Proskauer

UK Tax Round Up

October 2022

Welcome to the October edition of the UK Tax Round Up. October has been an extraordinary month in the UK, with political turbulence triggering reversals of many of the tax policies announced by the government at the end of September. In addition, there have been several interesting case law developments, including two potentially significant ECJ decisions.

Recent UK Government Tax Announcements

Reversal of announcements from the "Mini Budget"

As has been widely reported, several of the so-called Mini Budget proposals (summarised in our recent Tax Blog) have been scrapped.

These include:

- the proposed removal of the 45% additional rate of UK income tax from 6 April 2023
- the proposed reduction of the basic rate of UK income tax from 20% to 19% from 6 April 2023
- the proposed reduction in the UK dividend income tax rate by 1.25% from 6 April 2023
- the cancelling of the planned increase to UK corporation tax, which will now increase to 25% from 1 April 2023 as had previously been announced
- the proposed repeal of certain elements of the existing IR35 legislation from 6 April 2023.

Currently it is still the case that the previously introduced increase in national insurance contribution rates will be reversed from 6 November 2022 and that the proposed Health and Social Care Levy will not be introduced.

The government has announced that the fiscal statement due to be made on 31 October 2022 will now be given on 17 November 2022 and will be upgraded to a full Autumn Statement. It is possible that further tax changes will be announced then.

UK Case Law Developments

Unilateral relief allowed for US tax when unavailable under double tax treaty

In *HMRC v Aozora GMAC Investment*, the Upper Tribunal (UT) upheld the decision of the First-tier Tribunal (FTT) that the taxpayer was entitled to unilateral relief against its UK tax for tax paid in the US even though the taxpayer wasn't entitled to relief under the UK-US double tax treaty as a result of failing the limitation on benefits test in the treaty. The facts of the case are summarised in our May 2021 UK Tax Round Up, where we discussed the FTT decision.

The unilateral relief rules are UK rules which, in certain circumstances, provide double tax relief for UK taxpayers where a foreign jurisdiction and the UK would otherwise tax the same income and a double tax treaty does not apply. Where the unilateral relief rules apply, they work by reducing the UK tax liability.

There is a provision in the unilateral relief rules that states that they do not give relief where any relevant double tax treaty "expressly" provides that relief by way of credit should not be given in the circumstances. Based on this, HMRC argued that the unilateral relief rules should not give relief to Aozora because it was not entitled to benefit from the UK-US treaty because it didn't meet the limitation of benefits test.

For similar reasons as the FTT the UT found in favour of Aozora, finding that, because the exclusion from the unilateral relief rules requires an "express" treaty term, a general term like failing the limitation on benefits test should not mean the exclusion applies.

Although this seems a reasonably uncontroversial conclusion, it is a helpful one with general importance for UK taxpayers given that this point had not previously been considered in the UK courts.

HMRC's actual knowledge relevant to VAT assessments and HMRC entitled to refuse input VAT whilst claim is verified

The Supreme Court (SC) has held in *DCM (Optical Holdings) Ltd v HMRC* that the one year time limit on HMRC raising a VAT assessment in respect of incomplete or incorrect VAT returns only started when HMRC had actual knowledge of the relevant issue and that HMRC is entitled to verify taxpayer claims for input VAT credit.

DCM was an optician. Its supplies were in part subject to VAT (such as the sale of glasses frames) and in part VAT exempt (such as eye tests, laser eye surgery). Accordingly, DCM was partially exempt for VAT purposes and, like all partially exempt businesses, was able to recover VAT on costs relating to supplies made that were subject to VAT but not VAT on costs relating to its VAT exempt supplies. Accordingly DCM's income needed to be apportioned between VATable and exempt supplies to determine what input VAT it could recover.

HMRC made an assessment against DCM in relation to its apportionment method in October 2005 for under declared output VAT for the VAT periods between October 2002 and October 2003. There are various time limits on HMRC's ability to make VAT assessments.

When HMRC receives an incomplete or incorrect VAT return it must make an assessment for under declared VAT, broadly, by the later of two years after the end of the relevant accounting period or one year of the relevant facts coming to the "knowledge" of HMRC. What "knowledge" means for this purpose was the first issue for the SC to opine on. DCM argued that HMRC knew that there were issues with how DCM was applying its apportionment method in January 2004 and that it was at that point that the relevant one year clock began.

The SC rejected this argument on the basis that knowledge meant actual, rather than constructive, knowledge, even when it might be said that HMRC had information which would have allowed it to ascertain the relevant facts had it taken the necessary steps to do so. Although HMRC knew that there were issues in January 2004, it was later, after HMRC had gathered all the specific evidence, that it made the VAT assessment. The SC agreed that it was not until HMRC had obtained the relevant, specific evidence that the one year clock began to run.

HMRC had also reduced the VAT credits which DCM had submitted in its returns. DCM argued that HMRC did not have the power to do this because the relevant legislation required HMRC to pay DCM the VAT credits it claimed. The second issue for the SC to consider was whether HMRC was entitled to do this.

Where a taxable person has no output VAT or the amount of input VAT exceeds its output VAT then HMRC must pay the excess to the taxable person as a VAT credit. The legislation does not say that HMRC has a power to refuse to pay claimed VAT credits.

The SC found that, although HMRC does not have an express power to refuse to pay a claim under the relevant legislation, it is implicit that the obligation to pay a VAT credit only arises once it is established to HMRC's satisfaction that the VAT credit is due. The SC considered this interpretation to be consistent with HMRC's general obligation in the legislation to "be responsible for the collection and management of VAT" and the principle of fiscal neutrality.

The SC decisions in this case are not particularly surprising but provide important protections to HMRC in the assessment of VAT.

Sweet result in marshmallow VAT case

The question of whether a Jaffa Cake is a cake or a biscuit is an important one for VAT advisers, and the FTT has now considered in *Innovative Bites v HMRC* whether giant marshmallows should be treated like normal marshmallows for VAT purposes.

Normal marshmallows are confectionery for VAT purposes and, therefore, standard rate, whereas most food is zero rated. Innovative Bites claimed that their giant marshmallows were not confectionery and should be zero rated on the basis that they were intended to be roasted over a campfire or used as an ingredient in an American snack known as "s'mores" and not simply eaten as a sweet.

The FTT agreed with Innovative Bites, pointing to the marketing, packaging and consumption instructions of the product which distinguished their giant marshmallows from normal marshmallows notwithstanding that, other than the size, they are basically the same product.

Although by tax standards the facts here are amusing, this case does act as an important reminder that UK VAT legislation can produce very different tax results when the facts of a supply of goods or services change in subtle ways, so understanding the nature of the supply and the expected VAT treatment in any context is of paramount importance.

Other UK Tax Developments

HMRC interest rates increasing

Reflecting recent interest rate rises in the UK, HMRC's late payment interest rate increased to 4.75% and the overpayment repayment rate to 1.25% per annum from 11 October 2022.

It is possible that the general interest rate rises will also lead to a change to HMRC's "official rate" of interest from 6 April 2023, although no announcement has been made on this to date. We will report on any change if and when it is announced.

EU Case Law Developments

Payment under a loan sub-participation arrangement not subject to VAT

In *Szef Krajowej Administracji Skarbowej v Fundusz Inwestycyjny Zamknięty*, the European Court of Justice (ECJ) confirmed that payments under sub-participation agreements, under which a bank or other primary lender transfers its risk on an underlying loan to a third party, are not subject to VAT applying the exemption for the granting of credit in Article 135(1)(b) of the VAT Directive2006/112/EC.

The decision rejects the approach taken by the Advocate General (AG) in his recent opinion discussed in our May 2022 UK Tax Round Up. The AG had concluded that the sub-participant's supply was not exempt from VAT. This was on the basis that the sub-participant was effectively making two supplies, being the provision of capital and assuming credit risk. The AG considered that the risk management could not be viewed as ancillary to the provision of capital (or granting of credit) and, accordingly, the VAT exemption did not apply.

Contrary to the AG's opinion, the ECJ concluded that the service provided by the sub-participant to the primary lender fell within the VAT exemption for the granting of credit. This was on the basis that the supply was essentially a back-to-back loan and, therefore, a payment of capital for remuneration. The ECJ also considered that this view was consistent with the objectives of the relevant VAT exemption, which included not increasing the cost of consumer credit.

This decision provides welcome clarification for the financial sector. Had the ECJ followed the AG's opinion, the addition of VAT to payments under sub-participations may have materially impacted the attractiveness and continued viability of sub-participation arrangements.

While this decision is not binding in the UK post-Brexit, one would expect the UK courts to follow the ECJ decision given that it reiterates the generally taken position prior to the AG's opinion.

Leasing agreement can constitute a VAT invoice

The ECJ has held in *Raiffeisen v Republic of Slovenia* that a contract between two parties can constitute a VAT invoice for the purposes of the VAT Directive.

Two Slovenian companies entered into a sale and lease back arrangement in respect of a property. Red, the seller and lessee, issued a VAT invoice for the sale. However, Raiffeisen, the buyer and lessor, did not issue a VAT invoice for the lease back. The lease back contract provided that VAT was payable on the lease price. Even though Raiffeisen did not issue a VAT invoice, Red sought to recover its VAT cost. Meanwhile, Raiffeisen did not declare or pay any VAT to the Slovenian tax authority.

The Slovenian tax authority ordered Raiffeisen to pay interest on its unpaid VAT liability on the basis that it was required to account for the VAT under the lease back contract which, they said, was a VAT invoice which also gave Red a basis to recover its VAT cost.

Raiffeisen challenged the Slovenian tax authority's assessment and eventually appealed to the ECJ, arguing that the lease back agreement was not an invoice and, accordingly, Raiffeisen should not have to account for VAT (and, consequently, that Red should not be able to recover its input VAT).

Rather than addressing Raiffeisen's specific appeal, the ECJ considered whether and in what circumstances a contract was, in principle, capable of being regarded as an invoice for the purposes of the VAT Directive, with the Slovenian courts to then decide whether the lease back contract was a VAT invoice based on those principles.

The ECJ's conclusion was that a contract could, in principle, be an invoice for VAT purposes provided that it contained all of the information that the VAT Directive requires an invoice to contain.

In particular, the ECJ considered that it was not necessary for all the information that would usually be expressly set out in an invoice, such as the applicable VAT rate or the date of supply, to be stated in the contract. Instead, a contract may be treated as an invoice provided it is possible to "deduce" from the contract information sufficient information to determine from it (a) whether the service provider has an obligation to account to the tax authority for VAT and (b) whether a claim to recover input VAT by a service recipient was valid. The ECJ considered that this is all that is required in order to fulfil the purpose of the VAT Directive invoice provisions which is to enable tax authorities to collect VAT correctly.

The judgement provides no guidance as regards the length that tax authorities will be required to go to in order to "deduce" the relevant information from a contract. That unanswered question (which, as noted, is being left to the Slovenian courts to decide) is arguably the key one to determining the significance of this ruling across the EU, because it is not that surprising that the ECJ took the view that a document could, in principle, contain sufficient information to ensure proper VAT compliance and so be treated as a VAT invoice.

It also remains to be seen whether, or to what extent, this case is of relevance to UK taxpayers. As an ECJ decision it is no longer binding in the UK but may be found to be persuasive in the UK courts in the future if a similar question arises.

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