VAT focus

Navigating recovery of VAT on deal fees

Speed read

Recovering VAT on deal fees is a familiar process for many clients, but mistakes still occur, often due to practical oversights. Advisers must stress the importance of practical actions clients will need to take, at the correct point in the deal process, to help maximise successful VAT recovery. Management agreements should have genuine substance, reflect commercial reality, and be regularly actioned with fees charged. All such arrangements need ongoing monitoring to prevent costly errors.

Jonny Squires
Osborne Clarke
Jonny Squires is an Associate Director in Osborne Clarke's tax group. He has a broad advisory and transactional practice with particular experience advising on group structuring, reorganisations, and M&A and private equity backed transactions, often with an international perspective. Email: jonny.squires@osborneclarke.com.

VAT costs on corporate acquisitions can be significant, especially those that involve multiple teams of advisers. Once legal, financial and (the all-important) tax fees are added into the mix, that extra 20% VAT adds up, so VAT recovery is an important consideration. This area is well-trodden but practical oversights can lead to VAT recovery being denied, effectively increasing deal costs.

This article revisits the legal principles underpinning the recovery of VAT on deal fees, focusing on acquisitions by newly incorporated companies (Newcos) or established holding companies and the practical steps that can be put in place to avoid costly errors.

Fundamental principles

BAA Ltd v HMRC [2013] EWCA Civ 112 noted the following fundamental principles that must be met in order for the recipient to recover input VAT on deal fees:

1. The VAT must be incurred by the relevant entity in the course of an economic activity, involving the making of taxable supplies.
2. The VAT must have been incurred on goods or services that have a direct and immediate link to the entity's taxable outputs.

Failure to meet these conditions will likely lead to VAT recovery being denied, so they need to be carefully considered.

When is holding shares an economic activity?

BAA confirms the well understood position, established in the 1991 EU case of *Polysar* (Case C-60/90), that acquiring and holding shares is not to be regarded as an economic activity in its own right.

However, in *Cibo Participations* (Case C-16/00) a holding company that provided a broad range of genuine management services (administrative, financial, commercial or technical services) to its subsidiaries (that attracted VAT) was held to be undertaking economic activity. Similarly, in *Cloud Electronics Holdings Ltd v HMRC* [2012] UKFTT 699 (TC), the First-tier Tribunal allowed a Newco (that was formed for an MBO) to recover VAT on professional fees, provided that it had credible plans and documentation showing it intended to provide management services to the target. In each case it is important that any such supplies are for consideration, as it was held in *MVM* (Case C-28/16) that supplies of management services for no consideration did not amount to economic activity.

Where is the direct and immediate link?

If a shareholding is acquired by a holding company as a direct, continuous and necessary extension of a taxable economic activity of the holding company, the VAT incurred on acquisition of that shareholding may also have a direct and immediate link to taxable supplies and be recoverable (see HMRC's *VAT Input Tax Manual* at VIT40600). This will be most applicable on an acquisition by a trade purchaser where, for example, an existing business is acquiring a competitor to expand market share, or buying a company that holds an asset that it can use for its wider taxable supplies. Although as set out in this article, a management service agreement (MSA) is generally required to enable recovery of deal fees on a corporate acquisition, in this case, it won't necessarily be required if the holding company can show there is a clear link between the acquisition costs it incurred and its onward supply.

This is in contrast to where the buyer is a Newco and therefore has no existing business, in which case an MSA is commonly entered into to help evidence economic activity and a link to the supply of taxable services. This builds on the principles established in *Cibo*, and the joined cases of *Larentia + Minerva & others* (Cases C-108/14 and C-109/14), that if a holding company provides, or intends to provide, management services to its subsidiaries, then the cost of acquiring the shares in those subsidiaries may have a direct and immediate link with the holding company's general economic activity and form part of its general overheads and is deductible (subject to any partial exemption restriction in place); this is reflected in HMRC's guidance (see VIT40600).

Practical considerations

Understanding how VAT has been factored into a transaction helps frame the correct advice and recommendations. Given HMRC's scrutiny of VAT repayment claims (particularly those that are made in a first VAT return), and the complex and fact specific nature of this area, care should be taken of the extent to which VAT recovery is assumed in transaction modelling.

There are also a number of other practical steps that may assist with recovery and mitigate the risk of challenge.

Discuss VAT with deal teams at the outset

This ensures that the potential complexities, such as establishing an entitlement to recover input VAT, are adequately addressed at an early stage. Risks can be mitigated by flagging common pitfalls, such as invoicing before completion and/or before engagement letters have been entered into by, or novated to, the acquiring entity.

An understanding of the wider structure at an early stage can present opportunities. For example, if the acquiring entity/recipient of services is offshore, and the supplies will be outside the scope of UK VAT, UK VAT recovery considerations will fall away for most transactions (although the reverse charge position in the recipient jurisdiction may need to be considered).

Document intentions

If a Newco is incorporated, it is important that transaction documents (for example, board minutes, pitch documents and business plans) evidence Newco's intention to provide chargeable management services to the target, and that these documents predate or coincide with when actual costs are invoiced and, ideally, before they are incurred.

BAA highlights the importance of documenting intention in advance, as in that case the acquiring entity was denied input VAT recovery because it could not demonstrate that it had any intention other than to acquire shares, which the court described as being fatal to BAA's case. Evidence of intention is also important should a transaction abort, as input VAT may still be recovered if, at the time of incurring the expenses, the entity genuinely intended to supply taxable services (see *Ryanair* (C-249/17)).

As a key document that proves intention, the MSA should ideally be effective from completion. The MSA should accurately describe genuine services that will actually be supplied to the target, and provide for an arm's-length fee to be charged (often on a cost-plus basis). The fee should not be contingent on the underlying performance of the target or have any other conditionality attached that is non-commercial, and might attract scrutiny as to whether the MSA truly represents economic activity.

It is critical that the acquiring company actually follows through and provides the services reflected in the MSA, and retains evidence of doing so on a regular basis

Review contracts and invoices

Properly addressed contracts and invoices help support the acquiring company's economic activity.

Engagement letters should be reviewed to ensure that they name the acquiring company, and evidence the relevant advice that relates to the onward taxable services to be provided. If a Newco has not been incorporated at the time of engagement, the terms of the engagement letter should allow for it to be novated to Newco before fees are invoiced (HMRC accept that a holding company can be regarded as a recipient of a supply via a novated contract; see VIT40600).

Invoices should be checked to ensure they address the acquiring company. Payment should be settled by the acquiring company, and any final deliverables (for example, due diligence reports or tax papers) should be addressed to the same entity.

Timing is key

VAT registrations are typically applied for with an effective date of completion, particularly if establishing a group registration with the target; applications should be made no later than 30 days from completion (VAT Notice 700/2, para 2.22).

VAT incurred on services by another person in the six months prior to incorporation and the effective date of the VAT registration may be recoverable but the scope is limited. The services must have been for Newco's benefit or in connection with its incorporation, and supplied to a non-taxable person who became an officer or employee of the Newco and was reimbursed for the costs they incurred (SI 1995/2518, reg 111(1)(b)).

Incorporated entities that incur VAT on services prior to VAT registration may also be eligible to recover the VAT provided it is incurred in the same six-month window prior to registration and the services were used, or to be used, to make taxable supplies. Advisors therefore need to be clear on what services are going to be provided, and the invoicing terms that have been agreed, as this will determine when to VAT register Newco, and the effective date that is applied for so as not to fall foul of the pre-registration six-month window. In practice, this is often less of a consideration as it is common for invoices to be raised on or shortly after completion.

Consider VAT grouping

VAT grouping the acquiring company with the target can simplify administration and potentially improve VAT recovery if the target is fully taxable (for example, if the acquiring company is making loans to the target which are to fund taxable activities). However, *Commission v Ireland* (C-85/11) makes clear that VAT grouping is not a substitute for demonstrating that the acquiring company carries out genuine economic activity in its own right, and so the acquiring company that incurred the input VAT must still provide genuine management services for consideration.

If VAT grouping is pursued, timings need to be factored in given the significant length of time that HMRC are taking to process applications.

Balance the Boards

The Boards of the respective parties under the MSA should be reviewed on an ongoing basis to ensure there is sufficient expertise in the acquiring company to deliver services under the MSA. Care should also be taken if an individual sits on the boards of both the service provider and recipient, as that could give rise to questions from HMRC as to whether genuine services are being rendered (see *VAT Supply and Consideration Manual* at VATSC06513). Identical boards should be avoided.

Post-deal actions

It is critical that the acquiring company actually follows through and provides the services reflected in the MSA, and retains evidence of doing so on a regular basis. The acquiring company must understand that the MSA holds little value if there is no demonstrable substance behind it. Invoices should be regularly raised, and the level of fee should be monitored to ensure it remains arm's-length.

All essential documents should be preserved, including: engagement letters, board minutes, transaction deliverables, service agreements and cost allocations.

Consideration should also be given to the impact on VAT recovery and the MSA if the relevant entities change (for example, as part of a corporate reorganisation).

Conclusion

Maximising recovery of VAT on deal fees requires careful practical structuring around the specific facts. The MSA is a core part of this, but all transaction documentation must align. It is fundamental that after completion the directors of the acquiring company put the planning into practice by ensuring there is real substance behind the legal documentation; advisers play an important role in helping them understand that. ■