SLAUGHTER AND MAY

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The *Investec* case returns to the Upper Tribunal for consideration of whether (and if so, how) taxed partnership profits have to be brought into the tax computation of the partners' financial dealing trades. In *A Ltd v Finland Insurance* the CJEU confirms that premiums on contracts covering risks associated with cross-border company acquisitions should be taxed where the policyholder is located, not where the target is located. In *Morgan Stanley*, the CJEU rules on the input tax recovery of a French branch concluding that it is necessary to look through to the taxable activities of the UK head office. The government decides to align with EU law the VAT exemption for SIF management to provide certainty after the UK leaves the EU. Recent diverted profits tax developments are the December 2018 revised guidance and the launch of a new Profit Diversion Compliance Facility to encourage MNCs to reset their transfer pricing.

Investec - partnership profits brought into tax computation of partners' financial dealing trades

HMRC v Investec Asset Finance PLC and another [2018] UKUT 0413 (TCC) is a good reminder that whilst partnerships have existed as a creature of English law for a long time and are very widely used, there are very few provisions in the UK tax code dealing expressly with them and they have a tendency to throw up some difficult questions. Often, this occurs in areas where the rule that tax follows the accounts (which respect the partnership as a separate entity) bumps up against tax transparency (provided for by a relatively short-form statutory section).

To cut a (very) long story (very) short, in this case two taxpayer companies with financial trades (IAF and IAB) bought some interests in leasing partnerships. They contributed extra capital to the partnerships, the partnerships monetised some receivables they had and the proceeds were paid out to the partners as a mixture of returning partnership capital contributions and distributions of profit.

What do you do when each partner falls to be taxed on both the profits of its financial trade in accordance with its accounting treatment under s. 42 FA 1998; and on its share of the profits of the trade carried on by each partnership in accordance with the partnership's accounting treatment by virtue of s. 114 ICTA 1988 and s. 42 FA 1998? Also when, in one case, repayments of capital and distributions of profit by the partnership are brought into account by the partners as income; and, in the others, the partners' accounts "look through" the partnership and recognise the underlying receivables?

The traditional approach is to respect the fact that the partners' and partnerships' trades are each separate trades and calculate the profits of each. However, when calculating the profits of the partners' trades, the traditional approach ignores as "tax nothings" both the amounts paid to acquire the partnership interests and in making capital contributions; and the amounts received from the partnership as profit distributions or repayments of capital. (This approach is most likely taken on the basis that that is consistent with the basic transparency principle provided (at the time) by ICTA 1988 s 111 of not treating the partnership as a distinct and separate entity from the partners). The traditional approach, however, did not produce the result IAF and IAB were hoping for. They saw this as, in substance, an acquisition of receivables by the partners. In order to produce the "right" taxable profit as they saw it, they

needed to deduct the cost of acquiring the interests, and of making the capital contributions, from the income received by the partnerships.

HMRC had argued that either the costs were not deductible, either on the basis of being capital or of not being incurred wholly and exclusively for the purposes of the partners' trades, or that you should not adjust the partners' trading profits to remove distributions by the partnerships representing already taxed profit.

The FTT had found for the taxpayer on those three issues. On appeal, the Upper Tribunal earlier in the year had held that the FTT was right on the capital/revenue point; partly right on the wholly and exclusively point (the capital contributions were not incurred wholly and exclusively for the purposes of the partners' trades); but invited further argument on the double tax point. It agreed with the principle that taxable profits of the partnership should not be taxed again in the hands of the partners but queried the application of the principle to the facts at hand.

In particular, the Upper Tribunal mooted the possibility that it might be harder to leave returns of capital out of account rather than profit distributions per se when calculating profits at the partner level. It noted potential difficulties where the partner had accounted on a "look through" basis, inviting the parties to make further submissions. Unfortunately the latest judgment does not provide a lot of answers.

To the extent it was necessary to answer the "look through" question, that would need to be referred back to the FTT to find, as a matter of fact, for which trade(s) the accounts show a deduction for the acquisition costs and capital contributions. With regards to the capital return, the Upper Tribunal held that a capital return funded by the proceeds of the sale of lease receivables was not the same income as the lease receivables. However, it simply asserted that without any substantive reasoning. Instead the Upper Tribunal felt that must be right because otherwise that would mean that if the partnership had used the income to buy an asset from a partner, the sales proceeds had to be left out of account; or likewise if the partnership had used the income to repay a loan from a partner, the proceeds of the loan repayment would have to be ignored.

It would have been fairly straightforward for the tribunal to distinguish between:

- partnership transactions between partner (acting in that capacity) and partnership (distributions of profit, returns of capital), which do not fundamentally change the substance of the receipt and which have traditionally been regarded as "tax nothings", and are effectively just accounting to a partner for what is already really theirs; and
- non-partnership transactions (sale of an asset, repayment of a loan) which clearly do fundamentally change the substance of the receipt.

This raises the possibility of double taxation for partners in partnerships being simply dependent on the form in which their own monies are paid out to them and must surely be questionable. It is particularly unfortunate because, in the case at hand, this issue is "currently academic" because it was pleaded as an alternative to HMRC's appeal on the wholly and exclusively point and not in addition to it. Consequently, it was decided by the Upper Tribunal only in case Investec successfully appeal on the wholly and exclusively point.

A Ltd v Finland - insurance premiums taxed where policyholder located

In *A Ltd v Finland* (C-74/18) the CJEU addressed the question of where insurance contracts covering risks associated with cross-border company acquisitions should be taxed. The CJEU concluded they should be taxed in the place where the policyholder is located. This is consistent with Council Directive 2009/138/EC.

A Ltd is a provider of insurance products in connection with company acquisitions. A Ltd is established in the UK and operates in Finland through a market licence. The main insurance products it offers are warranty and indemnity insurance ("W&I insurance") and civil liability insurance relating to the liability connected with the tax situation of the undertaking concerned ("tax liability insurance"). In both cases, the insurance is not intended to cover risks connected to the operating of the target company or its proper functioning. It covers only the decreased value of the shares that might result from a seller's misrepresentations.

Finland's Central Tax Board had issued a ruling that Finland cannot levy a tax on insurance premiums when A Ltd offers insurance to a Finish company relating to the acquisition of a foreign company. The ruling also provided that the insurance premiums are taxable in Finland, however, when the company offers insurance to a foreign legal person related to the acquisition of a Finish company.

The CJEU disagreed with the Tax Board. Where the policyholder is a legal person, the location of the risk is the member state of the policyholder's establishment to which the contract relates. The CJEU said that both the W&I insurance and the tax liability insurance are designed "to protect exclusively the policyholder, whether he is acting as the buyer or as the seller of the target company, against the risk associated with the seller's breach of the representations and undertakings which he made in the contract for sale."

This case is a useful reminder of the importance of identifying correctly where insurance premium tax is payable so that it can be charged to the policyholder at the correct rate for the relevant jurisdiction.

Morgan Stanley - input VAT recovery of branch looks through to activities of head office

It is common in the banking industry for entities to operate cross-border in different member states using branches rather than subsidiaries. This can mean input VAT recovery calculations are more complex. The CJEU recently gave detailed guidance on this issue in the case of *Morgan Stanley v Ministre de l'Économie et des Finances* (Case C-165/17). In this case, there was a head office in London and a branch in France. Under French law, the branch had opted to tax in respect of financial services (France does not permit VAT grouping).

The branch claimed input VAT incurred on acquiring goods and services solely to provide supplies to its partially-exempt UK head office and input tax on its overhead costs used to make supplies both to the head office and to the branch's own clients. The branch argued it should recover all of this input tax because, following the case of *FCE Bank plc* (Case C210/04), the branch and the UK head office were part of a single entity for VAT purposes so there could be no "supplies" from the branch to the UK head office for the purposes of VAT. Accordingly, the branch argued, the only transactions carried out by the branch itself, with its local customers, were subject to VAT because of the option to tax in respect of financial services.

The French tax authority disagreed and the case was in due course referred to the CJEU. The CJEU confirmed that the branch could not (unless acting independently) make supplies to its head office. These transactions were "VAT nothings" which had no impact on the input tax recovery by the French branch. As the input tax was incurred by the branch but was used for making supplies by the head office, the CJEU ruled that account must be taken of the supplies made by the partially-exempt

head office. In effect, the branch could recover input VAT by looking through to the supplies made by the head office. The mechanism that the CJEU came up with to calculate the level of recovery is complex as it reflects the fact that the costs are attributable to a mix of taxable and exempt supplies. In order to be treated as taxable supplies for the purposes of calculating input tax recovery, it has to be shown that the supplies by the head office carry a recovery right both in the UK and (hypothesising had the supply been made in the branch's location and with the same election to tax in place) in France.

Banks, and other businesses, providing services through a branch network should take a careful look at this judgment and at the proposed method for calculating the proportion of recoverable input VAT by the branch.

Changes to VAT exemption for the management of SIFs

Following the 2014 decision of the CJEU in *ATP Pension Service*, HMRC has allowed businesses to choose whether to exempt fund management services under EU law (relying on the direct effect of EU law) or to apply the narrower exemption under UK VAT legislation. The government has decided to align UK law with EU law to provide certainty after the UK leaves the EU. The explanatory note explains that the amendments to UK law would have been made regardless of the withdrawal of the UK from the EU due to the need for legal certainty.

The Value Added Tax (Finance) (EU Exit) order 2019 (SI 2019/43) provides for the VAT fund management exemption to apply to defined contribution pension funds from the date of the UK's exit from the EU. It also removes the requirement for certain funds to invest wholly or mainly in securities for the exemption to apply so as to allow state regulated property funds to continue to benefit from the exemption (also in line with EU case law).

DPT revised guidance and the new Profit Diversion Compliance Facility

The November 2015 guidance on diverted profits tax (DPT) was replaced with a new version in December 2018. The revised guidance reflects legislative changes since the last guidance such as the extension of HMRC's review period from 12 to 15 months and the new rules on deduction of income tax from royalty payments for accounting periods ending on or after 28 June 2016.

The guidance now contains the correct application of DPT commencement provisions to Lloyd's members at DPT1395. (The November 2015 guidance was incorrect and HMRC promised to correct it in the next version of the guidance, publishing in the meantime an appendix with the correct text). The revised guidance makes it clear that the DPT only applies to profits referable to periods from 1 April 2015 and that DPT may apply to a year of account prior to 2013 if the year of account is in run off and there are profits referable to times on or after 1 April 2015. Profits within the scope of DPT of a year of account are allocated to each period on a just and reasonable basis.

The analysis of the non-tax benefits in the second reinsurance example in DPT1390 has been rewritten and emphasises that the use of group reinsurance in that example is driven by the tax mismatch.

Last month, HMRC launched the Profit Diversion Compliance Facility (PDCF) which confirms HMRC's intention to work DPT cases openly and collaboratively. The PDCF enables a taxpayer to tell HMRC that it is conducting its own investigation with a view to producing a report (which will probably be similar in form and content to the DPT or transfer pricing reports that HMRC itself puts through its own governance processes) that will support either the current or an amended transfer pricing position. To the extent that the transfer pricing position of the MNC concerned has

to be amended, then it will have to pay additional taxes and interest plus possibly penalties (which will be treated as mitigated by the submission of the report) at the time of submission.

The key benefits for those who are considering using the PDCF is "control" of the way in which the investigation is (initially at least) carried on, and the shortness (three months) of HMRC's committed response time. There will also be a "specifically designated, experienced team of specialists" looking at the reports when they are submitted on a priority basis.

What to look out for:

- On 12 February, the Supreme Court will hear *HMRC v Joint Administrators of Lehman Bros* on whether statutory interest is yearly interest for the purposes of ITA 2007 s874(1).
- Comments are requested on the new Life Assurance Manual by 22 February. The new manual explains the application of the legislation introduced in Finance Act 2012 effective from 1 January 2013 but does not include changes introduced by Finance Act 2017. Finance Act 2017 changes and additional material on friendly societies and mutuals will be incorporated in due course.
- The closing date for the consultation on the UK Digital Services Tax is 28 February.
- On 4 March the UT will hear the appeal in the *Ingenious Games LLP* case on whether the partnership is trading and whether expenditure was capital expenditure.

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