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ACCOUNTANCY, BUSINESS AND TAXATION CONSULTANTS

factsheet

Common VAT pitfalls for connected, unregistered businesses

Currently the turnover threshold for VAT registration is set at £85,000 for the 2018/19 tax year. After this point, all businesses exceeding this level of turnover, or who expect to exceed it, are required to register with HMRC for VAT purposes. Whilst this creates additional administration in the form of quarterly VAT returns, a lot of smaller businesses consider that being VAT registered is advantageous. It provides the ability to reclaim VAT incurred on bought in goods and services, which is a useful financial benefit. But more importantly, it can be good for their brand image too, by conveying the perception that the business is commercially successful.

However, there is an opposite side to this argument. Some business owners do not want to have the hassle of VAT returns, or they may be targeting customers who do not have the ability to reclaim VAT paid and would prefer not to have to pay VAT, especially for services purchased. In these instances, it's tempting to try and avoid having to register for VAT by splitting the business into smaller entities, none of which reach the required turnover threshold. This is known as business disaggregation, or contrived separation, and is considered to be an example of artificial tax avoidance. Some businesses can legitimately argue they are genuinely separate entities for VAT purposes but this can be a complex area to negotiate.

Business disaggregation – 5 common scenarios to be aware of

As a general rule of thumb, these scenarios, if identified by HMRC, will typically lead to further investigation to establish whether the separation is justifiable.

Scenario 1. VAT registered and non-VAT registered customers are supplied by separate business entities, e.g. a cleaning company could have two divisions and supply customers accordingly, depending on whether they are VAT registered businesses or private individuals;

Scenario 2. The same equipment or business premises are shared and used by the different entities on a regular basis. Frequently rental payments may be made between the businesses for use of the facilities or equipment, e.g. a hairdressing salon with a nail bar inside, or a pub with a separate restaurant area;

Scenario 3. Segregating services that would otherwise be provided by a single supplier. For example, a B&B business that also offers specialist excursions for guests, with the accommodation side of the business being separated from the excursions. It may also be a B&B offering evening dining for guests via a separate business entity that is located on the same premises;

Scenario 4. Separated businesses that otherwise appear to be a single business. For example, a pub and restaurant run under an identical brand but with separate accounting practices. Note that HMRC does make a distinction between this type of operation and a franchised "shop within a shop" arrangement – here the different businesses would be operating under different brand identities;

Scenario 5. A business with multiple outlets in different locations, that are under the same ownership and management. For instance, a group of hairdressers with identical branding but run as separate entities in different geographical locations.

Understanding how HMRC defines connections for business purposes

These are some of the most common reasons why HMRC will consider that businesses have been artificially separated:

- They have financial links, e.g. shared financial support, one business not being sustainable without support from the other, owners having common financial interest in profits;
- They have economic links, e.g. they share customers or the activity of one business benefits the other;
- They have organisational links, e.g. the same management or employees, premises or equipment.

A recent tax case involving a barber's shop and ladies' hairdressers (Belcher & Belcher), illustrates how HMRC can target businesses, that it believes are connected, for suspected non-compliance. HMRC argued that these two businesses, each trading without being VAT registered, were actually connected and should be a single VAT registered entity. It wanted to charge the business owners for backdated VAT that it believed was outstanding as a result. Although the businesses shared the same trading name and premises, they were not cross charging for utilities and other services e.g. banking, insurance, purchasing account for consumables. The businesses were partnerships and filed separate tax returns. In this particular case, the owners were able to successfully argue before a tax tribunal that they were independent because they were not closely connected by financial, economic and organisational links. The case does however serve as a useful reminder of the need to be cautious when it comes to the VAT registration of different businesses owned by the same people.

If you are running multiple businesses which have some common links, and one or more of them is not VAT registered, it is important to understand how HMRC views disaggregation. The government is currently very focused on tax anti-avoidance and on targeting businesses that it suspects have created artificial structures to avoid tax.

If you have any concerns over VAT registration we can help.

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