SLAUGHTER AND MAY

Slaughter and May Podcast
Tax News: June 2024

Zoe Andrews	Welcome to the June 2024 edition of Slaughter and May's "Tax News" podcast. I am Zoe Andrews, PSL Counsel & Head of Tax Knowledge.
Tanja Velling	And I am Tanja Velling, Tax PSL Counsel. We will discuss two Upper Tribunal decisions that we could not fit into the May edition because the Court of Appeal's decision in *Kwik-Fit* came out and we decided it would be better to discuss this alongside *BlackRock* rather than have them in two separate podcasts. That's why you'll be treated to a belated discussion of *Marlborough DP* and *Innovative Bites*. In this podcast, we will also cover the Court of Appeal's judgment in *Hotel La Tour* on input tax recovery in respect of deal fees and the Upper Tribunal's decision in *Burlington Loan Management* on the application of the purpose test in the UK/Ireland tax treaty and its impact on the secondary debt market. We will mention the upcoming election only briefly as I'm sure you're hearing enough about it elsewhere! The podcast was recorded on the 11th of June 2024 and reflects the law and guidance on that date. Shall we start with the cases we held over?
Zoe Andrews	Sure. I'll start with the Upper Tribunal's decision in *Marlborough DP*. Dr Thomas ran his dental practice through a limited company, Marlborough DP, and entered into a tax avoidance scheme. Under that scheme, Marlborough DP paid an amount equal to its profits to a trust and the trust made loans to Dr Thomas. The idea here was that Marlborough DP would get a corporation tax deduction for the payments to the trust – so reducing its taxable profits to nil – and the loans to Dr Thomas would not be subject to either income tax or national insurance contributions.
Tanja Velling	HMRC challenged that structure; its view was that the loans were taxable either as general earnings or under the loan charge in Part 7A of the Income Tax (Earnings and Pensions) Act 2003, and that a corporation tax deduction should be denied because the payments to the trust had not been made wholly and exclusively for the purposes of Marlborough DP's trade. The First-tier Tribunal concluded broadly that what you have here is, basically, disguised distributions. So, there was no charge under either general earnings or Part 7A, and no corporation tax deduction. The Upper Tribunal upheld the FTT's decision on general earnings but decided that

	Part 7A did apply and that, nonetheless, no corporation tax deduction was available. We want to note three points here. Do you want to take the first two?
Zoe Andrews	Sure! The Upper Tribunal delivered a bit of a masterclass on how to prepare for an appeal – especially when challenging the FTT's factual conclusions. We won't repeat the details here; if it's of interest to you, we suggest that you read the postscript to the decision where the Upper Tribunal summarised the relevant principles. The second is that "in connection with" is wider than "from" (at least in this context). Broadly, the general earnings charge bites on earnings "from" employment, whereas Part 7A applies in certain circumstances where there is a reward "in connection with" an employment. The Upper Tribunal considered this a deliberate difference, with a looser minimum nexus under Part 7A. In this case, it ultimately meant that the fact that all of the company's profits were ultimately the fruits of Dr Thomas's labour was insufficient to trigger a general earnings charge but sufficed for the purpose of Part 7A. And what's the third point?
Tanja Velling	That the tax charge under Part 7A did not render the company's payment to the trust deductible for corporation tax. Before the FTT, the deductibility point became moot given the conclusion that there was no tax charge under either general earnings or Part 7A. But the FTT did consider what the position would have been if the loans had been taxable. In that case, the FTT would have allowed the deduction by the casting vote of Judge Morgan. The reasoning would have been that, because the loans were taxable as earnings, the company's purpose for the expenditure "must be taken to be to provide Dr Thomas with earnings". Tribunal Member Woodman had disagreed with this approach and so did the Upper Tribunal. It concluded that the payments were not deductible because the company's purpose was not, in fact, to provide remuneration or otherwise benefit its trade; it was to empty the company of profits and provide a tax-free return to Dr Thomas. That the loans led to a charge under Part 7A is neither here nor there.
Zoe Andrews	Are you feeling peckish? *Innovative Bites* is another case about the VAT classification of food items – a topic that generally ranks somewhere between amusing and absurd. One tempting conclusion to draw from the case is that size matters when it comes to marshmallows. Mini and mega marshmallows can be zero-rated

	as products sold, respectively, for baking or roasting, whereas regular-sized ones should be standard-rated. But the case actually stands out for trying to bring some method to the madness. The relevant legislation is in Group 1 of Schedule 8 to the Value Added Tax Act 1994. This sets out which food items are zero-rated, starting with four general categories that would indicate zero-rating. However, there are then seven categories of excepted items that would fall to be standard-rated, unless they fall within one of the seven overrides to the exceptions. All of this is then followed by seven notes with additional explanations such as that "food" includes drinks. So, not the most straightforward.
Tanja Velling	And it's also really eleven notes, if you count Notes (3A) to (3D). But nothing turns on that. At its core, the case concerned the interaction between excepted item 2 – which provides for the standard-rating of "confectionary" – and Note (5) – which explains the term "confectionary". HMRC had argued that Note (5) is a deeming provision – so anything corresponding to the description in Note (5) would automatically be deemed standard-rated confectionary and that would be the end of the matter.
Zoe Andrews	The Upper Tribunal disagreed and set out how the analysis should proceed. Note (5) is the starting point, but if a product falls within it, that creates only a rebuttable presumption, and taxpayers may refer to other relevant factors to show that the product should not be standard-rated as "confectionary". This does bring some clarification, but I doubt that it will significantly reduce uncertainty in this area, not least given that, according to the Upper Tribunal, the approach to the Note (5) and confectionary questions (and whether they should be considered separately or together) will depend on the individual case. Usually, a multi-factorial assessment will be required, but there may be cases where this is unnecessary and the weight to be attached to different factors could vary. We also understand that HMRC is seeking permission to appeal the Upper Tribunal's decision.
Tanja Velling	There are significant administrative costs associated with the application of different VAT rates to what can seem like very similar products. And there's also the political gamesmanship associated with a system of multiple different rates. Following Brexit, we've seen successful campaigns for the zero-rating of period products (including, most recently, period pants). Calls for the abolition of the "tampon tax" were well-meaning, intended to make relevant products more affordable. But they ignore economic evidence that VAT-savings are not generally passed on to the end consumers and that wealthier consumers will derive a much larger benefit from lower VAT rates

	as they would tend to purchase a greater quantity of, and more expensive versions of, the products that are zero-rated.
Zoe Andrews	Perhaps period products are not the best example of this. But neither are they the end of the story. It was reported earlier this year that the Society of Radiographers called for bras to be zero-rated. Some argue that the high cost (with the addition of VAT) could prevent women from buying this essential product.
Tanja Velling	A little footnote here: any debate on whether or not bras are essential is firmly outside the scope of this podcast! But this raises the same issue as to who benefits from zero-rating. What campaigners seem to be aiming for is to make essential items affordable for those on low incomes. But zero-rating usually isn't an efficient way of achieving that. There's an interesting IMF working paper entitled "Designing a Progressive VAT" which suggests an alternative. Instead of applying different VAT rates based on the product purchased, it proposes to differentiate based on the person making the purchase. By harnessing new technologies, one could design a system of full or partial VAT rebates at the time of purchase; the customer would still pay the full (plus VAT) price but would simultaneously receive a VAT rebate in their bank account. In this way, period products or bras would actually cost less for those women whose interests the zero-rating campaigns seem to have at heart, but it would also avoid any stigma of having to prove eligibility for a rebate or lower rate at the point of purchase.
Zoe Andrew	This certainly sounds like an interesting idea. I wonder whether it would be workable, though. There would be practical issues (for instance, how does it work for cash purchases?) and potentially large implementation costs. It's also far harder to explain and sell than the headline-grabbing abolition of the tampon tax. But while we are on the subject of VAT, the Court of Appeal's decision in *Hotel La Tour* was a surprise and a disappointment to taxpayers, wasn't it?
Tanja Velling	Yes, based on the First-tier and Upper Tribunal decisions, taxpayers may have hoped to recover input tax incurred in connection with an exempt share sale where the purpose of the share sale was to raise funds for taxable general activity. As a quick reminder of the facts in this case, a holding company (HLT) sold the shares in a managed subsidiary and sought to recover input tax on the marketing costs and solicitors' and accountants' fees in connection with the sale.

	The case has been reported on a lot already (including in my post on the European Tax Blog) so we will restrain ourselves to highlighting three points of general interest – much like we did with *Marlborough DP*!
Zoe Andrews	The first is that the Court of Appeal has made it clear that there is no special rule for input tax recovery in fund-raising transactions. As HLT provided management services to the subsidiary, the sale of the shares in the subsidiary was an exempt supply, but both the FTT and the Upper Tribunal allowed recoverability of input VAT incurred on fees in relation to the exempt share sale on the basis that the share sale had the purpose of raising funds for the holding company's downstream taxable general activity. The Court of Appeal took a narrower view of the caselaw and concluded that HLT is prevented from recovering the input tax because, according to the long-settled rules of VAT, which have not been displaced by *Frank A Smart, SKF* or any other authority, the input tax had a direct and immediate link with HLT's exempt supply of shares.
Tanja Velling	So, what is the test for input tax recovery?
Zoe Andrews	The Court of Appeal preferred to describe the test for recoverability as an "either/or" test rather than a 2-stage test: either the inputs are directly attributable to the exempt share sale, or they bear a direct and immediate link with the taxpayer's economic activity as a whole. The Court of Appeal indicated that this did not imply an order of priority which may imply that the tribunal's task will be to look at the evidence in the round to determine in which direction there is the stronger link – the exempt share sale or the overall taxable activity. In most cases, this should be obvious: VAT on fees for advice on the negotiation and documentation would almost certainly be irrecoverable. But the Court of Appeal acknowledges that there is a more than "merely fanciful" possibility that VAT on (some) deal fees could be recoverable. So, around the edges, the decision may generate further litigation to determine exactly how fanciful (or not) the possibility is. That's it for the first point.
Tanja Velling	The second point is that the Court of Appeal clarified that the direct and immediate link test has not been varied to a test of incorporation of costs. The Court of Appeal concluded that there is no separate test of incorporation of costs on the basis that, according to caselaw, deduction is not dependent on where costs are incorporated in the prices of outputs. In case the Court of Appeal were wrong about this, though, they went on to say that it would not make a difference in this case as the costs were

	incorporated in the share sale in any event, because they were used to make the share sale and were met from the proceeds of sale.
Zoe Andrew	The final point relates to the effect of VAT grouping. This case further illustrates the limited effect of the statutory fiction contained in section 43 of the VATA 1994 which treats the business carried on by any member of the group as carried on by the representative member. The statutory fiction is a "simplification measure for VAT accounting purposes" and does not allow the facts to be overlooked. The taxpayer had argued that the existence of a VAT group comprising HLT and its subsidiary meant that the management services provided by HLT to the subsidiary should be disregarded, and so HLT would not be engaged in the economic activity at all, in which case the share sale, instead of being an exempt transaction, would be a VAT "nothing", falling within the *Kretztechnik* model – the argument then followed that the inputs should be treated as overheads and deductible, as the group's business was taxable supplies of hotel accommodation. The Court of Appeal disagreed that the statutory fiction extended this far. But even if it did have that effect, HLT as representative member was making supplies of taxable hotel services and so the *Kretztechnik* argument would not apply. Counsel for the taxpayer was effectively told he could not have his (jaffa) cake and eat it!
Tanja Velling	That is a very a good VAT joke, but now we bring some good news for secondary debt markets. Let me start by explaining the background to the *Burlington Loan Management* case. Exemption from withholding tax is a key concern for a purchaser of debt and they will want to know if they meet any criteria for such exemption. Treaty exemption is often relied on by a resident of a treaty jurisdiction which is the beneficial owner of interest to prevent the source state from taxing the interest, with the treaty giving sole taxing rights to the state of residence. But many of the UK's tax treaties have a purpose test which denies the benefit of the exemption where either party had a main purpose of taking advantage of the withholding tax exemption. The OECD's multilateral instrument (to implement treaty changes as part of BEPS) added a principal purpose test to many treaties for the first time, so it was no wonder that, as the first case on a purpose test in a double tax treaty, the FTT's decision in 2022 generated a lot of interest outside the UK as well as within. But what's the good news here?
Zoe Andrews	The good news is that the Upper Tribunal has dismissed HMRC's appeal concluding that the FTT was entitled to come to the decision that neither

	party had a main purpose of taking advantage of the withholding tax exemption provided by the treaty. The case involved the secondary market in claims against Lehman Brothers International (Europe), a UK company. One such claim was sold by SICL, a Cayman company, to a broker for £82.4m and from the broker to an Irish resident company, Burlington, for £83.55m. Both SICL and Burlington knew that SICL would suffer 20% UK withholding tax on interest payments made directly to it, but Burlington would not (because of the UK/Ireland double tax treaty) and the pricing effectively split the benefit of the gross payment (after deducting the broker's turn). There was no mechanism to adjust the price if Burlington suffered UK withholding tax on the interest (and this was crucial to the decision). Burlington was willing to pay more for the assignment than the debt was worth to SICL because it had to compete with other bidders who were likely also exempt from UK withholding tax whether on the basis of a treaty, or otherwise. SICL wanted to get the best price it could for the sale. HMRC submitted that the case should fall within the anti-abuse provision in Article 12(5) of the UK/Ireland double tax treaty because, in economic terms, SICL was taking advantage of Article 12(1) by selling to Burlington for a greater sum than it could have realised itself.
Tanja Velling	What did the Article 12(5) purpose test say and how was it interpreted by the Upper Tribunal?
Zoe Andrews	Article 12(5) of the UK-Ireland double tax treaty prevents treaty exemption from withholding tax on interest where "*it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid to take advantage of this Article by means of that creation or assignment*." It is for the fact-finding tribunal to determine the subjective purposes of both the seller and the purchaser, considering all the circumstances of the case. The UT concluded that the FTT had not made an error of law in making the determination they did and that HMRC's construction of Article 12(5) would turn it into something fundamentally different – instead of looking to prevent abuse of the treaty, it would be a provision directed at the avoidance of UK withholding tax by the seller, applicable whether or not the seller actually knew the basis on which the purchaser did not suffer a UK tax charge, so long as the mechanism for the UK withholding tax avoidance was the treaty. The Court of Appeal made it clear that UK withholding tax arbitrage is not enough on its own to mean that Article 12(5) is satisfied and the FTT was right to take into account all of the circumstances to determine if there has been an abuse of the treaty.

Tanja Velling	The Upper Tribunal did take a different view from the FTT on one aspect of the interpretation of Article 12(5), though, didn't they?
Zoe Andrews	Yes, on the significance of knowledge of reliance on Article 12(1) (which is the exemption from withholding tax). The FTT concluded that, in order for Article 12(5) to apply, SICL had to know that the purchaser of the claim would be relying on Article 12(1) specifically. The UT described this as an "*unjustified gloss on the actual words chosen by the contracting States in concluding the treaty*." This unjustified gloss was not material to the FTT's decision, however.
Tanja Velling	And what does this case mean for secondary debt markets?
Zoe Andrews	In general, an outright sale of an asset to an unconnected person who is entitled to treaty benefits in respect of it, by a person who is not, and where that is reflected in the pricing of the sale, ought not to fall foul of a treaty purpose test. The outcome would be different if the purchaser had been established in the relevant jurisdiction in order to benefit from the relevant tax treaty or if there is an adjustment mechanism to the consideration dependent on whether or not treaty relief is actually obtained. What did you want to say about the general election?
Tanja Velling	With the election being held on the 4th of July, we do not expect the usual "L-day" publication in July of draft Finance Bill legislation to entertain us over the summer, so you should have more time to watch the Euros or tend to the garden instead! An Autumn Budget is expected rather than anything hastily arranged soon after the election.
Zoe Andrews	Although, I suspect that it might be early autumn (or technically even late summer, if you're talking about astronomical summer) – the Shadow Chancellor stated publicly that there would not be a Budget without a forecast from the Office for Budget Responsibility. The OBR usually requires 10 weeks' notice to produce a forecast. 10 weeks from the election date takes you to mid-September. But let's not be overly pedantic about seasonal references. What else is there to look out for?
Tanja Velling	It seems that a lot is supposed to (or may) happen at the end of June in international tax terms. You may recall that the US, Austria, France, Italy, Spain and the UK reached a compromise on digital services taxes in October 2021. The US removed trade sanctions and DSTs could continue to apply during the negotiations for Pillar One, with credit to be given for

	DST paid against tax charged pursuant to Amount A of Pillar One. This agreement expires at the end of June. What will happen then? Well, the OECD also hopes to finalise the Multilateral Convention on Amount A and open it for signature by the end of June. I'm sceptical about whether this will happen, but if it did, it would clearly be a good sign, and an extension of the compromise until the MLC comes into effect would be likely. I also think it's likely that the compromise is extended if the OECD misses the end of June deadline, but all parties maintain that the work is "nearing completion". What happens if there is a point when it is acknowledged that no agreement will be reached is unclear. The US may well seek to re-impose trade sanctions although the appetite for this is also likely be influenced by the outcome of the US election in November.
Zoe Andrews	And that concludes this episode of the Tax News podcast. Remember to check out our special Tax Disputes podcast series if you haven't already. As always, thank you for listening. If you have any questions, please contact Tanja or me, or your usual Slaughter and May contact. Further insights from the Slaughter and May Tax department can be found on the European Tax Blog – www.europeantax.blog. And you can also follow us on Twitter – @SlaughterMayTax.