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CLIENT BRIEFING

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TAX AND THE CITY REVIEW

The Court of Appeal in *Target Group* decides that the financial services exemption from VAT does not apply to the loan administration services Target supplied to a bank. The L Day materials published on 20 July of interest to financial institutions include large business notification of uncertain tax treatment (draft guidance for which has also been published), taxation of asset holding companies, amendment to hybrid mismatches rules and a consultation on the change to income tax basis periods. The FTT in *Kwik-Fit* applies the loan relationships unallowable purpose rule to disallow debits on certain loan relationships forming part of a reorganisation which was intended to accelerate the use of tax assets.

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

The Court of Appeal in Target Group Ltd v HMRC [2021] EWCA Civ 1043 considered the application of the financial services exemption from VAT to outsourced loan administration services, including the operation of loan accounts and payment processing. This case illustrates how difficult it is, in light of developments in CJEU jurisprudence, for a loan service provider supplying outsourced functions to a bank, after the bank had originated the loan, to show these supplies should be exempt. The Court of Appeal unanimously agreed with the Upper Tribunal (UT) that recent CJEU case law has effectively overturned earlier Court of Appeal judgments in this area, such that the VAT exemption did not apply because the services supplied by Target are not 'transactions concerning payments or transfers' within article 135(1)(d) of the Principal VAT Directive (PVD).

It was therefore not necessary for the Court of Appeal to consider the exclusion of debt collection from the exemption in article 135(1)(d) of the PVD but Lady Justice Simler 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 QC's submission that almost every movement of money in the financial system is made to discharge a debt. This is a point to be resolved at another time, however!

L Day materials

L Day on 20 July saw the publication of draft legislation, explanatory notes, responses to consultations and some new consultations. Four measures relevant to financial services are:

Large business notification of uncertain tax treatment (UTT)

The draft legislation is much improved from the original starting point of the consultation process but, as is common practice these days, where the legislation is lacking in detail, it is supplemented by guidance, in this case comprising 40+ pages of draft guidance which was published on 19 August.

In brief, large businesses (those with UK turnover above £200 million per annum or a UK balance sheet total over £2 billion or both) will have to notify HMRC of uncertain tax treatment of any amounts in corporation tax, VAT, PAYE and income tax self assessment returns which have filing dates on or after 1 April 2022. So although the legislation and guidance are not yet final, the rules apply to in scope transactions taking place in the current accounting period.

For a company that is a member of the group, the UK turnover and UK balance sheet of all the companies in the group are aggregated for the thresholds. Businesses will only have to notify of uncertainties that exceed a £5m threshold (increased from the £1m originally proposed). The £5 million threshold applies separately to each relevant tax in each 12 month relevant period.

There is such a lot to say about the UTT rules and guidance but for the purposes of this article we have limited ourselves to commenting on the notification

triggers which have been reduced from seven to three:

- A provision has been recognised in the accounts in accordance with GAAP to reflect the probability that a different tax treatment will be applied.
- The tax treatment relies on an interpretation or application of the law not in accordance with HMRC's 'known' position.
- It is reasonable to conclude that there is a 'substantial possibility' that, if the matter came before a tribunal or court, it would be found that the tax treatment was incorrect in one or more material respects.

HMRC's 'known' position is not limited to the taxpayer's knowledge although it does include the businesses correspondence with HMRC and any dealings with HMRC. Such dealings include discussions with a CCM or HMRC tax specialist even where those discussions are not documented, which seems a recipe for further uncertainty so best practice would be to ensure a written record of such discussions is agreed with HMRC.

The 'known' position also picks up anything apparent from guidance, statements or other material of HMRC of general application, readily available and in the public domain. UTT13200 lists the types of publications that do or do not indicate HMRC's known position for the purposes of this trigger but as the lists are stated as merely illustrative and not exhaustive, there is still some uncertainty about what publications count.

The third of these triggers, the 'substantial possibility' test, is a new one and is causing some concern as it is difficult to apply in practice. Unlike in other contexts (such as the guidance on the substantial shareholdings exemption which suggests a 'substantial extent' of non-trading activities means greater than 20% of total activities), the draft legislation and draft guidance do not define 'substantial' by percentage. Instead, the draft guidance identifies factors that indicate the test has been met, including different advisers recommending different tax treatments and the decision over the correct tax treatment being 'fairly balanced'. As the list is not exhaustive, however, and each factor, by itself, does not necessarily mean a notification is due, there is still plenty of uncertainty about when this trigger applies! Yet the guidance states HMRC does not expect it will be necessary that legal advice should be obtained in order to comply with the UTT regime. HMRC expect a level of governance proportionate to the tax risk and level of uncertainty.

If more than one trigger applies, business is required to identify and notify the largest tax advantage calculated by reference to the trigger criteria. This is contrary to the summary of responses to the second consultation in which it was stated about the first trigger 'There will be some overlap with the new [third] trigger. Nonetheless the government believes there is value in retaining [the provision in accounts] trigger. Arguably this is the clearest and most straightforward trigger, and taxpayers will not need to consider the other triggers if this one applies.'

Taxation of asset holding companies

This is still work in progress and the government proposes setting up a small but diverse working group to discuss the draft legislation and specific design principles. It is clear from the consultation response that the main issue to be solved is how to allow the main tax benefit of investing via an asset holding company structure without HMRC losing tax that they do not want to lose. It is about how to attract asset management from, say, Luxembourg but without jeopardising the revenues from the existing asset holding structures based in the UK. The tax treatment of investors should mirror what happens at asset holding company level but HMRC is understandably worried about schemes turning income into capital. Regime TAARs may be needed (as always!) but they are not included in the draft legislation yet.

Stamp duty/SDRT is still under consideration. One possibility is that there will be an exemption for the repurchase of shares or loan capital (if the loan capital is not within the loan capital exemption) but no exemption for sales to third parties.

Hybrid mismatch

Even five years after the hybrid mismatch rules came in, tweaks are still being made and backdated to the start of the rules. Initially, HMRC hoped the hybrid mismatch rules would change behaviour and result in hybrid entities no longer being used. But there are commercial reasons for the use of hybrid entities and those still using them continue to lobby the government for exemption from the hybrid mismatch rules. This latest change ensures that certain entities that are seen as transparent in their home jurisdictions (including US LLCs) are treated in the same way as partnerships and that members of those entities are treated as 'partners'.

Change to basis periods for income tax

The government is consulting on a proposal to move from the complex current year basis of taxation to a tax year basis and to end overlap relief. This will affect fund managers and other professional services firms where individuals trade through a partnership. Businesses would be taxed on profits arising in a tax year, aligning the way self-employed profits are taxed with other forms of income, such as property and investment income. The specific rules for partnerships

with untaxed income and a trade could then be removed.

Although the measure will undoubtedly be a simplification, and one that is necessary in order for Making Tax Digital for Income Tax (MTD) to work smoothly, it is also intended to remove the advantage (which mostly only large businesses choose to benefit from) of deferring payment of income tax by up to a year by choosing an accounting date early in the tax year. The intention is to bring in these changes in tax year 2022-23 ahead of the mandation of MTD in 2023-24.

Kwik-Fit: unallowable purpose

In *Kwik-Fit Group Limited and others v HMRC* TC/2019/01818 the First-tier Tribunal (FTT) had to consider the application of the loan relationships unallowable purpose rule in Corporation Tax Act 2009, s441.

The appellants are companies in the Kwik Fit group. In 2013, following the acquisition of the Kwik Fit group by Itochu Corporation, there was a reorganisation of intra-group loans which involved assignment of intra-group receivables to an intermediate holding company, Speedy 1, (such loans were referred to as Pre-existing Loans). Some new debts were also incurred by the appellants to Speedy 1 (New Loans). The interest rate charged on these loans was increased from the pre-reorganisation rate. Speedy 1 had a carried forward non-trading loan relationship deficit (NTD) against which the interest on the intra-group receivables could be set. As a result of the reorganisation, £48m of NTDs in Speedy 1 were used in 2 to 3 years instead of the 25 years which the group tax manager had previously estimated it would take to use the NTDs. It was agreed that the acceleration of the use of the NTDs was a purpose of the reorganisation.

HMRC concluded that s441 applied to disallow debits arising to the appellants for the payment of interest under the intra-group loan relationships in the relevant periods. The disallowance was capped at the amount of the carried forward NTDs used by Speedy 1. HMRC distinguished between loans where the debtor did not have a pre-existing loan relationship with Speedy 1, where HMRC disallowed the whole of the interest debit, and the one loan where the debtor had a loan relationship with Speedy 1 prior to the reorganisation (the KFG Loan), where HMRC disallowed the interest debit only to the extent that it had been increased following the reorganisation.

The appellants argued that they were not party to the loan relationships for unallowable purposes because the borrowings had a commercial purpose and this did not change as a result of the reorganisation. If they were wrong on this, the appellants argued none of the relevant debits should be apportioned to the unallowable purpose because the relevant debits would have arisen to the appellants in any event by virtue of the application of the transfer pricing rules.

The FTT held that the appellants were party to the loan relationships (both the Pre-Existing Loans and the New Loans) with Speedy 1 for an unallowable purpose but allowed the appeal in part reaching a different conclusion to HMRC on the amount of debit which should be apportioned to the unallowable purpose for certain loans:

- In respect of the New Loans, the FTT disallowed all the debits attributable to the interest on the loans because it found that tax avoidance was <u>the</u> main purpose for which the debtors were party to the New Loans and so the debits in respect of the New Loans are wholly attributable to the unallowable purpose.

- In respect of the Pre-Existing Loans, the FTT saw no reason to treat the KFG Loan (where there had been no change of creditor) differently from the other Pre-Existing Loans and concluded that for all the Pre-Existing Loans the appellants were party to them for mixed main purposes – the commercial purpose of having borrowed those amounts in the first place and the tax avoidance purpose of accelerating Speedy 1's use of NTDs. The FTT applied a 'but for test' to the just and reasonable apportionment analysis and concluded that the amount of the original interest costs is attributable to the commercial borrowing and only the debits in respect of the increase in the interest rate should be attributed to the unallowable purpose. The FTT did not accept the appellants' argument that the higher rate of interest would be the arm's length provision under the transfer pricing rules as this was not made out on the facts.

- The FTT agreed with HMRC's approach that the disallowance should be capped at the amount of the NTDs actually used by Speedy 1.

Sadly there is not enough space in this column to analyse the judgment in detail but a few headline points to be aware of and which certainly merit more detailed consideration are that:

- Like the FTT in *Blackrock Holdco 5 LLC v HMRC* [2020] UKFTT 443 (TC), the FTT here considers the *Vodafone Cellular Ltd v Shaw* [1997] STC 734 approach can be applied in a s441 context and inevitable and inextricable consequences can be taken to be purposes irrespective of the taxpayer's conscious motives.

- Like the FTT in *Oxford Instruments v HMRC [2019] UKFTT 254 (TC)*, the FTT considers that an interest

deduction is a tax advantage per se and no comparator transaction is required to determine whether an advantage has been obtained or not.

- Rather oddly it appears the FTT has concluded the debits arising on the New Loans are wholly attributable to an unallowable purpose, the debtors thereunder 'did not have their own commercial purpose in borrowing' and yet should not be disallowed in full as a result of the disallowance being capped at the amount of the NTDs actually used by Speedy 1.

What to look out for:

- 10 September is the deadline for joining the working group to develop proposals for the modernisation of stamp taxes on shares following the new Stamp Duty and SDRT framework published on 21 July.
- 14 September is the closing date for responses to L Day draft legislation for inclusion in the next Finance Bill.
- There were some items promised for 'summer 2021' which have not yet appeared but could do so shortly, such as the response to the consultation on the economic crime levy and the response to the consultation on reforming the securitisation tax rules and details of next steps promised for summer 2021.
- Consultation on draft regulations to implement the OECD's mandatory disclosure rules (thus enabling the repeal of the legislation implementing DAC6) was promised during 2021 and so could appear soon.
- Legislation on changes to the bank surcharge are expected to be included in the next Finance Bill although nothing was published on L Day as the results of the government's review of the surcharge are not expected until this autumn.

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CONTACT

Mike Lane
PARTNER
T: +44 (0)20 7090 5358
E: mike.lane@slaughterandmay.com

Zoe Andrews
PSL COUNSEL & HEAD OF TAX KNOWLEDGE
T: +44 (0)20 7090 5017
E: zoe.andrews@slaughterandmay.com

London
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
T +852 2521 0551
F +852 2845 2125

Beijing
T +86 10 5965 0600
F +86 10 5965 0650

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