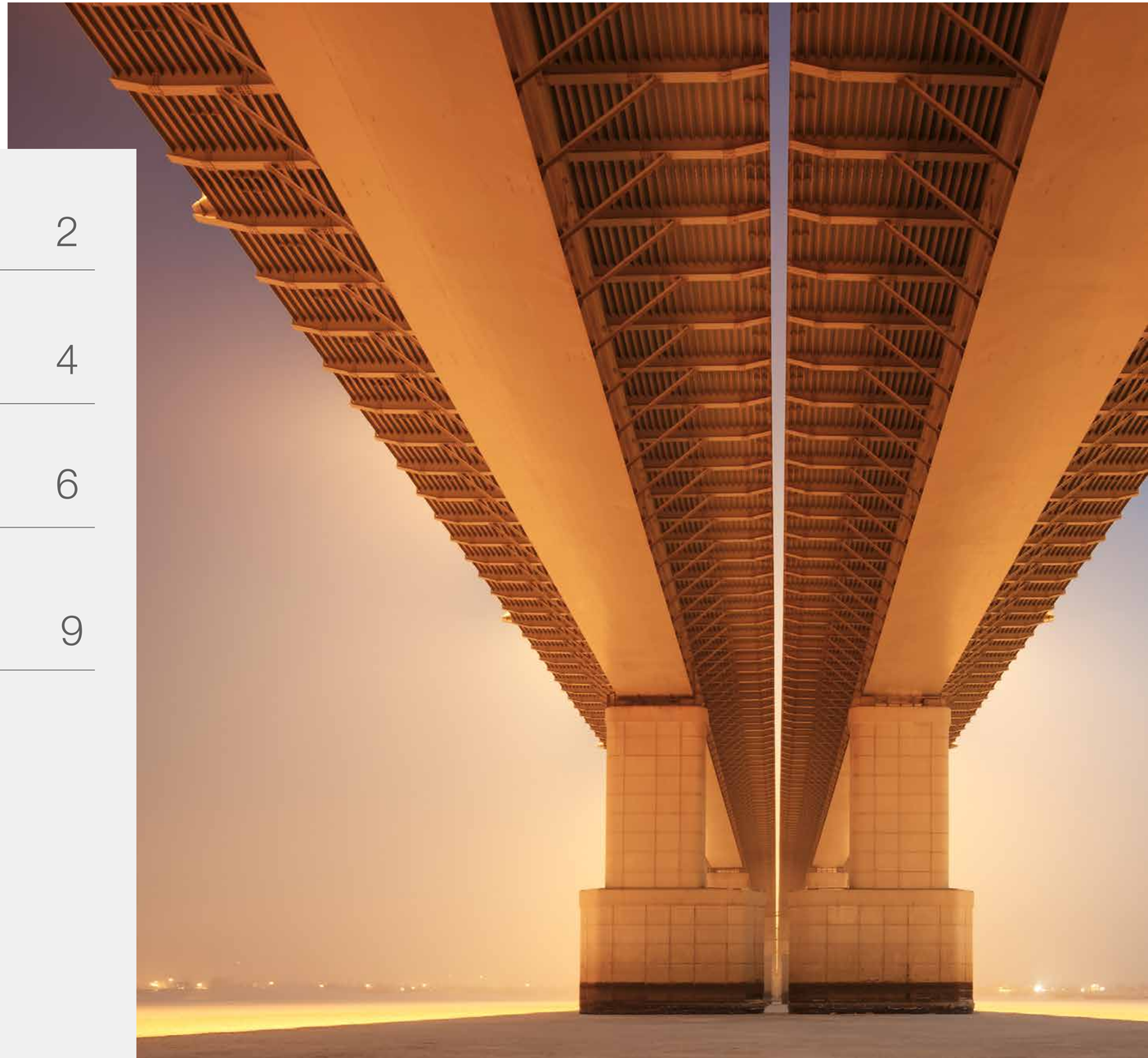
TaxTalk

Simplifying the complexities of Tax

November 2023

pkf-l.com

TaxTalk: November 2023



Why ‘silence isn’t always golden’ in an HMRC VAT review

Just because an HMRC VAT review doesn’t result in a VAT assessment doesn’t necessarily mean that HMRC agrees with what you’re doing.

Since 1989, a property company, Realreed, had owned a freehold block of over 600 flats in London known as Chelsea Cloisters. The company treated its supplies of the flats as VAT-exempt residential lettings and didn’t account for output VAT on its income.

However, in 2019 (following a VAT inspection in 2017) HMRC informed Realreed that the business was making VAT-able supplies of accommodation on the basis that, since at least 2005, two things had changed:

- fewer Assured Short-term Tenancy agreements had been signed and the proportion of occupants who stayed for more than 28 days had steadily decreased; and
- Realreed’s marketing had changed from direct marketing, including to Human Resources teams at large city institutions, to short-term / leisure travellers through Realreed’s brochure and website and the use of internet booking agencies.

In effect, HMRC was saying that the business was operating like a hotel, and consequently it raised output VAT assessments totalling £4.8m for the previous four years (the normal statutory limit for such retrospective VAT assessments).

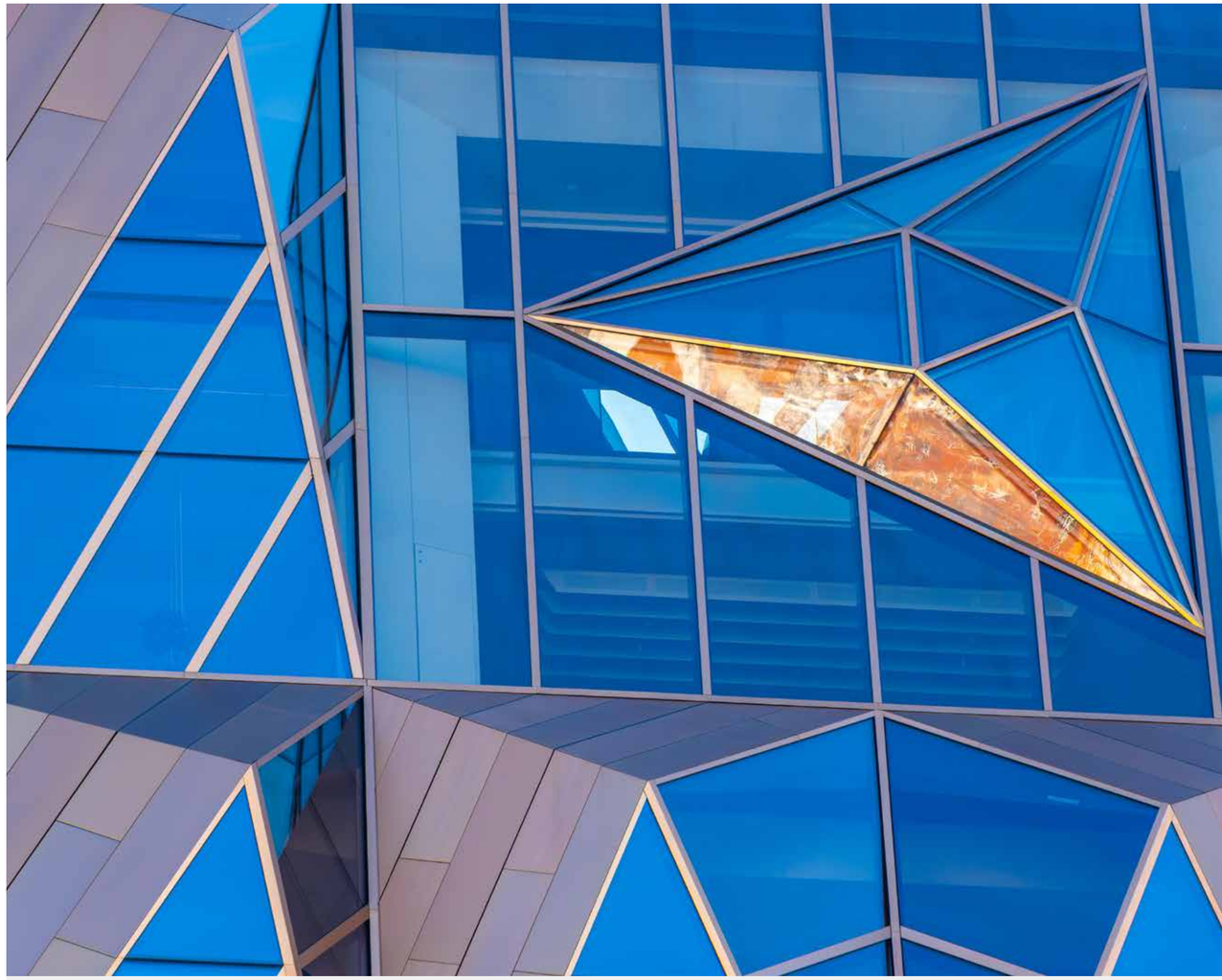
A ‘legitimate expectation’?

Unsurprisingly, Realread appealed, challenging HMRC’s 2019 assessments in the Tax Tribunal on VAT technical grounds, and bringing legal proceedings in the High Court.

The basis of Readreed’s legal case was that, even if its supplies were VAT-able, HMRC’s decision to issue retrospective VAT assessments was **unreasonable, conspicuously unfair** and an **abuse of power** because:

- HMRC had never queried Realreed’s VAT treatment of its supplies during any of its 11 VAT inspections in 1992, 1993, 1995, 2005 and 2014, and
- HMRC raised low-value VAT assessments during these inspections on related VAT issues that were based on Realreed’s supplies of the flats being exempt.

Realreed argued that it had a ‘legitimate expectation’ that HMRC had agreed that its income from Chelsea Cloisters was VAT-exempt.



Why ‘silence isn’t always golden’ in an HMRC VAT review

For detailed information and advice on any issues raised, please contact Mark Ellis.

Mark Ellis
Partner

+44 (0)20 7072 1102
mellis@pkf-l.com

The importance of evidence

However, the High Court sided with HMRC and their decision came down to a lack of evidence that during any of HMRC’s VAT inspections before the 2017 inspection:

- Realreed had informed HMRC (and provided ALL relevant supporting information / documents) as to how its supplies of Chelsea Cloisters had materially changed over the years
- Realreed had told HMRC how the business had concluded that its supplies were all still VAT-exempt despite the changes to its supplies
- Realreed had asked HMRC to give a view on the VAT treatment of its supplies in light of the changes
- HMRC had given its view on the VAT treatment of Realreed’s supplies in light of the changes.

In addition, because HMRC could not issue VAT assessments going back more than four years, the High Court found that Realreed had actually made a significant VAT saving by applying the incorrect VAT treatment to its supplies.

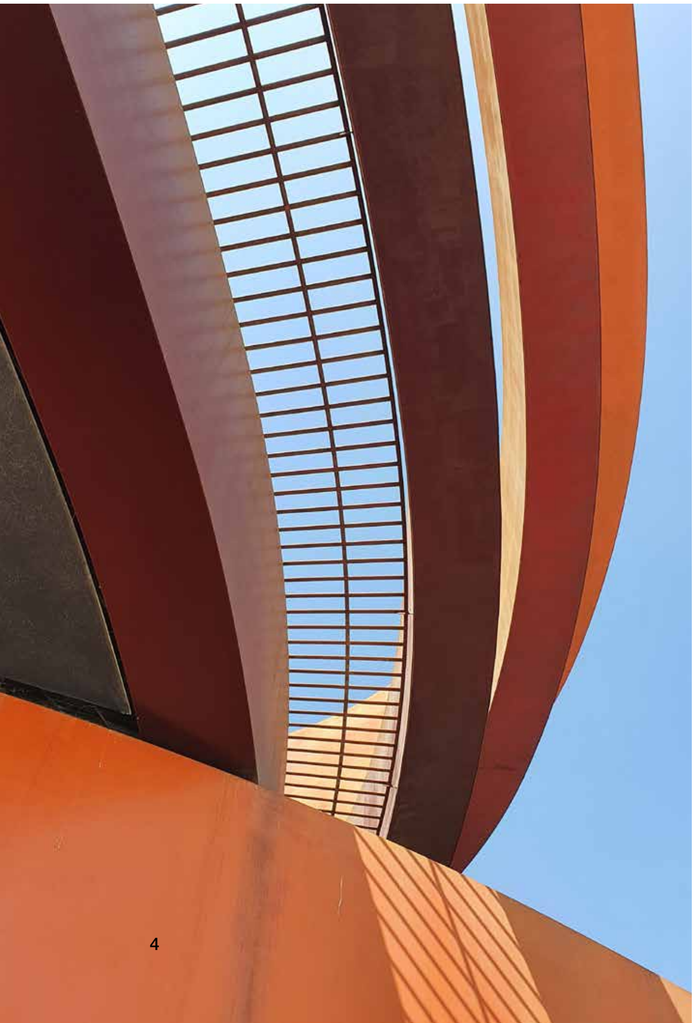
Don’t just assume

Businesses incorrectly read too much into HMRC (i) having sight of their transactions and (ii) not challenging the business’s chosen VAT treatment of those transactions at the time. To avoid a similar fate to that of Realreed, businesses faced with an HMRC VAT review (even just a pre-credibility check of a VAT return showing a net VAT refund) should consider taking the following steps:

- **Clarify the purpose of the review** and which transaction(s) HMRC will review
- **Provide all the information / documents HMRC needs** in order to reach an informed view of the correct VAT treatment of the relevant transaction(s)
- **Keep (for many years) a detailed record of the review** including (i) all information / documents provided to HMRC, (ii) written confirmation of the outcome of the review and (iii) any next steps from HMRC
- **Specifically ask for HMRC’s view** of the VAT treatment of the relevant transaction(s) giving HMRC options (with supporting rationale) for

What does it mean to be an associated company?

The reintroduction of old rules mean that, once again, it’s important that UK companies understand the impact on their tax and cashflow position.



2023 saw the reintroduction of the old associated company rule, which had been abolished by then Chancellor George Osbourne from April 2015.

For those who remember, the rates of Corporation Tax were more complicated until 2015, with lower and upper limits driving small and main rates of corporation tax, together with marginal relief. The need to calculate the correct number of associated companies added further complexity.

Since 2015, things have been simple with just one rate of Corporation Tax and a simplified 51% group company rule. However, from April 2023 the concept of associated companies has been reintroduced.

The importance of control

The key metric for determining whether a company is associated with another is ‘control’. In its simplest form, one company is associated with another if one company controls the other, or both companies are controlled by the same person(s) either now or in the future. There is a ‘test’ of control which is defined by voting power, ordinary share capital, distributable profits and rights on a winding up. Person(s) can be a company, an individual(s), trustees of a trust, or partners in a partnership.

Control also considers the rights and powers of a person’s associates, where there is substantial commercial interdependence. Associates include an individual’s spouse, civil partner, and siblings. You can also be associated by way of having “substantial commercial interdependence” with another company. This can exist as financial, economic or organisational interdependence.

There are some special considerations for control established by fixed rate preference shares, loan creditors and controlling trustees, which are not covered in this article.

The control test will still be met if the same group of persons, when taken together, have control of both companies. I.e. is a group of people controlling each company is identical then the control test is met and the companies are associated.

To consider this we would need to look at the “minimum controlling combination”. e.g. three unconnected persons, A, B and C, hold one-third of the shares in a company. There are three minimum controlling combinations: A and B together, B and C together, and A and C together.
As control is held by any two together, the addition of another person to the controlling combination is superfluous and not required to form a control group. If there is another company where B’s and C’s shares together give them control both companies would be considered under common control and associated.

Other principles

Once control has been established, a company then needs to determine its number of associates. There are a number of factors to bear in mind:

- Worldwide companies are included, whereas dormant companies and passive holding companies are excluded
- When companies join and leave a group during the accounting period, they are associated for the whole accounting period; and
- If one company controls a company, which in turn controls another company, it is not necessary to multiply downwards through the holding. It is only the direct shareholding which is considered.

What does it mean to be an associated company?

The impact of associated companies

- For Quarterly Instalment Payments (QIP) purposes, the new associated company rules have replaced the related 51% group company rules, impacting whether a company is determined to be large or very large.

  This means that it can be more likely that a company will fall into the large company QIP regime or the very large company QIP regime. For more details on the impact on QIPs read our article.

- Also from April 2023, the rate of Corporation Tax has a ‘small profits rate’ of 19% for companies with profits up to £50,000 and a ’main rate’ of 25% for profits above £250,000, with marginal relief available in between.
  These profits limits are reduced where there are associated companies, as the profit limits are divided by the number of associated companies. Previously, the related 51% group rule also applied, and the associated company rules replace this. For more details on the impact on the new corporation tax rates, see our article.

- The rules also impact companies that claim under the Patent Box regime and capital allowances long life asset rules.

The concept of control is also relevant for Transfer Pricing purposes (being the price of transactions between connected companies) which can impact tax reporting. If you think your company is affected by Transfer Pricing read our article.

Taking control

Understanding the number of associated companies you have should be established as soon as possible. This may determine the rate of Corporation Tax which applies for your company and the speed at which the QIP regime applies. Both of these can result in quicker and higher cash payments due to HMRC, which will impact cash flow.

Simplifying your group could be considered to reduce the number of companies, provided this is commercially viable, particularly where there are multiple entities with minimal activity or trade, or there is an opportunity to merge.

This may be particularly relevant if you are an acquisitive group that regularly acquires companies. There may be further tax implications as a result of this, which are not covered in this article.

If you would like further guidance, please contact Farjana Akhter or Catherine Heyes.

Catherine Heyes
Partner, Corporate Tax

+44 (0)20 7516 2237
cheyes@pkf-l.com

Farjana Akhter
Lead Assistant Manager

+44 (0)20 7516 2246
fakhter@pkf-l.com

“Exceptional circumstances” and the Statutory Residence Test

A recent Upper Tribunal case has highlighted HMRC’s strict view of what constitutes “exceptional circumstances”, Andrew McCready explains.

Since 2013 an individual’s UK tax residence has been determined by the Statutory Residence Test (SRT). The SRT works by counting the number of days you are present at midnight in the UK and applying that number against a series of tests and conditions.

As a concession, the SRT allows an individual to disregard up to 60 days in the UK in a relevant tax year if they are in the UK for “exceptional circumstances”.

The exceptional circumstances apply to days on which:

1. The individual is in the UK at midnight due to exceptional circumstances beyond their control.
2. Those circumstances prevent them from leaving the UK
3. They intend to leave the UK as soon as those circumstances permit.

The legislation gives examples of exceptional circumstances of “national or local emergencies such as war, civil unrest or natural disasters” and “a sudden or life-threatening illness or injury”, although this is far from an exhaustive list.
It is a question of fact whether an event is exceptional and if the particular circumstance prevents the individual from leaving the UK.

As such it is important in each case to consider whether the circumstances are exceptional and if they prevent a person from leaving the UK.

During Covid, HMRC issued helpful guidance on what would be considered exceptional in those circumstances which we have considered further below. However, what about other circumstances?

To be exceptional, the circumstance must be out of the ordinary and prevent the person from leaving the UK. HMRC has historically taken quite a narrow view to this and the recent case of A taxpayer v HMRC has further confirmed this.

A taxpayer v. HMRC: [2023] UKUT 00182 (TCC)

A recent judgment was given at the Upper Tribunal focusing on an exceptional circumstances claim.

The case centred on a taxpayer (“the Taxpayer”) who was residing in Dublin but was previously resident in the UK. After leaving the UK on 4 April 2015, the Taxpayer had declared herself to be non-UK resident under the SRT during the 2015/16 tax year.

“Exceptional circumstances” and the Statutory Residence Test

However, the Taxpayer had travelled repeatedly to the UK throughout the year to care for her twin sister who had been suffering from alcoholism and depression, and the sister’s two minor children. As a result, the Taxpayer had exceeded the number of days she could spend in the UK without becoming tax resident under the SRT. The Taxpayer made a claim under the exceptional circumstances provision to be treated as non-UK tax resident.

The First-Tier Tribunal (FTT) had originally concluded that whilst the “[Taxpayer’s] twin sister’s alcoholism and depression [does not], of itself, constitute exceptional circumstances”, the combination of the need for the Taxpayer to care for her twin sister and her minor children “at a time of crisis caused by the twin sister’s alcoholism does constitute exceptional circumstances”.

HMRC appealed to the Upper Tribunal on four grounds, of which all were allowed. The main outcomes of the case are as follows:

1. For exceptional circumstances to apply, the SRT reads that “[the Taxpayer] would not be present in the UK at the end of that day but for exceptional circumstances beyond [the Taxpayer’s] control that prevent [the Taxpayer] from leaving the UK”.

   The Upper Tribunal agreed with HMRC that the Taxpayer had failed to demonstrate that they were prevented from leaving the UK because of exceptional circumstances. They found that moral obligations are themselves not exceptional circumstances as they do not stop or render it impossible for you to leave the UK.

During the case in question, the Taxpayer had the choice whether or not to look after her sister’s minor children. She had no legal obligation to do so and thereby made a choice to remain in the UK. Ultimately, the Taxpayer could have left at any time.

Moral obligations arise by reason of conscience; you have a choice as to whether you meet those moral obligations. The Tribunal argued that it is not “out of the ordinary course, or unusual, or special, or uncommon” for an individual to have a moral obligation towards their relatives - they are neither sudden nor unexpected.

Nevertheless, it is important to distinguish between a moral obligation and a legal obligation.

Applying HMRC’s own examples of exceptional circumstances, it could be argued that if the Taxpayer had a legal obligation to affected children (for example, they were her own children), then the outcome of the case could have been different.

One point is certain however, if you choose to remain in the UK by reason of a moral obligation, exceptional circumstances will not apply unless other factors are present.

2. HMRC argued that if exceptional circumstances do apply, they “must be applied each day at the time the [person] stayed in the UK and at the end of the relevant day”. In this case, the Tribunal found that the Taxpayer had presented a lack of evidence to substantiate the reasons as to why she was prevented from leaving the UK.

“Exceptional circumstances” and the Statutory Residence Test

What HMRC means is that taxpayers who wish to claim exceptional days under the SRT must demonstrate that exceptional circumstances apply on each and every day of the claim. The Tribunal found that whilst the FTT rightly said that a taxpayer should not have to produce “an itemised timeline for each day”, they must present sufficient evidence to allow a judgment to be made for each day of the claim.

This case emphasises the importance of clear record-keeping and the need to maintain contemporaneous records. It is without question that taxpayers will need to demonstrate to HMRC that they were prevented from leaving the UK because of the exceptional circumstances on a day-to-day basis.

Covid-19 and exceptional circumstances

The Covid-19 pandemic impacted the freedom of travel to and from the UK, and many individuals were forced to remain in the UK for extended periods of time.

Luckily, HMRC responded quickly to the pandemic, publishing guidance which stated that individuals could claim exceptional circumstances if they:

- were quarantined or advised by a health professional or public health guidance to self-isolate in the UK as a result of the virus
- found themselves advised by official Government advice not to travel from the UK as a result of the virus
- were unable to leave the UK as a result of the close of international borders
- were asked by their employer to return to the UK temporarily as a result of the virus.

Whilst HMRC has stated they will look sympathetically at those who claimed exceptional circumstances because of Covid-19, the success of any claim will rely on its specific facts and available evidence. Importantly, any claim should still have been subject to the 60-day limit.

Individuals should also pay close attention to any workdays they may have spent in the UK during the pandemic. HMRC have confirmed they should have been treated as UK workdays and potentially liable to UK tax.

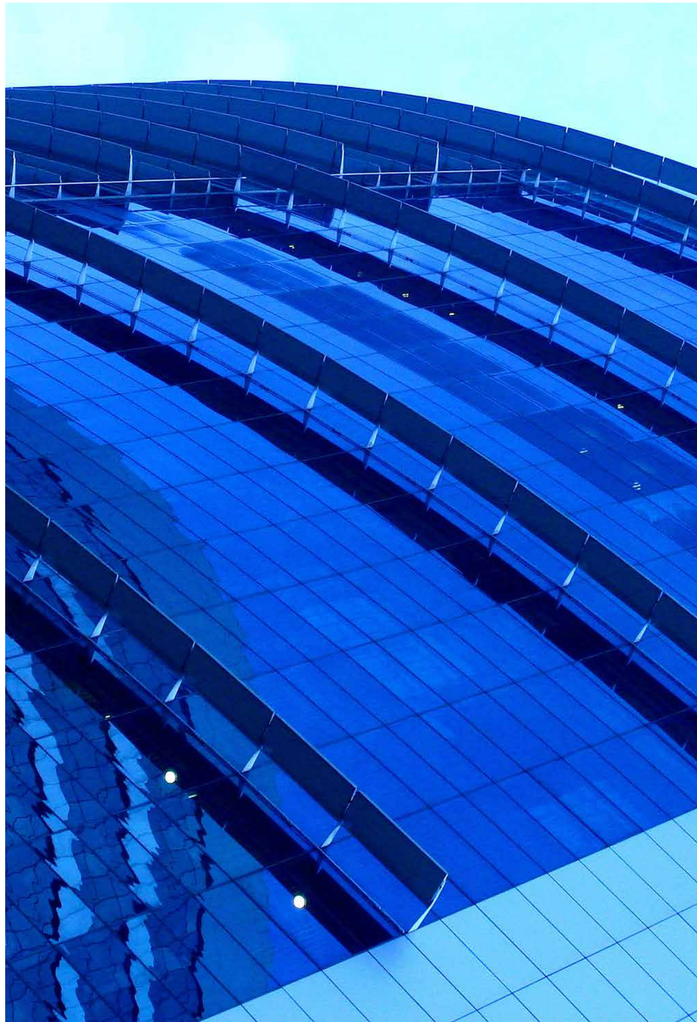
Key points for taxpayers and advisors

1. **Evidence is key.** For any exceptional circumstances claim to be successful, the taxpayer should maintain good record-keeping that supports an exceptional day claim on a day-by-day basis.
2. **Moral obligations are no excuse.** If you choose to remain in the UK by reason of a moral obligation, you will not meet the threshold for a valid claim. Whilst a moral obligation can exist, other factors must be present for exceptional circumstances to apply.
3. **60 days maximum.** You can only claim for 60 exceptional days in any given tax year.

For more information on issues raised in this article, please contact Andrew McCready.

Andrew McCready
Assistant Manager

+44 (0)20 7516 2272
amccready@pkf-l.com



About PKF
Simplifying complexity for our clients

PKF is one of the UK’s largest and most successful accountancy brands.

We provide a full range of audit, accountancy, tax and advisory services, and are experts at simplifying complexity – we’re particularly well-known for working with large, high-profile businesses with challenging issues in fast-moving and highly technical areas.

We are also an active member of PKF Global, an international network of legally independent accounting firms that gives us an on the ground presence in 150 countries around the world.

PKF in the UK

11th largest Tax practice in the UK

£153 million annual fee income

1450+ UK partners and staff

5th ranked auditor of listed companies in the UK

Our tax services At a glance

> “By bringing together the extensive expertise and experience of our tax specialists we can provide a fully rounded service that offers excellent value for money."

We offer comprehensive tax compliance and advisory services to a range of clients, both in the UK and globally, helping them find their way in the increasingly complex world of tax.

We find practical solutions that we use to our clients’ advantage. Our team of experts supports individuals, and businesses ranging from start-ups and SMEs to large international groups, both listed and privately owned.

Where understanding of our clients’ sector makes the difference, our experts invest their in-depth industry expertise to provide invaluable support and insights.

We offer the following specialist tax services:

Corporate and business taxes

Our Business Tax team will ensure that you are both tax compliant and efficient.

We provide specialist corporate and business tax advice on both a local and international level, which includes senior accounting officer and large business compliance, transfer pricing, transaction services, due diligence, R&D tax relief, employer solutions and global mobility. We also support both the personal and business affairs of partnerships and LLPs.

Read more

Personal tax and wealth management

Our team will guide you through the complex world of taxes, helping you meet all filing requirements and identifying risks and opportunities to help mitigate tax liabilities.

We advise individuals, the self-employed, partners, trustees and executors with their UK and international tax affairs. Our services include all aspects of tax, including Self Assessment, Capital Gains Tax, Inheritance Tax, property (both residential and commercial), trusts, family wealth and estate planning, residence and domicile issues.

Read more

VAT and Indirect taxes

Our indirect tax team will support you in meeting your VAT compliance objectives and advise you on any VAT issues that your business faces.

We can ensure that your VAT risk is assessed and managed, and that your VAT recovery is optimised. We can also provide advice and compliance services on other indirect taxes, such as Insurance Premium Tax, Customs duty, and Air Passenger Duty.

Read more

Tax disputes

HMRC is increasing the number and scope of tax investigations into both individuals and businesses, covering all aspects of potential underpayments of tax, including offshore investments, personal and corporate Self Assessment Tax Returns, PAYE and NIC compliance and VAT.

If an issue arises, our trusted advisors will match the right specialists with your needs to provide you the necessary support – whether for a routine HMRC enquiry or a more complex investigation.

Read more

PKF Littlejohn LLP

www.pkf-l.com

London

15 Westferry Circus,
Canary Wharf,
London E14 4HD

+44 (0)20 7516 2200

Leeds

3rd Floor, One Park Row,
Leeds, Yorkshire,
LS1 5HN

+44 (0)113 244 5141

Manchester

11 York Street,
Manchester,
M2 2AW

+44 (0)161 552 4220