is that HMRC accepted that the payment was not consideration for any supply made by the supplier to the customer but was, in fact, compensatory in nature or was a payment akin to damages for a breach of the contract.

This issue – whether the payment made by the customer is consideration or compensation – has been the subject of two referrals to the Court of Justice by the Portuguese courts. In both cases, a customer terminated a telecoms contract and, under the terms of the contract, was required to pay an amount to the supplier. The Court of Justice ruled (in judgments issued in November 2018 in the case of Meo and in June 2020 in the case of Vodafone Portugal) that the correct treatment of these payments was to characterise them as consideration and not as compensation. In the Court's view, as the termination charges were set out in the contract at the outset and were known and agreed to by the customer when he entered into the contract, the payments must be regarded as, in essence, part of the cost of the supply of the telecoms services.

HMRC has now published Revenue & Customs Brief 12/2020 which confirms that, following these judgments, HMRC's policy of treating such payments as outside the scope of VAT can no longer be maintained. Accordingly, HMRC now expects UK businesses to account for VAT on early termination and similar payments from the date of publication of the R&C Brief (ie 2 September 2020). However, HMRC has also stated that, unless a UK business has received a specific ruling from them confirming that such payments are outside the scope of VAT, all UK businesses that have treated the payments in this way should now correct the historic errors over the previous four years. HMRC has also amended its internal guidance on 'Supply & Consideration'. The amended guidance reflects the judgments of the Court of Justice and quotes from the judgment in Vodafone Portugal which stated:

"***In the context of an economic approach, an operator determines the price for its service and monthly instalments, having regard to the costs of that service and the minimum contractual commitment period… …the amount payable in the event of early termination must be considered an integral part of the price which the customer committed to paying for the provider to fulfil its contractual obligations***."

The guidance also confirms that there are, however, still circumstances when payments are genuinely to be treated as compensation. If there is no direct link between the payment that is made and any supply of goods or services, the payment will remain outside the scope of VAT. An example given by HMRC in its guidance is the case of Mohr where the Court of Justice decided that payments made by the State to farmers to cease milk production were not consideration for any supply. This was on the basis that the State did not directly benefit from the actions of the farmer but made the payments for the wider good and did not 'consume' any service. HMRC also state in their guidance that liquidated damages paid under the terms of a contract are also now subject to VAT even though it is accepted that such payments are compensatory in nature. The guidance confirms that although the payments are designed to compensate, they are made as a result of events envisaged under the contract. They are therefore part of the agreement and are consideration for what is provided under it.

Comment – Whilst it seems clear that early termination payments that were agreed 'up-front' by the customer form part of the consideration for the supply of the underlying goods or services, it is less clear whether HMRC's view on liquidated damages can be sustained when they are clearly compensatory in nature. It is also surprising that, despite its previous established policy (that such payments are outside the scope of VAT), that HMRC insist that UK businesses must correct the historic VAT accounting 'errors'. Whilst taxpayers can have no legitimate expectation to an incorrect application of the law, it does seem somewhat harsh of HMRC to expect VAT that has not been collected by businesses, as a result of existing policy, to now be handed over. Litigation is likely to follow…..

Partial Exemption Methods

Revenue & Customs Brief 08/2020

There are a number of 'golden' rules in the world of VAT. One such rule is that a business is only entitled to reclaim input VAT that is attributable to taxable supplies. This can be by way of direct attribution (where the item purchased is a cost component of the supplier's taxable output) or, in other cases, where the item forms part of the overheads of the business. In the case of overheads, these are 'consumed' by a business generally and do not have a specific direct or immediate link to an output.

HMRC maintained for many years that, where a supplier selling goods on HP attributes overheads to its VAT exempt activities, there was no right to reclaim the input VAT. Thankfully, the Court of Justice put HMRC right on that count in the case of VWFS (UK) Ltd. The Court confirmed that where a taxpayer makes both taxable and exempt supplies, it was entitled to recover a portion of the input VAT incurred on overheads irrespective of the fact that, internally, the taxpayer might allocate the overhead costs solely to the exempt supplies.

In June 2020, HMRC finally published revised guidance on how businesses that sell goods on HP could apportion their overhead input VAT. The Brief outlined a formula which HMRC stated could be adopted by affected businesses. Use of the outlined method was not compulsory however.

This week, HMRC has confirmed that in cases where the amount of credit supplied is less than the value of the asset then both the amount shown as the value of the asset in the formula and the value of the exempt credit should be reduced.

Businesses selling goods on HP should be aware of this Revenue & Customs Brief and, where necessary, should consider filing a claim to recover any input VAT that was originally disallowed. The formula suggested by HMRC in the Brief is not mandatory. Any fair and reasonable method may be adopted although any method based on 'use' is likely to be challenged by HMRC

Comment

Partial exemption methods can be tricky things to negotiate with HMRC. In many cases, businesses simply adopt the easy 'standard' method which apportions VAT on overheads in the ratio that taxable income bears to total income.

The standard method is the default method and the Court of Justice has said in many cases over the years that it is the method that should be adopted in the absence of a more accurate proxy.

A business is free to apply to use a 'special' method. This needs to be agreed with HMRC. In the case of HP businesses, HMRC has admitted that it cannot find a suitable 'special' method for apportioning overhead input tax and, as a consequence, it has suggested a method which produces a recovery percentage based on the value of taxable outputs as a proportion of total outputs.

The results will vary from trader to trader but, in the vast majority of cases, the formula will produce a much better recovery percentage than was previously the case. Affected businesses should consider lodging a claim with HMRC for input VAT that has been disallowed in previous VAT periods.

Preparing for Brexit

Postal Packet Regulations

Under the current EU VAT system, any supplier of goods to UK consumers that is not established in the UK is required to register for UK VAT under the 'distance selling' rules where the value of those sales exceeds a given threshold. From 1 January 2021 when a 'hard' border will exist between the UK and the rest of the world, these rules are changing. From that date, suppliers based outside the UK (including businesses established in the European Union and in 'third' countries) will be required to be registered in the UK and account for VAT due on the importation of the goods in question.

The regulations introduce concepts of 'qualifying' and 'excepted' importations. A qualifying importation will occur when the supplier agrees to supply goods for consideration to a customer, the supplier is not established in the UK, the goods in question are despatched from a place outside the UK to the UK in a postal packet, the value of the packet is £135 or less and the packet does not contain excise goods and the packet is not declared for any special customs procedure. If all of those conditions are met, the supplier will be liable to pay import VAT to HMRC. However, where the supplier enters into a contractual arrangement with a 'postal operator' for the postal operator to pay the import VAT or a non-UK postal operator has an arrangement directly with HMRC, the importation will be regarded as an 'excepted importation'. In such circumstances, the postal operator will be liable to pay the import VAT in relation to that supply.

A non-UK supplier is obliged to register for UK VAT with effect from the date on which the first qualifying importation is despatched by the supplier. HMRC will issue a unique identifying registration number to the supplier and the regulations require that number to be identified on all postal packets despatched as qualifying importations that are not excepted importations.

As one would expect, there are sanctions available to HMRC including the power to assess the tax due on importation and to assess for interest where appropriate. Where goods are sold through an online marketplace, HMRC also has the power to make the marketplace operator jointly and severally liable for payment of the import VAT.

Comment

In the modern world, thousands of postal packets are delivered to customers in the UK every single day. In many cases, these packets will be 'domestic' supplies (ie they will have been supplied by a UK business to a UK customer and UK supply VAT will be accounted for by the UK business through its UK VAT return).

In other cases, the goods will have been despatched to the UK customer by an overseas supplier (including from businesses established both in the EU and in the rest of the world). From 1 January 2021, non-UK businesses selling and despatching goods to UK customers will be liable to register for UK VAT in relation to 'qualifying imports' unless they have put arrangements in place with a UK postal operator for it to act on the supplier's behalf or a non-UK postal operator is obliged under the terms of an agreement with HMRC to pay the import VAT due.

The supplier's liability to register is immediate. Liability arises when the first qualifying importation is despatched by the supplier and there are penalties for any failure to register. Moreover, HMRC has the power to make postal operators and online marketplaces jointly and severally liable for any import VAT due from the supplier.

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