

A UK Update on Recent VAT Changes

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Set out below is a snapshot of some of the key VAT developments that have arisen so far in 2011 and a summary of their impact in the UK.

VAT in Respect of Services Following the European Court of Justice ("ECJ") Judgment in AXA UK PLC (CASE REF C-175/09) ("AXA")

Background

AXA was primarily concerned with the application of the exemption from VAT at Article 135(1)(d) of the EU VAT Directive for "transactions, including negotiation, concerning deposit and current accounts, payments, transfers, debts, cheques and other negotiable instruments, but excluding debt collection," which is implemented into UK law as the exemption for 'payments and transfers' at Item 1, Group 5 of Schedule 9 to the Value Added Tax Act 1994. The point in question being whether the services concerned fell within the scope of 'debt collection' and would therefore be liable to VAT at the standard rate.

Whilst this case had progressed through both the VAT Tribunal and the High Court in favour of AXA with findings of a separate exempt supply of payment services falling within Article 135(1)(d), upon reaching the Court of Appeal, it was determined that the issue was not clear and that the matter should be referred to the ECJ. Explicit consideration was therefore given to the specific functions of a business that would bring it within the VAT exemption.

The ECJ subsequently held that the supply present in AXA (which it summarised as the collection, processing and onward payment of sums of money due from third parties) was specifically excluded from the Article 135(1)(d) exemption as 'debt collection'. In reaching this position, it was noted in the judgment that the phrase 'debt collection' in Article 135(1)(d) covers "the collection of debts of any nature, without limiting their application to debts which were not paid on their due date" and also cover "debts which have not yet become due and which will be paid on the due date."

Implications

As such, 'debt collection' is not to be confined solely to the service of chasing and recovering overdue payments; as all services principally concerned with the collection of payments for the benefit of the creditor, regardless of whether those payments are received before, on, or after their due date, fall within the 'debt collection' exclusion and are consequently liable to VAT at the standard rate.

However, it has been noted by the UK Revenue ("HMRC") that supplies which involve the collection of payments as a minor or ancillary function but which are principally concerned with other payment related transactions that fall within the Article 135(1) exemptions (e.g., the movement

and settlement of payments between bank accounts) will not be affected by the AXA judgment and will continue to fall within the VAT exemption.

The implications for the VAT treatment of outsourcing arrangements and servicing and cash management arrangements in the context of securitisations, covered bond transactions and similar arrangements are matters that should be considered carefully. While historically exemption from VAT may have been claimed in respect of these areas under the 'payments and transfers' exemption, or by virtue of the exemption for 'management of credit by the person granting it,' it may be the case that the supply of these services will now be subject to VAT at the standard rate. However, servicing provided by the originator of the finance should arguably still be treated as exempt under the scope of management of credit by the person granting it.

Finally, it should be noted that HMRC confirmed that the status of the supplier is irrelevant in determining whether the service is taxable or exempt. As such, there is no presumption of banks being favoured as exempt in this regard.

VAT on Distressed Debt

Following referral to the ECJ by the German courts, the recent case of Finanzamt Essen-NordOst v GFKL Financial Services AG ("GFKL") (C-93/10) saw an Advocate-General (the "AG") take the view that GFKL, a German company, should not have to pay VAT on its acquisition of distressed debt. In reaching this view, the AG considered that the purchase of a portfolio of defaulted debts did constitute a service (by virtue of the fact that GFKL was taking the debts off the bank's hands and relieving it of the problems associated with collection) and by virtue of a service arising, so an economic activity was also present, which would therefore make GFKL subject to tax under the scope of the EU's Sixth VAT Directive.

However, the AG went on to state that in his view there was no direct link between the service provided and the consideration received and therefore the directive should not apply. The AG justified this on the basis that GFKL paid a lower than face value price for the debt portfolio because of the risk attached to recovering the debts, not for the cost of the service it was providing to the bank, so there was no direct link.

In addition to ascertaining if a service and economic activity was present, the ECJ also considered whether the assumption of the risk of loss is exempt from tax and if the recovery of the debts is exempt from tax as a single service. It was also queried if the consideration should be determined by the recovery costs agreed between the parties or the actual recovery costs.

The AG noted that having giving his opinion on the question raised by the German courts about consideration and economic activity, he did not have to answer the other queries. Despite this, he determined that the situation in the case amounted to debt collection and was therefore not exempt from VAT. He also voiced the opinion that the consideration should be based on the difference between the amount of debt that is actually recovered by GFKL and the price paid by it in acquiring the debt from the bank.

This case will now go back to the German courts, where, if the court agrees with the AG on point, there should be no taxable supply by the transferee to the transferor on performing the transfer of the debt/loan receivables in connection with the purchase of a debt portfolio. As such, no VAT concern should arise. If the German courts disagree, however, then the supply is likely not to have the benefit of any VAT exemption and will therefore be taxable.

In practical terms, the findings of the AG mean that although entities which are set up to acquire distressed debts from financial institutions might be providing debt collection services, the question of whether the acquisition of the distressed debt itself is taxable is likely to need to be

determined on a case by case basis (namely, is there a direct link between the service provided and the consideration received for the acquisition of the distressed debt).

VAT and Transaction Costs

The recent case of HMRC v BAA Limited [2011] UKUT 258 (TCC) (the "BAA Case") before the UK Upper Tribunal has potentially restricted the ability of holding companies to recover VAT incurred on the costs of buying companies.

The BAA Case was concerned with a newly formed company ("Bidco") being set to acquire BAA plc. In the process of this acquisition, Bidco incurred expenditure on advisers' fees. Following completion, Bidco joined the BAA VAT group, and the representative member of the group sought to claim a deduction for the VAT that Bidco had incurred on the advisers' fees.

However, whilst initially successful, upon HMRC's appeal, the Upper Tribunal has recently found that BAA was not entitled to recover VAT on Bidco's advisers' fees. In reaching this decision, it was noted that while economic activity was present on the part of Bidco (a requirement), it was considered that Bidco neither made nor intended to make taxable supplies. BAA had sought to impute the BAA group's taxable supplies to Bidco (following an ECJ precedent in respect of a partnership); however, the Upper Tribunal held that it was not possible to rely on a combination of the VAT grouping rules and the ECJ decision to impute BAA's taxable supplies to Bidco.

Having established an economic activity (although no taxable supply), the Upper Tribunal held that the time to test whether VAT is recoverable is the time when VAT is incurred. In connection with this, the Upper Tribunal did not accept that at the time that VAT on the advisers' fees was incurred there was a direct and immediate link between the VAT and the taxable supplies made by the BAA VAT group, because Bidco was not then part of the BAA VAT group.

Should this decision continue to be upheld, this will make VAT recovery on the costs which relate to a company acquisition much more difficult. However, it is expected that either BAA will appeal the decision, or that one of the similar cases that are currently on hold pending this decision will be heard by the courts.

As such, taxpayers who are likely to be involved in acquisitions should seek to ensure that strategies to maximise VAT recovery are in place at an early stage of a takeover.



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

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