SLAUGHTER AND MAY

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HMRC issued a statement on CFC State aid recovery which includes an explanation of how the OECD approach to significant people functions should be applied to intra-group lending. The decision of the Upper Tribunal in *Target Group Limited* illustrates the difficulty for a third party providing outsourced functions to a bank to meet the strict requirements for VAT exemption. HMRC publishes revised consolidated guidance on the Code of Practice on Taxation for Banks, alongside the 2019 Annual Report on the operation of the Code. The reform of the international tax rules continues to be a hot topic for 2020 as the OECD builds on the latest public consultation responses to facilitate a consensus solution by the end of 2020.

CFC State aid recovery: HMRC's statement

HMRC has applied to the EU General Court to annul the Commission's decision that the UK's CFC exemption for finance income which would otherwise be brought into charge as a result of it being derived from UK activity, is State aid. Nevertheless, the UK is still required to collect the State aid for the period 1 January 2013 to 31 December 2018 where finance income is derived from UK activity pending any subsequent annulment of the decision. (The rules were changed to remove the offending exemption from 1 January 2019.)

So how will HMRC recover the supposedly unlawful State aid? HMRC has sent a statement on recovery of State aid to affected companies. The statement confirms that no new legislation for recovery will be enacted at present but the possibility of introducing enabling legislation to facilitate recovery will be kept under review. Where possible, HMRC will use normal assessment methods (closure notices and discovery assessments) to recover the State aid, but, where time limits do not permit this, HMRC is inviting taxpayers to enter into a contractual arrangement as an alternative to HMRC taking action for recovery in the High Court.

The calculation of the amount of State aid is complex (and takes into account consequential adjustments to the debt cap) but reliefs can be used to reduce the CFC charge. Taxpayers will be glad to see HMRC intends to use its discretion under the current legislation to accept late claims for relief against the tax charge where, had those reliefs been claimed at the relevant time, they would have reduced the CFC charge.

State aid recovery is required only to the extent that there are exempt profits which passed through the CFC gateway as a result of significant people functions (SPF) in the UK. Detailed guidance on the identification of profits attributable to UK SPFs is given in Appendix 1 which is, on the whole, to be welcomed. The existing HMRC guidance quoted in the Commission's decision is widely perceived in the market as overstating the likelihood of finding UK SPFs in relation to intra-group lending in order to encourage groups to volunteer some UK tax on their overseas finance profits rather than seeking to demonstrate there is no tax due. Appendix 1 seeks to reconcile HMRC's existing guidance with the 2010 OECD Report which is incorporated into UK law and which the statement recognises provides "the definitive guidance".

HMRC have done a good job in Appendix 1 of explaining how to apply the definitive OECD approach to intra-group lending. The key factor is where the decision to lend is made. If the decision to lend was properly taken by the CFC in its place

of residence, the loan should not be attributed to a notional UK permanent establishment. Therefore, it should not give rise to profits which would have passed through the CFC gateway as a result of the SPF test (rather than the UK connected capital test in relation to which the Commission has accepted the finance company exemption is not unlawful). In the words of HMRC: "Most often the question is whether, on the facts, the CFC Board has taken an active decision to make a loan on particular terms, or whether it is instead implementing a decision that has already been made".

For taxpayers with suitable substance in their CFCs, e.g. those with appropriately qualified and adequately remunerated directors on the CFC Board making the decision to lend, the statement is good news. It should mean that if active decisions to lend were taken in the CFC and that is where the SPFs lie, the Commission is not going to challenge it on the basis that HMRC's existing guidance would suggest otherwise.

For those without suitable substance in the CFC, there is a lot of detailed work for individual taxpayers and HMRC to do to agree recoverable amounts, although the de minimis amount of EUR 200,000 State aid over a three year period will wheedle out any smaller amounts.

Target Group Limited: scope of VAT exemption for outsourced banking services

In *Target Group Limited v HMRC* [2019] UKUT 0340 (TCC), the Upper Tribunal (UT) reaches the same conclusion as the First-tier Tribunal (FTT) that the loan administration services supplied by Target Group Limited (TGL) to a bank were standard rated. But whereas the FTT found that the services supplied by TGL to the bank were transactions concerning payments or transfers within Article 135(1)(d) of the Principal VAT Directive but were excluded from the exemption as debt collection, the UT finds that the services are not within Article 135(1)(d) in the first place.

The UT had the benefit of the CJEU's decision in *DPAS* [2018] STC 1615 (which came out after the FTT's decision) which sheds light on how the use of BACS (an essential feature of the arrangement between TGL and the bank), is regarded for VAT purposes. In the UT's view, *DPAS* makes it clear that where the relevant service at issue involves the giving of an instruction to a financial institution to effect a payment, it does not constitute an exempt supply even though it may be a necessary step in order for the payment to be made. TGL's role was limited to passing instructions to the bank to effect payments, and it was the bank that actually effected the transfers of funds.

Whether a single composite supply of outsourced services is exempt will generally (but not exclusively) be determined by reference to the predominance of an element or a combination of elements of the supply. In this case, it was concluded that the predominant nature of the services supplied by TGL to the bank is not payments or transfers within Article 135(1)(d), or services within any of the other exemptions.

If the bank had carried out the outsourced services itself, they would have constituted an exempt supply of the management of credit by the person granting it. But because TGL did not make the loans, the UT agreed with the FTT that it was not entitled to rely on the exemption in VATA 1994 Sch 9 Group 5 Item 2A, or Article 135(1)(b).

This case illustrates how difficult it is for a loan service provider providing outsourced functions to a bank to show the outsourced supplies should be exempt.

Updated guidance on The Code of Practice on Taxation for Banks

Revised consolidated guidance published on 23 December provides clarification on a number of terms and includes new material on purpose tests. It also explains the interaction between the Code and other regimes such as the senior accounting

officer regime, the penalties for enablers of defeated tax avoidance legislation and the corporate offences for failing to prevent criminal facilitation of tax evasion.

HMRC's commitment to responding within 28 days to a Code approach (whereby the bank discusses plans in advance with HMRC if it is unsure whether or not the tax result of a proposed transaction is contrary to the intentions of Parliament) is now included in the guidance.

The 2019 Annual Report on the Code of Practice on Taxation for Banks, also published on 23 December, shows that banks have again improved their behaviour. During the period covered by the report (1 April 2018 to 31 March 2019):

- none of the banks which have adopted the Code have been determined to be in breach of the Code;
- no disclosures were made under DOTAS by banks that had adopted the Code; and
- all transactions reviewed either in response to a Code approach, or as part of risk assessment, were considered to be Code compliant.

Reform of international tax rules

The reform of the international tax rules continues to be a hot topic this year as the OECD continues to push to facilitate a consensus based solution by the end of 2020. There are enormous challenges ahead and huge amounts of work to be done.

The Inclusive Framework (now comprising more than 130 jurisdictions) is meeting to discuss (and hopefully agree an approach on) Pillar One (new nexus rule and profit allocation) and Pillar Two (global minimum tax) later this month. The OECD then hopes to publish an update and a more comprehensive consultation. It is clear from the recent public consultations that the proposals are now much broader than taxing the digitalised economy and constitute fundamental reform of the international tax rules.

The US played a wild card in December with a letter to the OECD suggesting that Pillar One should be optional and operate as a safe harbour rather than being mandatory as has been the working assumption so far. This was the first the OECD had heard of such a suggestion and it understandably caused some consternation about the effect of raising it at this stage given the mandate to find a solution by the end of 2020. It is understood, however, that the US has put on hold its proposal to make Pillar One an optional safe harbour until the design of Pillar One becomes clearer.

One of the key reasons for Pillar One is to remove, and prevent further enactment of, unilateral digital services taxes (DSTs) and the letter from the US Treasury urged "all countries to suspend digital services tax initiatives, in order to allow the OECD to successfully reach a multilateral agreement". Despite this plea, and undeterred by the reaction of the US to the French DST, Italy went ahead with implementing a DST with effect from 1 January 2020. The UK government has also made it clear that the UK will push ahead with its DST with effect from 1 April 2020. With more DSTs in the pipeline in other jurisdictions too impatient to wait for international consensus, things are going to get more complex for multinational groups before they can be improved, assuming international consensus is ultimately achievable.

What to look out for:

- The Court of Appeal began to hear *Smith v Nephew* in October 2019 on loan relationships, tax accounts and the meaning of 'fairly represents' but ran out of time. The Court of Appeal hearing is due to reconvene on 15 January.
- The UK is expected to leave the EU on 31 January. Assuming the European Parliament ratifies the Brexit deal before 31 January 2020, the UK would then enter the transition period maintaining the UK's current relationship with the EU until 31 December 2020.
- On 11 February, the Court of Appeal is due to start hearing the appeal in *Union Castle Mail Steamship* on whether an accounting debit linked to the derecognition of derivative contracts is a loss for the purposes of corporation tax under FA 2002 Sch 26, now rewritten in CTA 2009.
- Just when we were getting into the new timetable for Spring Statements and Autumn Budgets, the election threw a spanner in the works! The Budget is now scheduled for 11 March.

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