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# UK Indirect Tax Conference 2014

## Compliance in Perspective

### Financial Services

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14 November 2014



# Agenda

- Partial Exemption
- Transfer Pricing and VAT
- *Skandia* and implications
- Fund Management Developments
- VAT Mitigation – Cases

# Partial Exemption

# Partial Exemption

## Background – Principal VAT Directive

Default position for partly exempt businesses is laid down at Art. 173 – 175 of the Principal VAT Directive:

- Input VAT deductible to extent it is “attributable to transactions in respect of which VAT is deductible”
- Art. 174(1) sets out a “standard method” for calculating this proportion:
  - Numerator: “the total amount, exclusive of VAT, of turnover per year attributable to transactions in respect of which VAT is deductible”
  - Denominator: “the total amount, exclusive of VAT, of turnover per year attributable to transactions included in the numerator and to transactions in respect of which VAT is not deductible”
- The following amounts of turnover **shall** be excluded from the calculation:
  - Supplies of capital goods used for the purposes of the business
  - Incidental real estate and financial transactions
  - Other exempt supplies under Art. 135(1)(b)-(g) so far as they are incidental

# Partial Exemption

## Background – Member State Options

Art. 173(2) also gives Member States some further options on implementing VAT recovery methods:

- Require **and / or** allow separate calculations for each sector of a business
- Authorise **and / or** require calculation of deduction on the **basis of the use made** of the goods and services;
- Authorise **and / or** require calculation of deduction on the **basis of the proportion of taxable** supplies made as a whole (UK “Standard Method”);
- Where VAT which is not deductible is insignificant, to treat as nil.

# Partial Exemption

## HMRC Approach

- Considerable delays for agreeing new / amended methods
- Reluctance on HMRC's part to agree to a PESM proposal in the absence of worked examples
- More focus on consistency between proposed PESM methodology and other business methods:
  - Transfer Pricing Methodologies
  - Management Accounts
- HMRC Policy are looking to implement more consistently recent CJEU judgments, including:
  - *Banco Mais*
  - *Le Credit Lyonnais*

# *Banco Mais*

## Factual Background

Banco Mais (“BM” – a Portuguese bank) provided asset finance, personal loans and insurance services.

- BM argued that it should be entitled to include the value of the assets sold, as well as the interest charged, in its partial exemption calculations.
- The Portuguese Tax Authorities disagreed, determining that only the interest element should be included, as including the value of the assets would result in a breach of the principle of fiscal neutrality.
- Their view was that the inclusion of the asset values produced a level of input tax recovery that was distortive when reviewed in accordance with the actual use of input tax incurred by BM.
- The Portuguese Tax Authorities argued that a use-based partial exemption method should be applied.



## *Banco Mais*

### “A More Precise Determination”

30 [...] any Member State that exercises the option provided [...] must ensure that the method for calculating the right to deduct makes it **possible to ascertain with the greatest possible precision the portion of VAT** relating to transactions in respect of which VAT is deductible.

31 The principle of neutrality, which forms an integral part of the common system of VAT, requires that the method by which the deduction is **calculated objectively** reflects the **actual share of the expenditure** resulting from the acquisition of mixed use goods and services that may be attributed to transactions in respect of which VAT is deductible.

32 To that end, the Sixth Directive does not preclude Member States from using, for a given transaction, a method or formula other than the turnover-based method, provided that **the method used guarantees a more precise determination** of the deductible proportion of the input VAT than that arising from application of the turnover-based method.



# *Banco Mais*

## Implications

- Removal of capital items from turnover calculations for asset finance.
- Does a “standard method” require adjustments - is the mechanism for this the Standard Method Override in the UK?
- Reducing the residual base - direct attribution is now more important:
  - Challenging past assumptions
  - Smart procurement
- Undoubtedly used as basis for more general challenges, eg. HMRC Guidance on Holding Companies continues the theme.
- The *Banco Mais* plot thickens in conjunction with *Le Credit Lyonnais*

# *Le Credit Lyonnais*

## Factual Background

The case of *Le Credit Lyonnais* (Case C -388/11) (“**LCL**”) concerned the deductible portion of VAT applicable to the head office – and whether the income of overseas branches should be included in the calculation.

- LCL is a French bank with branches across the world.
- LCL made loans to its branches, some of which were located outside the EU.
- In calculating its deductible proportion of VAT in France, LCL included the interest income of its worldwide branches on the basis that its principal establishment along with its branches constituted one and the same entity.
- LCL argued that the income from branches ought to be factored into any partial exemption calculation.

# *Le Credit Lyonnais*

## Territorial Principles

CJEU – key comments:

- Calculation of the deductible proportion must fall within the scope of the national VAT legislation to which an activity or transaction must be linked for tax purposes (territoriality principle) and otherwise it would be distortive.
- A company may not take into account the turnover of its branches established in other Member States or third States.
- The directive does not permit a Member State to adopt a rule for the calculation of the deductible proportion per sector of business which authorises a company to take into account the turnover of a branch established in another Member State or in a third State.
- The concept of “sectors of business” refers not to geographic areas but to **different forms of economic activities**

# *Le Credit Lyonnais*

## Territorial Principles

In the course of its intervention in the case, the UK pointed out that EU law permitted Member States to take account of the activities of foreign branches where input VAT can be attributed to their activities.

It remains to be seen whether the UK's view on this will be revised in the light of the judgment.

The decision on the interpretation of what was Article 17(5) of the Sixth Directive (now Article 173(2) of the VAT Directive) seems to exclude the interpretation that the UK put forward.

# *Le Credit Lyonnais*

## Territorial Principles

- Is LCL now inconsistent with BM?
  - BM requires taxpayers to neutrally and precisely allocate input VAT to transactions based on actual share of expenditure.
  - Doesn't LCL produce a more imprecise result?
- Skandia may defeat LCL where VAT groups are involved:
  - A taxable output may be crystallised on recharge of costs from a head office to a branch.
- Where does this leave the “look through” principle?

# Transfer Pricing & VAT

# Transfer Pricing and VAT - Recap

TP	VAT
<ul style="list-style-type: none"><li>Ensures the appropriate value is attributed to allocations between two or more associated parties</li></ul>	<ul style="list-style-type: none"><li>Tax on supplies – for services, something must be done for a consideration</li></ul>
<ul style="list-style-type: none"><li>The appropriate value is subjective, but applies by reference to arm's length values, and is often demonstrated by a functional analysis of the services (benchmarking)</li></ul>	<ul style="list-style-type: none"><li>Valuation is secondary to establishing:<ol style="list-style-type: none"><li>Whether there has been a supply</li><li>If there has been a supply, what the VAT liability is</li></ol>This is done by examining the nature of the services (like a functional analysis)</li></ul>
	<ul style="list-style-type: none"><li>In some instances, anti-avoidance exists which can determine a value: e.g. in the UK, Open Market Value</li></ul>
<ul style="list-style-type: none"><li>Governed by OECD guidelines</li></ul>	<ul style="list-style-type: none"><li>Governed by the Principal VAT Directive (in the EU)</li></ul>



# Why should they be considered together?

- Transfer pricing and VAT are closely intertwined – any decision on one side will have an impact on the other
- In a VAT exempt sector the repercussions can be significant
- Forewarned is forearmed - upfront consideration of the potential implications can save significant amounts of money
- In an increasingly global market the opportunity to manage the position is a great advantage
- Further, joint interaction between TP and VAT specialists at the Tax Authority level is increasingly common
- Will BEPs increase the interaction?

# Some Key Areas to Consider in FSI

Characterisation of the charges made is key:

- **IP/Software** - Classification of service as technology would create a VAT charge – is it really an intermediary/execution service and therefore exempt from VAT?

Example: Algorithmic trading service provided by parent to a sub.

- Services bundled together for TP purposes could create a VAT charge on the full recharge – if individual services are identified, could the VAT impact be mitigated?

Example: Supplies made by an in-house SSC could include mortgage origination services, claims processing etc.

- Or, would services disaggregated for TP purposes create a VAT charge which may not arise if the whole set of services amounted to a composite exempt service?

Example: Separate fee for call centre/contact centre services. Could be supportive of an exempt supply.

# Recent Activity from HMRC

- An “indirect tax risk assessment programme covering Offshoring, Partial Exemption, **Transfer Pricing** and any other VAT Planning initiatives”
- HMRC’s aim is “to ensure that direct and indirect tax matters are approached in a consistent way”

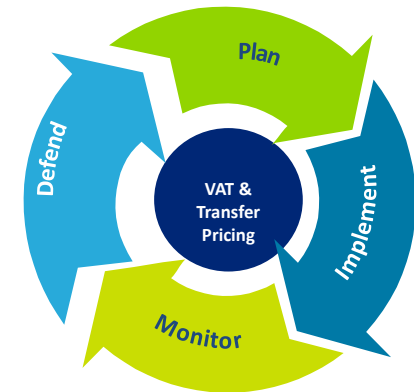
Some of the Information Requested	Potential Impacts
1. Details of all SLAs between overseas providers and recipients.	1. Difference between contractual relationships and economic reality – See <i>Levob. Paul Newey / Ocean Finance</i> .
2. List all business lines which have moved to the SSC.	2. Consideration of the capability of the SSC to provide an exempt service.
3. Provide a detailed list of all services offshored; all recipient entities and whether they are subs, branches, holding companies.	3. As above – VAT exemption, but also the impact of <i>Skandia</i> and the recovery of VAT by holding companies – see <i>BAA, Polysar</i> etc.

# Recent Activity from HMRC (cont)

<b>Some of the Information Requested</b>	<b>Potential Impacts</b>
4. Details and amounts of all direct expense, transfer pricing and management charges made.	4. Characterisation and valuation of services. Ensuring reverse charge VAT is picked up on all allocations, however made.
5. Explanation of any allocations which are “ <i>received</i> ” in one jurisdiction but “ <i>use and enjoyed</i> ” elsewhere.	5. Ensuring use and enjoyment provisions on supplies like the provision of software are being correctly applied.
6. Information on transfer pricing charges from the UK to overseas branches and subsidiaries. How much of these are made up of salary costs? How does this feed into the pro-rata calculation?	6. Pro-rata calculations. How much VAT is recovered at 100% and 0% and what is the basis for this?
7. Transfer pricing methodology, and mark-up applied; whether reverse charge is applied to the cost plus mark-up. Existence of cost contribution agreements.	7. Amount of reverse charge VAT to be applied: Valuation.

# What can be done? Best Practices

- Early VAT input into TP planning and documentation, and on BEPs discussions
- Apply integrated taxation approach to business decisions
- Regular risk assessment of structures/transactions
- Use of cost sharing, EDM structures?
- Discussions with HMRC



# ***Skandia* and implications**

# Skandia America Corporation (C-7/13)

## Background

### Facts

- CJEU reference from Sweden heard 12 March 2014, decision given 17 September 2014.
- The issue concerned VAT treatment of charges made between Skandia's head office in US and its Swedish branch which was included in the VAT group.

### Questions Referred

- Do supplies of externally purchased services from a head office in a third country to its branch in a Member State constitute taxable transactions if the branch belongs to a VAT group?; and
- If the answer is yes, does that render the head office in the third country a taxable person not established in the Member State so that the purchaser is taxed for the transactions?



# Skandia America Corporation (C-7/13)

## Advocate General's Opinion

### Advocate General's Opinion- Question 1

- Overseas establishments **can** be VAT grouped.
- Supplies between a head office and the branch are not supplies for VAT purposes but this differs to supplies between a branch and its customers regardless of whether they are members of the VAT group.
- By allowing a branch to join VAT group, Article 11 of the Principle VAT Directive is infringed.

### Advocate General's Opinion- Question 2

- Art 196 of the Principle VAT Directive should be interpreted so that it is the VAT group (of which the branch is a member) which is the recipient of the supplies and who therefore owes the VAT. Reverse Charge should be applied in this instance.

# Skandia America Corporation (C-7/13)

## CJEU Decision

Succinct decision handed down 17 September 2014 was in keeping with EU Commission's view on the interaction of head office- branch transactions and VAT grouping and followed the Advocate General's Opinion:

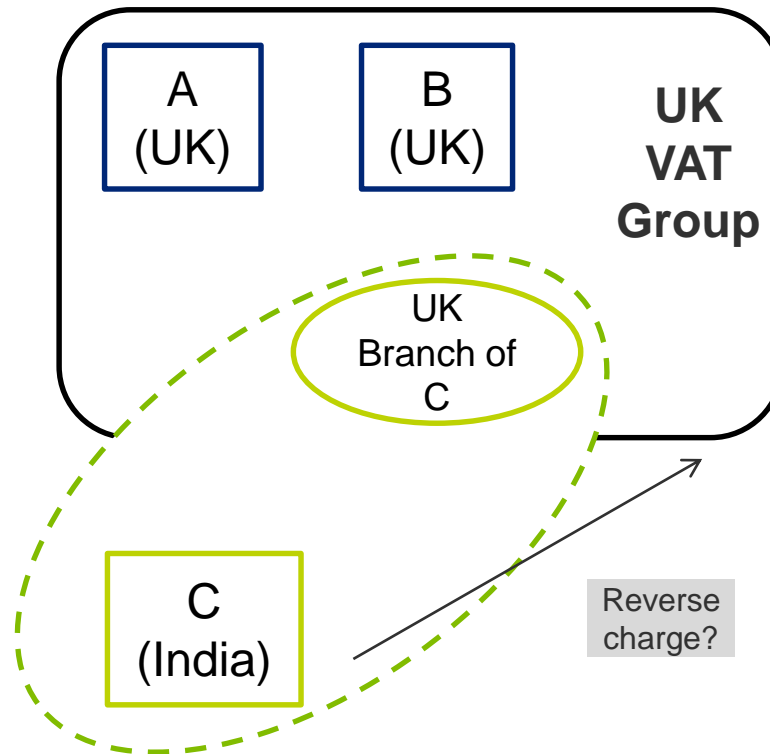
- Supplies of services from a head office in a third country to its branch in a member state are **taxable transactions when the branch belongs to a VAT group**.
- **VAT group** as purchaser **assumes VAT liability** for services.

### Why?

- Considering *FCE Bank*, branch is dependent on head office and therefore is not a taxable person for purposes of Art 9 Principle VAT Directive.
- “Single taxable person” concept of VAT grouping precludes members from individual identification as taxable persons.

# Skandia America Corporation (C-7/13)

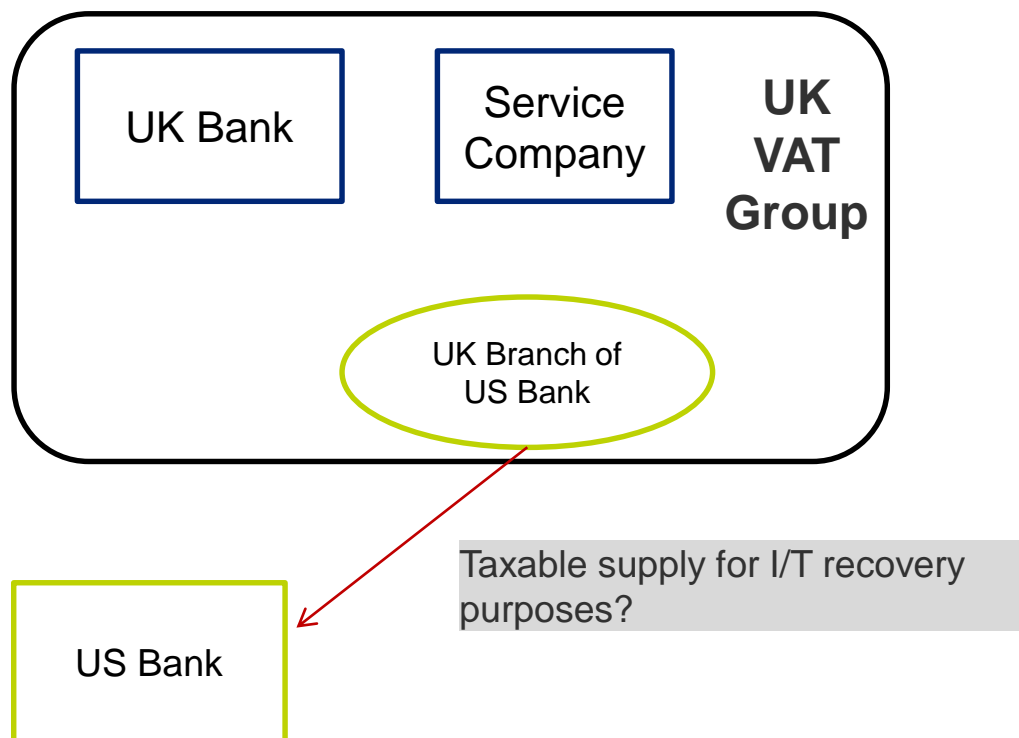
## Example 1- Services supplied by a head office to branch



Even though there may be little or no external supplies into C, the Skandia decision could lead to a VAT charge.

# Skandia America Corporation (C-7/13)

## Example 2- Services supplied by a branch to head office



The recharge out to the US Head Office may now be taxable for input tax recovery purposes, irrespective of the Head Office's operations (and so not dependent upon a "look through" principle).

# Skandia America Corporation (C-7/13)

## Tax authority reactions

### UK

- The official line:

*"HMRC is considering whether the judgment has any application to UK grouping provisions, which are different to those in Sweden."*

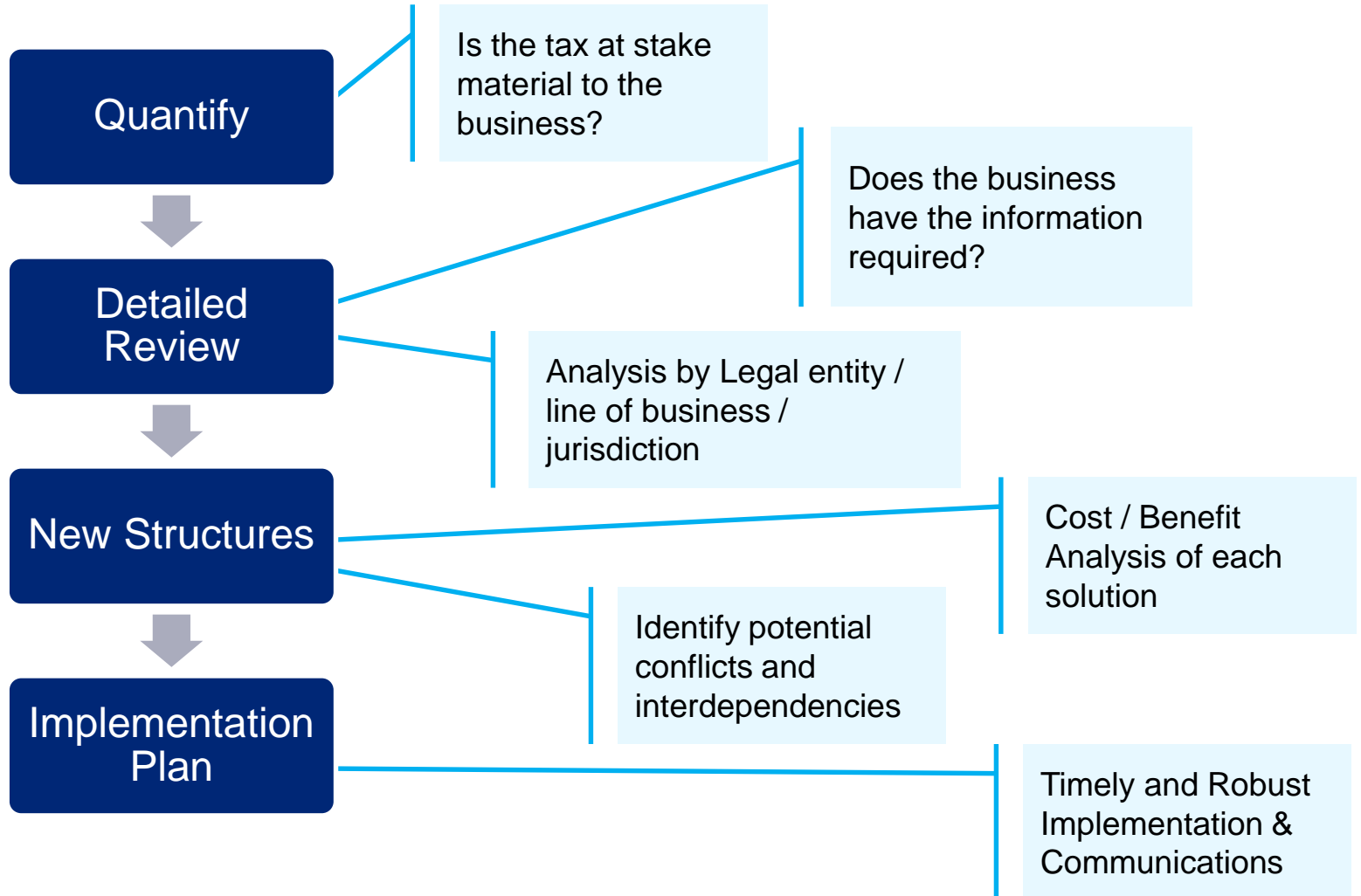
# Skandia America Corporation (C-7/13)

## Alternative structures

- Use of the Cost Sharing Exemption – create a Cost Sharing Group (“CSG”).
- Use of EDM Cost Allocations.
- De-grouping.
- Other exemptions/reliefs
  - *ATP*
  - *GFBK*
  - *Staff Hire Concession – Part B*

# Actions for affected businesses

Deloitte has set out a high-level framework for institutions likely to be impacted by *Skandia*. This will require tailoring to individual requirements, but sets out the main four tasks to be undertaken in the medium term.





# Fund Management

# Investment Management

## VAT Liability

Investment Management exemption – Article 135(1)(g) Principal VAT Directive  
“*The management of special investment funds as defined by Member States*”.

1) What is a special investment fund?

- ***JP Morgan Fleming Claverhouse*** (June 2007)
- ***Wheels*** (March 2013)
- ***ATP*** (March 2014)
- ***Fiscale Eenheid X NV cs*** (Referred in November 2013)

2) What is “management”?

- ***Abbey National Plc*** (May 2006)
  - ***GfBk*** (March 2013)
- 
- UCITS IV, AIFMD – fund management structures becoming much more international

# ATP Pension Services A/S (C-464/12)

## CJEU Judgment

- As per *Claverhouse*, when Member States identify “special investment funds” (“**SIFs**”), they must:
  - Respect the objective of the exemption, which is to facilitate investments in securities through investment undertakings by excluding the cost of VAT; **and**
  - Guarantee the principle of fiscal neutrality.
- The tests had previously been applied in *Wheels*, re DB scheme management.
  - Were the funds of DB schemes identical to vehicles which were SIFs?
  - Were the funds “sufficiently comparable” to those vehicles to be in competition?
- *Wheels* lost.
  - Funds of DB schemes are not identical to SIFs. They are not open to the public.
  - Scheme members do not bear any of the investment risk.
  - The employers do bear the risk, but they aren’t “investors”.

# ATP Pension Services A/S (C-464/12)

## CJEU Judgment

- In the case of the defined **contribution** pension schemes managed by ATP, they **were** “special investment funds”, provided a number of conditions were met.
  1. The schemes are funded by the persons to whom the benefits are provided. (The fact that contributions were paid by the employer is irrelevant.)
  2. Funds are invested using a risk-spreading principle; and
  3. The pension customers bear the investment risk.
- HMRC Response? Brief 22 (2014) – “*further reviewing the VAT treatment of pension scheme administration and fund management services*” in light of both *PPG* and *ATP*. Further guidance promised “*in the autumn*”.

# Investment Management

## Tax Transparent Funds (“TTFs”)

### “Authorised Contractual Schemes”

- Introduced in the UK with effect from June 2013.
- First UK TTF launched in June 2014.
- Two types of TTF: a co-ownership, and a limited partnership scheme.
- Enables investors to benefit from being treated as if they invested directly but retain benefits of collective investment (e.g. economies of scale).
- VAT implications:
  - Exemption for their management – new Item 9(aa) of Schedule 9 Group 5 (*“the management of... an authorised contractual scheme”*).
  - **BUT** who registers for VAT, and who are supplies made by and to?
  - HMRC Draft Guidance (ACSM6030) – *“The determination of the person liable to register for VAT is a question of fact that has to be determined on a supply-by-supply basis”*.

# Investment Management Property Funds?

## Reference in *Fiscale Eenheid X NV cs* (Case C-595/13)

- Reference by the Dutch Courts in November 2013.
- Two questions:
  1. Is [the fund management exemption] to be interpreted as meaning that a company which has been set up by more than one investor for the sole purpose of investing the assets assembled in immovable property may be regarded as a special investment fund within the meaning of that provision?
  2. If the answer to question 1 is in the affirmative, is [the exemption] to be interpreted as meaning that the term “management” also covers the actual management of the company’s immovable property, which the company has entrusted to a third party?

# Investment Management

## What is “management”?

“*Abbey II*” test: to be “management”, services must “*form a distinct whole and be specific to, and essential for, the management of special investment funds*”.

*GfBK* – clarifies and extends the exemption?

- New test: Are the services “***intrinsically connected***” to the activity characteristic of a special investment fund?

(So that the services have “*the effect of performing the specific and essential functions of management of a special investment fund*”.)

- Can include advisory and information functions. Can also include administration and accounting services (e.g. computing fund income, unit pricing etc.). Not necessary to alter the fund’s legal and financial position.

*ATP* applied *GfBk* – “management” includes the opening of pension accounts and crediting of contributions. They are essential to the management of the fund.

# VAT Mitigation – Cases



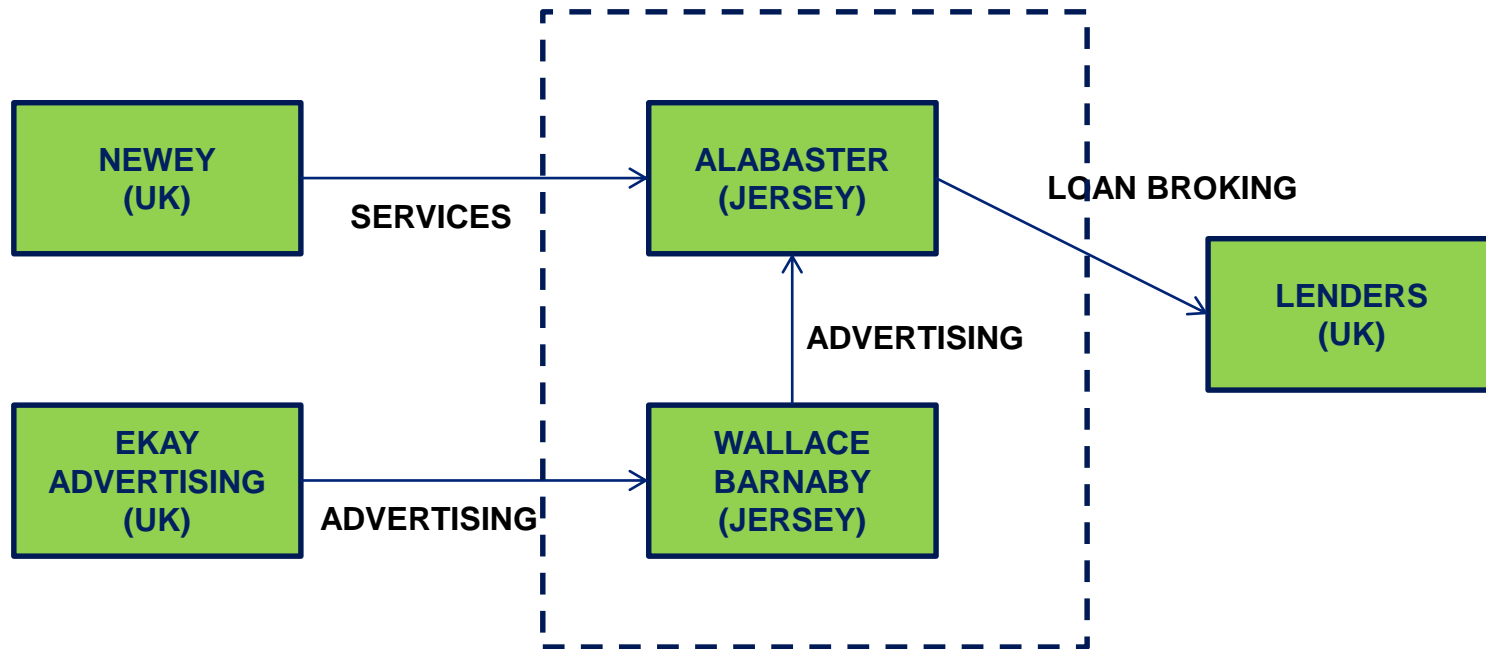
# “Abuse”

## **Halifax (Case C-255/02) – 2006 CJEU Judgment**

- Para 73 – *“Where the taxable person chooses one of two transactions, the [Directive] does not require him to choose the one which involves paying the highest amount of VAT. On the contrary... taxpayers may choose to structure their business so as to limit their tax liability”.*
- An “abusive practice” only exists if:
  1. the transactions concerned *“result in the accrual of a tax advantage the grant of which would be contrary to the purpose of”* the relevant VAT provisions;  
  
AND
  2. it is *“apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage”.*
- **Not** abuse if the activity *“may have some explanation other than the mere attainment of tax advantages”.*

# Application 1

## *Paul Newey (t/a Ocean Finance) (Case C-653/11)*



### Questions:

- What weight should be attributed to the contracts in determining the VAT supply position? In what circumstances should you depart from the contractual position?
- If you **don't** depart from the contracts, are the arrangements abusive – and, if they are, how should they be recharacterised?.

# Application 1

## ***Paul Newey (t/a Ocean Finance) (Case C-653/11)***

### **CJEU Judgment:**

- The legal contracts are one factor to consider when identifying supplier and recipient. However – sometimes the contractual terms “*constitute a purely artificial arrangement which does not correspond with the economic and commercial reality*”.
- In this case, it was “*conceivable that the effective use and enjoyment of the services... took place in the UK and that Mr Newey profited therefrom*”.
- For the UK court to decide whether this applies – and hence whether Newey himself supplied the loan broking services and received the advertising services.
- Contractual terms may be disregarded “*if it becomes apparent they... constitute a wholly artificial arrangement which does not reflect economic reality and was set up with the sole aim of obtaining a tax advantage*”.
- No separate consideration of “abuse”.

# Application 1

## *Paul Newey (t/a Ocean Finance) (Case C-653/11)*

### Key Points?

- CJEU did not address any establishment issues.
- If it had, *Welmorey* might have helped Paul Newey?

(Use of another entity's personnel and technical facilities in a Member State does not necessarily give you an establishment there, even if your activities and the other entity's activities "*form an economic whole*". The key is what human/technical resources you require for your **own** business.)

- Tax advantage no longer simply relevant to pure "abuse" issues – also brought into the analysis of the "*commercial and economic reality*" of contractual arrangements?
- Upper Tribunal now has the job of applying the CJEU judgment...
- What did the CJEU actually **mean** by "*commercial and economic reality*"?

# Application 2

## ***Bookit Limited* [2014] UKFTT 856 (TC)**

### **Facts:**

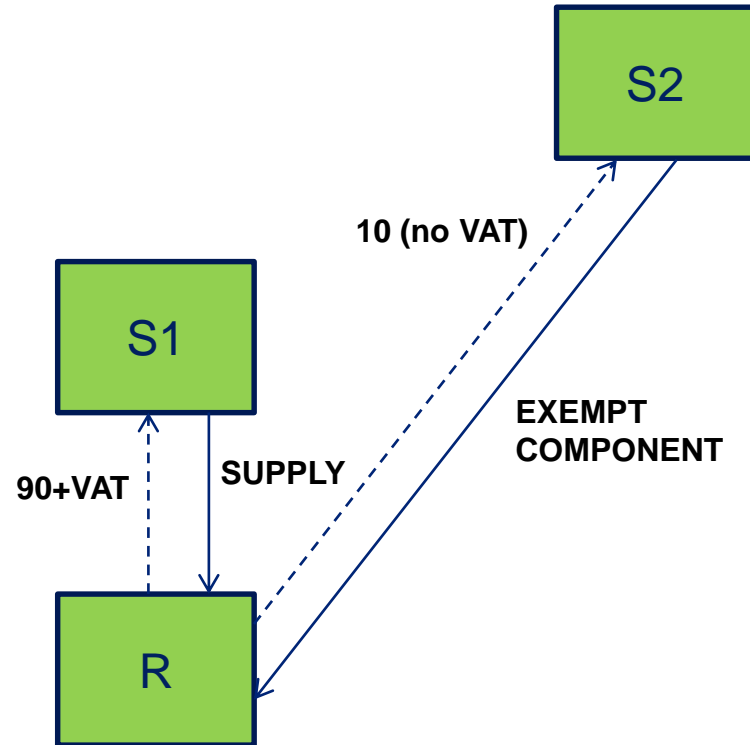
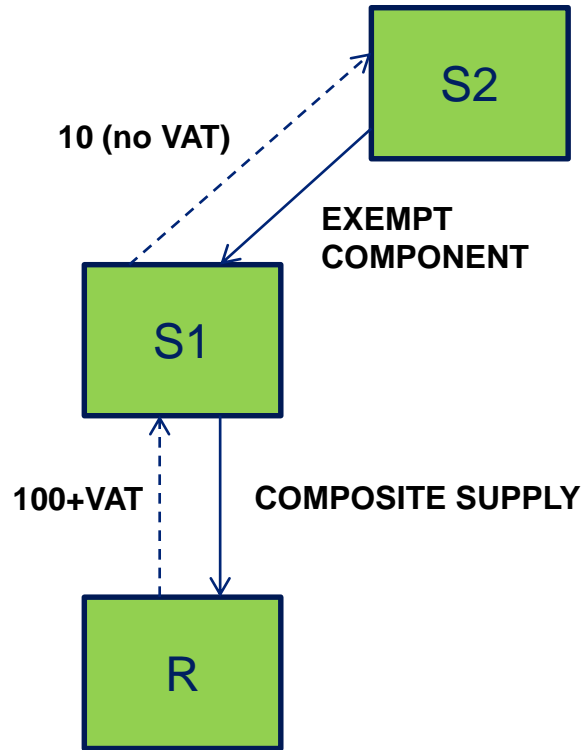
- Odeon tickets are available through the following channels.
  1. Counter and automatic ticket machine (“ATM”) sales at cinemas.
  2. Telephone sales via a telephone contact centre.
  3. Internet sales.
- In (2) and (3), Bookit sells the ticket as agent for Odeon and charges a separate fee (65-75p) to the customer for “card handling”.

### **Issue:**

- Is Bookit’s card handling service a “*transaction concerning payments*” which **isn’t** debt collection?
- If there is a tax advantage, is it contrary to the purpose of the Principal VAT Directive?

# Application 2

## Bookit Limited [2014] UKFTT 856 (TC)



# Application 2

## ***Bookit Limited* [2014] UKFTT 856 (TC)**

### **Decision:**

- Bookit's card handling services were not "debt collection". Debt collection implies collection on behalf of the creditor.
- Further guidance needed from the CJEU re whether Bookit's service is exempt as a "*transaction concerning payments*". (*SDC* vs. *Nordea*?)
- No need to consider second limb of *Halifax* test. Bookit accepted that it was set up with the essential aim of securing a tax advantage (i.e. exemption).
- Question was about the first limb: would exemption for Bookit be "*contrary to the purpose*" of the Principal VAT Directive?
  - Contractual arrangements accorded with economic and commercial reality (*Ocean Finance*). No "value shifting" from ticket price into card handling price.
  - Arrangements in Bookit "*made best use of the domestic legislation*". They were not contrary to the purposes of the Principal VAT Directive.

Questions?





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