SLAUGHTER AND MAY/

CLIENT BRIEFING

November 2022

Tax and the City Review

HMRC publishes the first in its series of 'Guidelines for Compliance' dealing with complex, widely misunderstood or novel risks, following the review of tax administration for large business. The CJEU rejects the AG's opinion and holds in the Polish case of *O Fundusz* that the sub-participation agreements are VAT exempt credit transactions. The OECD publishes a report on tax incentives to help the international community reassess and redesign tax incentives for a post-pillar two environment. The Supreme Court's judgment in *NHS Lothian* is a reminder of the importance of good record-keeping in order to recover input VAT. The UK Finance 2022 report shows the banking sector continues to generate a significant amount of the total tax contribution and highlights the need for the UK to remain competitive, but will this be borne in mind by the Chancellor as he prepares the Autumn Statement?

Guidelines for compliance

Following the review of tax administration for large businesses, HMRC has started to publish 'Guidelines for Compliance' (GFC) offering HMRC's view on complex, widely misunderstood or novel risks that can occur across tax regimes. The GFCs expand the scope of HMRC material, beyond interpretation of the law, offering insights into the practical application of the law and HMRC's administrative approaches. The intention is that following the GFCs will lower the risk of tax non-compliance and reduce the likelihood of HMRC checks.

GFC1 (2022), published on 6 October, is the first set of guidelines and is aimed at providing help to employers with PAYE settlement agreement calculations. This is an area where HMRC have identified a number of errors and emerging risks. GFC1 explains to employers how to reduce these risks and provides details of HMRC's preferred method of submitting agreement calculations.

Other GFCs are understood to be in the pipeline (including one on transfer pricing) and as they do represent HMRC's 'known position' for the purposes of the uncertain tax treatment rules for large companies, they should be borne in mind when applying these rules.

VAT treatment of sub-participation agreements

In the case of O Fundusz Inwestycyjny Zamknięty reprezentowany przez O SA (C-250/21) a number of Polish banks securitised loans with O Fundusz acting as the sub-participant. O Fundusz advanced an upfront payment to the banks and then receivables from the original borrowers were passed to O Fundusz. The issue before the CJEU was what was the VAT treatment of the payments from O Fundusz to the banks. Was the arrangement within the scope of the exemption in Article 135(1)(b) of the VAT Directive as a supply consisting of the granting of credit?

The Advocate General (AG) opined that the arrangement was outside the scope of the exemption because the supply included the non-exempt assumption of the risk of credit default. The CJEU did not follow the AG's opinion and instead held that in substance O Fundusz was making capital available to the banks in return for remuneration and that this was an exempt supply of credit.

If the CJEU had followed the AG's opinion, VAT would have been due on sub-participants' fees, contrary to market expectation, and would have been an additional cost in the supply chain which banks would not have been able to recover. This decision brings welcome confirmation that there should not be any VAT chargeable in a sub-participation transaction which will be a relief to the financial sector.

Although the CJEU judgment is not binding on the UK post Brexit, the current UK VAT law is transposed from the VAT Directive and so this case may be persuasive before a UK court or tribunal. At least until the provisions of the Retained EU Law (Revocation and Reform) Bill kick in for tax!

Tax incentives: effect on effective tax rates for pillar two

The OECD has published a report on tax incentives to help the international community reassess and redesign tax incentives for a post-pillar two environment. Pillar two calls into question the effectiveness of certain tax incentives because, where tax incentives drive an MNE's effective tax rate in a jurisdiction below the 15% minimum, the MNE would potentially be subject to top-up taxes under the GloBE rules.

The GloBE rules will not affect all taxpayers or all tax incentives in the same ways and to the same extent. Where tax incentives are successful in attracting tangible investment and jobs, the rules will have a more limited impact. However, where tax incentives allow MNEs to generate substantial low-taxed profits in a jurisdiction without providing substantial tangible investment or jobs, the GloBE Rules will help protect the corporate tax base.

Tax incentives that are not qualified refundable tax credits reduce the amount of covered taxes, i.e. the numerator, in the ETR calculation. In contrast, qualified refundable tax credits would instead be treated as additional income and increase the denominator of the ETR calculation. This will have less of an impact for the same amount of tax credit on the resulting ETR.

The UK's Research and Development Expenditure Credit (RDCE) is expected to be a qualified refundable tax credit, but other UK reliefs - super deductions or capital expenditure deductions that are not book deductible, such as rollover or reinvestment reliefs, are not qualified refundable tax credits and could result in UK ETR below 15%. If this is the case, the benefit of the incentive will be lost to the MNE by operation of a top-up tax by either the UK or another jurisdiction.

The report recommends jurisdictions examine which taxpayers are benefiting from different incentives and how different taxpayers and tax incentives will be affected by the GloBE rules. It also recommends that more immediately jurisdictions adopt a qualified domestic minimum tax (QDMT) so as to prevent a loss of tax revenue to other jurisdictions. 'Moving early will help maximise opportunities for domestic revenue mobilisation among developing and emerging economies.' Interestingly, the UK's plans to implement pillar two do not bring in a QDMT from the start – this is something to be considered later on.

NHS Lothian: Recovery of input VAT

The unanimous judgment of the Supreme Court in *HMRC v NHS Lothian Health Board* [2022] UKSC 28 highlights the importance of good record-keeping in order to recover input VAT, all the more so when claims go back to the 1970's!

The taxpayer operated scientific labs which mainly provided clinical services to the NHS (a non-business activity), but also undertook some external private work (a business activity). It sought to recover input tax incurred over a period of more than 20 years up to 1997 to the extent that it related to the business activity. It did not have sufficient records to show how much input VAT had been paid for the work done in the labs or to show the split of the work between business and non-business activity over the period. Instead, it quantified the claim by reference to the share of business activity for the year 2006/7 (which was 14.7%).

HMRC rejected this claim on the basis that there was a lack of evidence as to the business activity during the relevant period and the taxpayer had not established that a valuation extrapolated from the 2006/7 business activities was reasonable. The Supreme Court agreed with HMRC. Proof of the amount incurred is a substantive precondition for the exercise of the right to deduct input tax. Proof is usually in the form of VAT invoices but alternative evidence can be relied on where the taxpayer presents a credible method for estimating the amount of the claim with reasonable certainty.

The Supreme Court concluded that the FTT had not found as fact that the proportions of the taxpayer's business and non-business activities were essentially the same across the claim period and 2006/7 to justify the use of the 14.7% figure. The FTT's factual findings had been misinterpreted by the Inner House of the Court of Session which had decided the case in favour of the taxpayer.

What now for financial institutions?

It looked promising for financial institutions for a while – although corporation tax is increasing to 25% in April 2023 the bank surcharge was (according to Autumn Budget 2021) supposed to come down from 8% to 3% so as to impose a 28% combined rate on banks rather than a very uncompetitive 33% rate. Furthermore, the Chancellor at the time of the 23 September 2022 mini-Budget announcements promised to outline, in October, regulatory reforms to ensure the UK's financial services sector remains globally competitive.

We now await the Autumn Statement for confirmation as to what will happen with bank taxation. Doubt is cast over whether the banking surcharge will decrease as originally intended and the media sports rumours of a windfall tax to be imposed on banks.

UK Finance's report on the total tax contribution of the UK banking sector (published October 2022) shows the UK banking sector is estimated to have generated £38.8

billion in taxes in the financial year to the end of March 2022 (up from £37.1 billion the previous year). This represents 4.7% of total government tax receipts in 2021/22 (down from 5.5% in 2021/20). The survey covers the second year of the Covid-19 pandemic and illustrates the resilience of the sector and its continuing significant contribution to public finances.

The report shows that the UK is currently on a course to become a less competitive financial centre for banks compared to other financial centres because of the sector-specific taxes and the increasing rate of corporation tax. The projected total tax rate for the UK for 2024 is 45.7% (and that assumed the bank surcharge goes down to 3% and no further relevant tax rises), as compared with 27.4% for New York, 27.9% for Dublin and less than 40% for each of Amsterdam and Frankfurt.

Prime Minister Rishi Sunak has said 'economic stability and confidence' will be placed at the heart of the government's agenda. It is hoped that the Autumn Statement will take a more measured and long-term look at the taxation of financial institutions and the competitiveness of the UK rather than (yet another) knee-jerk short-term reaction. Ominously, with the Chancellor trying to plug a huge deficit, it has been warned that "nothing is off the table" so watch this space!

What to look out for:

- **The Chancellor will make his Autumn Statement on 17 November.**
- **The Upper Tribunal is scheduled to hear the appeal mid- November in *Prudential Assurance Company Limited v HMRC* on time of supply of investment management services and the VAT grouping rules.**
- **The Supreme Court is scheduled to hear the appeal in *News Corp UK & Ireland Limited v HMRC* on whether supplies of digital issues of newspapers were zero-rated (note zero-rating has applied to electronic publications from 1 December 2020 so the decision is of largely historic interest but there are large amounts of revenue at stake).**
- **The consultation on draft regulations to implement the OECD's model tax reporting rules for digital platforms with effect from 1 January 2024 closes on 13 December.**

This article was first published in the 11 November 2022 edition of Tax Journal.

CONTACT

Mike Lane
PARTNER
T: +44 (0)20 7090 5358
E: mike.lane@slaughterandmay.com

Zoe Andrews
PSL COUNSEL & HEAD OF TAX KNOWLEDGE
T: +44 (0)20 7090 5017
E: zoe.andrews@slaughterandmay.com

London
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
T +852 2521 0551
F +852 2845 2125

Beijing
T +86 10 5965 0600
F +86 10 5965 0650

Published to provide general information and not as legal advice. © Slaughter and May, 2022.
For further information, please speak to your usual Slaughter and May contact.

www.slaughterandmay.com

579185362