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UK Developments

Amendments to the Finance Bill – entrepreneurs' relief and intangibles

Three significant changes have been made to the Finance Bill published last October which will be included in the Finance Act 2019 (expected to receive Royal Assent in early February).

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Entrepreneurs' relief

We reported some key announcements arising out of the UK's 2018 Autumn Budget back in October, including amendments to the conditions for claiming entrepreneurs' relief (ER) on the sale of shares (see here). As discussed there, those changes introduced a new 5% economic rights test. The new test is based on the group relief rules and was widely criticised for its complexity and difficulty to satisfy.

On 8 January 2019, a proposed amendment to the draft legislation implementing the changes to ER was agreed in the House of Commons. The amendment, which was proposed by the Government following lobbying, introduces an additional and alternative 5% economic test for an individual to qualify for ER on the sale of shares. In addition to the new 5% distributions and assets on a winding up test announced in the Finance Bill, an individual may also benefit from ER if, throughout the requisite holding period (24 months from 6 April), he or she is entitled, by virtue of holding ordinary shares, to 5% of the proceeds from a disposal of the whole of the company's ordinary share capital for its market value.

This alternative economic test may be simpler for individuals to satisfy, particularly in transactions where the target company is funded using non-commercial loans or other sorts of preferred capital instrument. It will, however, still be considerably more difficult for individuals to qualify for ER on share sales than it was before 29 October and careful consideration will need to be given to capital structures where there is a desire for ER to be available.

As a reminder, it is important when assessing the availability of ER to understand what is and what is not ordinary share capital. In August, the Chartered Institute of Taxation, with HMRC's agreement, published a list of examples of share terms with HMRC's preliminary view on whether they are or are not "ordinary share capital". As can be seen, seemingly minor differences could have significant consequences if they mean that what is intended to be ordinary share capital is not or vice versa.

Intangibles

Also approved on 8 January 2019 were two new provisions in the Finance Bill relating to the intangibles regime.

The first relates to degrouping charges. Similar to the capital gains regime, transfers of intangible assets within a corporate group benefit from tax neutral treatment. However, to avoid abuse, a degrouping charge will apply if the company leaves the corporate group still holding the asset within six years of the transfer. In the capital gains regime, these degrouping charges are switched off in relation to assets held by a company being sold where the sale of the company qualifies for the substantial shareholding exemption (the UK's participation exemption). Under the changes to the Finance Bill, degrouping charges for intangibles will be more closely aligned with the capital gains regime, so that degrouping charges relating to previously transferred intangibles will also be switched off where the degrouping transaction is the sale of shares in a company owning the intangibles that

qualifies for the substantial shareholdings exemption.

In addition, legislation has been introduced that partially reverses the restriction on tax deductibility for acquisitions of goodwill that was introduced in 2015. Relief for acquisitions of goodwill will be given at a fixed rate of 6.5% of cost per year, but will be capped at six times the value of other IP assets (including patents, registered designs, copyright and design rights and plant breeders' rights) acquired alongside the goodwill. This will mean that no relief is available if the relevant transfer does not include any of these other assets. Relief will not be permitted in related party acquisitions. The new rule will apply to acquisitions from 1 April.

Each of these amendments have been welcomed and are positive for UK investment.

HMRC launches profit diversion tax compliance facility

HMRC has launched a profit diversion compliance facility intended to assist multinational enterprises (MNEs) to regularise their transfer pricing (TP) affairs, particularly where their TP policies and arrangements might not comply with OECD guidelines.

The key features of the compliance facility include:

- MNEs must submit a six-part report with prescriptive requirements, including a declaration of full and accurate disclosure by the senior responsible officer and proposals as to (and payment of) the amount of tax, interest and penalties payable as a result of the non-compliant TP arrangements.

- HMRC promises an accelerated process (with a stated aim of responding to the proposal within three months of submission) and that no diverted profits tax (DPT) notice will be issued for periods covered by the proposal. The disclosure does not, however, provide immunity from a criminal investigation, although HMRC states that it is highly unlikely to start a criminal investigation if taxpayers have made full and accurate disclosure. There is no offer of reduced penalties for taxpayers using the facility but disclosure will be treated as "unprompted". There are further penalty benefits for disclosures before 31 December 2019.

HMRC states that it intends to issue letters to those MNEs that it considers demonstrate features associated with profit diversion and that it is planning a programme of investigations of MNEs. The introduction of the facility might be taken to indicate that this is an area that HMRC intends to prioritise and that MNEs adopting aggressive TP policies might be advised to consider them further in the light of this development.

VAT: Question whether investment fund management services can be apportioned between standard rated supplies and exempt supplies referred to ECJ

In our September 2017 UK Tax Round Up we discussed the First Tier Tribunal (FTT) decision in *Blackrock v HMRC*, in which it was decided that the supply of investment management services via a computer program to both "special investment funds" (SIFs) and non-SIFs attracted VAT at the standard rate on the entire management fee as a single composite supply (notwithstanding that investment management services supplied to SIFs are VAT exempt) on the basis that the funds in question were predominantly non-SIFs.

In December, the Upper Tribunal (UT) confirmed the FTT's view that 'fintec' management services can, in principle, benefit from the SIF management exemption, but declined to comment on, whether in this circumstance an apportionment of the single management supply between the recipient SIFs and non-SIFs was possible. That question has been referred to the ECJ.

As we discussed in our February 2018 UK Tax Round Up in the context of *Stadion Amsterdam*, it is only in very limited circumstances and where there is clear legislative authority for doing so that a single supply can be subject to treatment as two distinct supplies for VAT purposes. So even if the ECJ find in Blackrock's favour, fund managers will be well advised to distinguish supplies made to SIFs and to non-SIFs to the maximum extent possible. The extent to which that is possible for a fund manager using fintec to manage multiple funds through a single computer platform would then have to be considered on a case by case basis.

We will update readers following the ECJ's ruling.

VAT: Provision of management services for contingent payment is not an economic activity

In *W Resources v HMRC*, the FTT has found that a parent company which provided management services to newly acquired subsidiaries, with payment for those services contingent on the subsidiaries generating income, was

unable to reclaim its input VAT on services that it received.

As a general matter, the parent company's ability to reclaim the input VAT associated with the management services was dependent on it having made supplies for consideration to the subsidiaries in the course of carrying on an economic activity.

The test in this regard is two-fold. First, is the taxpayer making supplies for consideration? Second, is the taxpayer making those supplies with a view to making a profit?

The FTT found the first requirement to be satisfied notwithstanding the contingent payment terms. It considered the second requirement to be more problematic. There was no guarantee that the contingency would be satisfied in the future so it could not be said that the parent's purpose in providing the services was to generate income on a continuing basis (in contrast to making a profit). Further, the assessment of this condition needed to be made at the time that the parent company incurred its input VAT costs. On the basis of the UT's decision in the *Norsemen* case, the FTT decided that the contingency meant that the parent company did not satisfy the second requirement of having an intention to generate income.

The FTT noted, however, that it was far from certain that its finding was correct, since a body of ECJ case law seemed to imply that if a holding company provided management services to its subsidiaries for consideration then it was by definition carrying out an economic activity. Ultimately, the FTT felt bound to follow the UT's decision in *Norsemen* on the point.

The case is the next instalment in a long line of decisions regarding recovery of input VAT by parent/deal companies following acquisitions, and there are likely more to come as HMRC focuses on this issue.

However, the key points for clients remain the same. Early establishment of the relevant companies and clear onward supplies with a view to generating income – with no contingencies – are crucial.

VAT: UT allows Tesco input VAT recovery from Clubcard scheme

In *HMRC v Tesco* the UT agreed with the FTT and held that Tesco was entitled to input VAT recovery in respect of the VAT it paid to third parties who accepted reward tokens as payment towards the purchase of their goods or services under Tesco's well-known Clubcard scheme.

The essential facts behind the scheme are that Tesco's customers can earn Clubcard points which they can then use to buy discounted goods and services from Tesco's "deal partners". Tesco pays the deal partners a fee (with VAT) for their involvement in the scheme and agreement to accept the Clubcard points in payment for their goods and services.

HMRC had argued that Tesco's payment to the deal partners was a third party payment in respect of the customers' purchases from the deal partners. If that was correct, Tesco would have had no basis of recovering its input VAT. In the alternative, HMRC they argued that only a small proportion of the fee paid by Tesco should be attributed to the deal partners agreeing to participate in the scheme and the rest of it should be treated as third party consideration, so reducing Tesco's input VAT recovery.

Tesco argued that the entire fee paid to the deal partners was for the deal partners' participation in the scheme and agreement to accept the Clubcard points as (part) payment. On that basis, Tesco was entitled to recovery of its input VAT as it was directly linked to Tesco's VATable grocery business.

The FTT had decided that the VAT was deductible as input tax since the deal partner was making a supply of redemption services to Tesco.

The UT has agreed with the FTT and dismissed HMRC's appeal on the basis that, applying the House of Lords' decision in *Redrow*, the transaction must be looked at from Tesco's perspective and whether it received a benefit, linked to its VATable business, as a result of its payment to the deal partners. Looking at the terms of the arrangements, the UT agreed with the FTT that Tesco was receiving a benefit from the deal partners of facilitating the operation of its Clubcard scheme, which was operated for the furtherance of Tesco's business.

The UT considered in detail the judgements of LMUK/Baxi that related to the Nectar and Baxi loyalty schemes. Both of these cases highlight the requirement to consider the economic reality of the particular arrangements in order to determine whether VAT is or is not recoverable. Although there were reward schemes where it may be appropriate to apportion the input VAT between consideration for services (deductible) and third party consideration (not deductible), the Clubcard scheme was not one of them. Neither the contracts nor the economic reality of the arrangements suggested that only part of the sums paid by Tesco was consideration for services supplied to Tesco and, as such, Tesco was entitled to input tax recovery for all of the VAT paid on the fees paid

to its deal partners.

International Developments

ECJ rule that contractual termination payments are consideration for VAT supply purposes and not compensation

The ECJ has held in *Meo v Autoridade* that an amount payable by the customer on default under a service contract was consideration for VAT purposes and not compensation for breach of contract.

The ECJ concluded that if the default payment was the same as the amount that would have been paid had the contract continued (as was the case here), the sum paid was consideration for the right to benefit from the supplier's performance of the contract even if the customer did not access the services (whether by choice or because of the customer's default).

Following this principle, the ECJ drew contrast with prior cases highlighting, on the one hand, the case where a deposit for a hotel room was compensation for the customer's failure to take up the room and, on the other hand, the case where the full price of an air ticket paid by a customer who failed to take their seat was consideration for a supply.

This decision is interesting in light of HMRC's recent announcement, summarised in our December 2018 Round Up, that from 1 March 2019 payments and deposits for goods and services that customers do not take up will be treated as payments for the supply of goods or services and not as compensation, regardless of the amount payable, and might mean that HMRC has to reconsider this position.

IPT: Relevant jurisdiction under W&I insurance contracts

We are increasingly seeing purchasers and vendors seeking insurance for breaches of representations, warranties and indemnities and tax indemnities given as part of M&A deal documentation (so-called W&I insurance).

The taxation of W&I insurance and payments is an evolving area too, and in this regard the ECJ has recently confirmed in *A Ltd v Veronsaajien Oikeudenvalvontayksikkö* that insurance premium tax (IPT) chargeable in respect of W&I insurance is levied where the insurance policyholder is established and not where the target company is established.

The relevant European legislation provides that the right to tax insurance contracts lies with the jurisdiction in which "the risk is situated". For building, vehicle and travel insurance this is based on the country of physical presence or registration. The Finnish courts that first heard this case felt unable to form a view on where the risk of W&I insurance fell since it could be where the target was established or where the policyholder was established. When referred, the ECJ noted that the general principle of insurance taxation is that it is levied where the contractual risk lies and it was determined that, as the W&I insurance is taken out in respect of the risk allocation as between purchaser and seller it should be the jurisdiction of whichever of those parties is the W&I insurance policyholder that is the IPT taxing jurisdiction, and not that of the target company.

This case acts as a reminder that IPT costs should be factored into assessments by purchasers and sellers of transaction costs. Rates of IPT varies across EU member states (it varies between nil at 24% across the EU and is 20% for W&I policies in the UK), so where IPT is levied is an important consideration.