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The Upper Tribunal in *Union Castle* agrees with HMRC that the issue of shares is a "provision" to which transfer pricing can apply. The recently published diverted profits tax statistics show a steep increase in both the numbers of notifications by companies and the preliminary notices and charging notices issued by HMRC. The AG's opinion in *C&D Foods*, if followed by the CJEU, may call into question the UK's treatment of input tax on costs where an intended share sale is aborted.

Union Castle: transfer pricing applies to shareholder transactions

There are a number of interesting points in the Upper Tribunal's (UT) judgment in *Union Castle Mail Steamship Company v HMRC* [2018] UKUT 316 (TCC). The case considers whether an accounting debit linked to the derecognition of derivative contracts fairly represented a loss arising on derivative contracts for the purposes of corporation tax under FA 2002 schedule 26, now rewritten in CTA 2009. The derecognition of the derivatives was triggered by the issue of bonus shares carrying dividend rights which entitled the shareholder to the economic benefit of 95% of the derivatives. In July 2016, the First-tier Tribunal (FTT) decided the case in favour of HMRC on the basis that there was no loss because Union Castle remained entitled to receive the cash flows under the derivative contracts and chose to give most of those cash flows away. There was, accordingly, no diminution of Union Castle's resources and therefore no real loss.

The UT decided the appeal in favour of HMRC, holding that there was a loss but it did not "arise from" the derivative contracts as the legislation required; rather it arose from the issue of the bonus shares. In the UT's view, there was a loss because there had been a diminution in the net worth of Union Castle as shown in its GAAP compliant accounts as a result of Union Castle having effectively given away 95% of the economic benefit of the derivatives to its parent.

Compare and contrast *GDF Suez Teesside Ltd v HMRC* [2018] EWCA Civ 2075 where the taxpayer's argument, that it had not made a "profit" to be taxed under comparable loan relationship rules because in transferring contingent claims to a wholly owned subsidiary its net worth as shown in its GAAP compliant accounts remained unchanged, has proved unsuccessful yet again. If the UT hearing *Union Castle* had heard *GDF Suez* they would surely have had to find the taxpayer successful in its appeal in the court below. Perhaps another indicator that Parliament really did intend taxable profits and losses arising on loans and derivatives to be determined by reference to accounting treatment - not identified by HMRC or a tribunal or court applying some unspecified rules and principles of their own choosing on the day.

Of more general interest, as a fall back before the FTT, HMRC had argued that the bonus issue of shares was a "provision" within ICTA Schedule 28AA (now rewritten in TIOPA 2010 Part 4) and that the effect of applying the arm's length price to the issued shares would be to reduce to nil the amount deductible for the debit. The FTT held that the issue of shares is not a "provision" and so transfer pricing does not apply. This was contrary to the FTT's prior decision in *Abbey National Treasury Services plc v Revenue and Customs Commissioners* [2015] UKFTT 0341 (TC). The FTT in Union Castle said, as obiter, that the reasoning in *Abbey National* was wrong – the starting point is that shareholder transactions are not within the scope

of transfer pricing and there is nothing to point to that would include them. In *Union Castle*, the UT said the FTT had erred in law in reaching this conclusion. The UT reached the same conclusion as the FTT had done in *Abbey National* as to the scope of the transfer pricing rules in this context. As the transfer pricing point was not material (HMRC having won on the point that the loss did not arise from the derivative contracts) the UT did not express a view on the other conclusions reached in the *Abbey National* case, in particular the conclusion that the comparator transaction in *Abbey National* was one where no relevant shares had been issued.

Agreeing with the FTT in *Abbey National* that share issues are within the scope of the transfer pricing rules has the potential to create a great deal of uncertainty. Where do you draw the line on recharacterisation? Could HMRC use it to argue that some of the shares in a fatly capitalised subsidiary should be recast as interest bearing debt? That would seem to go too far but is the sort of difficult question that is raised by confirming share issues as being within the scope of transfer pricing. And how do you apply the arm's length principle, which essentially asks what would have happened between independent parties, to transactions which only happen between parties with an equity connection? The *FTT* in *Abbey National* effectively said that because ANTS would never make a bonus issue to a third party, essentially giving value away, the appropriate comparator was no bonus issue. But bonus issues to non-controlling shareholders are common transactions, including for listed groups. Whilst self-evidently such groups would not give away shares to third parties, are they not good evidence that a pro rata bonus issue, where a shareholder neither receives nor loses any value in its shareholding but it is merely reorganised, is on appropriate terms and should not be adjusted or ignored? What about the implications for other shareholder transactions, such as a dividend?

Diverted profits tax

Diverted profits tax (DPT) appears to be working well for HMRC – both in terms of DPT actually collected in response to DPT charging notices but also in additional amounts of corporation tax resulting from behavioural change (together the "DPT yield"). In 2017/18 the DPT yield was £388m (£169m of which was in respect of behavioural change). In 2015/16 DPT yield was £31m, rising to £281m in 2016/17.

The behavioural change component of the DPT yield has two elements. The first is additional corporation tax paid as a result of HMRC intervention to ensure that profits earned in the UK are taxed in the UK. The second is voluntary behavioural change where businesses have changed their structure or transfer pricing arrangements without an HMRC intervention occurring.

Companies have to notify HMRC if they have arrangements that potentially fall within the scope of the DPT legislation. DPT notifications have risen from 48 in 2015-16 to 145 in 2016-17 to 220 in 2017-18. HMRC then has 2 years from the end of the accounting period in which it believes the DPT charge arose to investigate to determine whether it is reasonable to issue a DPT preliminary notice. Some companies have made protective notifications so as to get within the 2 year time frame, rather than the usual 4 years, and with the hope of speeding up resolution of any issues which may explain some of the increase in notifications.

HMRC will issue a preliminary notice before the 2 years expires where it believes DPT may be due. 200 preliminary notices were issued by HMRC in 2017-18, up from 16 in the previous year. Depending on the company's response to the preliminary notice, HMRC may then issue a charging notice setting out the amount of DPT to be paid by the company. Charging notices rose in

2017/2018 to 190, although as some of these include multiple notices in relation to a single arrangement, it is perhaps more instructive to note that the preliminary notices were issued to 28 business, 22 of whom then went on to receive charging notices. During 2015/16 HMRC did not issue any DPT preliminary or charging notices. In 2016/2017 HMRC issued 16 DPT preliminary notices and 14 DPT charging notices. The increased figures for 2017/18 suggest HMRC had an initial hit list of key targets and are now turning attention to others.

A draft clause for inclusion in Finance Bill 2019 was published on 19 July setting the annual rate of interest applying to diverted profits tax at 3% for the period from 1 October 2015 to 5 April 2017 and 2.5% thereafter. It appears that the rate setting provision had been omitted from the original DPT legislation.

C&D Foods: input tax recovery by holding companies

To a non-VAT specialist, it might seem odd that this topic has generated so much case law. But questions concerning the ability of a holding company to recover input tax on legal fees on the acquisition or disposal of a subsidiary, or on the aborted acquisition or disposal of a subsidiary have proved to be problematic. For input tax to be recoverable, two critical conditions have to be satisfied. First, the person incurring the input tax must have done so for purposes that would be recognised as a "business" (or in EU-parlance, an "economic activity") for VAT purposes. Second, the person incurring the input tax must intend to use the relevant inputs for the purposes of making taxable supplies. Over the years, to address the issue of input tax recoverability, the Court of Justice of the EU (CJEU) has developed the concepts of "direct and immediate link" and "cost component", notwithstanding no such language is to be found on the face of the Principal VAT Directive.

The latest case before the CJEU on this topic is *C&D Foods Acquisition* (Case C-502/17) which concerns the deductibility of costs directly related to an aborted share sale. The opinion of AG Kokott was released on 6 September (although it is at the time of writing not available in English). On the first condition, it is helpful that AG Kokott took the view that as the acquisition of shares by a holding company with a view to providing management services to the subsidiary can constitute an economic activity, likewise the disposal of shares which ends a holding company's management of that subsidiary is also an economic activity. On the second condition, AG Kokott suggests the passing of this case back to the national court to determine whether there exists a direct and immediate link between the legal advice provided to C&D Foods and the aborted share sale. If so, because the supply of shares is an exempt transaction, the input VAT would not be recoverable. If the national court finds that there is no direct and immediate link to the disposal (which seems unlikely as the main purpose of the legal advice seems to have been the disposal of the shares and the drafting of the contract to sell the shares) a possible link to the business as a whole could be explored.

The UK treatment of input tax on costs where an intended share sale is aborted is often to deduct it as an overhead. If the CJEU follows AG Kokott's opinion in *C&E Foods*, this treatment will be brought into question.

Earlier this year, AG Kokott opined in *Ryanair* that input VAT was recoverable on the costs of an unsuccessful takeover bid for Aer Lingus. Although the reference to the CJEU treated Ryanair as a holding company case, AG Kokott found it artificial to have regard to the future provision of remunerated management services by Ryanair as a holding company and instead applied a functional analysis. Her conclusion was that the costs had a direct and immediate link with Ryanair's main operating business. The CJEU's judgment in this case, released on 17 October, that the input VAT was recoverable in full was decided, however, on the basis of the questions referred which relied

solely on the intended provision of management services and consequently, the CJEU did not explore a functional analysis.

What to look out for:

- Two CJEU judgments released in October are of interest. On 17 October, the CJEU ruled in *Ryanair* (C249/17) that input tax on consultancy costs incurred on Ryanair's abandoned takeover of Aer Lingus is recoverable in full. On 18 October, the CJEU released its judgment in *Volkswagen Financial Services* (C153/17), a referral from the UK's Supreme Court. It will be a relief to the motor leasing industry that the CJEU accepted the categorisation of hire purchase under UK law as comprising distinct supplies of the taxable supply of a vehicle and exempt supplies of credit. The Advocate General (AG) had suggested the transactions should be treated as a single taxable supply with full input tax recovery, but that the supplier would be obliged to account for VAT on the credit element. Also helpful to taxpayers is the CJEU's ruling that the fact that VWFS decided to include the general costs not in the price of the taxable transactions (the cars were sold at cost to the customer) but solely in the price of the exempt finance transactions did not prevent the costs from being components of the price of the taxable supply of cars.

- The Court of appeal hearing in *Fowler v HMRC* on whether deemed trading income should be categorised as business profits for the purposes of a Double Tax Agreement is due to commence on 23 or 24 October.

- The Autumn Budget will be on Monday 29 October.

- Commencing 5 November to 7 November, the Upper tribunal will hear the appeal in *Blackrock Investment Management (UK) Limited v HMRC* on whether the exemption from VAT for the management of special investment funds applied to the supply of an investment management computer platform by a third party.

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