Proskauer

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Welcome to this month's Proskauer UK Tax Round Up. September has been another quiet month but there have nevertheless been some interesting cases as well as HMRC led developments with regards to tax avoidance and VAT fraud.

Case Law Developments

Place of supply for VAT purposes

The recent case of *American Express Services Europe Limited* (AESEL) *v HMRC* is a useful reminder of the well-established two-stage approach to determining the correct recipient of a supply of services for VAT purposes. The case also reminds us of the large degree of uncertainty surrounding the application of this approach. As we go on to discuss, this uncertainty is surprising given, as here, the VAT recoverability position of the supplier is dependent on the location of its supply.

AESEL, acting as a card issuer, supplied payment services to another member of the Amex group. The question in this case was which member of the Amex group that was. AESEL's VAT recoverability position was dependent on the recipient of those payment services being the US group entity that acted as network operator (as Amex contended) (the US Operator), rather than an EU group entity (as HMRC contended) that acted as an acquirer, entering into agreements with vendors to accept Amex cards (the UK Acquirer).

When an Amex card holder uses their card to make a payment, AESEL becomes liable to pay the purchase price to the third party vendor from which the card holder has made a purchase. However, AESEL does not make this payment directly to the vendor. Instead, AESEL makes the payment to the US Operator, in exchange for a fee (this being the supply of payment services in question). The US Operator in turn pays the same amount to the UK Acquirer, again in exchange for a fee. The UK Acquirer then makes the payment to the vendor.

The First-tier tribunal (FTT) took the two-stage approach to determining the recipient of AESEL's supply:

- first, the contractual position should be considered; and
- second, it should be considered whether the contractual position is consistent with the economic reality of the transaction.

The FTT first considered the contractual position in the card issuer agreement (Contract) entered into between AESEL and the US Operator, this stipulated the terms on which AESEL would supply the US Operator payment services.

The FTT agreed with AESEL's view that it was plainly stated in the Contract that it supplied services to the US Operator, in consideration for which it received a fee from the US Operator.

HMRC contended that, because the Contract stated that the US Operator acted "on behalf of" the UK Acquirer, this meant that the US Operator was acting as agent of the UK Acquirer and so the supply was properly made by AESEL to the UK Acquirer. The FTT disagreed, firstly on the facts – they considered it was incorrect to suggest that the US Operator had no role – but secondly, and more importantly, on the principle that this position could mean that the parties to a contract could be permitted to effectively nominate a third party to be treated as the recipient of a supply, even where there is no contractual agreement with that third party.

The FTT then considered whether the position set out in the Contract accurately reflected the economic reality of supplies made by AESEL. Citing relevant case law, the FTT set out that the economic reality was to be considered with regard to all the circumstances interpreted objectively, such circumstances including where the services are effectively used and enjoyed and who benefits from them and why the consideration is paid.

The FTT rejected each of HMRC's arguments in this regard:

- AESEL, the US Operator and the UK Acquirer being in the same group and under common control could be a relevant consideration in determining the economic reality of an arrangement, but here the fact that third party operators and acquirers participated under similar contractual arrangements suggested this was unlikely to be relevant;
- the amount of consideration received by AESEL (compared to the US Operator) for its services in the supply chain might also be a relevant consideration, but again on the facts the FTT held the differences to be commercially justifiable; and
- the US Operator's role was central to the operation of the business and that in order to fulfil this central role it needed to receive payment services from AESEL.

As mentioned, this case illustrates the two-stage approach to the question of who is receiving the supply of services, but it also highlights the lack of guidance surrounding the question of who is the correct recipient of a supply of services. This is a surprising position considering how fundamental an element this point can be to the correct implementation and functioning of the VAT system.

Company trading status, non–trading activities insubstantial

In *Potter v HMRC*, the FTT found that the appellants were entitled to entrepreneurs' relief (ER) on the winding up of their company, disagreeing with HMRC's finding that they were not so entitled on the basis that it was not a trading company or the holding company of a trading group.

A general condition of ER is that the shareholding in respect of which ER is being claimed must be that of a trading company or the holding company of a trading group. However, the ER trading condition will also be satisfied where the relevant company has ceased trading provided (a) the trading condition was satisfied throughout the period of one year ending with the date on which the company ceased trading, and (b) the trading ceased within the period of three years ending with the date of the disposal or liquidation.

The question as to whether the company was a trading company throughout the relevant period was considered by the FTT in two parts:

(1) Was the company trading during the relevant period?

(2) Was the company carrying out substantial non-trading activities during the relevant period such that it should be disqualified from classification as a trading company?

It is the analysis of, and answer to, the second question which is of particular interest. The FTT found in relation to this that the focus should be on the "activities" of the company as opposed to its business.

By way of background, the company was a finance broker. It partnered with a bank, allowing it to benefit from its regulatory license as well as earning commission on deals brokered. Following the 2008 financial crisis, the bank terminated their agreement which meant the company lost its regulatory licence.

Given the position it found itself in, the company purchased interest-bearing bonds with a view to protecting its position. The interest from the bonds was its only income during the relevant period. The company continued to seek new business but was unable to generate any, and ultimately it was liquidated in 2015. The appellants claimed ER in respect of the liquidation.

For ER purposes (and other tax purposes e.g. the substantial shareholding exemption (SSE)) a trading company is "a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities". Trading activities are defined as including activities for the purposes of preparing to carry on a trade. The FTT focused on the legislation's use of the word "activities".

On the question of whether the company was trading during the relevant period, the FTT found that the company's activities could be said to be carried out for the purposes of preparing to carry on a trade. It was determined that the company would only have fallen foul of this test if there was no longer any realistic possibility that efforts to seek business would succeed. In particular, the FTT rejected HMRC's argument that the company could not be said to have satisfied the requirement to be trading "throughout" the relevant period because of short periods where (because of personnel illness) no efforts to resume trading were made.

On the second question the FTT found that the company was not disqualified due to carrying on "substantially" non-trading activities, which is what HMRC had contended.

HMRC's guidance on the point states that "substantial" means more than 20% of the company's income, assets, expenses or time relate to non-trading activities. The FTT did not disagree with the guidance but focussed on the term "activities", stating that one had to take a step back and assess what the company actually did.

In this regard, the FTT differentiated between investments which required management, and those which could simply be left to mature and generate income. Although the company's assets and income may have pointed away from trading (HMRC calculated that the company had invested around 70% of its reserves in the bonds), the company's activities (that is, what it actually did), pointed towards trading (or preparing to trade) since there were no activities carried out in relation to the investments. The FTT ruled that the company's activities during the relevant period were entirely trading activities aimed at reviving the company's trade.

The decision in this case will be of interest to taxpayers considering their trading status for tax purposes, including the SSE.

Other UK Developments

VAT reverse charge on construction services delayed to 1 October 2020

With a view to tackling VAT fraud, whereby construction service suppliers charging VAT to customers but failing to account for it to HMRC, HMRC had planned to introduce a VAT reverse charge (whereby the customer rather than the supplier accounts for VAT) on such services in October 2019. However, following substantial industry concern and evidence that many businesses were not prepared for the changes, HMRC has agreed to defer implementation until 1 October 2020.

As of 1 October 2020, a VAT registered individual or business which receives supplies of construction services from a VAT registered business will have to account for that reverse charge VAT on its own VAT return. The reverse charge VAT will be recoverable as normal.

The reverse charge only applies to UK VAT registered individuals or businesses who are involved in the supply or receipt of specified services reported under the Construction Industry Scheme (CIS). Importantly, 'end users' (customers that are obligated to make payments for specified supplies through the CIS, but who do not themselves make supplies of construction services), supplies between connected parties (i.e. group companies) and supplies between landlords and tenants will be exempt from the rules.

Government launches independent review of 2019 loan charge

The disguised remuneration loan charge rules (discussed in our July 2018 issue) were introduced by the Finance Act 2017. The aim of the rules is to recover income tax from businesses and individuals that had utilised so-called 'loan-based avoidance schemes' to avoid paying income tax and national insurance contributions on their employment income by receiving a loan in place of a salary. These loans were agreed on terms which meant that, effectively, the loans would never be repaid. Loans were to be written off on death, and often written off if the individual moved abroad. In doing this, the intention was that the individual did not have to account to HMRC for income tax or national insurance contributions on the loan amount.

The basic mechanic of the loan charge is to add together all of the outstanding loans an individual has under a relevant loan based avoidance scheme over the course of up to 20 years (the period from 6 April 1999 to 5 April 2019), and tax that amount as income in one year. However, those who have already repaid the money owed on their loans or agreed a settlement with HMRC will not be required to make the loan charge repayment.

The loan charge was met with widespread criticism. Many participants in these schemes are viewed by campaigners as innocent people, who entered into these agreements on the advice and trust of more qualified persons such as accountants, lawyers and employers.

In response to these concerns, the government has launched an independent review of the loan charge. The review is to be headed by Sir Amyas Morse, with a report expected to be provided to the government in mid-November. The intention is to decide whether these rules are an appropriate and proportionate way to deal with those individuals who were involved in such disguised remuneration schemes.

Notwithstanding the review, the tax remains payable. Individuals who have chosen not to settle with HMRC were required to submit an information return to HMRC, setting out their loan balance, by 30 September 2019. These individuals must file a 2018/19 self-assessment tax return and pay the loan charge by 31 January 2020.