SLAUGHTER AND MAY/

CLIENT BRIEFING

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TAX AND THE CITY REVIEW

The Court of Appeal in *Centrica* concludes that as the expenses of management related to expenditure incurred after the strategic decision to sell and a change in the accounts to show the investment as 'held for sale', they were capital in nature and so not deductible. The Upper Tribunal considers the loan relationships unallowable purpose test in *Kwik-Fit* and agrees with the FTT's decision. The consultation document on the VAT exemption for management services provided to special investment funds sets out a proposal to codify current UK policy. From 15 December 2022 the tax treatment of reinsurance of basic life assurance and general annuity business (BLAGAB) is amended in two ways. The 2022 annual report on the bank code shows continued good behaviour across the sector.

Centrica: deductibility of investment management expenses

In HMRC v Centrica Overseas Holdings Limited [2022] EWCA Civ 1520 the Court of Appeal considered to what extent expenses associated with the disposal of a loss-making investment are deductible as investment management expenses under Corporation Tax Act 2009, s1219.

COHL, an intermediate holding company in the Centrica group, wholly owned an unsuccessful Dutch investment, 'Oxxio'. Following Centrica plc's decision in principle mid-2009 that Oxxio should be disposed of, it was accounted for in the 2009 accounts as a 'discontinued operation' and 'held for sale' from 30 June 2009 as it was anticipated it would be sold by 30 June 2010. Problems with the Oxxio business meant the sale process took longer than expected. Between July 2009 and early 2011, COHL incurred certain bank, accountancy and lawyers' fees on advice ranging from strategic considerations of how best to realise the investment to the drafting of the sale documentation. Finally, in February 2011, Centrica plc's board approved in principle a particular third-party offer for the Oxxio business and the transaction completed in March 2011.

Two separate tests

The two issues before the Court of Appeal were whether around £2.5m of fees incurred by COHL between July 2009 and March 2011 and claimed by COHL as a deduction from corporation tax were 'expenses of management' and, whether they were 'expenses of a capital nature'. On the first, the Court of Appeal agreed with the Upper Tribunal (UT) that the First-tier Tribunal (FTT) was entitled to reach the conclusion that it had. Expenses incurred in deciding whether or not to dispose of an investment (or indeed whether to acquire one) are expenses of management. Implementation expenses, on the other hand, are not.

On the second issue, the Court of Appeal held both the FTT and the UT had erred on the question whether the fees were capital in nature. The Court of Appeal disagreed with the UT's view that capital expenditure has a more limited meaning in the context of management expenses than trading expenses. According to the Court of Appeal, whether expenses are of a capital nature is to be determined in the same way for the purposes of s1219 as in the context of a trade for the purposes of CTA 2009 s53. The Court of Appeal concluded, on the basis of case law on whether trading expenses are capital or revenue, that all of the fees at issue here were of a capital nature (as they comprised expenditure in order to achieve the disposal of an investment) and were therefore non-deductible.

The facts of this case were quite unusual (in particular, the strategic decision taken in 2009 to dispose of the Oxxio business and to change the accounting of the investment to discontinued operations held for sale was a crucial feature) and there is little reasoning to go on for other cases where the facts do not line up. It is hoped that, if the Supreme Court grants permission to appeal, greater clarity will be gained in this important area of deductibility. In the meantime, it is helpful that the Court of Appeal confirmed that expenses up to the point of the decision to sell are deductible: although in this case this meant up to 2009 (when the decision to sell was made and recorded) rather than 2011 (when the eventual sale took place).

Exclusion of expenditure of a capital nature

In practice, the definition of expenses of management probably does exclude at least most costs of a capital nature (using the trading expenditure test) but if costs do pass the expenses of management test, notwithstanding they are capital in nature, s1219(3)(a) prevents them from being deductible. But is it correct to apply the case law on trading expenses to apply the capital v revenue test to expenses of management, or should there be a different test in this context (as the UT suggested) and if so, what is it?

An argument for a different test could be made along the lines that the revenue/capital nature of an item of expenditure depends on the activity of the party incurring it. So you could say Parliament's intent in enacting the expenses of management rules was to recognise a kind of investment activity, distinct from trading, where a company has a business of making investments and that business involves 'management' of those investments and arguably this requires a different test from the trading test to be applied. But then what would this test be and why is it not set out in the legislation?

This reminds us of the arguments about the (now repealed) 'fairly represents' wording in the loan relationships regime. One may have thought that if Parliament had intended a different method than the accounts to be used to identify profits and losses from loan relationships it would have said so rather than leaving the courts to make something up. But in the *Teesside Power* case the FTT, UT and even the Court of Appeal all happily made something up instead. It will be interesting, if the Supreme Court agrees to hear the case, to see whether it decides to develop a different test from the trading test, perhaps along the lines of a distinction between strategic consideration (if, how, to whom etc.) and actual implementation of a disposal transaction. Nevertheless, it will be an uphill struggle for the taxpayer to explain why the test should be different given the evidence suggesting the introduction of the capital test was about aligning the trading and management expense rules so the latter were not more generous in allowing deductions for capital expenditure precluded under the former.

Kwik-Fit: loan relationships unallowable purpose

In Kwik-Fit Group and others v HMRC [2022] UKUT 00314 (TCC) the Upper Tribunal upheld the decision of the FTT on the application of the unallowable purpose rule in Corporation Tax Act 2009 s441 to a number of intragroup loans in the Kwik-Fit group.

Speedy, a company in the Kwik-Fit group, had £48m of carried forward non-trading loan relationship deficits (NTDs) which it was estimated would take 25 years to utilise (this was before the change of law in 2017 that permitted NTDs to be surrendered as group relief). A reorganisation of intra-group loans was carried out (involving the assignment of some intra-group loans to Speedy, a new loan being made by Speedy in place of an original loan and the interest rate on existing loans from Speedy being increased to an arm's length rate).

Although there was no increase in overall group indebtedness, a higher rate of interest was paid by the debtor companies than was paid before the reorganisation. The debt reorganisation, therefore, resulted in more interest being received by Speedy which enabled Speedy to use the NTDs within 3 years instead of over 25 years. It was agreed that acceleration of the use of the NTDs was a purpose of the reorganisation.

The UT had to consider whether the FTT wrongly concluded there was an unallowable purpose for Speedy and for the debtor companies and, if the FTT was right on unallowable purpose, whether the FTT had erred in law on making a just and reasonable attribution.

Unallowable purpose

By way of reminder, an unallowable purpose of a company is one that is 'not amongst the business or commercial purposes of the company' (CTA 2009, s442(1)(b)). The effect of s442(4) is that a tax avoidance purpose is taken to be a 'business or other commercial purpose' unless it is the main purpose or one of the main purposes, for which the company is party to the relationship.

The UT concluded that the FTT had not erred in holding that Speedy and the debtor companies each had an unallowable purpose in becoming parties to the relevant loans. Speedy had an unallowable purpose of using NTDs to offset against interest income (the UT agreed with the FTT that the use of existing tax losses is a 'relief from tax' and therefore a 'tax advantage'). The UT interpreted the meaning of 'tax advantage' to include any combination of circumstances where the taxpayer is better off as against HMRC. The increased interest received by Speedy constituted a tax advantage in combination with the pre-existing NTDs notwithstanding that both before and after the reorganisation Speedy had no charge to tax. The UT concluded that Speedy's tax liability was less for the year when the NTDs were utilised against the increased interest income than it would have been had it not offset the NTDs against the profits.

The reorganisation included increasing debits (as the flip side or 'twin element' of the increased interest). So in addition to the (good) original commercial purpose for the borrowing, the debtors also had a bad purpose of increasing deductible debits. This was so even for the debtors which were loss-making and could not themselves benefit from the debits as the UT agreed with HMRC that a company can have a purpose

even if that purpose is ultimately unsuccessful. The UT found that the interlinkage of the twin elements also explains why there is no illogicality in the disallowance of the debits being capped at the amount of the NTDs. Once the NTDs had been used up, the debtors were no longer party to the loan relationship for the purpose of securing a tax advantage.

On the facts of the case, the UT concluded that it was open to the FTT to find the unallowable purposes of both Speedy and the debtors were 'main' purposes.

Just and reasonable attribution

The UT concluded that the FTT had not erred in the application of the just and reasonable attribution provisions in s441. The exercise of attribution is rooted in an objective assessment of the facts and circumstances. Accordingly, the UT agreed with the FTT that all of the interest on the new loans should be disallowed, but for the pre-existing loan with Speedy and the loans assigned to Speedy, only the interest above the original rates was attributable to the unallowable purpose. This was because the FTT had found as a matter of fact that if the reorganisation had not occurred the debtors would have continued paying interest at the original rate.

For those of you hungry for the next instalments of unallowable purpose case law to determine what is and is not acceptable tax planning, there is more in the pipeline: the Upper Tribunal hearing in *JTI Acquisition Company* is expected in 2023 as is the Court of Appeal hearing in *BlackRock Holdco (No. 5)*.

Re-insurance of BLAGAB: draft legislation for inclusion in Spring Finance Bill

HMRC has published draft legislation for inclusion in the Spring Finance Bill, but in force from 15 December 2022, to make two changes to the tax treatment of re-insurance of Basic Life Assurance and General Annuity Business (BLAGAB).

The first change classifies re-insured business as BLAGAB in the hands of the re-insurer where the re-insurance precedes a transfer of BLAGAB (an economic transfer of BLAGAB is typically effected by a re-insurance contract pending court approval of a BLAGAB transfer). A tax mismatch can arise as the profits from the business are initially taxed in the hands of the cedant as BLAGAB, then in the re-insurer as non-BLAGAB and finally in the re-insurer, after the business transfer scheme occurs, as BLAGAB once again. A loss of tax can occur if a non-BLAGAB trade loss arises in the re-insurer and is offset against total profits or surrendered as group relief. The change brings the tax treatment of the re-insurer into line with the seller of the business. This change has effect from 15 December 2022 and applies to re-insurance contracts whenever they were entered into.

The second change amends FA 2012 s92 (which deems certain BLAGAB trading receipts to count as deemed I-E receipts) to restrict its scope where substantially all the insurance risks of a book of BLAGAB are assumed by a re-insurer. The amendment ensures that any amounts received under the re-insurance can no longer count as deemed receipts within the I-E calculation. This addresses industry concerns that the current scope of s92 may be too wide and may inhibit commercial transactions. This change applies to accounting periods ending on or after 15 December 2022.

The Edinburgh Reforms: VAT treatment of fund management services

As part of the 30 point plan for the reform of financial services regulation to 'turbocharge growth' and take forward the government's ambition for the UK to be the world's most innovative and competitive global financial centre, the government published the long-promised consultation document on the amendment of the VAT exemption for management services provided to special investment funds (SIFs).

The consultation sets out a proposal to codify current UK policy for the VAT treatment of fund management (based on UK law, retained EU law, general principles, guidance and a body of case law) into UK law. This is intended to provide certainty and clarity, simplify the process considerably, reduce the scope for differing interpretations of law and case law and ultimately achieve a reduction in the amount of litigation which takes place in this area.

The legislation will include defined criteria to determine which funds are entitled to the SIF exemption, alongside the existing list of funds in VATA 1994 Schedule 9, Group 5, Items 9 and 10. The legislation will also contain a clear definition of 'Collective Investment' which will broadly mirror that provided within the Financial Services and Markets Act 2000.

Obviously, the proposed codification of the existing exemption is not as good for enhancing the UK's competitiveness as zero-rating would have been but the latter had already been ruled out early in 2022 as too costly in the current fiscal climate.

Bank code of practice annual report

The 2022 annual report on the code of practice on taxation for banks shows, unsurprisingly, that 'the Code continues successfully to support improved behaviour across the banking sector'. There was only one pre-transaction code approach in the year (where a bank which is unsure whether the tax result of a proposed transaction is contrary to the intentions of Parliament discusses those plans with HMRC in advance) and it was agreed by HMRC to be code-compliant within 28 days.

The low level of code approaches continues the trend from previous years which HMRC attributes to a better understanding of the code and continuing attitude change to tax avoidance and boundary pushing.

What to look out for:

- The OECD consultation on the draft multilateral convention (MLC) provisions on digital services taxes and other relevant measures closes on 20 January 2023. Note that the definitive list of existing measures to form Annex A is not part of the public consultation and will be agreed on by the Task Force on the Digital Economy as part of the continued negotiation of the MLC.
- OECD consultations on the GloBE Information Return and on Tax Certainty for the GloBE Rules close on 3 February 2023.
- The HMT consultation on codifying the VAT treatment of fund management closes on 3 February.
- The Court of Appeal is scheduled to hear the appeal in *Volkerrail Plant Ltd v HMRC* (group relief and EU law) on 8 February 2023.

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