Three-party transactions: the challenges of input tax

General Features



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In the second article of a two-part series, we consider the challenges of three-party transactions as far as input tax is concerned.

Key Points

What is the issue?

The long-running tribunal case of *Airtours Holidays Transport Ltd* was lost by the taxpayer, with the judge agreeing with HMRC that supplies of accountancy services were made to the bank, even though Airtours had paid the bill. It is all about which party is being supplied with goods and services as far as input tax is concerned.

What does it mean for me?

Only a party that is receiving a supply of goods or services can claim input tax. A business cannot deflect a purchase to another business just by asking the supplier to address the invoice to that business, even if the other business pays the bill.

What can I take away?

It is common for property leases to be in the name of an individual director rather than the VAT registered trading company but HMRC will allow the trading company to claim input tax if certain conditions are met.

When we think about the VAT implications of a three-party deal, we usually reflect on the output tax challenges, and I considered the practical issues of these supplies in my previous article for *Tax Adviser*. See ‘Three-party transactions: a complicated web’ (October 2023).

However, input tax problems can also arise when there are three parties in a transaction, and I have always enjoyed reading tribunal case reports on this subject. Predicting the decisions of the judges is like trying to guess the result of a football match between two finely balanced teams of equal standards, such as when Liverpool play Everton in the Merseyside derby. I will consider some historic cases in this article.

Landmark case: input tax on accountancy fees

Imagine the following scenario: a business has financial problems and its bank is getting fidgety about whether the business will be able to service its borrowings. The bank instructs a firm of accountants and tax advisers to do a major review/overhaul of the business finances and yes – you’ve guessed it – the borrower must pay the professionals for these fees rather than the bank.

In a nutshell, these were the facts of the long-running case of *Airtours Holidays Transport Ltd v HMRC* [2016] UKSC 21, which was finally heard in the Court of Appeal after a lengthy saga that ran for more episodes than a soap opera storyline. Needless to say, Airtours claimed input tax on the professional fees in the above scenario, which HMRC disallowed because the supply of services, the officer

claimed, was between the professionals (PwC) and the bank and not Airtours. HMRC won the case.

Lesson one: Just because a business pays the bill for goods or services, this does not give it an automatic right to claim input tax, even if the invoice is also made out to the business making the payment.

For a practical example of a three-party challenge, see ***Input tax and connected parties***.

Input and connected parties

ABC Legal Ltd only has taxable income and is registered for VAT, whereas ABC Financial Services is an associated business and only has exempt income, so is not registered. The directors have arranged for all accountancy fees and telephone bills of ABC Financial Services to be invoiced to ABC Legal Ltd so that it can claim input tax.

This is incorrect; the supply of services is from the accountants and telephone supplier to ABC Financial Services. This cannot be changed by asking for invoices to be addressed to ABC Legal Ltd, even if that business pays the bill.

Note: See the commentary about the Ashtons Legal case, which involved rental invoices issued to a connected business by the landlord. This case was won by the taxpayer.

HMRC guidance

The Airtours dispute basically came down to the important question that we must consider in the world of VAT: ‘Who is supplying what and to whom?’ We know that PwC was the ‘who’ and its professional accountancy services was the ‘what’. The key word in the case was ‘whom’.

The HMRC VAT Input Tax manual gives extensive practical guidance and reflects the impact of historic case law at both UK and EU level. The question of considering who is the ‘recipient of supply’ for input tax purposes is helpfully analysed by policy note VIT13300 in the manual. I have extracted five important points. See ***HMRC VAT Input Tax manual: who is receiving a supply?***

HMRC VAT Input Tax Manual: who is receiving a supply?

1. Only the person to whom a supply is made, for use in the furtherance of their taxable business, can make a valid input tax claim.
2. The above outcome overrides the question of who may have paid for the supply and also about which business holds the purchase invoice that is relevant to the supply.
3. It is therefore possible for a business to pay a supplier and receive a tax invoice addressed to it but still not be able to claim input tax.
4. The issues are more straightforward for goods because ownership is a requirement of claiming input tax – and ownership is a legal issue. However, the guidance highlights the fact that import VAT has been incorrectly claimed by third parties and agents in some cases (see Revenue and Customs Brief 2 (2019) issued in April 2019).
5. Agents can be given power to act on behalf of their client to enter into contracts with third parties, receiving and issuing invoices in their own name for imported goods. The agents can claim input tax but must treat the transactions as an onward supply by themselves to the customer and charge output tax (Value Added Tax Act 1994 s 47).

Case law: landlord and tenant

Common sense prevailed in the case of *Ashtons Legal (A Partnership)* [2022] UKFTT 422), about whether a partnership could claim input tax on rental invoices issued to a separate limited company.

Ashtons is a partnership which trades as solicitors and legal advisers. Due to a problem with the Law of Property Act 1925, it could not enter into a lease agreement with the landlord for its trading premises because it had more than four partners.

The lease was therefore agreed with a dormant associated company Ashtons Legal Ltd, with the following outcome:

- The partnership would still pay all rent to the landlord.
- The premises were wholly used for the taxable business supplies of the partnership.
- The rental invoices were addressed to the limited company in accordance with the lease but sent directly to an employee of the partnership.

HMRC said that the partnership could not claim input tax on the rental invoices because the supply of land services was from the landlord to the company. The onward supply from the company to the firm would then be exempt from VAT because the company had not opted to tax the building or registered for VAT.

The taxpayer's view was that the commercial reality was that there was only one lease between the landlord and the partnership. The company's involvement was irrelevant and only necessary because of restrictions imposed by the 1925 Act.

The judge focused on the *Airtours* case that I considered above. She concluded that it supported the taxpayer's view that the 'commercial and economic reality' of the deal was that the partnership had received the supply of rent and could therefore claim input tax. She noted that the company was a 'mere cipher' and had been inserted into the lease because of the issues created by the 1925 Act. The appeal was allowed.

Lesson two: The commercial reality of an arrangement is important for input tax purposes.

Lease in director's name

HMRC's guidance in its policy note VAT Income Tax VIT13440 deals with the situation when a lease is recorded in the name of an individual director rather than a

partnership or company – allowing input tax to be claimed by the partnership or company if certain conditions are met.

The guidance accepts that a relaxed approach to claiming input tax is necessary – as the motive of these arrangements is because ‘it is easier for the landlord to take effective debt recovery action if the rent is not paid.’ I always enjoy reading HMRC guidance that recognises a business-world challenge that needs a common-sense approach.

There are three conditions that must be met:

- The individual director is not registered for VAT in their own name.
- The director must pass on the rental invoices to the trading business, so they can be processed and paid to the landlord.
- The whole of the premises is used by the business for the purposes of its business activities; i.e. not by the director.

Final case law

The key issue in the case of *Mpala Mufwankolo* [2021] UKFTT 388 was whether a publican could claim input tax on rent for his licensed premises. He traded as The Pride of Tottenham and the landlord had opted to tax his interest in the property.

HMRC identified three problems with the taxpayer’s input tax claims:

- the lease for the premises was in his wife’s name, or possibly a partnership between the two of them;
- no VAT invoices were available to support the claim; and
- there was no evidence that the business had made any payments for the rent.

The judge noted that the input tax evidence was ‘defective’. There were no VAT invoices for rent addressed to the appellant or evidence of any partnership agreement between him and his wife. There was also no evidence of rent being paid in the business bank statements. The landlord’s rent demands were addressed to the taxpayer’s wife.

Lesson three: A business must justify its input tax claims rather than treat them as an automatic right. A successful input tax claim has to overcome more hurdles than the winning horse in the Grand National at Aintree racecourse.

The taxpayer failed to persuade the tribunal that he could claim input tax and the appeal was dismissed.

Conclusion

There’s an old saying which is very useful for all tax advisers: ‘If something sounds too good to be true, it usually is.’

If any of your clients proudly pronounce that they have achieved the utopian outcome of claiming input tax on a supply of goods or services without accounting for output tax as part of an onward supply – other than on general overheads, of course – they might have a major problem lurking in the shark infested waters of the nation’s favourite tax.

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