Business Brief

For the attention of News & Business Desks

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1. VAT: Judgement of the court of appeal in the case of Ivor Jacobs ([2005] EWCA Civ 930)

This Business Brief article sets out HM Revenue & Customs’ (HMRC) revised policy on the recovery of VAT by those using the ‘VAT refunds for DIY builders and converters’ scheme in cases where a mixed use building (used for non-residential and residential use) is converted into dwellings in light of the judgement of the Court of Appeal in the case of Ivor Jacobs (C3/2004/2457).

Background

Mr Jacobs had converted a former residential school for boys into one large dwelling for his own occupation and 3 flats. His claim for a VAT refund under the provisions of the ‘VAT refunds for DIY builders and converters’ scheme was rejected because none of the 4 resulting dwellings had been created exclusively from the conversion of the non-residential part of the school.

Mr Jacobs appealed against the above decision to a VAT Tribunal. The Tribunal found that, when looked at as a whole ie a ‘primary use’ test, the school was entirely non-residential and its conversion qualified for the refund scheme.
HMRC appealed the Tribunal’s decision to the High Court. The High Court rejected the Tribunal’s ‘primary use’ test and held that the school was in part residential and in part non-residential. However the High Court also rejected HMRC’s view that any additional dwelling must be created entirely from the non-residential part. It held that the VAT incurred on converting the non-residential part used in creating the 4 dwellings was recoverable through the scheme. This is because converting the school had created additional dwellings, the school having contained one dwelling before conversion and four afterwards. The VAT incurred on the conversion of the residential part of the school was not recoverable.

The Court of Appeal unanimously dismissed HMRC’s appeal and endorsed the High Court’s judgement.

**HM Revenue & Customs’ revised policy**

HMRC now accept that, for the purposes of the DIY Refund Scheme, the conversion of a building that contains both a residential part and a non-residential part comes within the scope of the Scheme so long as the conversion results in an additional dwelling being created. It is no longer necessary for the additional dwelling to be created exclusively from the non-residential part. However, VAT recovery is restricted to the conversion of the non-residential part.

**Builders and developers**

HMRC do not consider that the Court of Appeal decision has any impact in similar situations where a building, which is part residential/part non-residential, is being converted into a number of dwellings and the number of dwellings present post-conversion is greater than the number of dwellings present pre-conversion.

Items 1(b) and 3(a) of Group 5 to Schedule 8, VAT Act 1994 restrict the zero-rating to the dwelling(s) deriving from the conversion of the non-residential part. Our policy remains that the zero rate will not apply to any dwelling(s) deriving (whether in whole or in part) from the conversion of the residential part.
VAT treatment of past supplies

DIY house builders, who have converted property that was part residential/part non-residential and have increased the number of dwellings in the building overall, are invited to submit claims for VAT incurred on eligible expenditure in converting the non-residential part of the building into a part of the resulting dwellings.

HMRC will only entertain claims in respect of such conversions completed no later than three years prior to the date of this Business Brief.

2. Further clarification on the VAT position of share issues made to customers outside the EU

We have had one or two enquiries on Business Brief 21/05 which explained HM Revenue and Customs' position on share issues following the decision in the European case of Kretztechnik AG (Case C-465/03). This item clarifies the situation regarding issues of shares and other securities made outside the EU.

Consequences for the VAT (Input Tax) (Specified Supplies) Order 1999

Input tax on issues of shares made outside the EU

Prior to Kretztechnik, issues of shares and other securities to customers belonging outside the EU were treated as specified supplies. This meant that the input tax on related costs could be recovered under the Specified Supplies Order. From 29 November 2005, this treatment will no longer apply to new shares and securities issued outside the EU as they are no longer supplies, although input tax will still be recoverable on the related costs provided the issue is made for the purposes of a fully taxable business. If the issue is made for the purposes of a partly exempt business, then a proportion of the input tax will be recoverable under the business' normal partial exemption method.

The changes announced in paragraph 2 of Business Brief 32/04 will still apply to other incidental financial transactions not affected by Kretztechnik."
3. Recovery of VAT by businesses on road fuel purchased by their employees on their behalf

This Business Brief explains the new arrangements for recovery of VAT on road fuel purchased by employees. They are being introduced as a result of the judgment of the European Court (Case-33/03) in the infraction proceedings against the United Kingdom, which was issued in March 2005. The new rules come into effect from the 1 January 2006.

Background

There are several ways in which employees can purchase road fuel for use in their employers’ businesses. They can use fuel cards or credit or debit cards provided by their employers, they can charge the cost to an account operated by their employers at the filling station, or they can pay for the fuel themselves and then be reimbursed by their employers. The infraction proceedings concerned only the last situation, where employees purchase the fuel themselves and are reimbursed.

Up to now, recovery of VAT where fuel is purchased by employees has been dealt with under the Value Added Tax (Input Tax) (Person Supplied) Order 1991, which provided for recovery by employers where they reimburse employees for the cost of the fuel.

Infraction proceedings

The European Commission took infraction proceedings against the UK for two reasons:

- the purchases are actually supplied to the employees as private individuals and therefore the employers have no right to deduct because the goods are not supplied to them as taxable persons under the terms of Article 17(2)(a) of the Sixth Directive
- even if there were a right to deduct under Article 17(2)(a), employers as taxable persons cannot exercise that right because they do not hold a VAT invoice as required by Article 18(1)(a).
Judgment of the European Court

The UK argued before the Court that employers have a right to deduct where employees make purchases for, and on behalf of, the business and are then reimbursed by the business. This preserved the neutrality of the tax, accorded with economic reality and prevented unnecessary administrative burdens on businesses. The European Court found that the terms of the VAT Order were not compatible with Article 17(2)(a) and Article 18(1)(a) of the Sixth Directive. This was because those terms did not ensure that the VAT recovered related solely to fuel used for the purposes of the taxable person’s taxable transactions, and the taxable person was not required to hold a VAT invoice drawn up in accordance with Article 22(3) of the Directive. However, while the case itself went against the UK, the terms of the judgment meant that the Court accepted the UK’s arguments that employers are, in principle, entitled to deduct the VAT incurred.

New arrangements for VAT recovery

The Government has now introduced secondary legislation to comply with the judgment by repealing the Value Added Tax (Input Tax) (Person Supplied) Order 1991 and replacing it with a new Order to be known as the Value Added Tax (Input Tax) (Road Fuel Purchased By Employees) (Order) 2005.

Under the new Order, employers will be able to continue to treat as input tax the VAT incurred by their employees on fuel costs that are subsequently reimbursed by the employer, either on the basis of the actual cost of the fuel or by means of a mileage allowance. Unlike the existing Order, which the ECJ found to be incompatible with the Directive, the proposed new Order makes it explicit that employers can recover only that VAT on fuel which is for use in their businesses in making taxable supplies and must hold a VAT invoice in support of their claim.

This means that the current arrangements in practice for businesses to recover VAT on fuel purchased by employees are unchanged, except that businesses must now retain VAT invoices to support their claims. The invoice can be a full VAT invoice or a less detailed VAT invoice, as appropriate.

The guidance in Public Notice 700/64 is being amended to reflect the new arrangements.
4. Messenger Leisure Developments Limited – refusal of leave to appeal to the House of Lords

The House of Lords has refused the taxpayer leave to appeal in the case of Messenger Leisure Developments Limited. The case concerns the VAT treatment of supplies of sporting services and confirms HMRC’s view that VAT exemption for sporting services cannot be claimed by companies that are not genuine non-profit making bodies.

Background

Messenger Leisure Developments Limited (MLD) is a wholly owned subsidiary within a commercial group of companies. MLD owns and operates a number of golf clubs from which sporting services (such as the right to use golfing facilities) were supplied to the public. MLD claimed that these supplies were exempt from VAT under item 3, group 10, Schedule 9, VAT Act 1994. There are a number of conditions that must be met before sporting services can be exempt. One of these conditions is that such services must be supplied by a non-profit making body. MLD claimed to be a non-profit making body because its Memorandum of Association restricted its ability to distribute profit. The other members of the corporate group had no such restriction and did not claim to be non-profit making bodies.

The Court of Appeal decided on 25 May 2005 that MLD was not to be regarded as a non-profit making body. This was because the building up of reserves in MLD was a clear financial advantage to the group, and hence to its owners, and because the director of MLD had the power to remove the restrictions on distribution of profits set out in the company memorandum, making any surplus available to its owners.

MLD sought leave from the House of Lords to appeal, including in its petition a suggestion that the matter be referred to the European Court of Justice. Leave to appeal was refused on 26 October 2005. The grounds for refusal included a statement that the application of Community law on this point is so obvious as to leave no scope for any reasonable doubt.
Implications of the case

The House of Lords’ refusal to grant leave to appeal means that the Court of Appeal’s decision represents the final determination of the issues in the MLD case. Plainly, the Court of Appeal’s decision should now determine any other case involving a company which is a member of a commercial group.

HMRC take the view that the MLD precedent is also highly relevant to a number of other cases. The EC law, as set out in the case of Kennemer Golf and Country Club, is clear. Companies which are set up in a commercial context, with the aim of benefiting from the VAT exemption, do not qualify as non-profit-making bodies, even if their constitution precludes them from distributing profit.

It is normally clear that a company is operating in a commercial context if it is a subsidiary within a commercial group. However, there are in addition many examples where a purported non-profit making company operates in a commercial context, without being a subsidiary of another company.

In MLD the main witness’s evidence, to the effect that he was not interested in extracting profit from the business, was not challenged, and did not need to be, given the existence of the commercial group. It goes without saying that, in any case not involving a subsidiary within a commercial group, any claims to the effect that commercial parties were not intended to benefit from the arrangements in question will not be accepted by HMRC without challenge.

Businesses affected by the MLD decision

In HMRC’s view it is now clear that any company which is precluded from distributing profit, but whose function is nevertheless to create VAT exemption in the context of a wider commercial undertaking, is not a non-profit making body for VAT purposes. It follows that such a company is not entitled to claim the VAT exemption which is directed at such bodies.

Any such company, which HMRC has already decided is not a non-profit making body, should now consider its position in light of the fact that the MLD case has been finally determined in HMRC’s favour, and the EC law is clear.
Any such company, which has not so far been subject to such a decision from HMRC, should now contact the National Advice Service on 0845 010 9000 in order to regularise its position. Co-operation from taxpayers is taken into account when deciding the level of any penalty for failing to declare VAT or to notify a liability to register for VAT.

5. VAT: Place of supply of general legal services for individuals with no right to remain in the UK

This Business Brief article announces the publication of VAT Information Sheet 07/05 “Place of supply of general legal services – clarification of policy, in particular in relation to individuals who do not have a right or permission to remain in the UK”.

The Information Sheet simply clarifies the VAT position of the place of supply of legal services to individuals such as asylum seekers and does not represent a change in policy.

Further information

For further information and advice, please contact HM Revenue & Customs’ National Advice Service on 0845 010 9000.

The views expressed in this Business Brief are those of HM Revenue & Customs.

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