Tax and the City Briefing for April

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Unallowable purpose rule applies to disallow all debits

The Court of Appeal in *Travel Document Service and another v HMRC* [2018] EWCA Civ 549 unanimously dismissed the appeals of Travel Document Services (TDS) and Ladbroke Group International (LGI). The case concerns a tax avoidance scheme notified under DOTAS. The transactions took place in 2008, the essence of which was to exploit a perceived loophole in the FA 1996 loan relationships rules as they were at the time. The scheme involved TDS bringing a holding of LGI's shares within the loan relationships rules by entering into a total return swap (the Swap) in relation to them, then depressing the value of the shares by novating a large loan liability into LGI from another group company. On the basis of the unallowable purpose rule, HMRC disallowed both the large debit (in respect of the reduction in the fair value of the shares of LGI) in TDS and the smaller debits (as a result of interest on the novated loans) in LGI.

The Court of Appeal concluded that the First-tier Tribunal (FTT) and Upper Tribunal were right to take the view that the "unallowable purpose" rule contained in FA 1996 schedule 9 para 13 (now rewritten as CTA 2009 ss441-442) applied to deny all of the loan relationship debits claimed. The FTT was justified in concluding on the facts that TDS had an "unallowable purpose" for holding its shares in LGI. TDS had argued that it owned the LGI shares long before the Swap and had ordinary commercial reasons for holding them all along. But while the avoidance scheme was being implemented, the Court of Appeal agreed with HMRC that securing a tax advantage had become a main purpose of holding the shares because the hoped-for gain was large both in absolute terms (£70m) and relative to the apparent value of TDS (some £280m).

The Court of Appeal also held that the FTT was correct to attribute all of the debits claimed by LGI to its unallowable purpose. LGI had admitted it had an unallowable purpose for being a party to the loans that were novated to it but disputed the FTT's decision that it was just and reasonable to attribute the totality of the debits to the unallowable purpose. The Court of Appeal concluded that the materials before the FTT did not justify the attribution of any of the debits to anything other than the "unallowable purpose". LGI had not supplied any particulars of what loans would have been made to it, and at what rates, had it not adopted the avoidance scheme. It was not enough for LGI's witness to state that the novations could have been replaced by the payment of dividends as there was no information about what, if anything, LGI would have borrowed to pay dividends. This case highlights the importance of setting out full particulars of the alternative scenario in order to show at least some of the debits should be attributed to a "good" purpose.

Annual payments

Although the facts of *Hargreaves Lansdown v HMRC [2018] UKFTT 127 (TC)* are very specific (involving loyalty bonus payments paid to investors by a platform service provider), the discussion by the FTT of what is an annual payment is a welcome addition to the previous case law, the key case of which (*Campbell and another (Trustees of Davies' Educational Trust) v IRC (1968) 45 TC 427, HL)* is now nearly 50 years old. This case is a useful reminder that it's often necessary when considering payments made by financial services entities to think about whether they could be treated as annual payments.

The case considers whether the loyalty bonus payments have the four characteristics established by the earlier authorities of:

- being payable under a legal obligation;
- recurring or being capable of recurrence;
- constituting income and not capital in the hands of the recipient; and
- representing "pure income profit" in the hands of the recipient.

The first three characteristics are self-explanatory and are usually satisfied. "Pure income profit" (shorthand for the principle that the relevant payment must be a gross receipt of the payee) is the characteristic that often saves a payment from being an annual payment. If it is not a gross receipt of the payee, the deduction at source mechanism does not work properly. The FTT established that the loyalty bonus is a mechanism for reducing the net cost of the investor for the use of the platform and cannot be treated as pure profit.

The FTT's decision goes against HMRC's clear published view expressed in Brief 04/13 about "payments of trail commission" and endorsed in further guidance in 2014 following regulatory changes. It is likely, therefore, that HMRC will appeal.

There used to be a question whether residual payments made by securitisation companies constitute annual payments and therefore liable to withholding tax unless an exemption applied. To spare HMRC giving any more clearances on the point, regulations were made on 6 February 2018 (SI 2006/3296) to clarify that residual payments made by securitisation companies do not constitute annual payments, so that they can be paid without deduction of UK income tax.

Enhanced business risk review

In its response to the Large Business Risk Review consultation, HMRC has acknowledged the desirability of a range of risk categories within which to classify customers (rather than just "high" and "low") and the merits of setting out the advantages and disadvantages of each risk category. Further investigation is required, however, of what these advantages/disadvantages should be as the Government needs to create a consistent and level playing field for all of HMRC's customers.

HMRC will develop an enhanced business risk review (BRR) which should provide customers and HMRC with a clear set of actions and timelines in order to prompt and support continuous dialogue between a Customer Compliance Manager and his or her customer on reducing tax risks. Enhanced BRR should take more account of tax risk management work already required by large businesses (such as the Senior Accounting Officer regime and the requirement to publish a tax strategy). A pilot of enhanced BRR will run across a defined group of customers later this year. If successful, it will be rolled out to all sectors during 2019/2020.

EU tax transparency rules for intermediaries

Described by some as a "super-charged" version of our DOTAS rules, the EU's tax transparency rules will require intermediaries (such as tax advisors, accountants and lawyers) to report to their national tax authority tax schemes considered potentially aggressive cross-border arrangements. In the event that the intermediary is prevented from reporting (e.g. due to privilege), the obligation to report shifts to the taxpayer. The first filing of reports by intermediaries or relevant taxpayers is due by 31 August 2020 and will cover reportable cross border arrangements the first step of which was implemented between the directive's date of entry into force (i.e. 20 days after publication in the EU's Official Journal) and the date of application of the directive (1 July 2020).

The structure of the reporting rules is very similar to the UK's DOTAS rules and relies on arrangements meeting at least one of a number of hallmarks in order to be reportable. Unlike the UK's hallmarks which can (and have been altered frequently), the EU hallmarks are to be evaluated every two years and only amended by legislative proposal

(requiring unanimity) if necessary. (The Commission had wanted to be able to propose new hallmarks whenever necessary through delegated acts which could be adopted without unanimity, but the Council did not agree to this.)

The UK already has extensive disclosure rules and, with effect from 16 November 2017, the penalties for enablers of defeated tax avoidance schemes legislation. This EU proposal is likely to benefit the UK, however, as it will ensure that other Member States adopt disclosure rules to combat tax avoidance and evasion and the UK will be less out on a limb in this area. There are some differences between the scope of the UK's rules and the EU proposal (in particular, the UK rules do not currently contain all of the EU hallmarks) and if the UK intends to comply fully, some changes to the UK rules will be required.

Costs sharing

Ever since recent CJEU cases have established that the costs sharing exemption (CSE) in article 132 of Council Directive 2006/112/EC is limited to activities of "public interest", financial services companies have been waiting for HMRC's response. HMRC previously permitted UK businesses in the finance and insurance sectors to benefit from the CSE but, with effect from 22 March 2018, the scope of the CSE is restricted to certain exemption groups in VATA 1994 Sch 9 which do not include finance and insurance (Revenue and Customs Brief 3 (2018)). The CSE used to be applied to members of a cost sharing group (CSG) located in any EU member states but from 22 March this is restricted to CSE members located in the UK. A third change is that a CSE will not be permitted where an uplift has been charged on transactions for transfer pricing purposes. HMRC is considering the impact of the CJEU judgments on the test for directly necessary services which enabled CSGs to ignore certain non-qualifying supplies and further guidance will follow.

CSGs who have correctly applied the previous guidance will be allowed to continue this treatment until 31 May 2018 for services performed before that date, except where there is likely to be 'distortion of competition' involving groups or members outside the UK (VAT Information Sheet 02/18).

What to look out for

- The Court of Appeal is scheduled to begin hearing the taxpayer's appeal in the *GDF Suez Teesside Limited (formerly Teesside Power Limited) v The Commissioners for Her Majesty''s Revenue & Customs* case on 30 April or 1 May. The key issue to be decided in this case is whether the (now repealed) "fairly represents" language in the loan relationships code overrides GAAP.

- 11 May is the closing date for comments on the review of the corporate intangible fixed assets regime.

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