SLAUGHTER AND MAY/

CLIENT BRIEFING

November 2020

TAX AND THE CITY REVIEW

The FTT in *Blackrock* finds in favour of the taxpayer on transfer pricing and on the application of the unallowable purpose test. The Court of Appeal in *Total* decides that for the accounting period which straddled the tax rate increase, the taxpayers were entitled to elect to apportion profits on an actual basis, rather than by way of time apportionment, with the result that profits escaped the 32% rate of supplementary charge. Whilst the EU proposes a modernisation of VAT on financial and insurance services, in the UK the Chancellor confirms that at the end of the Brexit transition period, UK financial services exports to the EU will be treated the same as exports to other countries. Regulations are enacted providing for the circumstances in which loss absorbing instruments (such as shares and convertible debt) issued by overseas subsidiaries of UK resident entities can be deducted from equities and liabilities otherwise chargeable to the bank levy. According to the OECD's blueprints for international tax reform, financial services will not have to apply the new taxing right allocating residual profit to market jurisdictions but will be within the scope of the global minimum rate of tax.

Blackrock: transfer pricing and unallowable purpose

In *Blackrock Holdco 5 LLC v HMRC* [2020] UKFTT 0443 (TC) HMRC disallowed the deductibility of interest on $4bn worth of intra-group loans either, on the basis of the unallowable purpose rule in CTA 2009 s 441 which disallows debits in respect of a loan relationship where they are, or on a just and reasonable apportionment, attributable to the unallowable purpose or, in the alternative, on the basis of transfer pricing, arguing the loans would not have been made at all between independent enterprises.

The loan notes were issued as part of an acquisition funding structure for the Blackrock group. The structure comprised a chain of three Delaware LLCs. LLC 4 and LLC 6 were tax resident in the US, whereas LLC 5, which sat in the middle, was UK tax resident. LLC 4 issued $bn of loan notes to LLC 5 which subscribed for $4bn of preference shares in LLC 6. LLC 6 then made the acquisition of shares in the US part of the business of Barclays Global Investors from Barclays.

The First-tier Tribunal (FTT) first considered and concluded the transfer pricing point in favour of the taxpayer. HMRC had effectively sought to argue that because it would have been more expensive for LLC 5 to borrow from an independent lender than a US entity higher up the group, the transaction simply would not have been entered into with an independent lender. Judge Brooks, who also decided the transfer pricing issue in the taxpayer's favour in *Bluecrest [2020] TC 07782*, concluded that is not how the 'separate entity approach' works and the right comparator was a hypothetical $4 billion loan with the covenants which an independent lender would have required.

At first blush, the unallowable purpose decision is good news for taxpayers and a rare unallowable purpose win. It picks up where Judge Beare left off as obiter in *Oxford Instruments* [2019] UKFTT 254 (TC) on the question of how to do a just and reasonable apportionment where there are multiple main purposes, one commercial and one tax related. Here, having found that the taxpayer had both a commercial main purpose and a tax main purpose the FTT concluded that, as it had found on the evidence that LLC 5 would have entered into the loans in the absence of a tax advantage, the tax advantage had not increased the debits and, as such, on a just and reasonable basis all of the relevant debits should be apportioned to the commercial main purpose rather than the tax advantage main purpose.

However, prior to *Oxford Instruments*, many would have said that finding of fact was sufficient to mean there was simply no tax advantage. Paragraph C2.5 of the GAAR Guidance, for example, notes that the concept of a tax advantage requires a comparison and that the 'appropriate comparison or alternative tax

position will depend on the facts, but will usually derive from the arrangements that would have occurred without the abusive tax purpose (which may include no arrangement at all)'.

In *Oxford Instruments*, Judge Beare was of the view that the interest deductions were a tax advantage per se as a 'relief from tax', not because the appropriate comparator was simply that the infamous Step 8 would not have happened. And in *Blackrock* it is taken as read. It was 'common ground' that the interest deductions were a tax advantage. But in *Blackrock*, Judge Brooks takes things a step further and, based on *Mallalieu v Drummond* and *Vodafone Cellular v Shaw*, concludes it is necessary to look beyond the 'conscious motives' of the taxpayer and find that because securing a tax advantage was an 'inevitable and inextricable consequence' of the loans, it is a purpose and, because it cannot be described as merely incidental, a main purpose.

The logical conclusion of that is that pretty much any corporate borrower under an interest bearing loan inevitably has an unallowable purpose, irrespective of its actual 'conscious motives', since it will have obtained a tax advantage (the interest deduction) as an inevitable and inextricable consequence of borrowing. And that it only avoids a disallowance by virtue of also having a main commercial purpose to which the debits are attributable. That surely cannot be the right construction.

Whilst the taxpayer is obviously going to be happy with the overall result, it seems very likely HMRC will appeal. There are clear echoes of the *Lloyds Bank Leasing* saga here, where the Court of Appeal found that the FTT's decision in the original hearing that the main object, or one of the main objects, of the arrangements in question was not to obtain capital allowances was 'virtually unreasoned' and sent it back to be heard again. The FTT does not go overboard explaining the basis on which it considers the commercial purpose to be 'clearly an important purpose and, as such … a main purpose also' or, indeed, conversely on why an interest deduction is not 'incidental' to a loan.

Total: apportionment of profits

It is usual practice when there is a change of tax rates, or when new rules are introduced, for an apportionment of profits to be required where an accounting period straddles the date of change. The default position is usually that profits should be split on a time apportionment basis with the option to elect for profit apportionment on a just and reasonable basis in cases where time apportionment would not be just or reasonable.

In *Total E&P North Sea UK Limited and another v HMRC* [2020] EWCA Civ 1419, the taxpayers, both companies in the Total group, each had an accounting period which straddled an increase in the rate of the supplementary charge. How the profits were apportioned would determine how much of each company's ring fence profits would be subject to tax at 20% and how much at 32%. The legislation provided that the profits should be time apportioned unless this would work unjustly or unreasonably for the company, in which case the company could elect under FA 2011 s7(5) for another method of apportionment that was just and reasonable.

Instead of time apportionment, both companies elected to adopt an actual basis which allocated income, expenditure and capital allowances to the pre-change period or post-change period, according to when they arose. The effect of this method of apportionment was that all of the profits were allocated to the pre-change period, thus escaping the 32% rate of the supplementary charge for the accounting period in question. HMRC challenged this basis of apportionment as not being just and reasonable.

Although the First-tier Tribunal found in the companies' favour, the Upper Tribunal (UT) took a very restrictive approach to when an election for an alternative basis of apportionment could be made. The UT decided that an election under section 7(5) can be made only in exceptional circumstances requiring there to be something unique to the taxpayer in question that makes time apportionment unjust or unreasonable. The UT's interpretation of s 7(5) was that the alternative method of apportionment should operate only to the extent necessary to compensate for the factors specific to the company which led to time apportionment not being just and reasonable.

The Court of Appeal disagreed with the narrow view taken by the UT and allowed the taxpayers' appeal. The Court of Appeal unanimously held that any company which earned profits at a significantly faster rate in the pre-change period than the post-change period, and so stands to be materially prejudiced by time apportionment, can avail itself of the election. One of the reasons why the actual apportionment method led to no profits being allocated to the post-change period was the effect of capital allowances in respect of expenditure incurred after the rate change. It would be retrospective taxation if these allowances were required to be time apportioned to the period before the rate change, which is the very thing that the s 7(5) election is intended to mitigate.

Although the case is about apportionment for the purposes of the supplementary charge on oil-related activities, the principles could also be applied to other change of law situations where an election for just and

reasonable apportionment is available, such as the introduction of the loss relief restrictions and the corporate interest restriction rules.

Modernisation of VAT on financial and insurance services

The European Commission has published a 'roadmap' of plans to reform VAT on financial and insurance services. The current VAT rules are criticised for being complex, difficult to apply and not having kept pace with the development of fintech services including services linked to cryptocurrencies and e-money. The rules have also been applied inconsistently by member states. The result has been increasing litigation before the CJEU, legal uncertainty and high administrative and regulatory costs.

This is not the first time the Commission has promised such a reform, but discussions on the 2007 legislative package ended up in a standstill and the proposals were withdrawn in 2016.

Now reform is back on the table, the main policy objective is to address the competitive disadvantage faced by financial and insurance operators caused by the irrecoverable VAT they suffer because their services are exempt. Clarifying and harmonising the treatment to diminish existing discrepancies in the VAT treatment of the services in question across the EU is another key objective.

Two policy options are being considered: removing the existing exemption in order to tax financial and insurance services; or retaining the exemption but modifying the scope to tax only some types of services (e.g. those services that are fee-based as opposed to interest-based).

A public consultation is expected to take place in the first quarter of 2021, with the impact assessment to be completed in the third quarter. Although any such new rules will not be binding on the UK, it will be interesting to see whether the proposed EU reform has any impact on changes under consideration by the UK for after the end of the Brexit transition period.

The direction the UK was headed in when VAT regulations were made in February 2019 (SI 2019/408) in preparation for a no-deal Brexit, was to give UK businesses supplying insurance and financial services to EU customers an entitlement to increased input VAT recovery by treating supplies to the EU in line with the VAT treatment of supplies to customers in the rest of the world. But the services themselves would continue to be exempt. The Chancellor confirmed on 9 November that 'to make sure UK financial services exports to the EU remain competitive, we will treat those exports the same as we do for other countries. This means UK firms will be able to reclaim input VAT on financial services exports to the EU.' It is therefore expected that the regulations will finally be brought into force and that HMRC will issue guidance in due course.

Bank levy: rules on deductions for certain loss absorbing instruments

From 1 January 2021, a number of changes are being made to the bank levy by legislation enacted in FA 2018, including narrowing the scope to UK balance sheet equity and liabilities. Regulatory requirements published after FA 2018 mean that UK balance sheets will include funding raised externally by UK entities to fund overseas subsidiaries. FA 2018 contains a regulation making power to ensure that no levy should be charged on such UK equity and liabilities.

Accordingly, the Bank Levy (Loss Absorbing Instruments) Regulations 2020 (2020/1188) have been enacted after a consultation which ran from 13 July to 10 August. These regulations provide for the circumstances in which loss absorbing instruments (such as shares and convertible debt) issued by overseas subsidiaries of UK resident entities can be deducted from equities and liabilities otherwise chargeable to the bank levy.

(For more detail on the 2021 bank levy changes, see the article by Dominic Robertson also published in 13 November 2020 edition of Tax Journal.)

OECD blueprints: impact on financial services

The OECD's blueprints for international tax reform to address the tax challenges arising from the digitalisation of the economy were published on 12 October for consultation until 14 December. The blueprints provide that financial services will not have to apply the new taxing right allocating residual profit to market jurisdictions. Financial institutions are, however, in scope of the global minimum rate of tax. Currently, there are no sector or industry carve outs from the global minimum rate of tax but this may change as there are still political and technical aspects to be agreed.

Having missed the end of the 2020 deadline, the OECD now aims to bring the process to a close by mid-2021. Whether a consensus by then is possible, and how many of the jurisdictions participating in the discussions will actually agree to adopt the rules, is unclear. With the US arguing that the new taxing right should not be mandatory, and that US multinational groups should remain subject to GILTI rather than being within the global minimum rate of tax, the OECD's efforts may not be enough to avoid the trade wars and the uncertainty of unilateral measures.

What to look out for:

- The call for evidence on VAT grouping (looking at establishment provisions, compulsory VAT grouping and grouping eligibility criteria) closes on 20 November.
- Legislation making HMRC a secondary preferential unsecured creditor in business insolvency cases comes into effect on 1 December.
- Feedback on the Commission's roadmap for reform of VAT on financial services should be submitted by 19 November 2020. A public consultation is scheduled to take place in the first quarter of 2021.
- The consultation on draft amendments to legislation about the taxation of UK property rich collective investment vehicles and their investors closes on 16 December.

This article was first published in the 13 November 2020 edition of Tax Journal.

CONTACT

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

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

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