

COVID-19: VAT challenges for retailers

(Lecture B1215 – 15.39 minutes)

Background

There is no doubt that drastic measures will be carried out by many High Street retailers faced with unenviable trading challenges following the coronavirus crisis. Small-scale changes will probably not be enough. This session therefore considers some VAT issues that could be relevant in the future retail world.

Shop-in-shop arrangements

Imagine a clothes shop where the owner has decided to sublet some space to another business, what is known as a shop-in-shop arrangement. This could be quite common in the future, with retailers seeking regular rental income to help with their own fixed costs, including repayments on emergency bank loans taken out during the lockdown period.

There are two VAT challenges with these arrangements:

1. The liability of the rental income;
2. The way that the output tax will be declared on the sales of the second business, the concessionaire.

Is there a land supply?

For the rental income, the key issue is whether the space used by the concessionaire will be a clearly defined area of land in the shop that will be used exclusively for its own purposes. There will be a formal rental agreement in place. If the answer is 'yes', as would seem likely, the rent will be exempt from VAT as a licence to occupy land (HMRC Notice 742, para 2.6). If the space is allocated on an ad-hoc basis, with no fixed area, the supply will be standard rated on the basis that the main retailer is giving the concessionaire the 'right to trade' from the shop.

Partial exemption

The proposed shop-in-shop arrangement means that retailers receiving rent will be partially exempt. They will need to carry out calculations each VAT quarter and restrict their tax. This outcome could be avoided if the retailer opts to tax the building with HMRC and charges VAT on the future rental income received i.e. no exempt income. But is this wise?

Option to tax

A landlord or property owner should only ever opt to tax their interest in a building if there is a big input tax incentive for doing so. In other words, a landlord is buying a commercial property to rent out, and will either be charged a big amount of VAT when he buys the building, or if he carries out major improvement or repair works. This input tax would be blocked in the absence of an option to tax election because the costs will directly relate to exempt rental supplies. In a shop-in-shop situation, there is no major input tax incentive for opting to tax; the retailer's reason for opting would be to avoid the headaches given by partial exemption; that is not usually a strong enough argument.

There are two other possible reasons why retailers should not opt to tax their buildings:

1. 20-year rule - once made, an election with HMRC remains in place for 20 years before it can be revoked, and it applies to all income earned from a building, including the future sale. Future buyers or tenants might be running a VAT exempt business that cannot claim input tax e.g. an insurance broker, dentist or financial adviser;
2. De minimis limits – there is a good chance that many retailers will be de minimis as far as partial exemption is concerned and still be able to claim input tax on all of their costs. VAT Notice 706, section 11.

Shop-in-shop takings

In many cases, the main trading business in a shop-in-shop arrangement will deal with the sales and takings of the concessionaire. This means that the concessionaire does not need a till and cashier on the premises, which might not be practical.

The priority is to be clear whether the concessionaire is making sales of goods to the final customers or whether the commercial reality is that they are selling goods to the main retailer, and the retailer claims input tax and accounts for output tax on the sales. The concessionaire might give the retailer a discount on the selling price as a reward for collecting the cash.

Helpful and well-written guidance on this dilemma is given in HMRC's retailer manual - see HMRC's policy on shop-in-shop arrangements. In reality, officers are unlikely to get too excited about which accounting method is adopted because they are still getting output tax on the sales.

HMRC's policy on shop-in-shop arrangements: Extract from Retailer Manual: VRS8150

After examining various contracts, HMRC now accepts that some agreements are constructed so that the host store is the principal as far as the retail sale is concerned. In such cases, the host store will be accountable for the output tax due on the retail supply to shoppers, and the concessionaire will effectively be making wholesale supplies to the host store. Such supplies cannot be accounted for within the concessionaire's retail scheme.

Online trading to increase

A question that is likely to be very common with many retailers post Covid-19 is as follows:

“I expect my shop turnover to fall by 20% but I intend to replace this business with online sales. What VAT issues does this create? I’m going to use a computer specialist in India to deal with my website.”

The Internet has made the world smaller – it is likely that some goods will be sold to customers outside the UK. Here is a summary of five important VAT issues:

- Advance payments – it is likely that customers will pay for online orders in advance of the goods being delivered – this creates a tax point for VAT purposes;
- Zero-rated sales – retailers will need to ensure that zero-rated sales are properly identified, so that no output tax is paid on these sales e.g. children’s clothes for a clothes retailer, exports outside the EU;
- Returned goods and refunds – retailers must ensure that output tax is reduced for any goods returned by customers where the customer gets a refund. This requires strong accounting controls and clear policies;
- Audit trail – it would make sense for retailers to record a separate daily gross takings (DGT) figure for the online sales, separate to the till used in their trading shops. Retailers do need to issue tax invoices to their customers unless they request one. VAT Notice 700, para 16.2.1;
- Making Tax Digital – retailers might end up with more than one DGT figure for each day’s trading. The two totals must form part of their digital accounting records but there is no need for each individual sale to be part of the record. VAT Notice 700/22, para 4.5.

Reverse charge

Imagine if retailers use the services of an overseas website designer to help with their online sales e.g. an Indian supplier. This outcome means that retailers are buying VATable services from abroad and will need to do a reverse charge calculation on each VAT return. However, this will not produce any extra VAT bill: the output tax declared in Box 1 (based on payments made) will equal the input tax claimed in Box 4 because the expense wholly relates to taxable sales.

Residential dwelling - Example

A ground floor clothes shop owned by Rita consists of a separate first floor area that is used to store stock. Due to modern just-in-time buying policies and increased online sales, the first floor is surplus to requirements and Rita has decided to seek planning permission to convert it into an apartment that she will either sell or rent out. There are potential VAT wins with both options:

Zero-rated sale – if she sells the apartment on either a freehold basis or with a lease exceeding 21 years (20 years in Scotland), the sale will be zero-rated for VAT purposes. This would still be the case even if she opted to tax the building because an option is overridden in the case of residential property. The zero-rating would apply on the basis that it is a residential conversion. VAT Notice 708, section 5. She can therefore claim input tax on all of the project costs because they will relate to an intended taxable sale. The apartment must meet all of the conditions of a dwelling as per para 14.2 of the same notice.

Exempt rental income – if her plan is to rent out the apartment, input tax will be blocked under partial exemption. However, potential good news is that the services of builders converting a non-residential building into a dwelling will be subject to 5% VAT. This reduced rate also applies to materials supplied by builders as part of their work. But the services of professionals are always standard rated, e.g. architects, surveyors, and estate agents.

Payback and clawback rules

A potential pitfall is that if Rita changes her mind about the use of the apartment when completed, the input tax previously claimed or not claimed will be subject to the payback and clawback rules. For example, if she planned to sell the apartment but then encountered a post Covid-19 property downturn, she would need to repay all of the input tax claimed in the previous six years if she decided to rent it out instead. However, if the rental intention is temporary, there is an important input tax concession that was first introduced during the financial crisis back in 2009. The concession looks at a property over a ten-year life, so an intention to rent for, say, two years and then sell means that 20% of the input tax relates to exempt supplies rather than 100%. In many cases, the property owner will be de minimis again for partial exemption purposes, a perfect outcome. See VAT Notice 706, para 13.12.

Conclusion

The session has considered the VAT consequences of some radical measures that might be carried out by retailers in the post COVID-19 trading world. The challenge is to consider the output tax and input tax issues of each separate measure to hopefully arrive at the correct VAT outcome.

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