

Tribunal applies 'principle of abuse' to construction planning arrangement
Lime Avenue Sales & Services Limited and Benenden School Trust

Summary

In a case concerning the recovery of VAT incurred on the construction and leaseback of a school study centre, the Tribunal considered the principle of abuse and found that it applied. As a result, properly 'redefined' the construction services were supplied directly to the school and input tax recovery was denied. The Tribunal noted the decision in *Weald Leasing Ltd* (20003) (now under appeal), but found that it was unnecessary to apply that reasoning in this case.

Background

Lime Avenue Sales & Services Ltd (LASS) is a company wholly owned by Benenden School (Kent) Ltd (the School). LASS appealed against HMRC's refusal to repay its input tax claims for VAT incurred in the periods 08/00 to 02/02 on the construction of a study centre at the School. These transactions were referred to in the appeal as the 'initial arrangements'.

Benenden School Trust (the Trust) appealed against the refusal by HMRC to allow it to deduct VAT charged by LASS relating to the subsequent supply of land and buildings to the Trust. These transactions were referred to in the appeal as the 'further arrangements'. The School had intended to build the study centre for some time before these arrangements were in place, and there was evidence of other proposals from its advisers in which the School would have been the developer of the building. These plans were amended and LASS was chosen as the developer following the changes to the VAT legislation on land and property introduced in the Budget of 1999.

The initial arrangements

- The School needed a new study centre and owned the land on which the study centre was to be built. LASS ran the school shop and was registered for VAT.
- LASS bought the land from the School in February 2001 for £50,000; the transfer also contained a right of repurchase granted to the School. LASS had earlier contracted with builders and professionals for construction works for £2,193,866.
- The intention was that LASS would sell the land with the completed study centre back to the School for an amount (undetermined at the relevant time) payable by annual instalments.
- The Trust agreed to lend £3 million to LASS (via two loans) to fund the costs of construction.
- LASS incurred VAT on the building costs and professional fees. By August 2001, it was clear that HMRC would refuse LASS's claims on the basis of the principles emerging from the *Halifax* case.

HMRC contended that the claims for input tax by LASS would constitute an abuse of the right to claim relief for input tax. LASS should be treated as if it had neither made nor received any supplies in relation to the construction of the study centre, and its VAT returns should not have included claims for VAT in respect of the transactions relating to the project. Properly 'redefined', the School was to be treated as having received all the supplies of construction services for use in making its exempt supplies of education.

The further arrangements

- In January 2002, LASS agreed to sell the completed study centre to the Trust for £2,850,000. The School waived its repurchase rights on terms that the Trust should give it a similar right.

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- Following the purchase of the study centre, the Trust leased it to the School for an 'initial rent' of £5,000. The Trust elected to waive exemption in respect of the centre and applied to register for VAT.
- LASS charged VAT on the sale of the study centre to the Trust. The Trust sought to deduct this VAT as recoverable input tax. The Trust charged VAT on the rental charged to the School.

HMRC argued that, when considered in light of the Halifax decision, LASS's transfer to the Trust and the lease back to the School under the further arrangements were not supplies made in the course of any business. HMRC supported this contention by reference not only to the Halifax decision but also to the High Court decision in Yarburgh Children's Trust. Consequently, LASS should not have charged output VAT on the transfer and therefore there was no corresponding input tax for the Trust to deduct.

The Appellants' arguments

- The Halifax principal applies only to actual transactions, of which there were none until the further arrangements when LASS made the relevant supply of the completed centre to the Trust. The argument being that the 'essential aim' of a transaction cannot be determined until an actual transaction takes place. Its case was therefore that the initial arrangements should be ignored in determining whether the Halifax principle applied.
- The Halifax principal did not apply to the further arrangements because LASS's sale to the Trust was forced on it by economic circumstances caused by HMRC's refusal to repay input tax and thus the Trust's right to repayment of the loan to LASS was endangered.
- The tax advantage sought from the arrangements was not contrary to the relevant legal provisions because the School suffers irrecoverable VAT on the rent it pays (relying on Weald Leasing Ltd).
- Although the initial rent under the lease to the School was small, there was a right to rent reviews and therefore the rental was a bona fide business activity.
- The transactions could be distinguished from Halifax in that the funds for the developments were not provided by the ultimate user and the end user of the building occupied it as tenant and not outright owner.

Held

The Tribunal applied the principle of abuse, as set out in the Halifax case, to both sets of transactions and found that, properly redefined under that principle, the construction services were supplied directly to the School.

On the evidence, the Tribunal was satisfied that there were no commercial reasons of any substance for using LASS as the developer (its reasoning is summarised in paragraphs to 54-56 of the decision). The Tribunal's view was that the School would not, in the normal context of its operations, have had the opportunity to build the study centre without irrecoverable VAT arising on the construction costs, and therefore denying input tax recovery on those costs was not contrary to fiscal neutrality. The Tribunal notes that, in paragraph 81 of the Halifax decision, the ECJ ruled that it was for the national courts to determine the substance of the transactions and that, in doing so, they may take account of economic, legal or personal links between the parties. The arrangements were part of a scheme designed to achieve a tax advantage, they were artificial and they were made possible because of the links between the parties. Accordingly, the abuse principle applied to the initial arrangements.

The Tribunal also dismissed the Appellants' arguments on the further arrangements which, it found, were not forced on LASS by the threat of impending insolvency due to its not having received the VAT repayment under the initial arrangements. As the Tribunal put it: "We cannot therefore accept as a "commercial justification" for the Further Arrangements one that is, as here, based on LASS's failure to benefit from its abusive claim arising from the 'initial arrangements'".

The Tribunal noted the decision in Weald Leasing Ltd (now under appeal) in relation to the finding in that case that it was not contrary to the purpose of the EC Sixth VAT Directive for an exempt trader to spread the burden of irrecoverable input tax over a period by means of leasing goods. However, it considered that it was unnecessary to rely on the reasoning in that case and decided the present appeal without having to reconcile its decision with it.

In relation to HMRC's Yarburgh arguments, the Tribunal noted that there were close parallels between the cases. It found that, based on the ratio of construction costs (£2.8m) to the rent (£5,000 per annum) of 0.2%, the fact that the Trust allowed a rent review date to pass without action to uplift the rent, and that the Trust was not engaged in any other leasing activity, the lease by the Trust to the School was not an economic activity.

The appeal was therefore dismissed with the award of costs to HMRC.

Implications

Since there are clear similarities here with the arrangements in Halifax, it was always going to be difficult to persuade the Tribunal that the abuse principle did not apply to the transactions in issue. However, what is most interesting is the Tribunal's reference to the decision in Weald Leasing Ltd. In particular, it is not clear why (apart from the fact that it is under appeal) the Tribunal found it unnecessary to consider or apply the reasoning in that case. It is speculation to consider that the reason may be that, in Weald Leasing Ltd, the Tribunal found that any abuse arose not from the fact of the existence of the leases themselves, but from the levels of rentals under the leases and the interposition of an intermediary company. In Weald Leasing there was no evidence adduced as to what would have been open market rentals. In this case it was clear that, under normal circumstances, a building costing £2.8m would not have been let for a rental of £5,000 per year.