HMRC - VATSC80500 - How Do We Define ‘Artificial’?

Whether a situation is artificial is the primary thought to keep in mind when making a decision. There is no single definition of what HMRC considers to be artificial as this conclusion will always depend on the circumstances of each transaction, but in general terms we judge an arrangement to be artificial if the contractual arrangements are inconsistent with the economic reality of the transactions. This is also considered in the test for abuse where the essential aim of the arrangement is to obtain a tax advantage contrary to the purpose of the legislation.

The abuse principle was considered in Halifax and others (C-255/02) and applied subsequently to a supply splitting situation in Part Service (C-425/06). From principles established in the Halifax case an abuse occurs if the arrangements, whilst fulfilling the formal requirements of the legislation, produce a tax advantage that is contrary to the purpose of the Directive and the national provisions implementing it, and the essential aim of those arrangements apparent from a number of objective factors was to acquire that tax advantage. A finding of abuse requires the arrangements to be redefined so as to deny the tax advantage sought.

There are a number of other possible reasons why artificial arrangements might fail to achieve the tax advantages sought such as contracts being poorly implemented, not representing economic reality or being a sham arrangement.

The Counter-Avoidance guidance gives a list of signposts which can be used when considering whether an arrangement is artificial, these include

Transactions or arrangements which have little or no economic substance or which have tax consequences not commensurate with the change in a taxpayer’s (or group of related taxpayers’) economic position.

Transactions or arrangements exhibiting little or no business, commercial or non-tax driver

Transactions or arrangements involving contrived, artificial, transitory, pre-ordained or commercially unnecessary steps or transactions

Specifically in relation to single or multiple supplies, an artificial arrangement will exist where there is either supply splitting or supply bundling:

Supply splitting takes place where different elements of what appears to be a single supply are split into multiple supplies. This often occurs where the overall tax liability is reduced by splitting out a zero-rated element from a standard-rated supply. This may also lead to value shifting to the supply with the lower liability

Supply bundling takes place where different elements which would normally be supplied separately from each other are alleged to be a single supply. An example is reducing the overall tax liability by alleging a separate standard-rated element is ancillary to a single zero-rated supply

These options are useful to the supplier in situations such as where the separate liabilities include at least one that is below the standard rate or if different elements would have a different place of supply. Whilst a business is entitled to organise its affairs in a tax-efficient manner, an arrangement could be considered artificial if, for example, a business changes its structure from one entity to two entities in order to contend multiple supplies are made with the standard and zero rated supplies being made by separate entities. The artificiality of this could be where the end supply to the customer is effectively the same as under the previous structure with the only difference being the apparent multiple supply position and a lowering of the net tax payable.

The Finance Bill 2011 introduced legislation to counter specific supply splitting avoidance of this type involving printed matter. This was Notes (2) and (3) to Group 3, Schedule 8, VAT Act 1994 where any zero-rated books connected to a taxable or exempt supply of services (such as education) cannot be a supply in their own right even when supplied by different businesses - see VATSC80600.

If you suspect either supply splitting or bundling then you should check the usual sources of information for updates such as the Counter-Avoidance Spotlights before contacting the TAPE (Tax Avoidance and Partial Exemption) team or VAT policy. If abuse is then being contemplated Counter-Avoidance will then need to be contacted.

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