Proskauer

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Welcome to the October edition of the Proskauer UK Tax Round Up. It has been a reasonably busy month, with a number of interesting UK and EU tax cases being reported with a particular focus on VAT, further announcements by UK government in relation to COVID-19 and a few international tax developments.

UK COVID-19 Developments

UK Prime Minister's statement on COVID-19

On 31 October, the Prime Minister announced a number of measures designed to slow down the spread of COVID-19 to last for four weeks from 4 November and including the closure of non-essential retail and most hospitality businesses. Alongside these closures, it was announced that the employee furlough arrangements would be extended through December, and would cover 80% of furloughed employees' wages up to £2,500 per month, in order to help people and businesses in a difficult time. Details of the restrictions and government's support for business are yet to be voted on by Parliament and announced in due course. The government has also announced extension to the support for the self-employed. More details on this package of support are set out in our Tax Blog.

UK Chancellor's winter economy plan - deferral of VAT and self-assessment liabilities of over £30K

On 24 September 2020, the UK Chancellor announced a couple of measures intended to help support jobs and business in the UK during the COVID-19 pandemic.

With respect to VAT payments, businesses that were required to account for VAT between 20 March 2020 and 30 June 2020 and have opted to defer those payments until 31 March 2021 under the Chancellor's original plan announced in March this year will now be allowed to make payments on account of VAT under a new payment scheme. Under this scheme, businesses will have an option of opting in to spreading the deferred VAT payments over 11 instalments over the course of the 2021/2022 tax year.

In addition, those taxpayers who pay tax liabilities under the self-assessment scheme would be permitted to spread the payments over the course of 12 months until January 2022 instead of having to make a single payment by 31 January 2021. This would apply to those taxpayers who are required to account for tax in January 2021 and whose tax liabilities do not exceed £30,000 in total.

UK Case Law Developments

The Ice Rink Company - VAT and single or composite supply

On 27 September 2020, the First-tier Tribunal (FTT) allowed The Ice Rink Company's appeal and held that the company made two separate supplies of services for VAT purposes with the first being the entry to the ice rink (standard rated) and the second being the hiring of ice skates (zero rated) (as it did when it first heard the case in 2017).

During the first hearing at the FTT in 2017, The Ice Rink Company appealed HMRC's decision that the supply made by the company of ice rink entry with skate hire was a single, standard rated supply rather than a multiple supply with the two elements subject to different VAT rates.

The company operated an ice rink and charged visitors for admission to the ice rink and hiring of skates. Customers could pay either for entry and the hire of skates or just for the entry to the ice rink and provide their own skates (which they could also buy from the ice rink).

HMRC argued that the company only made a single supply of entry to the ice rink with the hire of skates being ancillary to it and that this single supply was subject to standard rated VAT. HMRC relied on the statement that it was not sufficiently demonstrated that the services of skating and the hiring of ice skates were separate and that the skates could be provided by the customer rather than hired. The taxpayer, on the other hand, argued that it made two separate supplies. This was based on the customers' understanding that they could either pay for access to the rink together with hiring of skates on the premises or, alternatively, they could pay for skating on the rink using their own skates. It was an important consideration that the customers had sufficient understanding of the separate and optional nature of the services provided and freedom in deciding how to pay for each supply of services.

When the decision was appealed by HMRC to the Upper Tribunal (UT) in 2019, the UT decided to refer the case back to the FTT for further fact finding (see our UK Tax Round Up from May 2020).

Having considered the case once again, the FTT upheld its initial decision that the taxpayer supplied a multiple supply of ice rink entry (standard rated) and skate hire (zero rated for children).

Compensation payment treated as income

In *Wilkinson v HMRC*, the FTT has held that the compensation sum received by a taxpayer as a result of interest rate swap misselling should be treated as income rather than as a capital receipt.

In this case, the taxpayer borrowed a loan from Barclays bank in connection with its UK property business. At the same time, the taxpayer entered into an interest rate swap to hedge the interest rate fluctuations on the loan. During the 2014-2015 tax year, the taxpayer received a compensation payment of £460,000 as a result of the bank's misselling of the swap. The taxpayer treated the sum received as capital and not subject to income tax.

The taxpayer, focusing on the economics of the transaction, argued that the compensation should be treated as capital because it was compensation for the implicit opportunity cost of entering into the swap. The taxpayer then argued that because the opportunity cost was not reflected in his accounts and he could not enter into an alternative hedging arrangement as a result of the missold swap, the compensation payment was capital in nature and should not be subject to income tax.

While the FTT agreed with the taxpayer that it was necessary to consider the economic effect of the transaction, including the opportunity cost of undertaking the relevant transaction, it was important for the FTT to identify the reason for the payment of the compensation. It was clear to the FTT that the payment was not made to compensate the taxpayer for his inability to obtain the swap

but rather it was paid to compensate the taxpayer for the extra expenses which he incurred under the missold swap that exceeded the expenses which the taxpayer would have incurred under an alternative swap. In addition, the documentation relating to the compensatory payment referred to a refund of payments (including interest on those payments) made by the taxpayer under the missold swap.

As a result, the FTT concluded that because the expenses represented revenue payments, the compensation payment was also revenue in nature and taxable as income.

This case is yet another example of the court undertaking a detailed analysis of the source and reason for a payment in order to determine whether a particular payment is capital or revenue in nature.

Other UK Tax Developments

OTS review of elections and claims including section 431 elections

The Office of Tax Simplification (OTS) has this month published a report on its review of the current operation of certain tax claims and elections together with suggestions on how the process might be simplified for UK taxpayers. This forms part of the overarching series of recommendations to the UK government on the simplification and modernisation of the UK tax system.

In the report, the OTS discusses the most commonly made claims and elections and sets out general and specific recommendations on how the process for making these claims and elections might be simplified.

The general recommendations include proposals to:

I. improve the functionality of the online HMRC accounts for both individuals and businesses, including the addition of a facility to make claims and elections and upload supporting documentation;

II. ensure that time limits for making claims and elections are linked to tax years or accounting periods;

III. provide for consistency when making claims and elections, whether they are made in or outside a tax return; and

IV. improve guidance on how to make claims and elections.

In addition, the OTS discusses a number of specific claims and elections that are commonly made by individuals and businesses and sets out certain recommendations to improve the administration process for those claims and elections.

Amongst the elections discussed, and of particular interest to the asset management industry, the OTS comments on the employment-related securities election under section 431 ITEPA 2003, which is important in ensuring that when employees acquire “restricted” securities, they and their employer are not exposed to potential employment tax when the securities are disposed of. In order to be effective, the employee and their employer have to complete the section 431 election within 14 days of the employee acquiring the relevant securities.

In its recommendation for the administration of section 431 elections, the OTS notes that the process could be simplified if the default position for the employee and employer was that the employee would be taxed on acquiring the securities as if they were unrestricted (which is the

effect of making a section 431 election) with an option to elect that the up front tax was based on the unrestricted market value (so, effectively, reversing the current process).

Given that most employees and employers will wish to enter into section 431 elections when employees acquire restricted securities, and that the lack of section 431 elections can be a significant due diligence issue for purchasers of companies in which employees own shares, it would be a welcome simplification if the default position was changed this way so that elections would generally not have to be made.

HMRC updates its VAT manual on employment bureaux

On 6 October 2020, HMRC made some updates to a section in its VAT manual relating to employment bureau.

Prior to these changes, there were some ambiguities in determining whether an employment bureau acts in a capacity of an employment business as principal or as an employment agent when making supplies of staff or staff introductory services.

In its update, HMRC sets out an extensive background to the general legal framework on how employment bureaux operate and HMRC's understanding of how supplies of services made by employment bureau should be treated for VAT purposes.

In HMRC's view bureau agency can operate as either principal or as agent and each will be treated differently for VAT purposes. HMRC refers to the FTT decision in *Adecco UK Ltd* , in which the court commented that the determination of an employment bureau's supply was indistinguishable from the question of to whom the workers were providing their services. Thus, if a worker has a contractual relationship with the bureau's client then the employment bureau would likely act as agent in an introductory capacity. On the other hand, if there is no contractual relationship between the worker and the client, then the employment bureau would be treated as supplying staff to its client as principal.

HMRC's updated guidance now includes additional sections setting out the analysis in respect of the different types of arrangements in detail and discussing the correct VAT treatment of them.

The changes also discuss the use of personal service companies (PSCs), HMRC notes that providing services through a PSC would not change the VAT analysis in the context of supplies by an employment bureau. Where a PSC supplies the services of an individual to the bureau, that bureau is acting as a principal in receiving and making a supply of staff as it engages the PSC to make its onward supply to the client. If, however, a PSC supplies the services of an individual to the client the bureau is providing introductory services as agent.

In summary, HMRC's updated guidance is a welcome step in helping taxpayers to determine the correct VAT treatment in connection with various transactions involving supplies of workers and introductory services by employment bureaux and recruitment companies.

EU Case Law

European Commission's decision to appeal ECJ's decision in the Apple state aid case

The European Commission (EC) announced on 25 September 2020 that it would appeal the EU General Court's (ECJ's) decision in the Apple state aid case. This follows ECJ's judgement in July 2020 in which it annulled the EC's August 2016 decision that Apple's two Irish subsidiaries

received illegal state aid from Ireland as a result of certain tax breaks resulting in reduced corporate taxes in an amount of approximately EUR13 billion.

The tax rulings contested by the EC approved the transfer pricing methods used by Apple's Irish subsidiaries to calculate their chargeable profits arising from their trading activity in Ireland.

Having assessed the ECJ's decision that there was no state aid granted, the EC has concluded that the case raises a number of important issues on the application of state aid rules and that the ECJ made a number of errors of law.

The decision on the appeal will, hopefully, provide useful guidance on the scope of the state aid rules in the context of tax arrangements with national tax authorities.

VAT and fund management services provided by insurance companies

In the *United Biscuits Pensions* case, the ECJ has decided that the supply of investment management services to trustees of pension schemes by an insurance company could not benefit from the exemption from VAT for insurance services because the services did not include an indemnity for risk (that is, they were not themselves insurance services).

In this case, trustees of a UK pension scheme received fund management services from various investment managers who were both insurers and non-insurers and applied for reimbursement of the VAT paid on the services from non-insurers on the basis that the services should be exempt from VAT. The claim related to the old UK rules under which a VAT exemption was available for supplies of fund management services made by professional insurers who were authorized by the UK insurance legislation ("insurers") but was not available for supplies of the same services by other persons who were nevertheless authorized to supply such services under other UK legislation ("non-insurers"). The trustees argued that the VAT exemption should be available on supplies of fund management services made by non-insurers because such supplies should be viewed as VAT-exempt insurance transactions for the purposes of the EU VAT Directive. The High Court had held that the exemption for pension fund management services was not available because the services could not be classed as insurance services. On appeal, the Court of Appeal referred the case to the ECJ to determine whether pension fund management services should be properly treated as "insurance transactions" within the meaning of the VAT exemption applying to such transactions under Article 135(1)(a) of the EU VAT Directive.

The ECJ examined the nature of the services provided to the pension scheme trustees as compared to the core insurance services provided by insurers. It was clear to the ECJ that the insurance services generally involved insurers agreeing to underwrite a risk in exchange for a premium payment. Having also examined the EU Insurance Directive, the ECJ noted an ambiguity which meant that insurance could in certain circumstances include management of group pension funds. However, the ECJ concluded that any such activities fell within the scope of the EU Insurance Directive that governed the authorisation of insurers and were not applicable in the context of the EU VAT Directive.

Noting that the exemption contained in Article 135(1)(a) of the EU VAT Directive must be interpreted strictly (and narrowly) as an exemption from the general principles that VAT must be levied on all supplies of services, the ECJ held that the services provided by non-insurers to the pension scheme did not involve an element of risk and could not fall within the scope of insurance services that were exempt under the EU VAT Directive.

The decision highlights the requirement to consider the nature of services carefully when determining whether or not an exemption, or favoured VAT treatment, might apply to them.

Scope of information notices under DAC

In the case *Luxembourg State v B and others* concerning cooperation between the EU Member States under the EU Directive for Administrative Cooperation in Tax Matters (known as the DAC), the Spanish tax authority had requested the Luxembourg tax authority to obtain and exchange certain information with respect to a Spanish taxpayer (the Spanish Taxpayer whose tax affairs were being investigated by the Spanish tax authority). In particular, the Spanish tax authority wanted to obtain some information held by certain entities located in Luxembourg such as the Spanish taxpayer's bank accounts, financial assets and transactions undertaken by the Spanish taxpayer.

In order to comply with the Spanish tax authority's request, the Luxembourg tax authority issued information orders to a number of other taxpayers (the Other Taxpayers). The Other Taxpayers wanted to challenge the information requests, but because there was no procedure to challenge such requests under Luxembourg law the Spanish Taxpayer and the Other Taxpayers asked the Luxembourg courts to vary or annul the orders.

The Luxembourg tax authority referred the case to the ECJ on the basis that the Luxembourg procedure was not consistent with article 47 of the Charter of Fundamental Rights of the European Union (the EU Charter), which provides for the right to an effective remedy for everyone whose rights and freedoms guaranteed by the EU law have been infringed. The ECJ had to consider the question of the interpretation of the EU Charter, including whether (1) the local legislation that did not provide for an appeal procedure was consistent with the EU Charter and (2) the information requests were consistent with the requirement for the exchange of information to be "foreseeably relevant" under the DAC.

Having determined that the EU Charter was relevant insofar as the EU Member State has implemented the relevant EU law, the ECJ noted that there was a general principle of EU law that ensured that EU taxpayers have an effective remedy and protection against arbitrary and disproportionate intervention by public authorities and that this principle could be relied on by any legal person to whom an information order has been addressed. The ECJ also stated that this right to protection had to be considered in light of Article 52 that allowed for a departure from the right to effective remedy.

The ECJ concluded that the EU Charter precludes the EU Member State that has implemented the legislation on exchange of information from:

i preventing a person who holds information from bringing an action against the Member State's tax authority that requested such information. This meant that the taxpayer who has received an information order could challenge the order, and

ii preventing other taxpayers mentioned in the information order from brining an action against the Member State's tax authority.

In addition, the ECJ held that the EU Charter does not preclude the EU Member State that has implemented the legislation on exchange of information from introducing rules that prevent a taxpayer who is subject to investigation from bringing an action against the information request. However, the ECJ noted that the taxpayer should have a right to challenge the outcome of the tax investigation in his or her home Member State.

While this decision is not of particular comfort to those EU resident taxpayers who may be the subject of tax investigations and information orders, it does offer additional protection to those categories of taxpayers who have been ordered by tax authorities to provide information or who are mentioned in information orders. It is likely that some Member States who do not already have

appropriate procedures in place to allow taxpayers to challenge information orders, may need to amend their legislation to comply with the ECJ decision in this case.

VAT input tax recovery on costs benefiting more than one person

In *Mitteldeutsche Hartstein-Industrie AG v Finanzamt Y*, the ECJ has held that a managing holding company resident in Germany (the Applicant) that received permission to redevelop and operate a limestone quarry on condition that the Applicant would also develop access to it by way of a public road belonging to the municipality in which the quarry was located was entitled to recover its input VAT incurred on the public road construction.

During the course of 2006, one subsidiary of the Applicant commissioned another of its subsidiaries to carry out the road extension as agreed with the municipality. The road was used by the first subsidiary for the purposes of accessing the quarry and by other vehicles in the municipality. The Applicant sought to deduct as input tax, the VAT incurred on the road extension services received from the second subsidiary.

Amongst a number of technical questions relating to German implementation of the VAT rules, the ECJ had to consider whether input VAT was deductible with respect to the road extension services when the services were performed for the benefit of both the Applicant and the municipality.

The ECJ reiterated that the right to deduct VAT was an integral part of the EU VAT scheme and ensured neutrality of taxation of all economic activities. The ECJ went on to refer to the settled case law and the requirement for there to be a direct and immediate link between a particular input and output transaction of the taxable person before the right to deduct VAT could arise. The right to deduct VAT also exists where the costs of the transaction in question form only part of the taxpayer's general costs and the corresponding price of the goods or services which he supplies. In this case, the costs still have a direct and immediate link with the taxable person's activity as a whole. The link needs to be assessed objectively in light of the transaction in question.

Having considered the services relating to the provisions of the road extension, the ECJ concluded that the taxpayer was entitled to deduct input VAT paid for the extension work that was carried out for the benefit of the municipality where the road was used both by the taxpayer in connection with its economic activity and also by the public. This entitlement existed provided that (i) the extension work did not exceed what was necessary to allow the taxpayer to carry out its economic activity and (ii) the costs of the work were included in the price of the services supplied by the taxpayer.

The decision by the ECJ is an interesting one confirming that VAT recovery is possible in relation to services which the benefit is received not only by the relevant taxpayer seeking to recover the VAT but also by a third person. The important conditions of being able to recover the VAT in such cases is to show that: (a) there was a direct and immediate link between the input and output services, (b) the services received were necessary to allow the taxpayer to carry out its economic activity and (c) the cost of the services received was included in the cost of the services or goods supplied by the taxpayer.

Other EU Tax Developments

Removal of Cayman Islands from the EU blacklist

As highlighted in our Tax Talks blog at the start of October, on 6 October 2020 the European Council announced that the Cayman Islands would be removed from the EU's list of non-cooperative jurisdictions for tax purposes after it had been placed on this list earlier this year.

The removal results from the EU being satisfied that the Cayman Islands has enacted the appropriate legislation to deal with the oversight of collective investment vehicles. This should add additional assurance to investors who are generally concerned (for policy reasons or otherwise) about making investments in collective investment scheme entities that are established in EU-blacklisted jurisdictions.

At the same time as removing the Cayman Islands, the EU has also removed Oman and added Anguilla and Barbados onto the list. The blacklist currently comprises 12 jurisdictions including American Samoa, Anguilla, Barbados, Fiji, Guam, Palau, Panama, Samoa, Seychelles, Trinidad and Tobago, the US Virgin Islands and Vanuatu.

European Commission's plans for a common EU-wide system for withholding tax relief at source

The EC has announced a plan for introducing an EU-wide system for withholding tax relief at source. In a recent Q&A discussing the Capital Markets Union Action Plan, the EC reiterated its wider plan to create a single market for capital across the EU. In the EC's view, this would facilitate investors, companies and projects benefiting from investments and savings from the single capital market and would make the market stronger, more efficient, integrated and competitive as a result.

Amongst its proposals is the EC's concern that the current procedures for claiming refunds and relief for withheld tax in connection with cross-border investment are burdensome and complex and lead to considerable additional transaction costs, thus minimising overall return on investment.

In order to minimise such costs and to prevent tax fraud, the Commission is considering introducing a common EU-wide system for withholding tax relief at source. Further details of the proposals are expected to be developed in consultation with the EU Member States and published by Q4 2022.

OECD/G20 inclusive framework on BEPS: Pillar One and Pillar Two blueprints

As part of the Action Plan on BEPS, the OECD has proposed an analysis of the digital economy in order to find solutions to the tax challenges of the digitalisation of the economy.

While the OECD recognises that the digital economy contributes to improvement of services and economic growth across the world, it considers that the international tax system is facing a number of challenges, the solution to which would require international consensus. The most notable challenges include such international tax concepts as permanent establishments and arm's length principles that are particularly difficult to apply in the context of the digitalised economy.

Following the work carried out by the 137 members of the Inclusive Framework, the group has come up with a two-pillar approach. Pillar One is focused on new nexus and profit allocation rules to ensure that the taxing rights with respect to business profits are no longer dependent on physical presence. The proposed rules discussed in the Pillar One Blueprint seek to adapt the international tax system to new business models that are focused on net basis taxation, avoidance of double taxation and the introduction of new tax dispute prevention and resolution mechanisms to create tax certainty.

Pillar Two is focused on remaining BEPS issues seeking to ensure that large internationally operating businesses pay a minimum level of tax irrespective of where they are located or the jurisdictions in which they operate, and the rules discussed in the Pillar Two Blueprint are aimed at achieving this result.

On 12 October 2020, the OECD/G20 Inclusive Framework on BEPS published two blueprint reports in relation to Pillar One and Pillar Two and is requesting public comments to be submitted by 14 December 2020. It is expected that public consultation meetings on the blueprints will be held in mid-January 2021 with a view to concluding the proposals by mid-2021.