Proskauer

UK Tax Round Up

May 2020

UK COVID-19 developments

Proposed deferral of DAC6 and DAC2

The European Commission has published a draft directive proposing a three month delay to the deadlines for certain information disclosures under the EU Directives relating to the disclosure of tax information known as DAC6 and DAC2. The aim is to ease administrative burdens on businesses during the COVID-19 crisis.

DAC 6 is the new Directive requiring disclosure of certain tax-related cross-border arrangements involving at least one EU Member State. Under DAC 6, the first reports were due to be made by 31 August in relation to reportable transactions implemented or made available for implementation between 25 June 2018 and 30 June this year. Even before the COVID-19 crisis there were concerns about this deadline given that the Directive was only published in January and a number of Member States have not yet published guidance on the sort of transaction that should be reported.

The proposal has not yet been confirmed by the Member State or the UK, but it is expected that the suggested delays will be implemented. The proposal provides for a further three month delay if that is considered necessary. The proposal does not, however, change the requirement to report on all relevant transactions entered into since 25 June 2018.

For more information on the delay to DAC6 reporting, see our blog post here.

VAT zero rating extended to PPE and certain e-publications

On 29 April, the government introduced the Value Added Tax (Zero Rate for Personal Protective Equipment (Corona Virus) Order 2020 which provides for zero rating for VAT purposes of personal protective equipment (PPE). The Order has effect from 1 May 2020 and applies to supplies of PPE from then until 31 July. The Order uses the definition of PPE given in the COVID-19 guidance published by Public Health England on 24 April (that is, PPE recommended for use in connection with protection from infection with coronavirus). This includes disposable gloves, plastic aprons, surgical masks and other named pieces of equipment. The big driver for the change is to assist businesses operating in sectors in which VAT recovery is not possible on such goods because of their VAT exempt status, such as the care or welfare sectors.

Announced on the same day was the introduction of the Value Added Tax (Extension of Zero Rating to Electronically Supplied Books etc.) (Coronavirus)) Order 2020 with the same effective date of 1 May 2020. This Order extends zero rating for books to cover books, booklets, brochures, pamphlets, leaflets, newspapers, journals, periodicals, children's picture books and painting books when supplied electronically. However, the order does not extend to all electronic publications. For example, it does not extend zero rating to electronic supplies of music or maps or to publications that are wholly or predominantly audio or video in content. This second exclusion is an EU legal requirement. The Order does not extend zero rating to e-publications for plans or drawings for industrial, architectural, engineering, commercial or similar purposes. Furthermore, standard rating will still apply to e-publications where there is a connected supply of the e-publication and a supply of goods and these connected supplies are made by different suppliers.

The extension of zero rating to e-publications is not wholly driven by the COVID-19 crisis. The government had expected to implement the extension of zero rating from 1 December 2020. The implementation has been brought forward to support and maintain literacy and the "stay at home" effort currently being recommended.

Government consultations extended by three months

The government has announced a three month extension to the deadline for responding to a number of consultations published as part of the Spring 2020 Budget. These include the modernisation of the UK's asset holding company regime, certain elements of the hybrid mismatch regime, the notification to HMRC of uncertain tax treatment positions by large businesses, preventing abuse of the R&D tax relief by SMEs, the tax impact of the withdrawal of LIBOR and the call for evidence on raising standards in the tax advice market.

The government have confirmed that the extension is not an indication of any change in the government's commitment to these consultations but is to give stakeholders more time to submit views in the current time of much disruption.

UK case law developments

Employment status – imposition of a contract not enough to satisfy requirement of mutuality of obligation

Professional Game Match Officials v HMRC¸ the latest in a string of cases considering whether individuals should be considered to be employees (or deemed employees in the context of IR35), continues to shine a spotlight on the significant issues in determining self-employed or employed status (considered in the context of the IR35 rules in the "*Government committee report on changes to the IR35 rules - the "Off -payroll working: treating people fairly" report*" discussed below).

The case related to whether certain referees engaged by the taxpayer (PGMOL) to officiate matches in the English Football Leagues 1 and 2 and, less frequently in the Championship and the FA Cup should be treated as employees of PGMOL. While not itself a case related to IR35, the legal issues considered are equally applicable to the "deemed employment" status required under those rules.

HMRC argued that the referees were employed by PGMOL. As is common ground, for there to be an employer/employee relationship, there must be an irreducible minimum of mutuality of obligation and control. There has, however, been much recent discussion about what is required for there to be mutuality of obligation of the sort required to create an employment relationship. HMRC's view is that the only requirement is for there to be a valid contract relating to the provision of and payment for work. Taxpayers have argued that there needs to be some commitment to either provide work or make some sort of payment in lieu of the provision of work.

The relationship between PGMOL and the referees was governed by two contracts. The first was an overarching agreement under which the referees were, effectively, on PGMOL's list and available to officiate at matches. The second was the contract entered into when PGMOL asked an individual to officiate at a particular match.

HMRC took this position in this case and argued that the presence of a contract (or two contracts) between PGMOL and the referees was sufficient to satisfy the mutuality of obligation requirement. PGMOL claimed that there was not mutuality of obligation of the sort required for there to be an employment relationship because, even when PGMOL had offered a particular engagement to a referee and entered into an individual contract with them in respect of it, the referee could still notify PGMOL that they could not officiate for a range of reasons.

The UT supported the FTT's decision that the contractual nexus between PGMOL and the referees did not create the sufficient mutuality of obligation of the sort required for an employment relationship, since that required that the referees were obligated to officiate at matches offered to them by PGMOL and that the extent of the referees' right to notify PGMOL that they could not officiate at any particular match was sufficient to mean that the required mutuality of obligation did not exist.

The case is important in showing that HMRC's approach to the extent of mutuality of obligation required to meet the irreducible minimum for a contract to be the sort that could create an employer/employee relationship is too narrowly focused in simply requiring a contract that relates to the provision of personal services. Rather, there must be an obligation to provide and pay for work and an obligation to perform it. This is highly relevant to the current discussion surrounding the difficulties with operating the IR35 off-payroll worker rules and their proposed extension to private sector clients and HMRC's insistence that its check employment status tool (CEST) is fit for purpose.

Hopefully, this decision will prompt HMRC to reconsider its approach to mutuality of obligation and also to try to improve CEST to reflect the extended requirements for mutuality of obligation to exist.

Advisers' fees non-deductible where management decisions made by parent company

In *Centrica Overseas Holdings Limited v HMRC*, the FTT has held that expenses incurred by a parent company on advisers' fees that related to a proposed disposal by a group subsidiary that were charged on to the subsidiary were not deductible as expenses of management of the subsidiary under section 1219 of the Corporation Tax Act 2009 because the decisions in respect of the disposals had been taken by the parent and not the subsidiary.

The decision provides cautionary advice on how groups should make sure that they operate and document as clearly as possible the different activities and decision-making process of their individual group members.

The case involved the disposal of certain investments by the Centrica group. Strategic decisions for the group were made by the parent company (Centrica plc). It decided to dispose of an investment held by Centrica Overseas Holdings Limited (COHL), one of its indirect subsidiaries. Various advisers were engaged to work on the disposal with Centrica plc paying the advisers' fees and then charging them to COHL by means of book entries. The transaction that was actually entered into involved COHL's subsidiary (Oxxio) hiving certain of its investments into a newly formed subsidiary and selling that subsidiary, so the actual disposal was made by a subsidiary of COHL.

The group decision-making process was facilitated by various central teams within the group. A distinction was drawn between investment decisions, which were made by Centrica plc, and operational decisions regarding how investments were to be run, financed and managed, which were made by cross-company teams within the group. COHL had no employees of its own and its directors were also employees of Centrica plc. There was a lack of clear delineation between the various roles in which the individuals who were the directors of COHL were acting. Directors of COHL would be aware of how the disposal was progressing in their group capacities as opposed to specifically in their capacity as COHL directors. This meant that there was no need to brief the directors of COHL or inform them about how any transaction was progressing as they would already know these things in their respective group capacities. Significantly, there would not always be a formal COHL board meeting considering any particular transaction and there were no COHL board minutes regarding the disposal in question.

The FTT held that the fact that COHL itself did not dispose of anything was not, of itself, a bar to the disputed expenditure being an expense of management of COHL’s investment business. The FTT also held that the fact that a subsidiary paid for services provided or procured by its holding company did not automatically bar the expenditure from being tax deductible for the subsidiary.

However, the FTT confirmed that deductibility required the relevant expenses to be "in respect of" so much of the company's investment business as consisted of making investments and that there had to be a link between the expenses and the investment business. As outlined above, the lack of delineation in function between individuals acting as directors of Centrica plc and COHL meant that those individuals did not consider the strategic decisions specifically in their capacity as directors of COHL as the investment company claiming deduction for the expenses. The FTT stated in this regard that “the real difficulty … is that COHL was not actually managing anything. Taking a realistic view of the facts it was [Centrica plc] which made all the decisions, strategic and otherwise. The various group functions did not think of themselves as providing services to COHL, they were working to give effect to [Centrica plc’s] strategic decision to divest itself of the Oxxio businesses”.

The FTT also considered a question about whether the relevant expenses could, in principle, have been expenses of management and whether they were revenue or capital in nature.

The case highlights the importance for groups of considering carefully the basis on which it might be seeking deductions for expenditure and to make sure that the correct corporate steps are taken, and that there is documentary evidence of the manner in which they are taken, to ensure that the transactions actually entered into satisfy the requirements of the relevant tax provisions. So, in this case, COHL should have held board meetings to consider the advice from Centrica plc and the COHL directors should have taken the disposal decision as directors of COHL notwithstanding that they might have already had all of the information necessary to take the decision as employees of Centrica plc.

In addition, the purpose and timing of expenditure should also be considered in relation to whether expenses are management expenses and whether such expenses are revenue or capital in nature. Therefore decision-making should be clearly documented as to both purpose and timing to maximise the ability to claim deductions for the expenses.

Contractual termination payment a trading not capital receipt

In *Looney v HMRC*, the Upper Tribunal (UT) has reiterated that categorisation of a receipt as trading (or revenue) or capital depends entirely on the facts in question and that the burden for displacing an assessment by HMRC falls on the taxpayer. The decision upheld the First-tier Tribunal's (FTT's) original decision that a payment on early termination of a contract to provide services was a trading receipt and not a capital receipt.

Mr Looney was a partner in Kieran Looney & Associates (KLA) which provided management training to the senior management of Trafigura Beheer BV (Trafigura), a commodities trading company. The case related to the tax treatment of two sets of payments: the payment of £1 million by Trafigura on the early termination of the contract and other payments under the contract totaling £3 million.

On the first payment, Mr Looney argued that the termination payment was compensation for the loss of a secret process (intellectual property) in KLA's proprietary performance management system and was, therefore, capital in nature. The FTT had rejected this and determined that the payment was consideration for the cancellation of the contract and loss of future revenue and was, consequently, a trading (or revenue) receipt. On the second payment, the FTT had rejected Mr Looney's position that the payments were not income of KLA but instead were made to Kieran Looney and Co Limited (KLCL) and a Panamanian company (Nower Inc) set up and owned by Mr Looney during the course of the contract with Trafigura. We will focus on the decision on the termination payment.

The contract that KLA entered into with Trafigura had a three year term with an annual fee of £3 million to be paid for each of the three years and the payment of a non-refundable deposit of £2.4 million payable on signing the contract and £600,000 on 1 August 2009. The payments covered the initial part of the training and three years' subsequent use of materials on license. The contract provided that the license would be assigned to Trafigura and that Trafigura could then use the performance management system at no extra cost if the contract ran its full three year course. The program materials were to remain the property of KLA during the term of the contract.

The contract also provided that on service of a termination notice by Trafigura and the payment of the early termination fee, the party's obligations would cease. The early termination clause in the contract specified that the contract could be terminated with written notice and that an early termination fee of £1,000,000 would be paid to KLA. Trafigura gave notice of early termination on 20 October 2009 and paid the £1 million early termination fee to KLA on 29 October 2009.

Mr Looney had claimed that the compensation was received as a payment for the loss of value in his unique computerised management performance system which, he said, Trafigura was bound to continue making use of. His evidence was that he had placed the compensation term in the Trafigura agreement to compensate for that loss of value in his intellectual property and that the £1 million was intended to be net of taxation. The FTT rejected this evidence and found that the purpose of the payment was to compensate KLA for the lost opportunity to profit from the remaining period of the contract. It concluded that the termination payment was not expressed to be compensatory for the disposal of intellectual property rights or any secret process contained in the KLA program. In fact, numerous contract provisions excluded Trafigura from using, acquiring or licensing the intellectual property except if the contract ran its full three year term.

In rejecting Mr Looney's appeal against the FTT's decision, the UT made clear that the issue of whether a receipt was capital or income in nature was one of "fact and degree and above all judicial common sense in the circumstances of the case" (as stated by Arden LJ in *IRC v John Lewis Properties plc*). The UT's task was to consider whether the FTT had erred in its task of looking at the circumstances and applying judicial common sense to the question in the light of those circumstances. Unsurprisingly, the UT held that the FTT had not made any such error, that it was entitled to reach the conclusion it did based on the evidence before it and that the payment was compensation for the lost opportunity to profit from the remaining period of the contract and was, therefore, a trading receipt of KLA. Further, there was nothing in the contract that explicitly transferred any intellectual property or secret process to Trafigura and nothing in the surrounding circumstances or evidence that indicated that the payment was as Mr Looney contended. Consequently, there was no basis for interfering with the FTT's conclusion regarding the characterisation of the termination payment. In addition, the UT kept in mind that case law provides that the tribunal should be slow to interfere with a first instance tribunal's evaluation where it is one based on a matter of degree, taking account of all the circumstances (*Able (UK) Ltd v HMRC*).

In short, the UT found that it was reasonable for the FTT to find as they did. The important points for consideration by the tribunal were the facts and the taxpayer's evidence. These were fairly considered and the finding was rightly based on these two aspects.

What this does show is that it will often be prudent to set out in detailed and specific terms the nature of the arrangements between the parties and the reason for making particular payments when the expectation by the parties is that a particular tax treatment will apply to a payment.

Direct and immediate link a requirement for input tax deduction

In *HMRC v Royal Opera House Covent Garden Foundation*, the UT held that the FTT had erred in law in allowing the Royal Opera House (ROH) to reclaim a proportion of its input VAT costs on its production expenses by attributing them to its VATable catering services.

ROH generates both VAT exempt (ticket sales) and taxable (programme sales and the provision of catering in bars and restaurants, including sales of ice-creams) income for VAT purposes. Input VAT is not recoverable on expenses incurred for exempt income but can be recovered for expenses with a direct and immediate link to taxable income (a cornerstone of VAT law that was not in dispute here). The ROH sought to recover a large proportion of its input VAT on its production costs on the basis that a direct link existed between those costs and, not only its exempt supplies, its taxable supplies of catering services. The link was a perceived correlation between the quality of the production, the subsequent effect on attendance and the increased income generated by the catering outlets.

HMRC argued that this approach resulted in a disproportionate level of VAT recovery. They agreed that the production costs were a cost component of, and directly linked to, the ticket and programme sales but not to the catering services.

The FTT decided in favour of ROH, agreeing that there was a sufficient link between the production costs and the taxable supplies to provide a justification for partial recovery of input VAT on the production costs.

The UT allowed HMRC's appeal on the basis that the FTT erred in law. The UT found that, while the production costs were directly and immediately linked to the income generated by ticket sales, the link between the production costs and the catering supplies was, at best, indirect. While the UT noted that the catering supplies were part of the ROH's "fully integrated visitor experience", this was not seen as a strong (or direct) enough link to conclude that the production costs were a cost component of the catering supplies. Consequently, there was no right of recovery on input VAT in relation to these taxable supplies.

The case illustrates, as stated by the UT, the importance of there being a direct and immediate link between the relevant expenses and taxable supplies if the input tax on the expenses is to be deducted. The UT further clarified that it has always been the case that a "but for" test of causation would never be, in itself, sufficient to satisfy the requirement for a direct and immediate link. This important qualification means, as highlighted by the UT, that "it will produce the result in some cases that an indirect link or a non-immediate link will not meet the requirement" for input VAT deduction.

Deeming provision in UK domestic law did not extend to application of double tax treaty

In *Fowler v HMRC* the Supreme Court (SC) has considered the fine balance and complexity involved in determining how a deeming provision in UK domestic law should interact with and be read into a double tax agreement (DTA).

Mr Fowler was a qualified diver who was tax resident in the Republic of South Africa. He worked in UK waters during the tax years 2011/12 and 2012/13 and HMRC argued that he was liable to UK income tax during this period by virtue of carrying out his employment duties in the UK. Mr Fowler argued that he was liable to South African tax only by virtue of the interaction of section 15 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA) and Article 7 of the UK/South Africa DTA (the Treaty). The Treaty states that the business profits of a South African resident can only be taxed in South Africa unless they are attributable to a permanent establishment in the UK. Section 15 ITTOIA states that individuals employed as divers in the UK are to be treated as carrying on a trade in the UK. Article 14 of the Treaty allows for employees to be taxed where they work (i.e. in this case, the UK).

It was accepted that Mr Fowler was, in fact, an employee. The question in point related to the effect of section 15 ITTOIA, which states that an individual employed as a diver in the UK is treated as carrying on a trade in the UK. This raised the question of whether Mr Fowler should be subject to tax applying Article 14 or Article 7 of the Treaty. This, in turn, rested on whether and to what extent the fiction in section 15 ITTOIA should be read into the Treaty.

Mr Fowler argued, and the FTT and CA had agreed with him, that the deeming provision in section 15 ITTOIA meant that he was not liable to pay tax in the UK on the basis that since he was to be treated as self-employed under section 15 ITTOIA for UK domestic tax purposes, he must also be treated as self-employed for the purpose of the Treaty.

HMRC argued, and the UT had agreed, that the deeming provision should not go to the question of whether someone is an employee under the Treaty, but should only be applied to determine the manner in which that employee is taxed if they are subject to UK tax. Therefore, as a de facto employee, Mr Fowler could be taxed in the UK under Article 14, albeit that his UK tax liability would then be calculated applying section 15 ITTOIA.

The SC referred to the UK case law on the extent to which the fiction of a deeming provision should be extended to other provisions, which states that the extent of the application of the fiction will depend on the context and purpose of the provision being considered and that the fiction should not be applied to produce an unjust, absurd or anomalous result unless that is required by clear words.

Applying this approach, the SC unanimously allowed HMRC’s appeal stating that the words of Articles 14 (salary, wages and other remuneration and employment) and Article 7 (profits of an enterprise) in the Treaty should be given their plain meaning and that applying the fiction of section 15 to the Treaty to say that Mr Fowler should be treated not as receiving salary and as being or carrying out an enterprise would produce a result that was contrary to the purpose of the Treaty of determining where income that results from employment as a matter of fact is subject to tax. Section 15 ITTOIA simply determines what basis of UK tax should be applied to that employment income.

The case is informative both as to how UK deeming provisions should be applied (or not applied) to DTAs and to the general question of how far a deeming provision should be applied when applying other taxing provisions to the arrangements to which the deeming provision has been applied (and whether the fiction created should be extended into other taxing provisions).

HMRC’s appeal on the deductibility of IFRS 2 debits rejected by the Court of Appeal

In *NCL Investments Limited v HMRC*, the Court of Appeal (CA) has upheld decisions of the FTT and the UT allowing the taxpayers’ appeal against HMRC’s rejection of a trading deduction that reflected the accounting debit arising under IFRS 2 on the grant of share options by an employee benefit trust (EBT).

The taxpayers were wholly-owned subsidiaries of a parent company, Smith & Williamson Holdings Limited (SWHL). Some of the taxpayers’ employees were granted options by an EBT to acquire shares in SWHL. The taxpayers accounted for the options in accordance with IFRS 2, the international accounting standard applicable to share-based payments. Under IFRS 2 the employing company must debit the fair value of the share-based payment to its profit and loss account. Where a parent company issues share options to employees of a subsidiary, the subsidiary has to recognise a capital contribution received from the parent as a corresponding credit on its balance sheet. From time to time the subsidiaries would make a recharge payment to SWHL through an intercompany account thereby reducing the capital contribution.

HMRC contended that section 54 of the Corporation Tax Act 2009 (CTA) allowed a deduction only for expenditure “incurred” for a trading purpose and “incurred” required a current or prospective legal liability. The CA rejected this point, holding that "incurred" in section 54 required only that the debit was required by IFRS 2. The CA also rejected HMRC’s argument that the debits (or the expenses that they reflected) were not incurred “wholly and exclusively” for the purposes of the trade on the basis that the grant of the options formed part of the remuneration package of the employees and the employees’ remuneration was incurred wholly and exclusively for the purpose of the taxpayers’ respective trades.

HMRC also argued that the debits were capital in nature. In rejecting this argument, the CA stated that HMRC's submission rested on a misreading of the FTT's findings as to the accounting evidence and stated that "the debits were required to be made in the taxpayers' profit and loss accounts because they represented the consumption of services provided by the employees to the taxpayers for the purposes of their trades. The debit was fixed by reference to the fair value of the options as a surrogate measure for the fair value of those services". Although the taxpayers, for accounting purposes, were treated as receiving a capital contribution from SWHL this was not determinative of whether the debits were capital in nature.

Although this case concerns the law prior to the amendments introduced by the Finance Act 2013 it provides useful discussion on deductions in relation to employee incentive arrangements and the interplay between the application of accounting standards and corporate tax legislation.

VAT: Single composite supply or multiple supplies?

In *HMRC v The Ice Rink Company*, the UT has overturned the FTT's previous decision that the taxpayer was providing two distinct services to children, being access to the ice rink (which was standard rated) and the hire of skates (which was zero rated) rather than one standard rated service. The case highlights the approach to be taken and the importance of the facts and available evidence in determining whether a transaction should be considered a single or multiple supply for VAT purposes.

The FTT had held that the taxpayer supplied two separate services because (i) customers could choose whether to buy just access to the ice rink or both access and skate hire and that it would not be artificial to split them and (ii) a considerable number of customers bought one component on some occasions and both on others the taxpayer should necessarily be treated as making two separate supplies.

The UT has held that the FTT applied the wrong legal test in determining that there were multiple supplies based on those findings and that it was not correct to assess what a "typical customer" who paid for both access to the ice rink and skate hire would consider they were buying by reference to the fact that actual customers could and did buy the separate elements of the package of services. Having overturned the FTT's decision, the UT has remitted the case to the FTT which will reconsider the facts in the light of the UT's advice on the correct approach to take to them.

The UT’s decision illustrates the importance of the facts and evidence in determining the nature of such supply to the “typical customer” for VAT purposes and that, where there is a supply comprising multiple elements, it will not necessarily comprise a multiple supply simply because a particular element of the supply can be acquired on its own. Rather, it is necessary to determine what the typical customer is buying when it acquires the package of services. It will be interesting to see how the FTT views the case in light of the UT’s findings.

Other UK developments

Finance Bill sub-committee report on the IR35 rules - the “Off -payroll working: treating people fairly” report

Since the changes to the off-payroll working rules were announced in the Finance Bill 2019-20, significant concerns have been raised on the proposed extension of the rules and on the overall regime. Related to this, the Economic Affairs Finance Bill Sub-Committee has published its report “*Off-payroll working: treating people fairly*”. The report is detailed and thoughtful with a core message that the government should use the additional time provided by the delay to the introduction of the new rules from 6 April this year to 6 April 2021 to rethink the IR35 legislation in its entirety and, particularly, link the revenue raising purpose of the IR35 rules to a wider consideration of the link between tax obligations and workers’ rights.

The report describes the extension of the rules to the private sector as “riddled with problems, unfairness and unintended consequences” and calls for a wholesale reform of IR35, further stating that the government has failed to properly and fully consider the unintended behavioural consequences of the proposed reforms regarding the extension of the off-payroll rules to the private sector.

The report focuses on the conclusions of the Taylor Report on the future of employment and says that the government should use the delay to the introduction of the new IR35 rules to develop a new, short term means of raising revenue that is based not only on revenue raising and ease of implementation (by transferring the tax assessment obligation from HMRC to businesses) but on a balanced combination of certainty, simplicity, fairness (giving workers rights that are commensurate with their tax obligations), supporting growth (and the flexibility of the UK labour market), being administratively straightforward and enforceable.

While it would be a very welcome result of the delay to the implementation of the new rules and the current COVID-19 crisis if the government and HMRC was to seek to create a new tax and rights framework contractors and other off-payroll workers, their approach to this very difficult issue to date does not give much confidence that they will do so.

The report also recommends that the government announce in October 2020 whether they do intend to introduce the new rules next April in the light of the COVID-19 effect on the economy and also that the current intention to carry out external research on the impact of the reforms six months after they come into effect should be changed to carry out this research 18 months after the rules come into operation to provide a fuller and more accurate picture of their effect.

EU case law developments

VAT: Actual rather than intended use of services determinative for input VAT deductibility

In *Sonaecom SGPS SA v Autoridade Tributária e Aduaneira*, the Advocate General's (AG's) opinion has concluded that, although the intended purpose of an aborted transaction will be relevant in determining whether input VAT costs on expenses incurred for that transaction are recoverable, the position might change if the subject of the transaction (here the proceeds from a bond issue) are actually used for another transaction.

The case related to the Input VAT incurred on consultancy services relating to a prospective corporate acquisition and to services relating to a bond issue intended to fund the acquisition. The acquisition did not proceed and the taxpayer then lent the bond proceeds to its parent company. The Portuguese courts referred the question to the ECJ of whether the subsequent actual use of the bond proceeds prevented recovery of the input VAT on costs incurred for the bond issue.

The AG opined that, while the input VAT on the bond issue was in principle recoverable where the proceeds were intended to fund an acquisition and the bond issuer intended to provide management services for a consideration to the target whether or not the acquisition proceeded, the subsequent actual use of the bond proceeds would override any original intention as to their use. In reaching this opinion the AG cited Article 168 of Council Directive 2006/112/EC (Directive) which restricted deductibility by the extent to which inputs were "used" for taxable transactions and further cited Articles 184 and 185 of the same Directive which allowed for adjustment to deductions reflecting "actual use more precisely". In addition, the AG pointed to the fact that the consideration of subjective, differing intentions around a transaction ending up with the same result might lead to both competitive advantage and disadvantage for parties depending on their stated original intention. On that basis, the input VAT on expenses incurred for the bond issue was not recoverable because those inputs were actually used for the VAT exempt activity of lending those proceeds.

The taxpayer also argued that its intention to use the proceeds lent to its parent for a future acquisition should be taken into account. The AG concluded that this was not relevant when there was an actual transaction between raising the bond proceeds and using them for an acquisition.

Taxpayers should keep this in mind in circumstances where they incur input VAT on expenses for an aborted transaction and then use those same expenses for a different transaction that might have a different VAT recovery result.

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