Tax and the City Briefing

August 2018

A legislative amendment is proposed to prevent "offshore looping" of the type seen in the *Hastings* case. The High Court determines in *Minera Las Bambas* that tax is not "payable" for tax indemnity purposes until the appeal against the tax assessment has been determined by the relevant court. The exemption from VAT for transactions concerning payments and transfers is so narrowly construed by the CJEU in *DPAS* that it is difficult to see how anyone other than a financial institution can fall within it. The FTT reminds us in *Wildbird* of the constituent parts of a loan relationship and shows that the content of the HMRC Manuals can be incorrect.

Prevention of "offshore looping"

The general position under current UK law is that the supply of (broadly) intermediation for financial services or insurance products is an exempt supply in respect of which there is no recovery of input tax. Where, however, such services are exported from the EU by a taxable person (one who is, or is required to be, registered in the UK for VAT), the supplier can reclaim the VAT incurred on the provision of the services (VATA 1994, s26(2)(c) and the VAT (Input Tax) (Specified Supplies) Order 1999, SI 1999/3121 (the "SSO")). This rule is currently being exploited by companies (particularly in the insurance sector) that form arrangements with organisations outside of the EU to re-supply or 'loop' those services back to UK consumers, allowing themselves to reclaim the VAT and thereby gain a competitive advantage over purely UK based companies which cannot reclaim the VAT.

One example of such exploitation is *Hastings Insurance Services Ltd v HMRC* [2018] UKFTT 27. The issue in that case was whether the supply of intermediary services was made to a UK fixed establishment or was made outside the EU. As the FTT decided the latter, the input tax was recoverable. HMRC has since lodged its appeal with the Upper Tribunal. Following HMRC's defeat in *Hastings*, however, other insurers have made it clear that if this distortion between offshore looping and purely UK supplies is not addressed, they will have to adopt similar structures to compete.

The government therefore intends to stop such arrangements from working. It has published draft regulations amending the SSO and is consulting on whether the draft amendments have the desired effect. Those amendments seek to prevent 'looping' by restricting the application of the SSO to cases where the final consumer is not in the UK, as was intended. The proviso at the end of SSO, regulation 3, will be amended so that if the intermediation supply is to carry the right to recover input tax, the transaction that is being intermediated must, itself, be an exempt insurance or financial supply made to a non-EU recipient.

The amended SSO relies on a narrower view of the Principal VAT Directive, Article 169(c) than the UK has previously taken, with "the customer" being read as the ultimate consumer in the context of intermediary services. So if in the *Hastings* case, Advantage's own customers belonged in, say, Gibraltar, the effect of the amended SSO would be that Hastings would still be able to recover input VAT on supplies of intermediary services to Advantage because there is also a supply (by Advantage) of insurance products to persons belonging outside the member states, whereas there would be no recovery for Hastings to the extent that Advantage's insurance products are supplied to UK customers.

An earlier version of the Gibraltar loop, involving the repayments to third country traders rules, was blocked in 2004 (in response to *WHA Ltd and another v C & E Comrs* [2004] STC 1081, CA). SI 1995/2518, regulation 190 was amended with the effect that no input tax has since been recoverable in respect of, inter alia, intermediary services supplied by a non-EU person which is not registered, or required to be registered, for VAT in the UK.

More recently, another variant of offshore looping, involving the provision of repair services to insurers, was blocked in 2016 (by the insertion of VATA 1994, Schedule 4A paragraph 9D). At the time of the 2016 change, the government considered further action - particularly in respect of the application of the VAT use and enjoyment provisions - but concluded no further change was merited at that time. The government is now considering additional measures to prevent VAT being lost in similar arrangements in other sectors. According to the ministerial statement about the latest change, given the additional risks since identified, the scope of the options now under consideration will be much broader, including the use of measures outside of the UK VAT system altogether.

It is good news for the UK insurance market and financial products market that the government has responded to the concerns raised and is taking action to level the playing field for the treatment of intermediary services where the ultimate consumer is in the UK regardless of whether or not there is a loop out of the EU and back again before the UK consumer gets their product.

Minera Las Bambas: when is foreign tax payable?

Minera Las Bambas SA & Anor v Glencore Queensland Ltd & Ors [2018] EWHC 1658 (Comm) (29 June 2018) involved a claim made under a tax indemnity in a share purchase agreement. The claim was in respect of Peruvian VAT assessed on the target company. An appeal has been made to the Peruvian tax court challenging the assessment to VAT which could take several years to determine. Minera, as purchaser, brought a claim under the tax indemnity to recover the Peruvian VAT but Glencore, the seller, refused to pay on the basis that the VAT was not yet payable. The issue before the UK High Court, therefore, was whether the VAT was "payable". The High Court determined that it was not "payable" for the purposes of the tax indemnity until the appeal against the tax assessment has been determined by the overseas court and the debt becomes "coercively enforceable" under Peruvian law.

There have been several cases in recent years involving the construction of tax indemnities under share purchase agreements and the lesson to be learned from them is that where, as here, the contract has been negotiated and prepared with the assistance of "leading international firms" the factual matrix carries little weight. The courts take a strict view of construction of such negotiated contracts and are unwilling to look beyond the agreed documentation to, for example in this case, internal emails about the importance of the early recovery of VAT, to see the intention of the parties. It is important, therefore, to ensure that the tax indemnity contains clear, express provisions dealing with the timing of payments where payment of tax is deferred (whether automatically or by agreement with the relevant tax authority) pending resolution of a dispute.

DPAS: VAT treatment of payment services

DPAS operated dental payment plans for dentists which involved collecting amounts from the patients and remitting these amounts (less the charge for DPAS' services) to the dentists. Following the case of *AXA UK* (C-175/09), DPAS restructured its contracts to provide payment handling services direct to the dental patients rather than the dentist. By doing this, DPAS hoped to avoid having its services categorised as debt collection (because it was then providing services to the debtor rather than to the creditor) and aimed to get itself within the exemption under Article 135(1)(d) of the Principal VAT Directive for payment services. The Upper Tribunal referred the case to the Court of Justice ("CJEU"), which held that DPAS was not entitled to exempt its charges under Article 135(1)(d) (see *DPAS Limited* (C-5/17)) as its services were administrative in nature. DPAS did not itself debit or credit any accounts but requested that the relevant financial institutions where the accounts were held transfer the funds. This was "merely a step prior to the transactions concerning payments and transfers". The CJEU regarded it as significant that DPAS was not ultimately responsible for the failure or cancellation of the direct debit mandate.

Although the CJEU reinforces the fact that the exemption should not be limited to banks and financial institutions (see paragraph 45), it is quite hard to see how anyone other than a bank or financial institution can benefit from the exemption if, as paragraph 41 seems to suggest, the exemption for payments or transfers applies only where a person either carries out the transfer of funds or otherwise "materialises" the transferred sums in the relevant bank accounts. It is not enough to merely trigger the payment transfer – the person claiming exemption would need to effect the payment transfer itself.

This case is likely to affect a range of businesses, particularly those operating in the financial services sector. Ultimately, any increased costs of outsourcing as a result of the DPAS decision are likely to be passed on to consumers.

Wildbird: back-to-basics on loan relationships

The decision of the First-tier Tribunal ("FTT") (Judge Kevin Poole) in *Wildbird Foods v HMRC* [2018] UKFTT 341 (TC) considered whether loans advanced by Wildbird Foods Limited ("Wildbird") to its 50% subsidiary, Birdforum Limited ("BFL"), were loan relationships. The FTT held they were loan relationships, which meant that Wildbird was entitled to an impairment debit. As well as being a useful reminder of the constituent parts of a loan relationship, the case also shows that the HMRC Manuals are not infallible – they are HMRC's interpretation of the law which can, as was shown here, be wrong!

The relevant facts are that £1.5m of interest-bearing loans had been advanced by Wildbird but no interest had been paid and no repayments of principal had been made. Wildbird claimed a non-trading loan relationship debit equal to the amount of the loans advanced during each of 2013, 2014 and 2015 on the basis that the loans were unlikely to be recoverable in the short term and were accordingly provided for in Wildbird's accounts. The loans were made on an arm's length basis on the understanding that if, and when, BFL generated income, or there was an intention for it to be sold, the debt and interest would be paid out before the remaining funds were shared between the shareholders. The FTT applied CTA 2009, sections 302 and 303 to see whether the loans in question were "money debts" arising from a "transaction for the lending of money".

HMRC's arguments were based on the 1937 case of *Smart -v- Lincolnshire Sugar Limited* (20 TC 642) HL in which the issue was whether a cash payment to the sugar company was a trading subsidy or a loan. This case is commented on in HMRC's Corporate Finance Manual at paragraph CFM31030:

Extract from CFM31030 about *Smart -v- Lincolnshire Sugar Limited*

"Lord Wright, in the Court of Appeal, said that the subsidy had none of the 'marks' of a loan. Not only was there no 'firm or unqualified obligation to repay', it did not carry interest, and was 'not an ordinary mercantile transaction by way of loan'.

On this basis, a contingently repayable amount is likely to be a debt - and hence a money debt within CTA09/S303 - if it has the hallmarks of a loan: for example, if evidenced by a debt instrument, carries interest, ranks above share capital in a liquidation, and so on. Accounting treatment may be one of these 'marks', but is not in itself decisive."

The gist of HMRC's arguments is that there was no "money debt" because the amount owing did not bear the hallmarks of a loan but rather bore the hallmarks of equity. HMRC identified the following missing debt hallmarks: (i) interest had never been charged or paid; and (ii) BFL had not made a profit and did not have capacity to repay the advances. In short, HMRC argued that this was not a true arm's length transaction bearing any resemblance to the commercial reality of a loan relationship.

The FTT pointed out that the commentary in CFM31030 misrepresents what Lord Wright actually said in *Smart*. The statements attributed to Lord Wright in that commentary were merely his rehearsal of arguments for the Crown and were not endorsed, except for the statement that the transaction was "not an ordinary mercantile transaction of a loan" which was self-evidently true on the facts. The FTT found that *Smart* cannot bear the weight suggested by HMRC as there were too many obvious differences.

The FTT found that the advances are, in law, repayable with interest and have not been legally written off. There is a clear contractual agreement between the parties that interest is payable, it is just the case that the parties have agreed there is no point in the interest actually being charged unless and until funds are available to pay it. There can be no change to the legal status of the advances as debts due from BFL to Wildbird simply because of the latter's failure to require repayment.

The FTT explains that modern business has many examples of companies, especially tech companies, with no cash and no immediate prospect of generating a profit which go on to be very successful. Clearly Wildbird considers BFL to be such a company and is prepared to wait until it becomes successful for repayment of some or all of its loans and interest.

On the "hallmarks" specifically, the FTT determined that there is no requirement for a loan relationship to exist that either:

i. interest must be charged – otherwise many perfectly normal intra-group loans would fall foul of that requirement; or

ii the lender has to have any degree of certainty that the debt will be repaid - lack of fixed repayment date for a loan is perfectly commonplace.

What to look out for:

- The closing date for comments on the draft Finance Bill 2019 legislation is 31 August. The draft legislation includes further technical tweaks to ensure that the corporate interest restriction and the carried-forward loss rules work as intended, including some changes to the latter specific to insurance companies.
- September will see the information obtained under the OECD's Common Reporting Standard exchanged across more than 100 jurisdictions. It will be interesting to see how the relevant tax authorities make use of this information.

This article was first published in Tax Journal on-line on 1 August 2018.

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

Zoe Andrews
T +44 (0)20 7090 5017
E zoe.andrews@slaughterandmay.com

553928501