# Cash back

**Indirect Tax**

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Claire McCabe explains why many tax experts disagree with HMRC’s approach to VAT recovery on transaction fees

## Key Points

### What is the issue?

The VAT that companies incur on professional fees in relation to corporate acquisitions can be substantial. Businesses keen to recover that VAT are facing frequent challenges by HMRC. HMRC have issued revised guidance in light of its success in the BAA case which many tax advisers have disagreed with. Companies should put in place commercially justifiable arrangements that are supported by a transfer pricing analysis

### What does it mean for me?

VAT recovery is more important than ever to consider the issue as early as possible in a share acquisition

### What can I take away?

Considering VAT recovery early in a transaction and taking a 'best practice' approach should put an acquisition vehicle in the best possible position to recover its input VAT on professional fees

HMRC are increasinglychallenging the commerciality of arrangements that are in place to recover VAT incurred on transaction fees. HMRC's view is that VAT should only be recoverable on inputs associated with a share acquisition if the taxable supplies the acquisition entity (the Holdco) intends to make will enable it to recover its acquisition costs within five to ten years. The revised guidance at VIT40600 states:

'HMRC are likely to challenge claims that the costs are to be recovered over timescales which would not allow the capital expenditure to be recouped for many years.'

This view of the law is controversial and many tax experts would disagree with HMRC's prescribed approach. To obtain a refund of input VAT on transaction costs, HMRC require that the arrangements put in place between Holdco and the target company (the Target) are commercially justifiable. If a return on capital is not expected within five to ten years, HMRC will consider that the costs were incurred in connection with the passive activity of holding shares and receiving dividends (rather than in connection with any
taxable activity).

Taxpayers should therefore avoid putting in place a standard management services agreement on completion that bears little resemblance to the intended ongoing dynamic between the Holdco and the Target. Such an arrangement could be construed by HMRC as a smokescreen for VAT recovery. Careful thought should be given to how the Holdco can assist the Target and which services it can provide; either from its own resources or through providing services from third-party advisers.

The same care should be taken to ensure that arrangements are at arm's length are commercially justifiable and are supported by substance, as would be the case if a group structure were considered from a transfer pricing or BEPS point of view.

## The importance of transfer pricing

The importance of transfer pricing within the realm of VAT recovery on deal fees was emphasised in the First-tier Tribunal's decision in *African Consolidated Resources plc v HMRC* [2014] UKFTT 580 (TC) (ACR).

In ACR, the holding company provided capital to its subsidiaries in such a way that the tribunal accepted it could be an ‘economic activity’. Such financing was provided by the Holdco at a fixed rate of 4% interest which management considered to be about right. The tribunal agreed that a ‘third-party commercial lender might have been prepared to lend on these terms’ (although not on a fixed basis without a defined term).

However, as the interest rate was not reviewed after the loan was made, and taking into account the changing circumstances, the FTT concluded that the Holdco’s activity was more closely aligned with an equity investor than a commercial lender.

For this reason, the activity of intra-group financing was determined not to be an ‘economic activity’ for VAT purposes. In effect, the Holdco fell at the first hurdle because it put in place arrangements that were not similar enough to those that would have been offered by a third party – ie it did not get its transfer pricing right.

The Holdco also provided management services to its subsidiary for a fixed fee of £10,000 a year. The subsidiary in question was a prospective mining company whose principal asset had been confiscated by the Zimbabwean government. It was considered by the Holdco that £10,000 a year was all the subsidiary could realistically afford. If the ongoing claim against the Zimbabwean government was successful, the subsidiary’s trading conditions should materially improve and there would be scope to charge more for the management services that were being provided.

Taking these commercial considerations into account, the FTT concluded that the provision of management services for a fixed fee ‘cannot be treated as a taxable supply’ because there was a ‘lack of any relationship between the level of the fees and the value of the services’.

On that basis, the provision of management services was determined not to be the provision of taxable services. The Holdco company was wholly denied the recovery of its input VAT on the basis that it did not make taxable services for consideration.

The case of ACR demonstrates the importance of putting in place commercially justifiable arm’s-length arrangements.

## Beyond the five- to 10-year range

It is expected that, even if businesses disagree with HMRC’s view of the law, most will endeavour to develop structures that ensure as much VAT as possible is recoverable in accordance with the guidelines issued by HMRC.

However, there will be times when such structures are not possible and a holding company will not be able to provide services that have an arm’s-length value large enough so that it can recover its input costs within five to 10 years.

When such instances arise, HMRC’s revised guidance should be considered in the light of the ECJ case of *Cibo Participations SA v Directeur Regional des Impots du Nord-Pas-de-Calais* (Case C-16/00) (Cibo).

In Cibo, the holding company incurred general expenditure in relation to the acquisition of shares in a subsidiary company. The holding company carried out a number of management functions for its subsidiaries. The ECJ commented:

‘There is no direct and immediate link between the various services purchased by a holding company in connection with its acquisition of a shareholding in a subsidiary and any output transaction…in respect of which VAT is deductible.’ (Para 31)

It was acknowledged that, when a holding company uses input services to carry out both taxable and exempt transactions, it can deduct only the proportion of its input VAT that is attributable to the former. However, the passive receipt of dividends is not within the scope of VAT, and any turnover deriving from dividends is excluded from the fraction used to calculate VAT recovery.

In Cibo, the relevant expenditure incurred by the holding company in relation to the share acquisition was directly linked to its business and formed part of its general overheads. If the only outputs that the holding company made were taxable it should be able to recover all of the input VAT it had suffered (irrespective of the value of the taxable services it was intending to provide to the new subsidiary).

On that basis, it would be incorrect for HMRC to require that taxable outputs are at such a level that input VAT is recoverable within any defined period. To win its case in court, however, the holding company would need to justify its position on a commercial basis. A company that carries out only a small amount of taxable supplies that appear to be put in place to recover VAT is far less likely to be successful than a holding company that brings real value to its subsidiaries through the provision of a significant volume of commercially important services on an arm’s-length basis. Such a company would be in a strong position to argue that its input VAT on transaction fees relates to its business as a whole, forms a part of its general overheads, and should be recoverable in accordance with its usual position – even where the input costs incurred would not be recoverable in five to 10 years.

# Best practice

While not wholeheartedly agreeing with HMRC’s view of the law, it is clearly preferable, where possible, to work with it. With this in mind, the following represents best practice on the acquisition by a company (the Bidco) of a new subsidiary (the Target):

1. The Bidco should be incorporated as early in the process as possible and should engage professional advisers directly, with engagement letters addressed to the Bidco naming it as the client.

2. Immediately after incorporation, the Bidco should:

   (i) apply for VAT registration as an intending trader; and
   (ii) hold a board meeting expressing an intention to:
   (a) acquire the Target, and
   (b) on acquisition, provide taxable services to the Target for consideration.

   Such services could include management services, legal services, accounting or compliance services, human resources, the provision of business plans or monitoring services. Some financial services can also be taxable supplies eg consultancy and advisory services provided for commercial reasons.

   It is preferable for the Holdco to have a senior board of directors and employees who can provide at least some of the aforementioned services. The Holdco can also provide the services of third-party advisers in exchange for a fee.

3. Immediately upon completion, a services agreement should be put in place between the Bidco and the Target which describes the services that will be provided and the fee that will be paid by Target. The fee should be sufficient to allow Bidco to recoup its costs of the acquisition in a maximum of five to 10 years. If the fee is contingent, at completion it should be anticipated to be sufficiently high that the costs would be recovered within the prescribed timeframe).

   The fee should correspond to the value of the services to be provided. Arrangements in place between the Bidco and the Target should be properly documented, on arm's-length terms, and referred to in board meetings. It should be clear that all the arrangements have been given careful consideration. The services should actually be provided and should be of material value to the Target.

4. Immediately after completion, the Bidco should issue an invoice for the taxable services it provides the Target.

5. The Bidco's professional advisers should invoice the Bidco for the fees it has incurred during the acquisition.

6. The Bidco should ensure that the services it provides the Target are provided on arm's-length terms akin to those provided by a third-party commercial provider. The terms of the supplies should be reviewed in a way similar to that of a third-party commercial provider. For example, any increased credit risk in a subsidiary should be met with an increased interest rate on intra-group financing.

7. Sometimes it is intended that the Bidco and the Target will become members of the same VAT group. If this is the intention, a VAT-grouping application should only be made after the Bidco has established itself as a taxable person with its own economic activity for a long enough period to ensure that there is supporting documentary evidence of its activities).