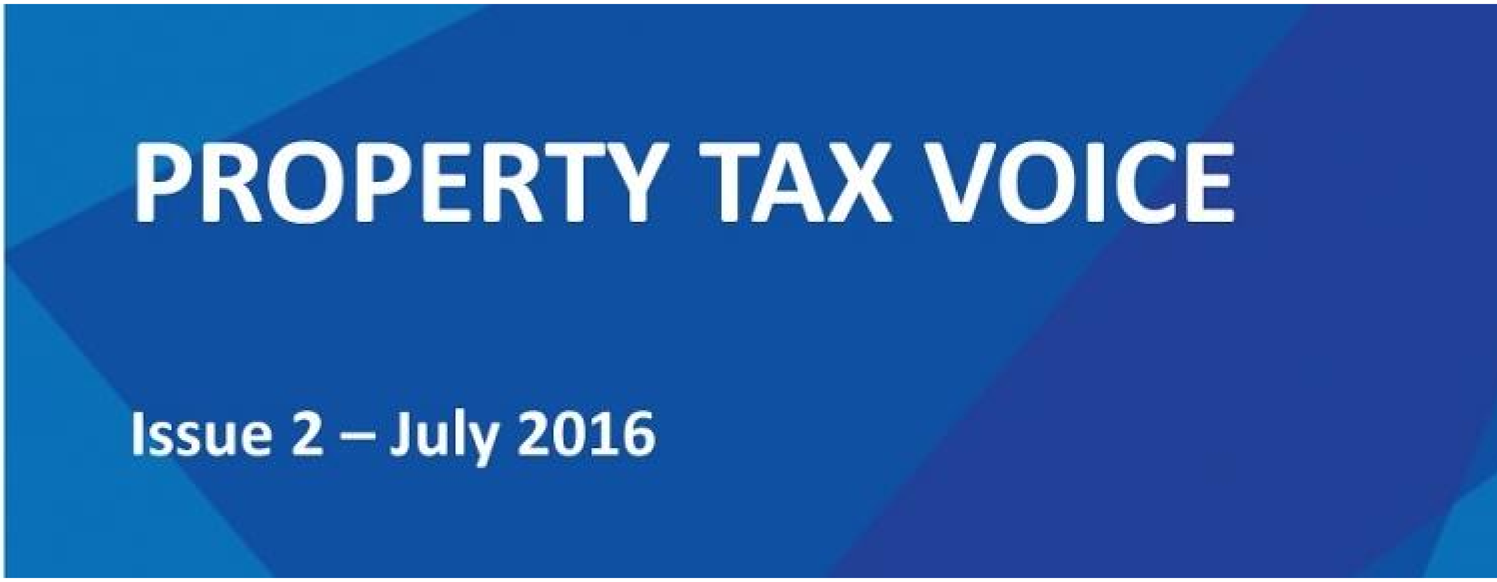
HMRC win the argument but lose the cash

Personal tax Tax voice



27 July 2016

Paul Emery provides an insight into the application of the much criticised SDLT anti-avoidance legislation in the Project Blue case

Background

The Court of Appeal decision in *Project Blue Limited v HMRC* [2016] is an important tax case for SDLT. It is currently the only case we have which gives us any insight into how the courts interpret the application of the anti-avoidance rule contained in s75A FA 2003 which applies to property transactions. Section 75A was introduced with effect from 6 December 2006. Since then it has caused considerable confusion and difficulty for taxpayers when trying to apply it to their transactions given how widely it is drafted (the FTT referred to it as a "blunderbuss").

Project Blue first came into the news in 2013 following the FTT decision and many readers will be familiar with the facts of the case. They are, however, worth summarising again for ease of reference: In April 2007, Project Blue Limited (PBL) contracted to buy the freehold of Chelsea Barracks from the Secretary of State for Defence (SSD) for £959m. In order to finance the purchase in a Sharia compliant way, PBL contracted to sell the freehold to a bank, Masraf al Rayan (MAR), for £1.25bn with a lease back to PBL. The £291 million difference represented the cost of finance. All three property transactions were completed at the same time on 31 January 2008.

PBL filed its tax return on the basis that "sub-sale" relief under section 45(3) FA 2003 applied and MAR claimed "alternative finance" relief under section 71A FA 2003. HMRC did not dispute that the reliefs were available but instead raised an SDLT assessment on PBL under section 75A.

The decision

The Court of Appeal has held that as PBL was treated as having acquired the property in accordance with sub-sale relief, MAR was not eligible for section 71A “alternative finance” relief and should have been assessed to £50m of SDLT in respect of its acquisition of the property for £1.25bn. Section 75A then had no application to the transaction since the normal rules gave rise to a “proper” amount of SDLT. Unfortunately for HMRC, they were out of time to assess MAR given that they closed the enquiry into MAR’s return in July 2011. This is certainly a lesson in procedural matters which can easily trip up both HMRC and taxpayers alike.

The decision raises a number of interesting questions such as:

- Are sharia compliant banks exposed to uncertain SDLT charges? and
- Is there any greater certainty as to how section 75A should be applied to property transactions?

Sub-sale relief

Sub-sale relief allows an intermediate purchaser to avail itself of SDLT relief where property is acquired and immediately sold on to an end purchaser. The relief facilitates liquidity in the market by allowing an intermediary to participate in the property transaction without them suffering an SDLT charge which might otherwise make their role uneconomic. The intermediary does not normally acquire an economic interest in the property given that the acquisition and sale take place contemporaneously. It is on that basis that Parliament has decided not to subject the intermediary to an SDLT charge.

Sub-sale relief has been completely overhauled since the Chelsea Barracks transaction in January 2008 because, in its original form, HMRC felt that it formed a key constituent of many avoidance schemes. In 2008, the relief worked by ignoring the actual transactions entered into by both the intermediary and the end purchaser. It instead created a hypothetical transaction which the end purchaser entered into for consideration equal to the amount paid by the intermediary together with any additional amount paid by the end purchaser. This meant that PBL’s acquisition of the freehold from SSD was completely ignored.

The precise characteristics of the hypothetical transaction are not so important for sub-sale relief, but as discussed below, they do become important for alternative finance relief.

Alternative finance relief

Section 71A FA 2003 provides an exemption from SDLT on both the acquisition of property by a financial institution and a leaseback of the property to the same person in order to facilitate Sharia compliant financing. The application of section 71A will usually be straightforward for a financing transaction where the “borrower” already holds the property having paid SDLT on its acquisition. It will also be straightforward where the financial institution acquires the property directly from the third party and leases it to their client. In this second scenario, the bank will incur SDLT which it will need to price into the transaction.

The claim for alternative finance relief by MAR was only available if it could be shown that PBL was the “vendor” in relation to the hypothetical transaction created by the sub-sale provisions. Based on the findings of the Court of Appeal in another case concerning sub-sale relief, *DV3 RS LP v HMRC* [2013] EWCA Civ 907, the court found that the effect of sub-sale relief was to completely disregard the substantial performance or completion of the contract between SSD and PBL. By implication, the court also found that section 45(5A) (which then provided that "…references in this Part to the vendor shall be read, where the context permits, as referring to either the vendor under original contract or the transferor…") could not be read to allow PBL to be treated as the vendor under the hypothetical transaction under which MAR was the purchaser given that PBL's acquisition of the freehold had been disregarded. Hence MAR's claim for alternative finance relief was invalid.

It does seem unfortunate that a financial institution could enter into a sale and lease back arrangement believing that the conditions for alternative finance relief were met, only to discover that the relief was not available because of entirely separate arrangements entered into by their client. Under the new "pre-completion transactions" regime which replaces the old sub-sale provisions, only sub-sale relief (and not alternative finance relief) would be available in circumstances similar to Project Blue. Financial institutions wishing to avail themselves of alternative finance relief will need to make adequate enquiries to confirm that the conditions for relief are satisfied.

Application of section 75A

Section 75A applies where there are a number of "scheme" transactions including a disposal of property by V and an acquisition of that property, or an interest derived from it, by P and the SDLT on a hypothetical transaction between V and P is more than is the case on the actual scheme transactions. Given the findings in relation to alternative finance relief discussed above, section 75A was ultimately not critical to the case. However, given its potential importance for statutory interpretation, it is worth picking up on the comments made by Patten LJ in relation to section 75A.

Firstly, a key and consistent finding in each of the decisions concerning this case is that an avoidance motive or intention is not a pre-condition to the application of section 75A: the provisions of section 75A operate according to their own terms and must be applied mechanically. Patten LJ reaffirmed this point.

Secondly, there has been some confusion as to how to identify P: this is relevant for determining the SDLT due under section 75A. Patten LJ considered that pre-conceptions such as who had really avoided SDLT or who was the real purchaser (as opposed to the financier) should be ignored. Given that the transfer to PBL from the SSD was to be disregarded by virtue of sub-sale relief, he noted that the only transactions involving chargeable interests were the transfer of the freehold of the site to MAR and the grant of the lease to PBL. Patten LJ went on to explain that 75A imposes an order of priority which means that "if V's interest (and not a derivation from it) is acquired by a person in the chain then one need look no further". He accepted that the lease acquired by PBL also satisfied the condition in section 75A, but in his view the purchase of the freehold by MAR is "the primary and obvious acquisition of V's chargeable interest". This more mechanical approach sets aside the assumption that MAR, as financier, cannot be treated as the purchaser.

Lastly, Patten LJ kills off any notion that section 75A only levies SDLT on the amount of consideration paid by the person who is in substance the purchaser. Instead, he confirms the mechanistic approach that results in chargeable consideration of £1.25bn i.e. including the finance element of the transaction.

So in summary, we continue to have to apply section 75A mechanistically, without a motive test, and without any discretion from HMRC not to apply section 75A to ordinary commercial transactions. Section 75A has been described as a Blunderbuss. Put another way, it is like a class detention when only the minority were misbehaving.

It remains to be seen whether HMRC will seek leave to appeal against this decision. But until the case is finally settled, they do not intend to replace their outdated and clearly misguided guidance and they will not seek to convert this Blunderbuss into a sniper rifle.