Tax and the City Briefing

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A new, non-sector specific, hybrid capital instrument regime will apply in place of the regulatory capital securities regime from 1 January 2019. The Court of Appeal finds in *GDF Suez Teesside* that the (now repealed) 'fairly represents' requirement in the loan relationship rules is a separate and overriding provision. The UK's categorisation of a hire purchase transaction as a taxable supply of a car and exempt supplies of credit is confirmed as correct by the CJEU in *Volkswagen Financial Services*. The legislative change to combat 'offshore looping' will be targeted more tightly on the known avoidance - insurance intermediary supplies where the principal supply is made to consumers located within the UK.

Hybrid regulatory capital

The UK has for many years adopted a policy of allowing banks and insurers which issue securities which, though legally debt, contain certain equity-like features in order to meet regulatory capital requirements deductions for the coupons thereon. Pre-CRD IV and Solvency II, so-called 'innovative tier 1' capital, was deductible on first principles although this required careful analysis of the terms and conditions of each particular issue. Although perpetual in nature, and therefore 'equity notes', they were not held by 'associated persons' and were debt because they fell to be repaid on a winding up of the issuer. Payments were subject to a 'solvency condition', which did not make coupons 'results dependent', because that only went to timing of payment, not quantum. And it did not matter that coupons were accounted for as dividends, the pre-2016 loan relationships regime still recognised them.

For AT1 and RT1 instruments which were required to have more equity-like features, this was achieved under The Regulatory Capital Securities Regulations, SI 2013/3209 which took a much more broad brush approach. Provided the instrument satisfied certain regulatory conditions, the regulations provided, inter alia, that coupons were not to be distributions, credits arising on a write down or conversion were not to be taxable and for exemptions from withholding tax and stamp duties.

Following the announcement in June that the Netherlands would be removing tax deductibility for CoCo bonds with effect from 1 January 2019, partly after the European Commission had expressed state aid concerns, the market had been waiting to see how other jurisdictions, particularly the UK, would respond. In a welcome development the UK has taken the opportunity to revisit the tax treatment of debt capital more generally in the light of the forthcoming Bank of England MREL requirements and announced at the Autumn Budget that the regulatory capital securities (RCS) regime would be repealed and replaced from 1 January 2019 by a new hybrid capital instrument (HCI) regime which is not restricted to banks/insurers (a move utilities are thought to be particularly interested in).

An HCI is a loan relationship on which the debtor (but not the creditor) is allowed to defer or cancel interest payments. An HCI must have no other significant equity features (new CTA 2009 s475C(2) defines 'no other significant equity features'). Provision for conversion or write down is permitted only if the debtor is experiencing solvency or liquidity problems or where the instrument must include a term allowing conversion or write down for regulatory or other legal reasons.

The HCI regime will be elective: this ensures HMRC is given an early warning of anyone using the regime (the election must be made within six months of the issue of the HCI, or for loan relationships already in existence on 1 January 2019, by 30 September 2019). The election will be ineffective where there are arrangements, the main purpose, or one of the main purposes, of which is to obtain a tax advantage for any person. Reassuringly, the Technical Note issued on Budget day states that neither the choice of HCI for commercial purposes nor the use of HCI to enhance a credit rating will normally indicate a tax avoidance purpose.

The HCI regime represents a move away from the RCS 'blanket fix' approach. It does not simply provide for payments on a HCI not to be distributions. Rather, the legislation focuses on making the minimum changes necessary. So, the HCI rules only prevent coupons being treated as distributions because of a provision allowing the issuer to defer or cancel an interest payment (which in HMRC's view creates a results-dependency issue) or the equity notes rules. Other provisions of the distributions code will need to be analysed as normal. Coupons accounted for as equity will be recognised notwithstanding the 2016 changes to the loan relationships rules. There is an exemption from stamp duties, but not from withholding tax, and HCI's are 'normal commercial loans' for grouping purposes.

This means more work for lawyers who had become more relaxed about the terms and conditions of such instruments provided they satisfied the regulatory conditions. And not just in relation to new issues but also in relation to existing instruments once the new rules come into force on 1 January 2019 as there is no general grandfathering provision (although there are certain transitional rules such as the repeal of the withholding tax exemption not applying to regulatory capital securities in issue immediately before 1 January 2019 until 1 January 2024).

The HCI regime contains no special treatment for write downs/releases or conversions (conversions are not usually a taxable event). Although in general, credits on releases or write downs would be taxable, it is understood HMRC had expected that one of the exceptions in CTA 2009, s322 would apply. However, whilst the Prudential Regulatory Authority seems to have accepted this is likely to be the case for banks, it has taken a different view in relation to insurers and has published a consultation paper (CP 27/18) suggesting insurers will need to take into account the maximum tax liability which could arise on write down when calculating their regulatory capital requirements.
A new CTA 2009 s352B will eliminate tax mismatches by allowing an external loan relationship to be taxed on an amortised cost basis if there is a qualifying link to one or more loan relationships between connected companies. There will be a qualifying link if the capital raised is wholly or mainly used to fund loan relationships between connected companies.

GDF Suez: 'fairly represents' rule

The Court of Appeal has given judgment in *GDF Suez Teesside Limited v HMRC* [2018] EWCA Civ 2075. TPL (the name of GDF at the relevant time) had a substantial number of claims against other members of the Enron group. As contingent assets, the claims were not recognised in TPL's books but they had an agreed value of £200m. TPL entered into a scheme devised by EY, which was disclosed under DOTAS, which involved TPL setting up a Jersey subsidiary, TRAIL, and TPL transferring the claims to TRAIL in consideration for the issue of shares. As the claims were taxed as loan relationships, the expectation was that tax would follow the accounts in both TPL (and, for CFC purposes, TRAIL). TPL's accounts did not recognise any 'credits' on the transfer on the basis that TPL had, in effect, swapped the claims, which were contingent assets which it was not permitted for accounting purposes to recognise until it was virtually certain they would pay out, for shares the value of which was wholly derived from those same contingent assets. TRAIL was obliged under the accounting rules to record the base value of the claims at their market value of £200m. Consequently, a profit taxable for TPL under the CFC rules would arise only to the extent that the claims realised exceeded the book value of £200m.

Although on the face of it TPL has lost the case three times now, it is worth noting that TPL won consistently on the correct accounting treatment throughout. HMRC had argued that the accounts were not GAAP compliant; or if they were, that another GAAP compliant method existed which HMRC should be entitled to substitute for the method actually used. HMRC even argued (unsuccessfully, thankfully) that UK GAAP at the time was not compliant with the Companies Act 1985. Although the Court of Appeal did not need to give further consideration to the accounting issues, Lord Justice Henderson suggested none of HMRC's arguments came close to persuading him that any material error of law could be identified in the Upper Tribunal's treatment of the accounting issues.

Having used the correct accounting method was not enough, however, to save TPL from tax. HMRC successfully persuaded the Court of Appeal (as it had persuaded the First-tier Tribunal (FTT) and the Upper Tribunal (UT) before it) that Finance Act 1996, s84(1) enabled HMRC to tax TPL anyway. This part of the case turned on the effect of the 'fairly represents rule' in s84(1) (now repealed in the current loan relationship rules). At one end of the spectrum, taxpayers, including TPL, had taken the position that the rule merely provides a bridge between the accounts and the loan relationships rules to enable profits from the accounts to be allocated to the correct period for tax purposes. At the other end of the spectrum, HMRC had argued that the rule gives them a general accounts override.

In this case, the Court of Appeal was persuaded to view the 'fairly represents rule' as being more than a mere attribution rule. The Court of Appeal reached this conclusion based on two sets of changes to the loan relationship rules. The first change removed from section 84(1) the wording "in accordance with an authorised accounting method" as part of updating the loan relationships rules with effect from 2005 for changes to UK GAAP and was not meant to be a fundamental change to s84(1). The second change was a package of amendments introduced in 2006 which did not alter the drafting of s84(1) but the explanatory notes for which said that the amendment to s85A(1) makes it clear that "the 'fairly represents' rule does override the accounting treatment". The reasoning of the Court of Appeal raises the question of the extent to which it is permissible to use explanatory notes to a later Act, on the clarification of a later section, to construe another section. It is also a reminder that explanatory notes are produced by HMRC/HMT, not by Parliament and so cannot, without more, be taken as the intention of Parliament.

TPL argued that if Parliament had intended that HMRC could set aside the accounts, the drafting of s84(1) would have been more explicit, particularly in providing a method for determining profits and losses in the event of an accounts override. The Court of Appeal noted the force of this argument but ultimately did not think it was a problem that the legislation does not provide a method to identify profits or losses in circumstances where the accounts are being overridden. The Court of Appeal pointed out that both the FTT and UT had had no difficulty in identifying the same amount of profit to tax, namely £200m. It did not seem concerned either that the FTT and UT had arrived at that figure using different methodology, nor that the £200m was not a profit but a gross receipt.

Volkswagen Financial Services: VAT treatment of hire purchase transactions

The CJEU's judgment in *Volkswagen Financial Services* (C153/17), a case referred by the UK's Supreme Court, is welcome news for taxpayers, particularly in the motor industry. The CJEU confirms the UK's treatment of car hire purchase transactions as comprising a number of separate supplies, including a taxable supply of a vehicle and exempt supplies of credit. The CJEU did not follow the Advocate General's suggestion that the transactions should be treated as a single taxable supply with full input tax recovery with the supplier being obliged to account for VAT on the credit element.

Volkswagen Financial Services (UK) Limited (VWFS) supplies Volkswagen cars to customers under hire purchase terms. It concludes a hire purchase agreement (HPA), purchases the car from the dealer and supplies it to the customer at cost plus a finance charge. The HPA provides that ownership of the vehicle does not pass to the customer until all payments due under the HPA have been made.
The CJEU held that the fact that VWFS includes its general costs (such as staff training and recruitment, maintenance and enhancement of IT infrastructure and premises and stationery-related overheads) 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. It is hoped that this will put an end to HMRC's long-running argument that input tax recovery is only available to the extent that the cost of an input can be traced to the price of a taxable output.

VWFS and HMRC disagree on the extent to which VWFS is entitled to deduct input tax on general costs. HMRC had proposed restricting recovery by excluding the value of the car from the partial exemption calculation but the CJEU held that this method is not capable of ensuring a more precise apportionment than that which would arise from the application of the turnover-based allocation key. The CJEU did not suggest what a fair and reasonable method would consist of, so it may still be some time before this issue is finally resolved for the leasing industry.

Offshore looping: confining the draft legislation to insurance intermediaries

Providers of insurance services generally cannot reclaim the VAT they incur on their costs because their services are VAT exempt. An offshore loop is a cross-border structure that enables these VAT costs to be recovered by routing insurance services primarily carried out in the UK via a body located outside the EU. These services are then used to provide insurance back into the UK market.

The VAT (Input Tax) (Specified Supplies) Order 1999 (SI 1999/3121) (SSO) will be amended to prevent VAT avoidance by insurance intermediaries in the form of offshore looping. The change to the SSO is in response to HMRC's defeat in *Hastings Insurance Services Ltd v HMRC* [2018] UK FTT 27 (which showed the offshore loop worked). The intention is to level the playing field so that those insurers using offshore intermediaries are not in a better recovery position than those who do not.

A draft SI amending the SSO was published on 19 July 2018 for consultation and as a result of comments received it will be amended to target it more tightly on the known avoidance - insurance intermediary supplies where the principal supply is made to consumers located within the UK (the earlier version applied to insurance intermediary and financial intermediary services and restricted input tax recovery where the principal supply was to consumers located within the UK and the EU). The statutory instrument will be laid in December 2018 and will be implemented on 1 March 2019.

What to look out for:

- Beginning 19-21 November the Upper Tribunal will hear the appeal in *Ball UK Holdings* on whether accounts had been prepared in accordance with GAAP.
- The Court of Appeal will begin to hear the appeal in *Farnborough Airport* on 20 or 21 November on whether the appointment of a receiver triggered degrouping.
- On 6 December, the Supreme Court will hear *Hancock & Hancock v HMRC* concerning the interaction of the CGT rules which relate to corporate reorganisations and those which relate to qualifying corporate bonds.
- The OTS consultation on the impact of tax on business closes on 7 December.

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