Tax and the City Briefing for February

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Deposit-taking business involved exempt banking services

In *ING Intermediate Holdings Limited -v- HMRC* [2017] EWCA Civ 2111, the representative member of the ING VAT group wished to recover a proportion of VAT expenses incurred in connection with a deposit-taking business. Both the First-tier Tribunal (FTT) and the Upper Tribunal (UT) had found that the business consisted of more than simply receiving deposits and constituted the provision of exempt banking services. The Court of Appeal agreed.

ING had argued that the deposit-taking consisted of borrowing, therefore not involving a VATable transaction by the borrower at all. But the FTT had found as a fact that the operation of the easy-access deposit account involved more than the bank taking a loan from the depositor. The provision of 24-hour telephone and internet banking services for depositors to access their money and obtain statements were more than peripheral services and brought the activities into the classification of exempt banking business. The FTT had found that the services provided by the bank were central to the customers' decision to deposit the monies. The UT had agreed that this was not just borrowing and lending because the bank was providing accounts with the features described by the FTT.

Before the Court of Appeal, it was argued that the banking services were merely ancillary to the main transaction of lending by the customer but this argument did not succeed. It was further argued that the banking services were provided for no consideration (and so there would be no exempt supply). Although the marketing of the deposit account suggested there were "no fees, no exceptions", the Court of Appeal agreed with the FTT and the UT that this meant no express fees. There was consideration given by the customers in the form of a lower interest rate being paid by the bank; otherwise the bank would not be able to make a profit from the deposit-taking. Once it had been found that the bank had made supplies for consideration, there could be no recovery of the disputed input tax as the expenses incurred had a direct and immediate link with exempt supplies made in the course of the deposit-taking activities.

This case is a reminder that, although labels given by the parties to a transaction are not determinative of the character of the transaction for VAT purposes, the court will only look behind the contract if it does not reflect the true agreement of the parties. In this case, the terms and conditions referred to the arrangements as "services". The parties' own description of the nature of a transaction is contemporaneous evidence as to what it really was and may sometimes throw light on the matter. The UT had not erred in its approach.

This case is a warning to other financial service providers to check they are applying the correct VAT treatment to the expenses of their deposit-taking business following *ING*.

Importance of compliance with notice provisions

In Teoco UK Ltd v Aircom Jersey 4 Ltd and another [2018] EWCA Civ 23, the Court of Appeal dismissed Teoco's appeal, relating to tax claims brought by Teoco (the "purchaser") under a share purchase agreement against two Aircom companies (the "sellers"). This case is a reminder to advisers of the importance of complying carefully with notice requirements when acting for a purchaser bringing a claim against a seller for breach of warranty and/or a claim under the tax covenant. When negotiating a contract, advisers should ensure that the purchaser does not agree to notification requirements which are too onerous and where possible should ensure that the giving of notice is not a condition precedent to the seller's liability.

In April 2016, the High Court struck out the purchaser's claim under the share purchase agreement because the purchaser had not followed the provisions of the contract when it came to notify the sellers it was making a claim. The purchaser's correspondence with the sellers was too vague and sloppy to constitute valid notice of its claim under the contract and it did not explain whether the claim was under the tax indemnity or warranties or specify particular breaches of warranty. The High Court also held that the purchaser had failed to give notice of the claims "as soon as reasonably practicable" after becoming aware that it had such claims.

The Court of Appeal agreed with the High Court judge that the "omnibus reference to Warranty Claims or Tax Claims" was not good enough to meet the requirement to give "reasonable details of the Claim". The Court of Appeal concluded that the Judge's order was correct and so it was not necessary to consider the other grounds on which the Judge had found in favour of the sellers.

The outcome in the case seems harsh given that plenty of detail was provided to the sellers even though the notification requirements had not strictly been complied with. It illustrates the contrast between the court's increasing willingness to construe tax legislation ever more purposively and the strict interpretation given to contractual documents such as share purchase agreements or tax covenants. The case of *Takeda Pharmaceutical Company Ltd v Fougera Sweden Holding 2 AB* [2017] EWHC 1995 illustrates how difficult it is to persuade a court to imply terms into a professionally drafted contract. Permission for Takeda to appeal to the Court of Appeal has been refused so the case is now final.

Purposive or statutory construction?

The recent UT decision in *Cyclops Electronics Limited and Graceland Fixing Limited v HMRC* [2018] UKUT 0007 (TCC) is a post-*UBS* example of purposive construction being applied to an employee remuneration scheme designed to avoid PAYE and national insurance contributions. Unsurprisingly, the UT concluded, following the Supreme Court's decision in *UBS*, that forfeiture provisions which were commercially irrelevant and designed only to secure the benefit of the tax exemption in ITEPA 2003, s425 did not make the loan notes "restricted securities". This was so even though the contingency created by the forfeiture provisions in the loan notes had a greater possibility of occurring than in *UBS*.

The UT considered that although the death of an employee would be a "real world" event, it is of no consequence unless the restriction had been inserted for a business or commercial purpose. In the light of this conclusion it was not necessary for the UT to consider HMRC's arguments about redirected remuneration based on the *Rangers* case [2017] STC 1556.

By way of contrast, purposive construction of the legislation was not appropriate in *Trigg v HMRC* [2018] EWCA 17 Civ. The Court of Appeal overturned the UT's decision and ruled that a Euro conversion clause was not a "provision for conversion" with the result that the loan notes in question were qualifying corporate bonds ("QCBs"). The Court of Appeal agreed with the UT that the words in TCGA 1992, s117 were a "statutory construct" to which purposive construction could not be applied. However, whereas the UT had gone on to apply the words of the statute and conclude the terms of the notes were capable of operating as conversion provisions, the Court of Appeal reached the opposite conclusion in favour of the taxpayer. The Court of Appeal concluded that the conversion clause was redundant because, in the event of the UK joining the Euro, currency conversion would happen as a matter of law and not under the terms of the bonds.

Although the case ultimately depended on the mechanics of how monetary union would have come about, had the UK ever joined the Euro (what a bizarre hypothetical scenario to be discussing in the Brexit climate!), it is interesting that the Court of Appeal agreed with the UT and HMRC that s117 is a statutory construct and not one to which purposive construction should be applied. The Court of Appeal explained that this is because, in the context of s117 as a whole and having regard to the circumstances in which the exemption was introduced, there is nothing which requires the section to be given any special or qualified meaning. The Court of Appeal's analysis was influenced by the fact that the case was not concerned with tax avoidance.

Although this decision gives a common sense result in the context of this case, it rather upsets HMRC's historic practice of accepting that a bond that can be converted into, or redeemed in, Euros cannot be a QCB, insofar as individual noteholders are concerned, even if the conversion is dependent upon the UK's participation in the single currency. In the light of the *Trigg* case, anyone relying solely on a similar *automatic* Euro conversion upon monetary union to ensure non-QCB treatment must now be concerned about rollover treatment but anyone who included a Euro conversion feature (in the same way it is common to include a dollar conversion feature) should still get non-QCB treatment given the rationale of the Court of Appeal.

Cooperative compliance

The OECD has announced that the Forum on Tax Administration began a pilot of the new International Compliance Assurance Programme (ICAP) on 23 January. ICAP is a voluntary programme for multilateral cooperative risk assessment and assurance. It will provide increased and earlier tax certainty for MNE groups and gives tax authorities assurance that any tax risks have been identified. The voluntary process is available to large MNE groups headquartered in the jurisdiction of one of the eight participating tax administrations (Australia, Canada, Italy, Japan, Netherlands, Spain, UK and US).

The focus of the programme will initially be transfer pricing and permanent establishment (PE) risk but could include any other material international issues agreed between the group and participating tax administrations. The PE risk within scope is the risk of a PE not being recognised for tax by the jurisdiction in which it is located and also the risk that profits have not been allocated correctly to the PE. According to the ICAP pilot handbook, in future years ICAP may be extended to cover other material international tax risks such as hybrid entities and hybrid financial instruments, withholding taxes and the application of relevant international treaties.

The ICAP process will enable participating MNE groups to meet the relevant tax administrations to talk through their country by country reports (CBCR) and other documentation and provide clarity to aid understanding of their cross-border activities. This should help tax administrations to reach an early decision about the level of transfer pricing risk, permanent establishment risk and other specific international tax risks, if any, presented by the data contained in the CBCR and which the relevant tax authorities agree to include. The timeline for ICAP will depend upon a number of factors, but in most cases the period from the initial meeting of the taxpayer and tax authorities to the issuance of assurance letters should be within 12 months. It is hoped that the process will reduce the amount of disputes that have to go into mutual agreement procedures (MAP).

This pilot will be welcomed by large MNEs if it does indeed work to speed up and give certainty on international tax risks. Any reduction in the number of MAP cases is to be welcomed. At home, UK companies have not been enjoying collaborative compliance with HMRC as much as they have in the past with reports that it is very difficult at the moment to receive positive confirmations from HMRC. It has also been reported in the media that HMRC investigations are dragging on for an average of 3 years which signals a lack of HMRC resources.

What to look out for:

- The consultation on enlarging the scope of UK tax to include gains by non-residents on disposal of commercial property closes on 16 February.
- On 20 February, the Court of Appeal is scheduled to hear the case of *Travel Document Service and Ladbroke Group v HMRC* on the application of the unallowable purpose test to a deemed loan relationship.
- The deadline for responses to the consultation on extending royalty withholding tax is 23 February.
- 28 February is the deadline for responses to two consultations on how the tax rules should be amended to deal with changes to the lease accounting rules.
- The Chancellor will deliver his Spring Statement on 13 March. As promised by the Chancellor, we do not expect significant tax announcements at the Spring Statement, "unless the economic circumstances require it".

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