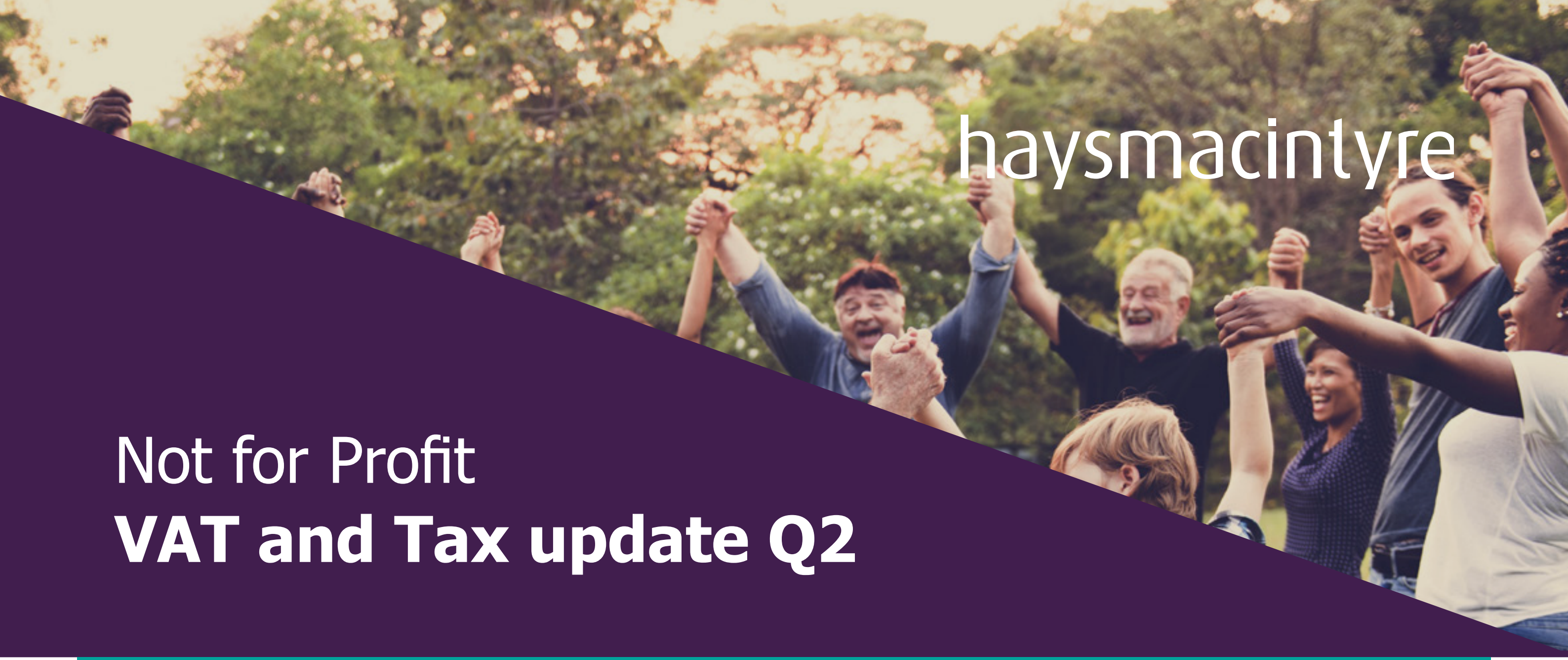

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Not for Profit
VAT and Tax update Q2

Here is our second quarterly tax newsletter for not for profit organisations. If you are still following Government guidance and working from home, then I would have suggested taking a break from your desk and popping into the garden to have a break and read through this, but looking at the weather outside, maybe just change rooms for a change of scenery.

VAT

Business or Non-Business?

Colchester Institute Corporation (CIC) is an FE College. Like most such colleges, it is predominantly grant funded (at the time of the judgement it received grant funding of £31.9M compared to only £700k in tuition fees charged to students).

It had assumed that it was carrying out grant-funded non-business activities and acted accordingly. It then constructed a building and in accordance with what is known as the Lennartz principle, it deducted input tax in full on this but accounted for output tax on deemed supplies of education and vocational training, thus securing a cash flow advantage. The Lennartz principle is no longer used so the reason for the case is of somewhat academic interest, but what follows is not.

CIC then decided that it was engaged in business activities after all and that the grant funding was in fact third party consideration for exempt supplies of education and vocational training. It therefore submitted a claim for repayment of the deemed output tax. It did offset against this some of the input tax on the construction costs of its new building, but most of this was time-barred such that it ended up having recovered most of its input tax without accounting for output tax.

Unsurprisingly, HMRC took issue with this approach and refused to repay the output tax. It argued firstly that there was no supply for consideration and that CIC was engaged in non-business activities as it had originally believed, but in the alternative, S81(3A) of the VAT Act allows them to bring into account all of the input tax on the construction costs, which under normal rules would be time-barred. The input tax on the construction costs would offset any output tax that was repayable if CIC succeeded in winning its main argument that it was in business.

HMRC was supported in their arguments by the First-tier Tax Tribunal which held that CIC was engaged in non-business activities. In late December 2020, the Upper Tribunal upheld an appeal by CIC, and said it was making exempt supplies in return for third-party consideration in the form of grant funding.

However, it went on to uphold HMRC's alternative view that it could bring the input tax back within time, thus wiping out the claim. In a sense, CIC lost the battle but won the war.

This is an important case because it opens up the possibility that other types of grant funding might actually be consideration, meaning that the grant recipients are actually engaged in carrying out business activities with possible implications for VAT recovery.

On 26 May 2021, HMRC published a Brief stating that they do not intend to appeal the case because they won on their alternate grounds, but that they do not agree with the Upper Tribunal's decision on the primary point and will be seeking to find another case to appeal against to overturn the Upper Tribunal's decision.

This is extraordinarily cynical of HMRC, as it means that whichever organisation they choose to use to challenge the CIC judgement will know that they must go to the expense of a First-tier Tribunal hearing, at which HMRC will certainly lose because they will be bound by the Upper Tribunal's decision, knowing that HMRC will then appeal the decision to the Upper Tribunal. This will be followed by a further appeal to the Court of Appeal, all of which will come at considerable expense to the unlucky organisation HMRC selects as its test case.

Our understanding is that HMRC took this view because they won the case on their alternative argument, but a more principled approach would have been to seek to appeal the Upper Tribunal decision on the point it lost, or fund the appellant's appeal.

We now have the extraordinary position where instead of HMRC saying we disagree with a judgement and will appeal, they are effectively saying we are going to ignore the law as it stands.

Fixed establishment

In the European Court case of Titanium Ltd, a Jersey company owning and letting property in Austria, the Court decided that as the company had none of its own staff in Austria and the property management was sub-contracted to a third-party property management company, the company had no fixed establishment in Austria.

The significance of this judgement is that while the place of supply rules state that a supply can be made or received where the supplier or customer belongs, a supplier or customer can belong in a country if they have a fixed establishment in a country which is most closely linked with the relevant supply.

A fixed establishment can be created if an organisation has sufficient human or technical resources to make or receive supplies, so what this judgement is saying is that outsourcing work to a third party does not give you sufficient resources to make or receive supplies. This could be relevant for international charities working through partner organisations as opposed to using their own staff.

Potential changes to VAT as it applies to Land and Property

HMRC issued a call for evidence on 12 May 2021 on simplifying the VAT exemption for land and property. On the face of it this is most relevant to the property industry, but it could have a significant knock-on effect for not for profit organisations.

Such organisations should therefore consider whether they wish to contribute to the call for evidence to set out their concerns.

The essential purpose of the call for evidence is to simplify the VAT exemption in this area. Of itself that is unobjectionable, but the document revives a number of possible options which had previously been ruled out, but which may now be back on the table.

At present, the starting point is that most interests in land and property are exempt from VAT, but a person with an interest in land can opt to tax to it where the property in question is not residential. Charities using property solely for non-business use (but not as an office) can override an option to tax. Given that most not for profit entities cannot recover VAT in full, the VAT on the rent or purchase of an opted property can create significant irrecoverable VAT.

The freehold purchase of a new non-residential building is automatically subject to VAT (regardless of whether an option to tax has been made), except where the building is intended to be used solely for a relevant residential or charitable purpose.

The Office for Tax Simplification (OTS) had previously looked at this area. One of the options previously rejected by the OTS but now seemingly back on the table is the abolition of the option to tax. At first glance this would be helpful for the not for profit sector, but property developers would be unable to recover VAT on the construction of buildings which cannot be opted, and would simply pass their irrecoverable VAT on to tenants through higher rent or purchase prices so in practice this may not benefit not for profit organisations as much as it would appear to.

In addition, there are a number of not for profit incubator organisations who would themselves lose the ability to recover VAT.

An alternative option was to reverse the position and remove the VAT exemption and subject all supplies of land and property to either the standard or a reduced rate of VAT, but with an option to exempt supplies. This, on the face of it, would increase the VAT burden across the sector.

New possibilities being mooted are whether one should define a short term or minor interest in land. The issue here is that a bare letting of land would, subject to an option to tax, be exempt from VAT. But if services are provided with the letting, then it makes it taxable, eg a not for profit theatre hiring out its theatre to a visiting not for profit company which also provides sound and lighting technicians.

If all short term lets become taxable, this achieves simplicity and removes the borderline between what is exempt and what is taxable. but what about a church hall used by mother and toddler groups or the local Scout troop who now face a 20% increase in price?

The above is not an exhaustive list of the issues which could arise and affected organisations are invited to send in their own suggestions as to what changes might be made. But this is clearly an area where some of the changes being mooted could affect the sector.

Case law

We reported in April 2020 that the Upper Tribunal had overturned an earlier First-tier Tribunal decision in the case of the Royal Opera House (ROH). The ROH had argued that its production costs were used in part in making supplies of catering and ice cream. The gist of their argument was that there was a "virtuous circle" in that opera and ballet were central to everything they did and that it was economically realistic that the production costs were essential for the ROH to make its supplies of catering. This was accepted by the First-tier Tribunal, but then overturned on appeal by HMRC.

The ROH appealed this decision and the Court of Appeal rejected that appeal on 17 June 2021, supporting the decision of the Upper Tribunal in favour of HMRC. This is a blow for similar arts organisations who might have been able to recover additional VAT.

On 31 March 2021 the Supreme Court released its decision in the case of Balhousie Holdings case. The first grant of a major interest in a building designed as a dwelling, or a building which is intended for use for a relevant residential or relevant charitable purpose is zero-rated.

If, within a period of ten years from receiving a zero-rated major interest, there is a change of use such that the building is no longer used for a qualifying purpose, or the recipient disposes of its entire interest in the building, there is a form of clawback which imposes a VAT charge on the recipient.

Balhousie acquired a zero-rated new building which was intended for use for a relevant residential purpose, namely a care home. Instead of financing its acquisition by way of bank borrowings, it did so by entering into a sale and leaseback transaction. HMRC sought to argue that the sale of the building meant that it had disposed of its entire interest in the building and thus the clawback was triggered. In a fairly dismissive judgement, the Supreme Court rejected this argument since it had simultaneously leased the building back and at no point therefore did it not have an interest in the building.

Employment tax

Hybrid working arrangements

Throughout the COVID-19 pandemic it was possible for many office-based employees to be able to work from home.

Whilst the Government introduced an exemption for employer-reimbursed expenses to cover the cost of relevant home-office equipment, the exemption will come to an end on 5 April 2022. Under the terms of the exemption, employees receive the full reimbursement for the purchase of equipment to enable them to work from home.

What are the wider implications employers need to consider when assessing the future of flexible, or hybrid-working arrangements?

Now that the pandemic restrictions are lifting, working from home will, for many, primarily be a matter of personal choice: an employee may typically split their week by working at the office two-three days and work the remainder of the week at home. Where this is the case, the office will remain the place of work and the cost of travelling to the office will not qualify for any tax relief.

However, where offices are permanently closed, for example, as part of a significant reorganisation, then consideration will need to be given to the following:

- What are the employee's duties?
- Where do they carry out their duties?
- Are they an area-based employee, responsible for a set region?

Whilst technology has enabled working remotely with relative ease, the underlying tax and National Insurance rules associated with employee travel were last reviewed in 1998. Consequently, employers must consider the impact of the long-standing legislation when they introduce any hybrid working arrangements:

1. Do any of the expenses associated with working from home incurred by the employee satisfy the 'wholly, exclusively and necessarily in the performance of the duties' conditions found in the legislation?
2. Are there any income tax or National insurance implications of travelling to the office?
3. What can be reimbursed to area-based employees?

Meeting the 'wholly, exclusively, and necessarily' test can prove challenging, as all parts of the test must be fulfilled; specifically the costs need to be incurred in the performance of the duties, not simply to put the employee in a position to be able to carry out their duties. The strict application of the test was the reason why the aforementioned exemption was introduced for the reimbursement of home-office equipment during the pandemic.

For a tax relief claim for home-working to be substantiated, it must be possible to demonstrate that it is a requirement of the employment that duties can be carried out at home and cannot be performed elsewhere. It is not sufficient to show that it is convenient, or even more efficient, for them to be carried out at the employee's home. Consequently, travel from the employee's home to their normal place of work will be a cost of commuting and will not be a claimable expense for tax purposes. The same restrictions will also apply to any journey which is substantially the same as the employee's normal commute.

For area-based employees, any travel undertaken in their area will be allowable for tax purposes. However, where the employee lives outside of their designated work area, travel into the that area will be considered a cost of commuting.

Whilst the rules my initially seem fairly straight forward, employers need to ensure all internal staff policies and guidance clearly set out the following:

- The basis upon which all hybrid working arrangements will be applied
- State where the employee's normal place of work will be
- What costs the employer will reimburse to its employees

For many organisations the post-pandemic era will present a real opportunity to revise employee working practices especially where they can work, helping to provide a better work-life balance. A further benefit is the possibility to extend the catchments area for recruiting new employees and not being restricted to candidates based within reasonable commuting distance of the office. Where new policies are introduced, we recommend they are fully reviewed by a member of our Employment Tax Team to ensure they are compliant with current income tax and National Insurance legislation.

For more information or to discuss your status, please contact Nick Bustin.

Not for profit tax

Gift Aid on waivers and refunds

HMRC have recently updated their guidance regarding the application of Gift Aid on waived refunds and loan repayments.

Previously, for a waived amount to be accepted as a donation qualifying for Gift Aid, the original funds needed to be repaid by the charity to the donor, with a subsequent qualifying payment by the donor then being made; the latter payment then qualifying for Gift Aid.

Given the number of events cancelled as a result of COVID-19, HMRC has agreed to relax its stance on this repayment point and is now allowing a charity to claim Gift Aid on waived repayments, refunds and loans.

In order for the waived amounts to qualify, the charity must hold a Gift Aid declaration from the donor, keep a record of the waiver made by the donor, and all other Gift Aid requirements (including the limits on benefits given to a donor) must be met. Gift Aid can be claimed in the period of the waiver, rather than the date of original payment (where these are different).

Where the amounts involved are relatively small, HMRC only expects the charity to keep an auditable record detailing that no refund has been requested and that the amount should be treated as a donation to the charity. For larger amounts, HMRC expects more detailed records including, where necessary, legally binding documents between the donor and the charity.

These changes may have a wide application across the sector for deposits paid, tickets purchased, and loaned amounts that are now being waived and may unlock valuable additional cash for charities.

For more information or to discuss how the changes may impact you, please contact Louise Veragoo.

Carry back of Corporation Tax losses

The 2021 budget saw temporary changes to the use of Corporation Tax losses for UK companies.

For companies with accounting periods ending between 1 April 2020 and 31 March 2022, tax losses can be carried back and offset against profits of the previous ***three*** accounting periods. Prior to this date, the legislation only allowed a one-year carry back.

Trading losses are offset on a last in, first out (LIFO) basis, which allows an overall cap of £2m for a group.

Often trading subsidiaries make use of the nine-month rule allowing them to pay profits after the year end via a Qualifying Charitable Donation (QCD), a donation to the parent charity. If trading declined after the year end, then this post year-end payment option may not be possible as the year progresses and cash reduces. These new rules could therefore be useful, allowing losses of a later period to extinguish those profits of an earlier period, without the need for a QCD.

Alternatively, if in a previous period taxable profits remained and Corporation Tax has already been paid, then a loss carry back could also enable a cash repayment from HMRC.

Where there is no capacity or desire to carry back a loss for the extended period, then the alternative option of a carry forward remains available.

The future of Gift Aid?

The OTS have recently published a report titled *Making better use of third party information*. The report looks at various sources of tax-related data currently collected by third parties and discusses whether this data could be instead received directly by HMRC to the benefit of the taxpayer.

Gift Aid is a key focus area, as it is reported that £564m of Gift Aid goes unclaimed every year, with an additional £180m claimed in error.

The report concludes that given the combination of the complexity of Gift Aid and a lower trust by taxpayers (compared with financial services institutions), that ***mandatory*** automated reporting is currently an impractical solution. However, it was noted that there is still scope to improve the taxpayer experience by facilitating ***voluntary*** third-party reporting of Gift Aid data. Given this, the OTS suggests that the automated reporting of Gift Aid donations should not be mandated but that HMRC should continue to work with the charity sector to develop better automated systems operating on a voluntary basis.

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Shortlisted 2019 National Firm of the Year

Shortlisted 2019 Tax Team of the Year

Highly Commended Partner of the Year

Winner: Audit Team of the Year

Winner of the Bronze Award for 2018 and 2017

Top adviser to the top 5,000 charities, Charity Financials' league table 2021

Top ten by audit fees in the 2020 Charity Finance Audit Survey