

VAT grouping and the capital items scheme

[University of Essex \[2010\] UKFTT 162 \(TC\)](#)

Summary

This case concerns the VAT treatment of arrangements under which the Taxpayer developed new student accommodation. After granting a lease to the Taxpayer, the owner of the site (UAG) was acquired by the Taxpayer and joined its VAT group. HMRC sought to argue that, when UAG joined the Taxpayer's VAT group, the property became a 'capital item' for the Taxpayer and that it was required to adjust the input VAT recovered on the development costs. The First Tier Tribunal held that UAG's admission to the Taxpayer's VAT group did not affect the position under the capital item scheme, and therefore allowed the Taxpayer's appeal. This case nonetheless stresses the complexities which can arise concerning capital items and VAT grouping.

Background

The case concerns the VAT treatment of arrangements under which the Taxpayer developed new student accommodation (the Development).

In 2002, the Taxpayer contracted with a third party company (UAG) to construct the Development on land owned by UAG. In June 2002, UAG (unsuccessfully) sought confirmation from HMRC that, if it sold the Development to the Taxpayer, no capital items scheme (CIS) adjustment would be triggered (UAG having opted to tax the Development). In September 2002 the Taxpayer issued to UAG a zero-rating certificate (under note 12 group 5 Sch 8 VAT Act 1994) certifying that the intended use of the Development was 96.22% for relevant residential purposes (RRP) and 3.78% for other non-qualifying purposes. In October 2002 the Taxpayer issued a revised certificate to UAG certifying that 97.45% of the Development was intended for use for RRP and 2.55% for other non-qualifying purposes. This revision was due to a small reduction in the proposed commercial areas within the Development.

Between November 2002 and September 2003, UAG constructed the Development and incurred input tax totalling £3.75m. In September 2003, UAG leased the Development to the Taxpayer for a term of 25 years commencing on 1 August 2003 ("the Lease") for an annual rent of £1,550,000. The Development was first used by the Taxpayer on 26 September 2003. In October 2003, following another change in design, the Taxpayer issued another revised zero-rating certificate certifying that 98.73% of the Development was intended for use for a relevant residential purpose. Since then, the Taxpayer had paid to UAG all premiums and rents as they fall due, and the Development had been used by the Taxpayer in accordance with the zero-rating certificates issued by it from time to time.

**WE HOPE YOU FIND THIS NEWS ARTICLE HELPFUL. IF YOU WOULD LIKE TO REGISTER TO RECEIVE
FUTURE UPDATES BY EMAIL THEN PLEASE SEND A REQUEST TO**

info@4eyesltd.co.uk

This VAT update is published for the general information of 4 Eyes Ltd personnel, clients and contacts. It provides only an overview of the rules and regulations in force at the date of publication, and no action should be taken without consulting the detailed legislation or seeking professional advice. Therefore no responsibility for loss occasioned by any person acting or refraining from action as a result of the material contained in this e-mail will be accepted by the authors or the firm.

On 18 June 2004, the Taxpayer acquired the entire share capital of UAG for £24.7m and in July 2004 UAG applied successfully to be deregistered for VAT purposes and included in the Taxpayer's VAT group, effective from 2 August 2004. In ensuing correspondence, HMRC set out their understanding of the supplies made by UAG under the lease and the VAT consequences as regards capital item adjustments under the Regulations. HMRC considered that, by virtue of the VAT grouping, the Taxpayer had become responsible for the CIS scheme in respect of the Development and would be liable for VAT adjustments because, unlike UAG, the Taxpayer was using the Development for exempt purposes. HMRC requested a summary of input tax reclaimed by UAG and also stated that, as a result of UAG joining the Taxpayer's VAT group, the payments of rent made by the Taxpayer were disregarded for VAT purposes.

In April 2005, HMRC indicated that an application by UAG to leave the Taxpayer's VAT group would be considered favourably and that, if UAG had been left outside the Taxpayer's VAT group and use of the Development had remained as before, no capital item adjustment would have been necessary. Consequently, in April 2005, UAG applied to be removed from the Taxpayer's VAT group and in May 2005 applied for the removal to be backdated to 1 August 2004 (as if the original VAT grouping application had never been made). HMRC refused the back-dating, but removed UAG from the VAT group with effect from May 2005. UAG registered for VAT and, following negotiations with HMRC, included a CIS adjustment of c.£248k in its November 2006 VAT return.

The Taxpayer's advisers subsequently made three submissions on its behalf:

1. that the Taxpayer, while UAG was a member of the Taxpayer's VAT group, was not using the Development to make exempt supplies which could not be ignored under the CIS scheme and no adjustment was required;
2. that the CIS adjustment made by UAG was not due and should be refunded to UAG; and
3. that UAG's termination of membership of the Taxpayer's VAT group should have been backdated in accordance with its request.

HMRC rejected all three submissions, resulting in the current appeal.

Held

On the first point, HMRC sought to argue that the effect of VAT grouping was that the business activity of UAG ceased for VAT purposes, and the only business use was by the Taxpayer in making its VAT exempt educational supplies. The Taxpayer argued that the lease from UAG to the Taxpayer remained in place and therefore the use by UAG had not changed, and no CIS

**WE HOPE YOU FIND THIS NEWS ARTICLE HELPFUL. IF YOU WOULD LIKE TO REGISTER TO RECEIVE
FUTURE UPDATES BY EMAIL THEN PLEASE SEND A REQUEST TO**

info@4eyesltd.co.uk

This VAT update is published for the general information of 4 Eyes Ltd personnel, clients and contacts. It provides only an overview of the rules and regulations in force at the date of publication, and no action should be taken without consulting the detailed legislation or seeking professional advice. Therefore no responsibility for loss occasioned by any person acting or refraining from action as a result of the material contained in this e-mail will be accepted by the authors or the firm.

adjustment was due. Furthermore, the Taxpayer continued to use the Development for a RRP and UAG remained the "person constructing", and therefore nothing had changed and no adjustment was due.

The First Tier Tribunal, following the case law (in particular Kingfisher plc [1994] STC 63 and Thorn Materials Supply Ltd [1998] STC 725), considered that the members of a group continue to exist and, whilst the transactions between them may be disregarded for VAT purposes, they do not cease to exist. There was nothing to indicate that the Taxpayer owned the Development: it continued to occupy under the terms of the lease from UAG.

In order for the Development to constitute a capital item in the hands of the Taxpayer, the Taxpayer would have to have acquired the Development in accordance with reg 113 VAT Regulations 1995, and in particular by a supply which was not a zero-rated supply and exceeded a value threshold. The Taxpayer had acquired its interest by means of zero-rated and exempt supplies from UAG (the exempt rental supplies being disregarded for CIS purposes by virtue of reg 116(3) following the initial zero-rated grant), therefore the Development was not a capital item of the Taxpayer.

Consequently, no CIS adjustment was required of either the Taxpayer or UAG and therefore the appeals on the first two points were allowed.

On the third point, concerning the backdating of VAT grouping, the Tribunal considered that the Taxpayer and UAG may have been misled to some extent by advice from HMRC on the implications of VAT grouping for CIS purposes, but could find no error of law in HMRC's refusal to exercise its discretion to back-date, nor could it be said that the refusal was unreasonable. Consequently, this aspect of the appeal was dismissed.

Implications

This case emphasises the importance of carefully considering the full VAT implications when decisions are being taken on matters such as VAT grouping. The interaction between the grouping, CIS and anti-avoidance rules which can apply to both property and VAT grouping can make these decisions very complex. In this case, there appears to have been a significant risk that a major VAT cost could have arisen, even though there was a great deal of correspondence and discussion, before and after the fact, with HMRC.

**WE HOPE YOU FIND THIS NEWS ARTICLE HELPFUL. IF YOU WOULD LIKE TO REGISTER TO RECEIVE
FUTURE UPDATES BY EMAIL THEN PLEASE SEND A REQUEST TO**

info@4eyesltd.co.uk

This VAT update is published for the general information of 4 Eyes Ltd personnel, clients and contacts. It provides only an overview of the rules and regulations in force at the date of publication, and no action should be taken without consulting the detailed legislation or seeking professional advice. Therefore no responsibility for loss occasioned by any person acting or refraining from action as a result of the material contained in this e-mail will be accepted by the authors or the firm.