

Management charges – beware of the VAT issues

(Lecture B1110 – 11.17 minutes)

Introduction

What exactly is a management service or management charge? They are often used as a way of reallocating costs or profits between two separate businesses; for example, a holding company might incur wage costs and professional fees and want to recharge these costs between its trading subsidiaries. It is important to recognise that these charges can have important VAT implications, and I will consider two practical situations in this session.

Holding company situation

Holding Company Ltd owns 60% share capital in Trading Company A. It has no employees or assets, but needs cash to pay dividends to its shareholders. It cannot extract the money from A by getting A to declare a dividend because this will mean payments to the other 40% shareholders, so it uses its right to raise an 'annual management charge' to A for £150,000. It pays corporation tax on the fee and then A gets a deduction against its own profits. So far, so good. However, should the holding company be VAT registered on the basis that it makes annual taxable supplies exceeding £85,000? After all, management services are standard rated when charged to a UK business.

Solution

To add a twist, let us assume that Trading Company A is partially exempt so a £30,000 annual VAT charge on a management fee would create some irrecoverable input tax. This creates the potential problem of both a late registration penalty for Holding Company Ltd (HMRC has the power to correct a late registration up to 20 years) and irrecoverable input tax for A. The challenge is to consider exactly what Holding Company Ltd does in return for its payment of £150,000.

What is a management charge?

A key message with VAT is that the tax always depends on what happens in practice, rather than what an invoice, contract or other document says. In most cases, both will be the same. The key challenge is to therefore ask if Holding Company Ltd is really providing management services to Trading Company A? Is it actually making taxable sales that exceed £85,000 and therefore requires it to be VAT registered? Or is the reality that the annual payment of £150,000 is outside the scope of VAT because there are no supplies of goods or services in the equation? Outside the scope income is ignored as far as the threshold is concerned.

HMRC guidance

The good news is that HMRC 's guidance caters very well for this situation, and the best reference is policy note VATSC55400, within the Supply and Consideration Manual. Don't forget that the internal guidance is directed at HMRC officers dealing with taxpayers, which is different to the public notices that give information to business owners and advisers. See Extract from HMRC guidance VATSC55400.

The policy note gives examples of when it considers that management charges are not being made e.g. no staff are employed by the holding company; common directors exist between the two companies; the holding company has no premises or assets and it is not clear what supplies are covered by the management charge.

Extract from HMRC guidance VATSC55400

“With holding companies, ‘management charges’ may be the only supplies that actually appear to be made. If these relate to supplies actually made, the holding company is entitled to register for VAT and claim input tax. Therefore it is necessary to check that supplies are actually being made in order to confirm the registration is valid.”

HMRC’s policy note is not targeted at providing a happy ending to late registration challenges such as Holding Company Ltd but to prevent holding companies getting a VAT number and reclaiming input tax if they are not making genuine supplies.

Case law – Stirling Investments (TC374)

Here are the facts of an important case lost by HMRC in the First Tier Tribunal:

A married couple carried out an investment business as a partnership and a similar business as a company. Both entities were registered for VAT.

The company sold two properties in 2006 and the profit was transferred to the partnership through a management charge for £525,000 plus VAT. However, the Stirlings overlooked the fact that the company was partially exempt so could not claim input tax on costs relevant to exempt property sales, including this management fee. In effect, the partnership had charged and accounted for output tax on the management fee, which was disallowed as input tax by HMRC against the company.

The company’s adviser successfully argued that the £525,000 payment was not a management charge but was actually a dividend, a way of getting profits out of the company and into the pockets of the Stirlings. There was no management service being provided by the partnership in terms of costs, salaries and other overheads being incurred and recharged. And dividends are outside the scope of VAT.

Trading companies making charges

Bill and Ben each own 50% shares in a profitable property management business (VAT registered) with net assets of £200,000 on the balance sheet.

A separate company does property maintenance work (not VAT registered) with 1/3 share each owned by Bill, Ben and Bob. Annual taxable sales are £75,000 but the company does not make a big profit. In order to increase profits and allow Bob to receive a dividend, a sales invoice for £30,000 was raised to the management company on 31 March 2017 and again on 31 March 2018, described as being for ‘management services’.

The annual taxable sales of the maintenance company therefore exceeded the registration threshold on 31 March 2017, with a registration date of 1 May 2017. What is the solution?

The maintenance company has a VAT problem because annual taxable sales including the management charge exceed the compulsory registration threshold. Its customers are all private householders unable to claim input tax, so a 20% (or 1/6) VAT hit on sales would be a big issue. However, the key fact was the motive behind the fee: it was not reflective of any supplies of goods or services made between the companies and only a way of moving profits for dividend purposes. The management fee did not relate to taxable sales and therefore could be ignored as far as the VAT threshold is concerned.

Conclusion

The key message is that great care is needed when transferring funds between businesses. What do these transfers actually relate to and is there a VAT issue? Forgetting about VAT on any business deal is not recommended!

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