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UK VAT Update

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There have been a number of interesting developments in the application of the UK's value added tax ("VAT") rules. This Alert summarizes those developments.

In particular, although the recovery of VAT on corporate transactions has often been challenged, the outcome in a number of recent cases, (both in the UK Tax Chamber of the First-Tier Tribunal (the "Tribunal") and the European Courts of Justice (the "ECJ")) may be helpful to those seeking to recover VAT. Most notably, the BAA group succeeded in its claim to recover VAT on various costs incurred by a bid company which acquired the BAA group in 2006.

Takeover Acquisitions – *BAA Limited v HMRC* (Tribunal – January 2010)

In 2006 an investment consortium led by the Spanish infrastructure group Ferrovial launched a successful takeover bid for the UK airport operator BAA plc ("BAA"). The bid vehicle was a new company called Airport Development and Investments Limited ("ADIL"). ADIL incurred significant fees of investment banks, lawyers and others in connection with the takeover and those fees carried VAT. As ADIL had joined the BAA VAT group, the representative member of the VAT group then reclaimed that VAT as input tax of the group, attributable to the general overheads of the group.

HMRC disputed the input tax recovery on the basis that the costs incurred by ADIL related to the acquisition and were therefore investment costs with no direct and immediate link with any taxable supplies made (or to be made) by the BAA group. HMRC therefore raised a VAT assessment against the BAA group in the amount of approximately £6.7 million. The representative member of the BAA VAT group appealed against that assessment to the Tribunal.

The Tribunal held that the VAT incurred by ADIL was recoverable by the BAA VAT group on the basis that ADIL did carry on an economic activity from its inception even though it never made an actual taxable supply in its own right.

"Economic Activity"

The Tribunal accepted that ADIL's activities went beyond that of a mere holding company as ADIL provided management services, governance and advice to the rest of the BAA group, which the Tribunal considered sufficient to constitute the carrying on of an economic activity.

Intention to make taxable supplies

The Tribunal acknowledged that there can be no economic activity without taxable supplies (or, at the very least, the intention to make taxable supplies). There was no evidence in this case that ADIL had any intention to make taxable supplies when it received the supplies for which VAT recovery was sought. However, the Tribunal took account of ECJ case law (in particular *Faxworld*) in holding that, as the result of joining the BAA VAT group, ADIL was treated for VAT purposes as a single entity together with the other group members and ADIL could therefore take advantage of

the taxable supplies of the BAA VAT group. Accordingly, the taxable supplies of the BAA group could be imputed to ADIL with the result that it carried out an economic activity.

Direct and immediate link between the input tax claimed and the output supplied

The Tribunal stated that "*[f]ollowing Faxworld, there should be a direct and immediate link [between the input tax and…] the output supplies taken into consideration in determining the existence of an economic activity… Given that ADIL is a member of the BAA VAT group the direct and immediate link is to the outputs of the representative member of that group…*". The Tribunal noted that "*[a]bsent a group situation the direct and immediate link is with general overheads*" and the Tribunal considered that "*the same result should follow in a VAT group so that the direct and immediate link is with the general overheads of the representative member of the group*".

Disposals - *Skatteverket v AB SKF* (ECJ – October 2009)

Directive 112/2006/EC provides that transactions in shares are VAT exempt and VAT is therefore not dues on share transactions. The Directive also provides that input VAT related to VAT exempt output transactions cannot be recovered. Accordingly, HMRC (as well as many other EU member state tax authorities) has taken the view that VAT incurred in relation to the transfer of shares could not be reclaimed as there was a direct and immediate link between the VAT costs incurred (such as fees of advisers) and the VAT exempt share transaction.

However, the ECJ has recently considered whether a parent company can recover the VAT that it is charged on transaction costs when it sells the shares in a subsidiary. The ECJ indicated in *Skatteverket* that the costs incurred on the sale of the shares of an actively managed subsidiary may form part of the selling company's general overheads, either on general attribution principles or on the basis that the sale constitutes a 'transfer of a going concern'. The ECJ considered that, under those circumstances, there should be a right to deduct input VAT on services supplied in relation to such a sale of shares on the basis that there is a direct and immediate link between the costs associated with the input services and the overall economic activities of the taxable entity.

***Airtours Holiday Transport Limited ("Airtours") v HMRC* (Tribunal – October 2009)**

This case concerned whether Airtours (formerly My Travel Group), which was in severe financial difficulty, could recover VAT on fees paid to advisers on a restructuring. PricewaterhouseCoopers ("PwC") was engaged to put together a rescue package to save the business. HMRC argued that, although Airtours paid for PwC's services and was a party to agreements between PwC and the creditors, the supply for VAT purposes was made by PwC to the creditors alone and not Airtours. HMRC placed particular emphasis on the drafting of the PwC engagement letters, which were addressed to the "Engaging Institutions", being the creditors. Accordingly, HMRC considered that Airtours could not recover the VAT.

The Tribunal disagreed. The Tribunal noted that Airtours was also party to the engagement letters on the basis that, among other things, the letters expressly stated that PwC invoices would be issued to, and paid by, Airtours. The letters referred to the services being provided to "you" and stated that "you" meant the entity or entities on whose behalf the relevant letter of engagement was acknowledged and accepted, which included Airtours. Accordingly, in applying the principles established by the House of Lords in Commissioners of Customs & Excise v Redrow Group Plc [1999], the Tribunal held that the VAT could be recovered by Airtours on the basis that the Airtours Group had received supplies from PwC, which Airtours had paid for and used for its business.

Commentary on BAA, Skatteverket and Airtours

The ability to recover input tax in corporate transactions has been considered difficult and is often not pursued, given the risk of challenge by HMRC. The decisions made by the courts in the above cases will therefore be welcomed by taxpayers.

Airtours serves to highlight the importance of properly and carefully drafting contractual documentation, particularly engagement letters with advisers – HMRC will rely on poorly drafted documentation to reject any claim for recovery of VAT.

BAA and *Skatteverket* provide useful guidance to taxpayers on the situations in which VAT may be recovered in certain corporate transactions, namely:

- ***Acquisitions:*** Holding companies which were previously set up as acquisition vehicles (a "Bidco") should be able to recover VAT incurred in connection with acquisition costs where:
  - Bidco provided and charged its target group companies for management services; and/or
  - Bidco joins the targets VAT group and thereby imputing to it the taxable supplies of the target group subsidiaries (although this is subject to the outcome of any appeal by HMRC regarding the BAA case).
- ***Disposals:*** Holding companies which have been involved in the management of subsidiaries and have made supplies of services to such subsidiaries should be able to recover VAT incurred on the sale of its subsidiaries shares if such sale is:
  - a 'transfer of a going concern'; or
  - an exempt supply but the costs of the sale are attributable to the overall economic activity of the parent.

On the basis of the above, taxpayers that have been involved in similar transactions should, if not already having done so, consider making a claim to HMRC to recover VAT.

Other Notable VAT Developments

Graphic Procédé (ECJ – February 2010)

The ECJ has ruled that the mere reproduction of original documents in the same physical format as the originals constitutes a supply of goods for VAT purposes. However, where additional services are provided in the production of the documents, such as "adapting, modifying and altering the original" for the purposes of producing copies which are different from the original documents, the national court will have to determine if the supply is a supply of services in addition to, or instead of, a supply of goods. Listed companies (or companies seeking to list) and investment funds that produce prospectuses and other materials should take particular note in the nature of the supply of such reprographics services, given the differing VAT treatment for a supply of service versus a supply of goods.

New EU VAT Package

The EU 'VAT Package' is a series of changes to the VAT rules. The VAT Package introduced changes taking effect from 1 January 2010, which, broadly, are as follows:

- Changes to the Place of Supply for Services Rules: Prior to 1 January 2010, the place of supply of services was where the service provider is established for VAT purposes. Under the new rules, and subject to certain exceptions, the place of supply for business to business ("B2B") services is that such services are deemed to be supplied where the recipient of the services is established. Business customers will be obliged to account for VAT under the reverse charge mechanism.
- EU Sales Lists ("ESLs"): Changes to ESLs for goods and new rules for ESLs for intra-EU B2B supply of services.
- Changes to the EU Cross-Border Refund Mechanism: A new electronic VAT refund procedure will be introduced across the EU for all claims submitted after 1 January 2010 to replace the current paper-based system.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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