Proskauer

UK Tax Round Up

May 2024

Welcome to May's edition of the UK Tax Round Up. This month has seen three interesting tribunal decisions on the unallowable purpose test applied to intragroup loan arrangements, the meaning of income tax advantage in the transactions in securities rules and VAT recovery on advisers' fees in a share sale.

UK Case Law Developments

Unallowable group purpose for intragroup loan arrangement

In *Kwik-Fit Group Ltd v HMRC*, the Court of Appeal (CA) has agreed with the Upper Tribunal (UT) that Kwik-Fit Group Ltd and certain other Kwik-Fit group companies (referred to as the taxpayers) had an unallowable purpose in being party to certain intragroup loans and, as a result, were denied deductions in respect of (most of) the interest expense on the loans.

As discussed in our December 2022 edition of the UK Tax Round Up, the case involved a reorganisation of the Kwik-Fit's group finance arrangements in order to allow certain non-trading loan relationship deficits (NTLRD) in one of the group's members (Speedy 1 Ltd or Speedy) to be accessed more quickly than they would otherwise have been as a result of group borrowers increasing the interest that they paid to Speedy which generated increased current year deductions in the borrowers which could then use them against their own or other group companies' profits.

The group had in place a number of existing intragroup loans which were originally advanced for commercial purposes. At the time of the reorganisation, Speedy had a carried forward NTLRD of £48 million which could only be set off against its own taxable profits and was expected to be utilised over a period of 25 years due to the low level of taxable income that it was expected to receive. As part of the reorganisation, the interest rate on a number of loans under which Speedy was the lender was increased from 0.74% to LIBOR plus 5% and some other existing group loans were assigned to Speedy. Speedy also entered into two new loans at the 5% interest rate. The rationale given by the group for the increased interest rate was that it reflected an arm's length rate under transfer pricing principles at the time of the reorganisation. The effect of the reorganisation was to accelerate the utilisation of the NTLRD by Speedy from 25 years to two to three years as a result of its increased interest income and to generate enhanced interest deductions for the debtor companies which could be set off against the group's taxable income on a current year basis. HMRC sought to disallow the enhanced interest deductions on the loans on the basis that the relevant borrowers were party to the loans for an unallowable purpose.

The reorganisation was implemented, and the "arm's length" interest rate set, following advice from EY and PwC which described the tax advantage that would be generated for the group from increasing the interest on the existing loans and entering into the new loans. The group had discussed the proposed interest rate with HMRC, which had confirmed that the reorganisation could proceed on the terms proposed, and it was accepted that the group would not have put it in place had HMRC responded adversely to the proposal. The discussion with HMRC had not referred to the new loans.

The test in sections 441 and 442 CTA 2009 is that a taxpayer has an unallowable purpose if securing a tax advantage for itself or any other person is the main purpose or one of the main purposes it has in being party to a loan relationship for an accounting period. Where there is a mix of unallowable and allowable purposes, interest (and other) deductions should be disallowed applying a just and reasonable apportionment to the unallowable purpose.

The case had been discussed at the First-tier Tribunal (FTT) and the UT focusing largely on the tax advantage obtained by Speedy through the accelerated use of its NTLRD. At the CA, Counsel for the taxpayers (which did not include Speedy) argued that the accelerated use of the NTLRD by Speedy was not a tax advantage since the NTLRD had been generated from preexisting, commercial loan arrangements.

The FTT had held, and the UT had agreed, that the borrowers under the existing loans had a new and separate purpose in being party to their loans when they agreed to the interest rate being increased and that purpose was unallowable. Accordingly, the FTT had disallowed all of the increased interest as attributable to that new unallowable purpose and had disallowed all of the interest on the new loans.

The taxpayers had argued that the increase in interest rate was purely to put the loans on arm’s length terms and that the use of the NTLRD did not result in a tax advantage for Speedy.

The CA agreed, broadly, that the accelerated use of the NTLRD by Speedy was not a tax advantage generated by the reorganisation, since the deduction would have been available for use in the future and Speedy was not put in a better position vis a vis HMRC by generating additional taxable income that it did then not have to pay tax on as it would have had no tax to pay if the loan terms had not been varied.

However, the CA approached its decision, and stated that the FTT and UT had approached their decisions, by considering the purpose of the taxpayers in the context of the purpose of the group as a whole. Counsel for the taxpayers had argued that while the taxpayers had a purpose of allowing Speedy to accelerate use of its NTLRD, they had known that increasing the interest rate on their loans would have the effect of generating deductions for them but that had not been a purpose for them. The CA did not accept that distinction and concluded that the taxpayers' directors had been aware that the actual group tax advantage was not Speedy's use of its NTLRD but was the increased current year tax deduction that was created and could be used by the taxpayers or other members of the group through group relief surrenders to shelter current year profit. The use of the NTLRD by Speedy on its own served no purpose. The only reason for the taxpayers agreeing to pay the increased interest rate was to generate the increased current year deduction. On that basis, the CA concluded that the taxpayers did have a main purpose of securing a tax advantage for themselves or other group companies. Indeed, that was their only purpose in agreeing to the increased interest rate. The CA also stated that the tax advantage, and the surrender of group relief in particular, did not have to be specified or specifically identified or quantified and it was enough that it was understood to be the general reason for the interest rate increase.

The taxpayers had also argued that all that had been done was to align the interest rate with what it should be adjusted to under transfer pricing rules. The CA rejected this argument and stated that the opposite was the case. The interest rate had been fixed at what was considered an amount that was not more than an arm's length rate. In addition, certain loans had been left with their existing, low interest rate because that worked better from a tax perspective. Ironically, if the group had simply applied a transfer pricing adjustment to all of their intragroup loans as a matter of policy, the conclusion might have been different.

The case supports the approach taken by the CA in the recent *Blackrock* case that a group's purpose in entering into arrangements which are designed to generate a tax advantage for the group considered as a whole can, depending on the facts, be attributed to each individual member of the group as opposed to accepting that each member might have its own, narrow purpose(s). This is likely to be the case when arrangements are entered into that involve a number of group members each of which participates with a view to facilitating the group benefit.

Share buyback generates income tax advantage

In *Osmond and Allen v HMRC*, the FTT has held that proceeds received by the taxpayers from the buyback of shares which qualified for enterprise investment scheme (EIS) relief from capital gains tax were subject to tax as income under the transaction in securities (TiS) rules in Chapter 1 Part 13 ITA 2007.

Under section 684 ITA, a person can be assessed to income tax if he or she is party to a transaction, or one or more transactions, in securities, the circumstances of the transaction(s) are as prescribed in the rules, the main purpose or one of the main purposes of the transaction(s) is to obtain an income tax advantage and the person or any other person obtains an income tax advantage as a result of the transaction(s). The scope of the prescribed transactions was materially narrowed in 2016 and the case predates that change so, while the principles relating to income tax advantage and main purpose discussed below are still relevant, the particular transaction considered in this case might not be susceptible to counteraction under the TiS rules if entered into today.

In general terms, the case involved a buyback of shares held by the taxpayers in a UK company, Xercise Ltd. They had acquired the shares in 1995. The shares qualified as EIS shares so that, among other tax advantages, no capital gains tax (CGT) was payable when they were disposed of. The company was not profitable and was sold in 2002. The taxpayers ensured that the sale was structured in a manner which meant that they did not dispose of their shares which continued to benefit as EIS shares. Subsequently, the company was used, in a complicated transaction, to acquire a life insurance and pensions group alongside a number of coinvestors. Similarly, when that group was sold in 2009, the taxpayers managed to structure the sale so that they retained their shares in Xercise Ltd, with Xercise becoming an investment company owning listed company shares. The Xercise shares still benefited from EIS status. As a result of these transactions, Xercise Ltd had share capital and share premium of about £20 million. In addition, it had distributable reserves of about £34 million.

In 2013, one of the taxpayers got concerned that the EIS CGT relief might be withdrawn and wanted to effect a disposal of the shares so as to secure the relief. Since there was no external disposal transaction available, the taxpayers agreed to a buyback of their shares by the company for an amount equal to its share capital and share premium. This was intended to be a capital transaction that would benefit from the EIS CGT relief and would generate no income tax liability because the amount paid was equal to the company's share capital and premium and so did not result in an income distribution.

HMRC served TiS counteraction notices on the taxpayers assessing them to tax on the proceeds as distributions because the share buyback was a transaction in securities (this was not contested), it secured an income tax advantage (because the proceeds were not taxed as an income distribution) and obtaining the income tax advantage was a main purpose of the transaction (because it was designed to trigger CGT and/or EIS relief from CGT and not anything taxed as income). The taxpayers argued that obtain EIS relief was not a relevant tax advantage because it was a statutory relief and that there was no alternative transaction which would have led to income tax because the taxpayers would never have arranged to receive any amount as a dividend. It was accepted that the taxpayers did not need the proceeds received from the share buyback and the only reason that they entered into the transaction was to obtain the EIS relief that they were concerned would otherwise be lost.

Under section 687 ITA a person obtains an income tax advantage if the amount of income tax that would have been payable in respect of "relevant consideration" had that consideration been received as a distribution is less than the amount of capital gains tax that is payable on the consideration. Relevant consideration is consideration which, among other things, is or represents the value of assets which are available for distribution by way of dividend.

HMRC argued that the TiS rules applied on two bases:

1. first, and most generally, the simple fact that the taxpayers entered into a capital disposal of their shares with the admitted purpose of receiving proceeds to which EIS relief would apply meant, as a simple matter of law, that the main (and only) purpose of the buyback was for them to obtain an income tax advantage; or
2. second, the facts supported a conclusion that the taxpayers did have a main purpose of obtaining an income tax advantage because they were aware that receiving a dividend from the company would result in income tax and they had

> set the terms of the transaction so as to receive the proceeds from a share buyback and in an amount which meant that there was no income distribution and no income tax.

Taking these in reverse order, the FTT disagreed that the facts supported a conclusion that the taxpayers had a main purpose of avoiding paying income tax. This was because the FTT accepted the taxpayers' evidence that they did not need the share buyback proceeds and would not have extracted the money from the company if there were another way of crystallising the EIS relief. As has previously been determined by the courts, in order for there to be an income tax "advantage" as a general matter there must be an alternative transaction which would have generated more income tax than the transaction entered into. The FTT agreed with the taxpayers that there was no comparative transaction since they would never have extracted the money from the company in a manner which would have resulted in income tax.

On the first point, however, the FTT agreed with HMRC's argument that "at first blush caused the judge to raise a quizzical eyebrow". It was not disputed that the share buyback was a transaction in securities or that it resulted in an income tax advantage (subject to the point below on section 685(6)). The FTT agreed that the fact that the taxpayers' main purpose in effecting the share buyback was to access EIS relief meant necessarily that their main purpose was to obtain an income tax advantage. Because the main purpose was accepted to be to crystallise the EIS relief and that was an income tax advantage as defined, the main purpose also had to be to obtain the income tax advantage. In respect of the requirement for an alternative transaction that would result in income tax referred to above, the FTT stated that the alternative transaction was baked into the definition of income tax advantage as being the receipt of a qualifying distribution. Because the main purpose was agreed to be accessing EIS relief and the CGT payable was less than the income tax that would have been payable on a distribution there was a main purpose of obtaining the income tax advantage notwithstanding that, in reality, the taxpayers would never have entered into any transaction that resulted in any income tax. The fact that crystallising the EIS relief was the main (and only) purpose of the share buyback meant, as a matter of law, that there was a main purpose of obtaining the (deemed) income tax advantage.

This is in some ways a strange decision in accepting that the required alternative transaction is embedded in the definition of income tax advantage, and it means, effectively, that, subject to the relevant transaction(s) in securities falling within the current, narrower scope of the rules, any transaction which has as a main purpose crystallising a capital gain, such as effecting a disposal in anticipation of an increase in CGT rates, could be counteracted when the company in question has sufficient distributable reserves. It will be interesting to see whether the decision will be appealed (and there is a considerable amount of tax at stake) and, if it is, whether the UT will conclude that a more realistic alternative, income tax generating transaction is required for the rules to apply.

No VAT recovery on adviser fees in share sale

In *Hotel La Tour Ltd v HMRC*, the CA has overturned the UT's (and the FTT's) decision and held that VAT incurred on adviser fees related to a share sale was not recoverable notwithstanding that the proceeds of the sale were used by the seller group to fund further activities which were subject to VAT.

The case involved Hotel La Tour Ltd (HLT) disposing of the shares that it held in a subsidiary, Hotel La Tour Birmingham Ltd (HLTB), which owned a hotel. HLT was the representative member of the VAT group of which HLTB was a member and HLT provided management services to HLTB for a fee. The reason for the sale was for the HLT group to raise funds to develop a new hotel in Milton Keynes. HLT incurred third party fees on market research, identifying potential buyers, financial modelling, tax advice and legal advice (the services) with a view to maximising the HLTB share sale proceeds.

The central matter discussed in the case was whether HLT was entitled to recover the input VAT element of the fees because there was sufficient link between the use of the services and the VATable business that would be carried on by the new hotel or was not so entitled because the services were linked to the VAT exempt sale of the shares in HLTB.

Both the FTT and the UT had held in favour of HLT because, broadly, the services had an "immediate and direct link" with the group's VATable business and that link would only have been broken by the services being used for the purpose of the share sale if the fees paid for them had comprised a cost component in the price paid for the shares. These decisions applied the "modified approach" to determining whether or not input VAT was recoverable and to identifying the relevant activities to which the VAT cost was linked that derived from the EU and UK cases on the question decided since the *BLP* decision, including, in particular, the decisions in the *SKF* and *Frank Smart* cases.

HMRC appealed stating that the UT (and the FTT) had erred in law by failing to apply correctly the two stage test of asking first whether there was a direct and immediate link between the use of the services and an identifiable supply for consideration constituting an economic activity (here the sale of the HLTB shares) and second, if and only if the answer to that question was no, whether there was a direct and immediate link between the use of the services and HLT's general economic activity. HLT put forward an additional basis for VAT recovery, that, because HLT and HLTB were members of a VAT group, the management services supplied by HLT to HLTB should be ignored so that the sale of the shares was outside the scope of VAT and the principle from the *Kretztechnik* case should be applied to treat the input VAT as attributable to the group's general overheads and recoverable accordingly.

The CA considered in detail all of the relevant UK and EU cases and discussed how the approach to determine what, if any, direct and immediate link with relevant services should be applied. It concluded that the UT and FTT had erred in concluding that the current state of the case law pointed to the question being whether the cost of the relevant services was reflected in the consideration received from a specific transaction (e.g. the sale of the HLTBN shares) or comprised a cost component in all of the goods and services supplied by the taxpayer, as referred to in the *Sveda* case. The CA concluded that this was not the correct test to apply in determining whether the services were used for a particular transaction or what transaction had a "direct and immediate link" with the services. Rather, as put forward by HMRC, the question of VAT recovery had to be ascertained by asking the "either/or" question of whether there was a direct and immediate link with a specific transaction and only if the answer to that was no was there a link with the taxpayer's general supplies. The CA also concluded that this was the correct analysis of the various cases that had been referred to as developing the principle in *BLP* that VAT incurred in connection with an exempt share sale was not recoverable and that the general principle had not been changed by cases which, on the facts, had allowed VAT recovery by deciding that the costs were actually used by the taxpayer in the provision of its general supplies other than in clarifying that it was not "necessarily" the case that VAT on fees connected to a share sale would not be recoverable.

The other point that was raised by HLT was that the case law now stated that in fund raising transactions (such as this) one had to consider whether the fees paid for the services made up a cost component of the share sale or a general overhead cost of the business.

The CA agreed with HMRC that, notwithstanding the requirement to consider the facts in determining what the services were used for, the VAT incurred on the fees was not recoverable because the services had a direct and immediate link with the sale of the HLTB shares. It was, therefore, not necessary to consider whether they also had a link to HLT's overall economic activity. Having decided this, the CA said that it did not need to consider separately whether the costs were incorporated in the consideration received for the shares, as that was not the pertinent question, but that if it were then the costs were so incorporated as they had an "objective economic link to" the share sale and were used to make, and were paid out of the proceeds of, the share sale.

The case provides an extremely useful summary of the case law related to the recovery of VAT incurred on fees related to share sales and other fund raising transactions and also restates the principle question to be answered of whether a specific transaction can be identified as having a direct and immediate link with the provision of the relevant services.

Other Developments

EU directive on simplifying withholding tax

The European Commission (EC) has published a draft directive intended to make withholding tax (WHT) administration among Member States more efficient and secure for publicly traded shares and bonds (the draft Directive for Faster and Safer Relief of Excess Withholding Taxes).

In order to simplify the procedures for WHT and its recovery under double tax agreements, the draft directive proposes introducing:

- a common digital tax residence certificate which can be used for all WHT relief and refund claims; and
- a two track procedure for simplifying WHT relief and reclaims requiring Member States to operate one or both of a “relief at source” or “quick refund” process.

In addition to this, and to protect against abuse, a standardised reporting obligation will require certified financial institutions to report dividend and interest payments on publicly traded shares and bonds to the relevant tax authority so that the transactions can be tracked.

The EC expects that the new processes will both simplify WHT relief and refund claims for taxpayers, allowing them to use their single digital tax residence certificate for all WHT claims and also reduce WHT avoidance and abuse by providing tax authorities with a clearer picture of the entire payment chain. It is also hoped that the new digitised procedure will simplify WHT administration and operation for financial institutions.

The proposal is that Member states will have to include the directive into national legislation by 31 December 2028 and that the national rules will have to apply from 1 January 2030.

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