

# FL MEMO

EXTRACTS

VAT

2011-2012



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## CHAPTER 1

**Basic principles**

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This section aims to give a **broad overview** of the main principles behind the operation of the VAT regime. It provides an outline of the rationale and workings of the VAT system together with the compliance and reporting requirements.

Full details are contained in the respective relevant parts of *VAT Memo*.

**A. What is VAT?****15**

EC Directive  
2006/112

VAT is a tax on **the supply of goods and services and imports** which is charged at each stage in a supply chain as goods or services flow from one trader to another. It is not a tax on profits.

Its principle is based on a system which allows every taxable person (¶30) in the supply chain to **recover** the VAT he incurs on costs. In this way it is the end consumer who ultimately bears the tax burden.

VAT is charged on:

- the supply of goods and services in the UK;
- the acquisition of goods and services in the UK from another EU country; and
- the importation of goods and services from outside the EU.

**Scope****20**

The current VAT system forms the basis of the measurement of the contributions by each member state towards the European Union's (EU's) budget. It is designed to establish a **common basis of indirect taxation** and it also provides the means of harmonising the fiscal treatment of transactions within the EU. Its principles are contained in a Directive issued by the EU (¶9997). Many, but not all, of the provisions of this Directive are binding on member states. This means that national law in the EU member states must give **direct effect** to the provisions in the Directive, although member states have a choice as to the methods they use to achieve that effect. VAT has now spread throughout the EU, with all new members being obliged to introduce it when they join. In addition, many other non-EU countries have introduced VAT in some form or another.

## B. How does VAT operate?

VAT is a transaction-based tax, and the charge is levied on all UK supplies of goods and services that are:

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- made by a **taxable person** in the course or furtherance of a **business** (¶240) in return for consideration; and
- not exempted from (¶350), or specifically outside the scope of (¶115), VAT.

**MEMO POINTS** 1. In general the **UK** includes:

- England, Scotland, Wales, Northern Ireland and the Isle of Man, but not the Channel Islands or Gibraltar; and
- the territorial waters surrounding them.

In certain circumstances, the Isle of Man is excluded from the definition.

2. Special rules apply to treat certain **cross-border transactions** as being made in the UK. (See ¶9000 onwards.)

### Taxable person

Broadly, under UK legislation a taxable person is an individual, firm, company or trading entity who is either **registered** for VAT, or required to be so.

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In the UK a person is required to be registered if he makes taxable supplies above certain value limits. Traders that make supplies below these limits can choose to be registered voluntarily.

See ¶2600 onwards for details.

**MEMO POINTS** 1. Any person who makes **wholly exempt supplies** is unable to register for VAT. There is an extensive list of exempt supplies, contained in statute, including health and welfare services, education, etc. See ¶352 for the full list.

2. **Person** takes its legal meaning and therefore includes individuals, partnerships, companies and charities.

3. The EU uses a wider definition of a taxable person, i.e. a person who independently carries out any **economic activity**, irrespective of the purpose or results of that activity.

### Place of supply

For a supply of goods or services to fall within the scope of UK VAT it must be made in the UK. It is therefore necessary to determine the place of supply. The rules differ depending upon whether the supply is one of goods or services (¶275). Particular rules apply for cross-border transactions to determine whether they are within the scope of VAT (¶9002). To be treated as supplied in the UK goods must be either:

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- located and supplied in the UK (¶277); or
- installed or assembled in the UK (¶9154).

Goods that are installed or assembled by, or on behalf of, the supplier are supplied where the installation or assembly takes place. This may result in a UK trader being required to register overseas, or an overseas trader being required to register in the UK. See ¶9154 for more details.

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**MEMO POINTS** 1. If the contract between the parties is for two supplies (one for the supply of goods, the other for installation), they will usually be treated as a single composite supply (¶310).

2. If the installation or assembly is subcontracted to a third party, the place of supply for the manufacturer remains the place of installation or assembly.

## CHAPTER 3

## Penalties

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There are two types of penalty for failing to comply with VAT legislation:

- a. civil penalties, which are used to enforce most aspects of VAT compliance; and
- b. criminal penalties. Criminal proceedings are normally only taken in serious fraud cases.

Normally, criminal and civil penalties cannot both apply for the same offence. The only exception to this rule is that the default surcharge (¶4082) can be charged in addition to a criminal penalty.

**MEMO POINTS** From 1 April 2010, HMRC have power to **publish the names** of both corporate and individual taxpayers who:

- are penalised for deliberately understating tax due, overstating claims or losses of more than \$25,000; or
- deliberately fail to notify HMRC when required to do so, leading to a loss of tax of more than \$25,000; or
- are penalised for deliberately committing certain VAT offences leading to a loss of tax of more than \$25,000.

Names will **not be published** of those who make a full unprompted disclosure or a full prompted disclosure within the required time. Details will be published quarterly within one year of the penalty becoming final and will remain on HMRC's website for 12 months.

## SECTION 1

### Civil penalties

#### I. Penalties common to most or all taxes

##### What has changed?

On 1 April 2009, the system of penalties for dishonest evasion (including evasion by officers of companies), misdeclaration and negligence was **replaced by** a new system of penalties for errors covering all taxes.

From 1 April 2010, the new regime also applies to a number of other specific failures to comply with the legislation, and the penalty for deliberate inaccuracy is extended to cover acts by third parties.

From a date to be announced, the default surcharge (¶4082) will be replaced by a new system of penalties for the late submission of VAT returns and late payment of VAT.

Offences relating to import VAT are penalised as though they related to Customs duty, and are not subject to this regime: see ¶4104.

**MEMO POINTS** The previous penalty regime is **retained for** any act of dishonest evasion which does not involve inaccuracies in a document or form or a failure to notify HMRC of an under-assessment by them. This is expected to be of very limited application. For details, see VAT Memo 2010-11.

3955

Sch 24 FA 2007;  
Sch 41 FA 2008

SI 2008/568

##### Types of penalty

There are three types of penalty which can be charged under the new regime:

- an **inaccuracy penalty** (¶4000) for submitting an inaccurate return or other document, or failing to notify HMRC that a VAT assessment is insufficient;
- a **penalty for failure to notify** (¶4010) HMRC of the trader's position in specified circumstances; and
- a penalty in relation to **VAT wrongdoing** (¶4020) in specified circumstances.

The three types share a set of general principles.

3956

## CHAPTER 2

# Flat rate scheme and annual accounting scheme

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**4630** This chapter deals with the flat rate scheme and the annual accounting scheme, and their interaction when both are used at the same time.

## SECTION 1

## Flat rate scheme

### A. General principles

**4635** The flat rate scheme is the only simplification scheme which can reduce (or increase) the amount of VAT payable to HMRC by a trader. It is **only available** to small businesses.

**MEMO POINTS** A separate **agricultural flat rate scheme** is also available (95970).

## Purpose of the scheme

The flat rate scheme simplifies VAT accounting for small businesses, and may also reduce VAT liabilities. The **VAT payable** to HMRC is based on a percentage of turnover.

The scheme **avoids the need to:**

- calculate or record output and input tax, except for a few items not covered by the scheme;
- consider complicated rules regarding input tax deductibility for certain items; or
- carry out partial exemption calculations.

The scheme is **not suitable** for traders who regularly receive VAT repayments, and would **probably not benefit** businesses which:

- make more zero-rated or exempt supplies, or supplies to other EU states, than the average for that trade sector;
- incur more input tax on purchases and expenses than the average for that trade sector; or
- sell a lot of second-hand goods.

**MEMO POINTS** A trader within the scheme will charge his customer the normal VAT rate for the supply. It is amount of the VAT payable to HMRC which is calculated using the flat rate scheme percentage.

## Measuring the benefit of the scheme

The **flat rate percentage** depends on the trade sector to which the business belongs. The rate for each sector is designed to produce a VAT liability similar to that which would result under normal VAT accounting, taking into account average input tax claims. If a higher liability would arise under the scheme, a business might nevertheless use the scheme for the time and cost savings.

A **ready reckoner** which compares VAT liabilities using the flat rate scheme and normal VAT accounting is available from the HMRC website (<http://vatreadyreckoner.hmrc.gov.uk>).

**EXAMPLE** A Ltd sells a mixture of standard-rated and zero-rated goods, and the flat rate for its trade sector is 7.5%. Its latest annual results were as follows:

	VAT £	Total £
Sales	13,500	100,000
Purchases and expenses	6,500	70,000

There were no sales or purchase of items outside the flat rate scheme

The VAT liability for the year, using normal VAT accounting, is £7,000. (13,500 – 6,500)

If A Ltd used the flat rate scheme, the VAT liability would be £7,500. (100,000 × 7.5%)

A Ltd must decide whether the simplified accounting arrangements justify the higher VAT liability.

## Eligibility

A VAT registered person can use the scheme if, on reasonable grounds, he expects that his **taxable supplies** in the next 12 months will not exceed the scheme limit (£14605). Taxable supplies include standard-, reduced- and zero-rated supplies but disposals of capital assets and the value of services received under the reverse charge rules are excluded.

**MEMO POINTS** Flat rate traders should review annual turnover on each anniversary of joining the scheme, to ensure that they can remain within it.

**EXAMPLE** Mr B's expected income for the next 12 months is as follows:

	£
Standard-rated normal sales, excluding VAT	140,000
Sale of a capital asset, excluding VAT	20,000
Exempt supplies	30,000

Mr B is eligible to join the flat rate scheme, as taxable supplies are £140,000, below the scheme threshold. The exempt supplies are not included.

**4637**  
s 26B VATA 1994;  
SI 1996/2518  
regs 55A – 55V;  
Notice 733

**4639**

**4640**  
VAT FRS 7300

**4644**  
SI 1996/2518  
reg 55L  
Notice 733 para 3.1  
SI 2009/586

## Estimating turnover

**4646**

Notice 733 para 3.3

Estimates must have a reasonable **basis**, such as accounts or VAT returns for previous periods. A person who has been VAT registered for less than 12 months may use the estimate given in the VAT registration application. Other acceptable methods include estimates based on business plans, or business information from a previous owner.

Notice 733 para 3.4

**MEMO POINTS**

HMRC have stated that they will not penalise anyone for **incorrectly estimating** that taxable supplies would not exceed £150,000 if there was a **reasonable basis** for the estimate, and that they will normally allow a business to remain in the scheme, if it has not otherwise become ineligible. If, however, HMRC consider that there was **no reasonable basis** for an estimate, they may immediately exclude a business from the scheme. Records supporting an estimate should therefore be kept in case of any enquiry.

## Exclusions

**4648**

SI 1995/2518  
regs 55A(2), 55B(3),  
55L

VAT FRS 6100

The following table summarises the circumstances in which a person will not be eligible to use the scheme:

Reason for exclusion	Details	¶¶
Business circumstances	Using the margin scheme or auctioneers' scheme	¶6625, ¶6750
	Intending to use the capital goods scheme	¶2280
	Eligible for a VAT group registration within the last 24 months	¶8800
	Part of a VAT divisional registration within the last 24 months	¶2744
	Associated with another person within the last 24 months	¶4650
	Tour operators	¶7490
Offences in relation to VAT	Convicted of any offence in connection with VAT in the previous 12 months	
	Made a payment to settle proceedings in relation to a VAT offence in the previous 12 months	
	Been assessed to a penalty for dishonestly evading VAT in the previous 12 months	
Protection of tax revenues	HMRC believe that tax revenues are at risk	
Previous use of scheme	Ceased to use the scheme in the previous 12 months	

**4650**

VAT FRS 6200

A person is regarded as **associated with another person** for these purposes if:

- one is under the dominant influence of the other (for example where one business has the right to give directions to another business, or where a business generally complies with the instructions of another business); or
- they are closely bound by financial, economic and organisational links.

Persons **are not associated** by reason only of normal business relationships.

**EXAMPLE**

1. A business is not associated with its customers simply because it supplies goods in the form that they request them.
2. If a husband and wife are, for example, separately VAT registered as an architect and an antiques dealer respectively, and he rents the upper floor of her shop at a market rate to use as his office, they will not be associated.

## B. Joining the scheme

### Application

A business can apply to join the flat rate scheme **using form** VAT 600 FRS, or form VAT 600 AA/FRS if the business is also applying to join the annual accounting scheme (¶4745).

The application **must specify** the:

- main business activity; and
- flat rate percentage for the trade sector to which the business belongs (¶4666).

The application **may specify** a chosen start date, which can be the VAT registration date.

If an application is accepted, HMRC will notify the business.

If HMRC **refuse an application**, the business can ask them to reconsider, and can appeal against a decision to a tribunal (¶4260).

**MEMO POINTS** 1. **Postal applications** should be sent to the following address:

National Registration Service  
HM Revenue & Customs  
Imperial House  
77 Victoria Street  
Grimsby  
Lincolnshire  
DN31 1DB

2. **Electronic applications** should be emailed to: frsapplications@hmrc.gov.uk.

### Scheme start date

A business will **normally** start to use the scheme at the beginning of an annual accounting period, or the next VAT return period after HMRC process the application to join the scheme, **unless** some other date was specified in the application. If the start date is not the beginning of a VAT period, two separate calculations for that period will be required, as in ¶4722.

To encourage take-up of the scheme, HMRC **may allow a retrospective** start date if a person:

- registers for VAT late; or
- finds at the end of a year that his VAT liability would have been lower if he had used the scheme.

For further details if also joining the annual accounting scheme, see ¶4827.

**MEMO POINTS** The VAT tribunal has considered the issue of what constitutes **exceptional circumstances** for permission to join the flat rate scheme with retrospective effect. The trader was refused permission to join the FRS retrospectively, but argued that he should have been permitted to do so as he would have saved VAT. In addition, he had not been informed about the scheme in person, despite visits by an HMRC officer.

The tribunal held that although the trader had been made aware of the scheme by way of published leaflets, **HMRC had acted unreasonably** in not permitting the trader to join the FRS retrospectively, as he had not previously been informed about it in person. *David Eric Burke* [2008] (VTD 20881)

**4654**

Notice 733  
paras 5.2 – 5.6

Notice 733  
para 16.1

**4656**

SI 1995/2518  
reg 55B  
VAT FRS 3100

Customs Manual  
VI-23 chapter 6  
para 3.3  
VAT FRS 3200

## CHAPTER 8

**Agents**

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**7090**

A person's liability to VAT cannot be avoided by using an agent. As an agent potentially only accounts for VAT on his commission, the wrong classification of a person (as an agent or not) can result in errors (and therefore, potentially, penalties).

Some common examples are as follows:

- certain businesses, such as hairdressers and driving schools, arrange for their employees to become sole traders, who then trade directly with the customer and remain below the VAT registration threshold – this reduces the amount liable to VAT;
- employment agencies may want to charge VAT on their commission only, so that their exempt or partly exempt clients suffer less irrecoverable input tax; or
- an agent who deals with zero-rated goods (such as farm produce) may wish to structure his business so that his commission can also be zero-rated.

The term “intermediary” is often used in a VAT context but it is not synonymous with “agent”.

## SECTION 1

## The agent/principal relationship

An agent is someone who acts for another person (known as the principal) in arranging supplies of goods or services with the mutual consent of both parties. The supplies that the agent arranges are made by – or to – the principal. An agent can therefore be a buying agent or a selling agent.

The use of particular **terminology**, such as “agent” or “commission”, does not dictate whether an agency relationship exists. It is the conduct of the parties which is of greater significance. There are many instances when someone is casually called an agent, particularly as a job title (e.g. advertising agent), but is not an agent in law. Conversely, a person may sometimes act as an agent when normally he is a principal (e.g. a solicitor or taxi driver).

### Definition

The agent/principal relationship has been defined as the relationship which exists between two persons, one of whom consents that the other should represent him or act on his behalf, and the other who agrees to represent the former or act on his behalf. *C & E v Johnson* [1980]

It is **imperative** that the agent:

- is genuinely arranging transactions on behalf of the principal;
- never acquires title to goods or services which are bought or sold for the principal; and
- does not alter the supplies between the principal and third party in any way.

An agent will have a fiduciary **duty** to account to the principal for any monies derived from the transactions undertaken on his behalf.

### HMRC's policy

The **burden of proof** in relation to status as an agent falls on the trader.

HMRC state that they look at the following **factors** when deciding whether an agency relationship exists, although the absence of one or more does not necessarily mean that a person is not an agent. The weight given to each factor will depend on the exact circumstances of the case.

Factor	Detail
Title	Title should remain with the principal
Identity	Goods or services dealt with by the agent should be clearly defined
Value	The principal must have full knowledge of the price obtained, and any discounts must be passed back to him
Separation	The agent's supply (commission) must be separately identifiable from the main supply, and the calculation of the commission can be stated either as an absolute amount, or as a percentage, but in all cases it must be clear
Direction	The direction of the supply between buyer and seller cannot be altered by the existence of the agent
Nature	The nature of the main supply and its value cannot be altered by the agent, although the agent may have authority to negotiate a price on the principal's behalf

HMRC assess these factors in light of the following **evidence**:

- a. any agreement, correspondence, and other commercial documentation;
- b. the practical business arrangements put in place between the parties; and
- c. the conduct of the parties, and in particular whether this has been consistent with an agency relationship.

7095

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**7100**  
Customs Manual  
V1-5 chapter 2  
para 2.8

7102

It is important to realise that although the contractual position does not necessarily establish the VAT position, it has been of increasing relevance in recent cases. *Spearmint Rhino Ventures (UK) Ltd v HMRC* [2007]; *Newcastle United plc v HMRC* [2007] (¶1958)

**EXAMPLE**

1. A company provided catering services to a number of care homes run by a charity, for which it received a management fee. The company also kept any discounts obtained on the bulk purchase of food. However, the company only accounted for VAT on the management fee and not the discounts.

Because the charity felt that the company was making too much profit, the actual income received by the company was varied as follows:

April 1990 to April 1991	Management fee and discounts
April 1991 to April 1992	Discounts
April 1992 to April 1993	Fixed management fee

The company argued that it was acting as both an agent (running the bars, canteens, etc) and a principal (when sourcing its supplies and obtaining the discounts).

It was held that this division of activity was artificial. The company was also an agent of the charity when making the bulk purchases, so that the discounts were part of the consideration received in return for the provision of catering services. *PBK Catering* [1993] (VTD 11426)

2. In prior years, a company had employed nurses who were supplied to hospitals on a temporary basis. However, the agreement between the nurses and company was then altered so that it expressly stated that the nurses were self-employed (and this treatment was followed for income tax purposes).

Under the amended agreement, the nurses:

- were required to buy their own uniforms and to pay insurance premiums;
- could be changed or withdrawn if the work was unsatisfactory;
- wore badges bearing the company's name when on duty;
- were paid mileage allowances for using their own car; and
- had to give reasonable notice if wanting to take time off.

The nurses were paid for all work done, and did not bear any financial risk.

The tribunal held that the company was still acting as a principal and not an agent, and the nurses remained employees of the company. Hence the company was making exempt supplies of nursing services. *Allied Medicare Nursing Services Ltd* [1984] (VTD 5485)

3. In a similar case, another company provided self-employed temporary nurses to hospitals. Under the terms of the contract between the company and nurses, the company controlled the nurses' activities, and there was no specific mention that the company was acting as their agent. The nurses completed timesheets and were paid by the hour. The company made PAYE deductions. The nurses were always paid for work they performed, even where the client did not pay the company, as this was stipulated by a code of practice.

HMRC decided that the company was supplying exempt nursing services to the hospitals. The company appealed on the basis that it was a recruiting agency and it was the nurses who supplied the exempt nursing services.

It was held that the company was supplying suitable nurses rather than nursing services as a question of fact, and so it was not making exempt supplies. On upholding the decisions, the High Court stated that the tribunal had relied on the terms of the contracts but had also taken an overall view of the facts. *C & E v Reed Personnel Services Ltd* [1995]

## Agreement

**7104**

Notice 700  
para 22.2

The **form** of the agency arrangement may be verbal, written, or even implied by the actions of the two parties. The commercial reality and actual facts of each case will decide whether an agent/principal relationship can be construed, even though the parties themselves may not recognise that such a relationship exists.

**7106**

There are many examples of case law which illustrate the importance of the agreement.

**EXAMPLE**

1. A music shop acquired second-hand musical instruments which it valued and then sold. The vendor was required to sign an agreement appointing the shop as his agent, which also stated that commission would be paid if the shop managed to sell the instrument above the valuation price.

HMRC issued an assessment which charged output tax on the full sale price of the goods, because the vendor did not know what the final price would be or whether commission would be due, and the shop guaranteed the instruments for the new owner (which would normally indicate that the shop had acquired title).

It was held that the terms of the contract agreed between the company and the vendors made it clear that the company was acting as an agent rather than as a principal. *C & Ev Music & Video Exchange Ltd* [1992]

2. A school photographer negotiated the price of his photos with local headmasters, along with each school's cut of the sale proceeds. The photographer only accounted for VAT on the amount he actually received from the schools.

It was held that there was a sale of photographs to the schools and the schools then resold them to the parents. There was no evidence that the photographer had agreed that the schools should act on his behalf. So the photographer was correct to only account for VAT on the net amount he received. *C & Ev PLA Paget* [1989]

3. In 1974 a dormant subsidiary started to make exempt supplies when it took over the insurance department of its parent company, which continued to incur the salary costs of the department's staff. New staff were recruited by interview with the subsidiary's managing director, who was also responsible for firing staff. An offer of employment was made on the subsidiary's letterhead, but the contract of employment was with the parent company.

In January 1980 the staff were formally told that they were now employed by the subsidiary. It was held that until 1980 the employees had entered into contracts with the parent company and there had never been a time when they had agreed to being employed by the subsidiary. The parent company was therefore a principal making a taxable supply of staff to its subsidiary company. *C & E v Tarmac Roadstone Holdings Ltd* [1987]

## SECTION 2

# VAT accounting for agents

The agent will be **involved in** at least two supplies:

- a.** the main supply between the principal and the third party; and
- b.** his own supply of services to the principal, for which he will charge commission or a fee.

It is important to distinguish between these two supplies. Their VAT liability will not always be the same (e.g. the sale of books is zero-rated, but any commission received by an agent in relation to the sale is standard-rated).

When there is an agency relationship, it is important **to determine**:

- who is making the main supply;
- the type of main supply;
- the location of the various parties; and
- the VAT rate which is applicable.

## Agent acting in his own name

Agents are sometimes given the right by the principal to enter into contracts with a third party on the principal's behalf. In such cases, particularly where the principal wishes to remain unnamed, the agent may receive and issue invoices in his own name for the supplies concerned. An agent who acts in this way is usually referred to as an **undisclosed agent** (¶17142+). Often the name on the invoice to the customer is indicative of whether the agent is acting in his own name or that of his principal.

**7115**  
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para.22.3

**7117**