SLAUGHTER AND MAY/

CLIENT BRIEFING

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# TAX AND THE CITY REVIEW

The Supreme Court in *Target Group* decides that the financial services exemption should be construed narrowly and does not apply to the loan administration services supplied in this case. Draft legislation is published for inclusion in the next Finance Bill to ensure that supremacy of EU law will continue to apply for the purposes of interpreting VAT and excise law (so the principle of consistent interpretation remains applicable), but VAT and excise law can no longer be quashed or disapplied for being incompatible with EU law. The Supreme Court in *Vermilion* decides that the relevant option is an employment-related securities option pursuant to the deeming provision in ITEPA 2003, s471(3). HMRC updates its guidance on the double tax treaty passport scheme with some timing changes worth noting.

## Target Group: outsourced loan administration services not within financial services exemption

The Supreme Court in *Target Group Ltd v HMRC* [2023] UKSC 35 considered the application of the financial services exemption from VAT under article 135(1)(d) of the Principal VAT Directive to outsourced loan administration services, including the operation of loan accounts and payment processing, and unanimously concluded that the services did not fall within the exemption.

In order for the financial services exemption to apply, the services must have the effect of transferring funds and changing the legal and financial situation of the relevant parties. The taxpayer and HMRC disagreed on the proper interpretation of the case law as to whether causal effect was sufficient for these purposes (the wider interpretation) or if the services must in themselves have that effect and make that change (the narrow interpretation). The taxpayer argued that, based on the Court of Appeal's decision in *C&E Comrs v FDR Ltd* [2000] STC 672, services which involve giving instructions which will automatically and inevitably result in a payment being made, fall within the financial services exemption. HMRC, on the other hand, argued that later CJEU case law meant that the narrow interpretation is correct. In particular, HMRC relied on *HMRC v DPAS Ltd* [2018] STC 1615, which the CJEU decided during the course of the *Target Group* litigation.

The Supreme Court took the narrow view of the financial services exemption, as had the Upper Tribunal and Court of Appeal before it and concluded that the VAT exemption did not apply. The Supreme Court concluded, after reviewing the case law, that the narrow interpretation is consistent with the principle that exemptions should be interpreted strictly. The Supreme Court described the domestic law as having taken 'a wrong turn in *FDR*' and concluded *FDR*, and several other Court of Appeal cases which followed *FDR*, must be overruled. The giving of instructions was not enough to constitute 'transactions concerning payments or transfers' within article 135(1)(d), even if it inevitably resulted in a payment or transfer. According to the Supreme Court, functional participation and performance is required.

The Supreme Court also considered whether the entries in the loan account maintained by Target could effect a payment or transfer or result in a change in the legal position of the parties. The Supreme Court held it was apparent from the findings of the First-tier Tribunal (FTT) that the entries made were of 'expected' payments which were 'assumed' to be made and were reversible and so they could not and did not legally change anything. The Supreme Court distinguished *ATP Pension Service A/S v Skatteministeriet* (Case C-464) as the account entries in that case 'did change the legal and financial situation by transforming a right held by a worker against his employer into one held in relation to a pension fund'. Although *ATP* is an example of how the financial services exemption may apply to non-financial institutions, the Supreme Court has construed it narrowly and it is difficult to see what other types of accounting entry by a non-financial institution could be said to make the necessary legal and financial changes.

### *Debt collection*

The FTT had found that the services Target provided to a bank did include payments or transfers within the financial services exemption but as it also found that there was a single, composite supply of services, the predominant nature of which was debt collection, the services were excluded from the exemption. All three of the Upper Tribunal, the Court of Appeal and now the Supreme Court held that the financial services were standard rated supplies and so did not have to determine the debt collection point. In the Court of Appeal, although also not necessary given the conclusion reached, Lady Justice Simler (who was recently promoted to the Supreme Court) commented it is difficult to see clearly where the line is drawn between collecting money and debt collection and she saw the force of Mr Cordara KC's submission that almost every movement of money in the financial system is made to discharge a debt.

The Supreme Court did not say anything further on debt collection. Interestingly, the Tax Journal article of 13 October by Hui Ling McCarthy KC and Michael Ripley (who both acted for HMRC in *Target Group*) seeks to distinguish the FTT's conclusion on debt collection as particular to the facts of this case, rather than founded on a broad reading of the debt collection exception. Their view is that it is the totality of the activities which comprise the package of the services which is key. We will now have to await another case to explore the scope of the debt collection carve-out from the exemption in the context of money movements in the financial system.

*Scope of exemption post-Target Group*

In light of the narrow view of the exemption taken by the Supreme Court, it is difficult to see how a loan service provider supplying outsourced functions to a bank, after the bank had originated the loan, could show these supplies should be exempt. The article by Hui Ling McCarthy KC and Michael Ripley suggests that 'traders willing to take the risk of, and responsibility for, bringing about a legal and financial change may well be able to bring themselves within the exemption' but it is difficult to see how a non-financial institution would do this in practice.

### Bespoke approach to interpretation of VAT and excise law

The Retained EU Law (Revocation and Reform) Act 2023 (REUL Act) ends the supremacy and special status afforded to retained European Union law in the UK. On 20 October, draft legislation for inclusion in the next Finance Bill was published for consultation which modifies how the European Union (Withdrawal) Act 2018 (EUWA), as modified by the REUL Act, applies in respect of 'enactments relating to value added tax or any duty of excise' (VAT and excise law) in order to broadly preserve the status quo in relation to the interpretation of VAT and excise law. Supremacy of EU law will continue to apply for the purposes of interpreting VAT and excise law (so the principle of consistent interpretation remains applicable), but VAT and excise law can no longer be quashed or disapplied for being incompatible with EU law.

According to the explanatory note: 'This legislation ensures the stability of the VAT and excise regimes and provides legal certainty for business following the changes in the REUL Act taking effect. It mitigates the risk of re-litigating settled interpretation of UK law, protecting billions of pounds of Exchequer revenue — VAT and excise duty (on alcohol, tobacco and hydrocarbon oil) raise over £200 billion of revenue per year.'

The commencement date is to be confirmed as it will have effect from the commencement of the amendments to be made by the REULA to the EUWA (expected to be at the end of 2023). This timing raises the same issue as the changes to be made by the Finance Bill in relation to the 1.5% stamp duty/SDRT exemption as noted in the October edition of Tax and the City.

### *Vermilion*: ITEPA 2003 section 471(3) is a bright line rule

The Supreme Court in *HMRC v Vermilion Holdings Ltd* [2023] UKSC 37, considered the question whether an option was an employment-related securities option and concluded that it was because the deeming provision in ITEPA 2003, section 471(3) applied.

This is a case that divided opinion in the lower courts on the proper interpretation of section 471, so the Supreme Court's decision brings welcome clarity. The FTT said the option was not an employment-related securities option, the Upper Tribunal overturned that decision only for the Court of Session to reinstate the FTT's decision, although there was a dissenting judgment by Lord Carloway. It was unsurprising, then, that HMRC appealed the case to the Supreme Court and won.

Mr Noble owned and was a director of Quest, a consultancy company. In 2006, Quest provided corporate advisory services to Vermilion in return for the grant of a share option because the cost of the services exceeded Vermilion's budget. When Vermilion subsequently came into financial difficulty, it was crucial to the success of a rescue funding exercise that Mr Noble became a director of Vermilion and that the 2006 option in favour of Quest was replaced with a new option (the 2007 option) on amended terms and in favour of Quest as Mr Noble's nominee. In 2016 this option was novated replacing Quest with Mr Noble as the holder and the option was exercised. HMRC assessed Vermilion to PAYE tax and national insurance on the exercise of the option of around £386k. Vermilion has an indemnity from Mr Noble for any tax consequences arising from the exercise of the option so although Vermilion is the one challenging the tax assessment, it is Mr Noble who bears the economic consequences.

A key issue in this case is the interaction between subsections (1) and (3) of section 471 Section 471 defines when ITEPA 2023 chapter 5 of Part 7 relating to securities options applies. Subsection (1) states that it applies 'where a right or opportunity to acquire the securities option is available by reason of an employment'. Subsection (3) provides that, where such a right or opportunity is made available by a person's employer, it 'is to be regarded for the purposes of subsection (1) as available by reason of an employment'.

HMRC's position before the FTT was essentially that, as an option granted by a company to its director, the 2007 option falls squarely within the deeming provision in subsection (3) and that should be the end of the matter. The FTT, however, considered that the result of the deeming provision would be at variance with the factual circumstances: if one asked whether the 2007 option was granted by 'reason of' Mr Noble's directorship, looking purely at the wording of subsection (1), the real reason would seem to be the surrender of the 2006 option.

The majority of the Court of Session agreed with the FTT's reasoning in this respect regarding subsection (1) as the leading provision with subsection (3) being subordinate to it. If, as a matter of fact, something is not made available by reason of an employment as per subsection (1), the majority held subsection (3) cannot operate to deem it to be for such reasons regardless of the facts.

The Supreme Court noted that section 471(1) is a causal test and can lead to difficult judgments and different assessments, as this case illustrates. The Supreme Court held that the purpose of the deeming provision in section 471(3) is to create a bright line rule to avoid such difficult questions. It asks 'who' conferred the right or opportunity and not 'why'. If section 471(3) applies, there is no need to consider section 471(1). 'The purpose of the deeming provision is to avoid the decision-maker having to carry out the section 471(1) assessment' (paragraph 26). Vermilion was Mr Noble's employer at the time the option was made available to his nominee and Vermilion's reason for doing so is irrelevant when section 471(3) applies.

On the facts of this case, it was fatal that the 2006 option was cancelled and replaced with the 2007 option at a time when Mr Noble was an employee of Vermilion rather than the option being varied as this brought it within the deeming provision.

### Changes to double tax treaty passport scheme guidance

HMRC has published updated guidance on the double tax treaty passport scheme (DTTPS). The DTTPS began in 2010 and provides for double taxation relief on UK source loan interest payments to eligible overseas lenders who submit an application for passport holder status using form DTTP1. Passports are valid for a period of five years after which they may be renewed. There are three timing changes to note in the revised guidance. First, the previous guidance stated that HMRC would review a DTTP1 application within 30 days, but the revised guidance no longer commits to a particular time period for consideration of applications or renewals.

Second, HMRC used to issue reminders when a treaty passport is due to expire but will no longer do this. This seems an odd change to bring in when there is a move towards modernising and digitalising tax administration. The revised guidance provides that a renewal request must be completed by the passport holder within three months of the passport expiry date. If it is not received by HMRC by the expiry date, the passport holder status will be withdrawn. The renewal request must state whether there have been any material changes since the original passport.

Third, borrowers should tell HMRC of any passported loan using form DTTP2 'as soon as possible once the loan arrangement is entered into', to allow HMRC time to review the application. The previous guidance said HMRC had to be informed at least 30 working days before the first interest payment. In addition, the DTTPS terms, conditions and guidance has been rewritten to express more clearly what happens once a DTTP2 form has been submitted online before the first payment of interest. The borrower must withhold tax from the interest payments until HMRC issues the direction to withhold at the relevant treaty rate (which may be zero). If the borrower wishes, however, from the date of receipt of HMRC's acknowledgement of their online submission the borrower may provisionally withhold at the relevant treaty rate in advance of receiving a formal direction (see DTTP30610). DTTP30640 now states that 'HMRC will backdate the effective date of the Direction, once issued, to the date of submission of the successful DTTP2 application. Any payments of interest made after the effective date of the Direction may be made at the appropriate treaty rate.'

**What to look out for:**

- **The 5th annual OECD Forum on Tax Administration Tax Certainty Day will be held virtually on 14 November which will provide an opportunity to reflect on priorities for the coming year.**
- **17 November is the closing date for the consultation on the draft legislation to broadly preserve the status quo in relation to the interpretation of VAT and excise law.**
- **The Chancellor will deliver his Autumn Statement on 22 November.**

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