Tax and the City Briefing for May

11 May 2018

Limits of the distinct and separate enterprise fiction

Attribution of profits to a permanent establishment (PE) of a non-resident company is not straightforward and partnerships can also raise complex issues. Put these two topics together and you get a 38-page decision of the First-tier Tribunal (FTT) in *Bloomberg Inc & BLP Acquisition Holdings LLC v HMRC* [2018] UKFTT 205 (TC). The appellants are US resident companies each liable to UK corporation tax through having a PE in the UK. They are liable to tax on the profits attributable to their respective PEs. In the corporation tax returns for the PEs, the appellants made elections under Finance Act 2002, Schedule 29 (rewritten to CTA 2009, Part 8) for intangible fixed assets (IFAs).

The IFAs were in a Delaware limited partnership, BFLP, which was held by another Delaware limited partnership, BLP. The appellants had increased their holding of units in BLP by acquiring units from Merrill Lynch. The appellants argued that the separate and distinct entity principle required this acquisition to be treated as an acquisition of a proportion of the underlying IFAs by the PEs. HMRC argued that there was a change in ownership of BLP but no change in the assets of BLP (the IFAs stayed in BFLP) and so no election could be made.

Relief is given under Schedule 29 by reference to expenditure written off or written down for accounting purposes. So the accounting treatment determines whether or not an election can be made. The key question was what was the appropriate level from which to construct the notional accounts in respect of the PEs? HMRC argued it was at the partnership level so the accounting treatment is that of an increase in investment. The appellants argued that the correct perspective is that of the PEs and that the correct accounting treatment is a transfer of assets, including IFAs.

The FTT looked at the purpose of the US/UK Treaty and concluded, following the FTT's decision in *Irish Bank Resolution Corporation Ltd and another v HMRC* [2017] UKFTT 0702 (TC) that the function of the treaty is the allocation of taxing rights. Accordingly, there is nothing in the treaty which requires the accounts to regard expenditure as having been in relation to IFAs as opposed to partnership units. Article 7 of the treaty deals with the rights to tax business profits. There shall be attributed to a PE the profits which it might be expected to make if it were a "distinct and separate enterprise" engaged in similar activities, under similar conditions and dealing wholly independently with the company of which it is a PE (this is known as the separate enterprise principle) (Article 7(2)). The appellants had argued that partnership is not one of the "similar conditions" to be taken account of when applying the separate enterprise principle. They argued the reference to "similar conditions" is to similar commercial conditions. But the FTT held that the existence of the partnership is a relevant factor to take account of and cannot be ignored – this is not inconsistent with the separate enterprise principle. The relevance of the partnership is that it informs the calculation mechanism through which the profits of the PE are calculated.

For CGT and corporation tax on chargeable gains purposes partners are treated as having an interest in underlying assets of the partnership. But this does not mean the same approach should be taken for accounting purposes. The FTT's decision in *Armajaro Holdings Limited v HMRC* [2013] UKFTT 571 (TC) shows that a fiction for corporation tax purposes did not extend for the purposes of accounting. In *Bloomberg*, the FTT said it was not necessary to decide whether *Armajaro* was correctly decided on the limited effect of the deeming provision, however, as that case was not considering what accounts were to be constructed in the context of a PE.

It is, as the FTT acknowledged, very difficult to articulate exactly how the appellants might be successful in their primary argument. The FTT agreed with HMRC that the separate enterprise principle does not mean that the acquisition of the partnership units is to be treated as a transfer of assets of the partnership. The perspective to construct the accounts of the PEs is the partnership level which shows no acquisition of IFAs.

Loan administration services are standard rated as debt collection

In *Target Group Limited v HMRC* [2018] UKFTT 0226 (TC) the FTT held that supplies of loan administration services made by Target Group Limited (TGL) to a bank were standard rated as debt collection. The fundamental difference between this case and *Customs and Excise Commissioners v Electronic Data Systems Limited* [2003] STC 688 is that the core supply in the latter was the making of loans whereas TGL did not make the loans, the bank did. The FTT considered that the transactions TGL performs are intended to obtain the payment of pecuniary debts and so the predominant nature of the supply is one of debt collection, which is a standard rated supply.

The addition of VAT makes outsourcing of processes by financial institutions more expensive than it would otherwise be but, as the FTT points out in the context of fiscal neutrality, the additional VAT cost will be only one element of the decision whether to outsource on cost or other grounds. Banks should bear in mind that if it is possible to outsource the loan-making to the same person supplying the loan administration, this will be more tax efficient. This issue is also one to bear in mind when setting up securitisation structures.

Reform of limited partnerships

The Department for Business, Energy & Industrial Strategy is consulting on the reform of limited partnership law. The reform is intended to limit the risk of misuse of limited partnerships. One proposal, to prevent limited partnerships being used for money laundering, is to require all presenters, those seeking to register a limited partnership, to be registered with an anti-money laundering supervisory body. The other proposed changes will make limited partnerships more similar to limited companies.

There is currently nothing in legislation requiring a partnership to maintain a connection with the UK. Two alternatives are being considered: requiring a limited partnership's place of business to remain in the UK; or allowing the principal place of business to move outside the UK but introducing a requirement for a service address to be maintained in the UK (akin to the position for a company's registered office).

In 2017 a requirement was introduced for Scottish limited partnerships to begin a form of annual reporting to the Registrar of Companies. It is being considered whether this regular reporting requirement should be increased and extended to all limited partnerships registered in the UK bringing them into line with the reporting requirements of limited companies to prepare accounts and reports.

Finally, it is proposed that the Registrar be given powers to strike off limited partnerships from the register in certain situations because currently the register will still show the limited partnership as being "live" even if it has been dissolved or is no longer in operation.

Payments by way of capital contributions not wholly and exclusively for the purposes of the trade

HMRC v Investec Asset Finance PLC and Investec Bank PLC [2018] UKUT 0069 (TC) concerns the deductibility of payments (i) to acquire partnership interests in partnerships conducting leasing trades, and (ii) in respect of additional contributions of capital to those partnerships. The appellants, IAF and IBP, collectively "Investec", had no intention of carrying on the leasing trades but planned to (and did) terminate the leases to receive distributions and sale proceeds from selling on the remaining partnership interests.

HMRC issued closure notices disallowing the expenditure on the basis that it was capital, not revenue. Alternatively, if the expenditure were capital HMRC argued it was not incurred wholly and exclusively for the purposes of IAF's and IBP's respective solus trades, as opposed to the trades carried on by the leasing partnerships. The closure notices did not set out any alternative arguments but a covering letter sent with the notices did contain an alternative argument that if HMRC lost on the deductibility points, the profits of Investec's trade should be computed and assessed to corporation tax separately from, and without reference to, the profits of the trades carried on by the leasing partnerships.

The Upper Tribunal agreed with the FTT that the expenditure was revenue in nature but allowed HMRC's appeal in part on the ground that sums paid by way of capital contributions to the leasing partnerships should be disallowed as not wholly and exclusively for the purposes of Investec's trade. The capital contributions were made to enable the partnership to purchase assets which were either already leased or leased subsequently so they were made for the purpose of the partnership's trade, not Investec's.

On the closure notice point, the Upper Tribunal upheld the FTT's decision. Although the closure notice did not itself mention HMRC's alternative argument, it was accompanied by a covering letter which made it clear that HMRC would raise the alternative argument if unsuccessful on their main arguments. The Upper Tribunal applied Kitchin LJ's third principle (as set out in *Fidex v HMRC* [2016] STC 1920) that a closure notice must be read in context. In this case this means it had to be read with the covering letter. The Upper Tribunal have not determined HMRC's alternative argument as further submissions are required.

Halifax abuse of rights principle

Anyone hoping that the Court of Appeal's decision in *HMRC v Paul Newey (T/A Ocean Finance)* [2018] EWCA Civ 791 would bring finality to this case will have been disappointed. The Court of Appeal concluded that the FTT had made errors of law (including in its application of the first limb of the *Halifax* test (whether the tax advantage is contrary to the purposes of the VAT Directive) and that the UT had itself then made an error of law in concluding the errors made by the FTT were immaterial. In consequence, the Court of Appeal remitted the case to the FTT for further consideration of the facts in the light of the guidance of the CJEU and the Court of Appeal. Of course the FTT might, after all this, confirm its earlier decision that although the decision to restructure the business of Ocean Finance in Jersey was purely tax driven, it is not contrary to the purposes of the Sixth VAT Directive. But it must do so this time without making errors of law, assessing the question of artificiality by reference to the business relationships actually entered into between the parties with a view to testing whether they reflected underlying commercial reality.

What to look out for

- The transitional arrangements for the VAT cost sharing exemption end on 31 May.
- 31 May is also the closing date for written submissions to the Treasury in relation to its inquiries into VAT, tax avoidance and evasion and tax dispute resolution.
- The Insurance Companies (Taxation of Re-insurance Business) Regulations 2018 (SI 2018/538) update and replace the 1995 regulations concerning the taxation of investment returns from basic life assurance and general annuity business (BLAGAB), where life insurance companies re-insure this business, with effect from 1 June 2018. These regulations define the scope of the charge and provide the method of calculating the amount of the investment returns. The charge is intended to represent the amount of the investment return accruing to a company that reinsures the risk in respect of a policy or contract attributable to its BLAGAB.

This article was first published in the 11 May 2018 edition of Tax Journal.

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