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UK VAT grouping disputes: implications of the *HSBC* decision

Key points of principle relating to the interpretation of the UK's VAT grouping rules have been established by the Upper Tribunal in ***HSBC Electronic Data Processing (Guangdong) Ltd & others v HMRC****. In particular, the UT held that each body corporate eligible for VAT group membership must itself be 'established' in the UK and the test of 'establishment' should be informed by that used in the place of supply rules. This may make it harder to establish VAT grouping of UK branches with limited resources in the UK to provide group services. The UT also ruled that HMRC's power to terminate VAT group membership where 'necessary for the protection of the revenue' is not limited to abusive scenarios, which may further impact the scenarios in which VAT grouping may be achieved.*

The decision of the Upper Tribunal (***UT***) in *HSBC Electronic Data Processing (Guangdong) Ltd & others v HMRC* [2022] UKUT 41 (TCC) represents what is likely to be the first major instalment in a series of cases relating to the UK VAT grouping of (in particular) offshore service companies. Or perhaps, more precisely, the circumstances in which companies are eligible to be VAT grouped, and in which VAT group membership can be terminated or denied.

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There are a number of cases stayed behind this one and so the UT's views on some of the key technical points relating to the interpretation of the UK's VAT grouping rules, which in turn inform how those rules should be applied, will be of interest to many.

Factual context

This was a decision on four preliminary issues in the context of an appeal by HSBC Bank plc and five 'global service companies' (***GSCs***) within the HSBC group against HMRC's decision to remove the GSCs from the HSBC VAT group.

Although the preliminary issues largely concerned pure points of law, some basic facts were agreed which it is useful to explain as context to the decision. The essential elements of these, as rehearsed by the UT, were that:

- The GSCs are incorporated in foreign jurisdictions.
- The GSCs were set up as part of a programme of relocating the provision of various functions and processes (e.g. payment processing and call centre functions) from the UK to offshore, lower cost jurisdictions.
- The GSCs provided services to or for the benefit of entities within the HSBC corporate group.
- The GSCs have branches in the UK which are registered with Companies House.

From a VAT perspective, it was clearly beneficial for the GSCs to be included within the HSBC VAT group so as to eliminate any VAT on the supply of services by the GSCs to other group members. HMRC's decision to terminate the GSCs' membership of the HSBC VAT group would have the effect that UK recipients of services from the GSCs would be required to operate the reverse charge under s 8 VATA 1994 and account to HMRC for output VAT on the fees paid for those services. In other words, it would create a VAT cost for the HSBC group.

In order to appreciate the significance of the UT's decision on the preliminary issues, it is also useful to understand the key questions raised by HSBC's appeal. These were:

1. whether the eligibility requirement for VAT group membership in s 43A VATA 1994, that bodies corporate be 'established' or have a 'fixed establishment' in the UK, was satisfied by the GSCs;
2. whether the provisions in s 43C VATA 1994 which permit HMRC to terminate VAT group membership if necessary for the protection of the revenue are ultra vires; and
3. whether HMRC was entitled to exercise that power to remove the GSCs from the HSBC VAT group, i.e. whether that step was necessary for the protection of the revenue.

Slightly unusually, the case was transferred to the UT for hearing – with the important consequence that the decision will be binding upon the First-tier Tribunal in any subsequent hearing of the GSCs' substantive appeal and other similar cases.

Issue 1: the meaning of 'establishment' (the s 43A issue)

Section 43A VATA 1994 permits bodies corporate which are under the same control to be treated as members of a VAT group if they are 'established' or have a 'fixed establishment' in the UK. It was common ground that in this respect s 43A VATA 1994 implements words used in Article 11 of the Principal VAT Directive 2006/11/EC (***PVD***), underlined in the following extract:

'*each Member State may regard as a single taxable person <u>any persons established in the territory of that Member State</u> who, while legally independent, are closely bound to one another by financial, economic and organisational links*'.

The first issue for the UT to consider was the meaning of the terms used in the UK legislation, which it was agreed should, so far as possible, be interpreted compatibly with Article 11.

HSBC's main argument was that the territorial requirement in Article 11 could be satisfied if close links between members of the group were 'forged in' the relevant territory, and that s 43A VATA 1994 therefore did not require each member of the group to be established in or to have a fixed establishment in the UK.

The UT disagreed with this interpretation. Analysing Article 11 according to the wording used, its context and objectives, the UT concluded it was clear that Article 11 contained two conditions for persons to be comprised in a VAT group:

- each person must be established in the relevant territory; and
- they must be closely linked with one another.

The UT also disagreed that the registration with Companies House of the UK branch of a foreign company was enough for the body corporate in question to be established or have a fixed establishment in the UK. On this, the UT pointed to Parliament's clear intention that s 43A VATA 1994 replace the previous tests, which used concepts that had their roots in company law, with concepts that were more consistent with those used elsewhere in the VAT code.

In line with this, the UT further held that the meaning of 'established' in Article 11 should be informed by the concepts of 'established in' and 'fixed establishment' under the place of supply rules, although the UT stopped short of saying that the tests are the same. The UT also noted the highly fact sensitive nature of the meaning of 'establishment', which it considered better determined in the context and circumstances of any particular case.

Pausing there, it may be assumed from the nature of HSBC's arguments on this issue that it was thought unlikely the GSCs would be regarded as 'established' in the UK as that term is understood in the place of supply rules context, i.e. (broadly) as having their principal place of business in the UK or, failing that, an establishment with a sufficiently permanent presence from which business activities are carried on. These are fiddly concepts to apply, and while the UT has not gone so far as to stipulate that they should be adopted for the purposes of establishing eligibility for VAT grouping, it is likely at least to prove necessary to consider them.

Issue 2: the relevance of failure to consult with VAT Committee

'Who are the VAT Committee and what have they to do with anything?' you might ask. The second issue the UT was asked to consider again comes

back to the wording of Article 11 PVD, which begins:

'*After consulting the advisory committee on value added tax (hereafter, the 'VAT Committee'), each Member State may regard as a single taxable person…*'

This issue boils down to whether, if it was established that the UK had failed to discharge its obligation to consult the VAT Committee before introducing s 43A VATA 1994, HMRC would then be unable to rely on s 43A VATA 1994 to the detriment of the taxpayer – and so would be unable to exclude bodies corporate from membership of a VAT group for failing to meet the establishment requirements.

There have been a number of CJEU cases in which a failure by the Member State in question to discharge an obligation to consult enshrined in the Directive has been held to result in the national tax authority being unable to rely on the relevant domestic provision to the detriment of the taxpayer. But those were all cases where the relevant part of the Directive had direct effect and so in principle could not be limited, unless the proper consultation process had been adhered to. In the UT's view, in those cases the direct effect was critical to the outcome and they were of no assistance in a situation where the relevant rights were not directly effective.

It was established by the CJEU in *Larentia & Minerva* (C-108/14 and C-109/14) that the predecessor to Article 11 PVD did *not* have direct effect, because it did not have the necessary feature of unconditionality - national legislation being needed to determine what constitutes 'close financial, economic and organisational links' – and it was accepted that the same reasoning carried across to Article 11.

That sealed it for the UT on this issue: whether HMRC could rely on s 43A VATA 1994 in the absence of any consultation with the VAT Committee was the mirror image of the question whether a taxpayer could claim the benefit of Article 11, and since the answer to the latter question was 'no' because Article 11 does not have direct effect, the answer to the former question must be 'yes'.

On that basis, even if a failure to consult were established as a matter of fact, it seems unlikely that it could form the basis of an argument to the effect that s 43A VATA 1994 is ultra vires and so cannot be relied upon by HMRC against the taxpayer.

Issue 3: measures to prevent tax evasion or avoidance

HMRC's power in s 43C VATA 1994 to terminate VAT group membership if 'necessary for the protection of the revenue' is clearly based upon the final words of Article 11 PVD (which are referred to below, adopting the approach of the UT, as Article 11(2)):

'*A Member State exercising the option provided for in the first paragraph may adopt any measures needed to prevent tax evasion or avoidance through the use of this provision.*'

> **"The third issue for the UT related to the meaning of 'tax evasion or avoidance'…**

The third issue for the UT related to the meaning of 'tax evasion or avoidance' in Article 11(2). In particular, whether that phrase should be interpreted consistently with the concept of 'tax avoidance' described by the CJEU in *Direct Cosmetics* (C-5/84) or the higher threshold of tax avoidance or evasion caused by an abusive practice, as defined by the CJEU in *Halifax* (C-255/02).

The key difference here is that an abusive practice under the *Halifax* principle arises only where, in addition to the relevant transaction resulting in a tax advantage, on an objective assessment the essential aim of the transaction was to obtain a tax advantage – whereas the *Direct Cosmetics* definition looks only to whether the transaction objectively reduces VAT, regardless of whether there is any intention to avoid tax. There are no prizes for guessing that HSBC was arguing for the higher *Halifax* threshold and HMRC for the lower-level test from *Direct Cosmetics*.

The UT favoured HMRC's interpretation, holding that it was clear from the Article 11(2) wording that the provision was not limited to scenarios involving abusive practices per *Halifax* - including because while other Articles of the PVD refer to abuse in addition to tax evasion and avoidance, that was not the case in Article 11(2).

This will clearly make it difficult for taxpayers to argue that HMRC's 'protection of the revenue' power to terminate VAT group membership should be reserved for the most egregious of cases. However, it remains to be seen in what factual circumstances VAT grouping is considered to amount to 'tax evasion or avoidance' in the *Direct Cosmetics* sense so as to permit invocation of 'protection of the revenue' grounds in order to terminate that grouping relationship.

Issue 4: how to apply s 84(4D) VATA 1994

Section 84(4D) VATA 1994 applies where an appeal is brought against a notice terminating membership of a VAT group and the grounds of appeal relate wholly or partly to the date of termination specified in the notice. It provides that the tribunal shall not allow the appeal in respect of the date unless it considers that HMRC could not reasonably have been satisfied that it was appropriate.

The final issue for the UT involved two questions around this provision: whether it was engaged in this case and, if so, what were the factors that the tribunal must take into account in considering whether HMRC decided on an appropriate date.

Having concluded that s 84(4D) VATA 1994 was engaged here, the parties were broadly aligned on the relevant factors for the tribunal to consider and the UT agreed with these. The factors are similar to those that would be considered in testing reasonableness as part of a judicial review, being whether HMRC:

- acted in a way no reasonable Commissioners could have acted;
- took into account irrelevant factors;
- disregarded a factor to which they should have given weight; and
- erred on a point of law in choosing the date.

It was also emphasised that the test must be focused on the outcome (i.e. the reasonableness of the decision reached) rather than the process. Accordingly, even one of the errors alleged by HSBC's grounds of appeal was found to be valid, provided there was some basis on which HMRC could still reasonably have specified the relevant date, the tribunal should not overturn that decision.

Implications for other cases

With a number of cases in the pipeline concerned with eligibility for VAT group membership and the circumstances in which it can be terminated, the UT's decision is inevitably going to have some fairly broad ramifications.

> **"...the UT's decision may make it easier for HMRC to defend decisions to terminate VAT group membership..."**

In particular, while the 'establishment' question is of course (as the UT pointed out) a factual one to be tested on a case-by-case basis, the UT's guidance that the concept should be informed by that under the place of supply rules means that the grouping of UK branches with limited resources in the UK to provide the underlying group services may be difficult.

HMRC's approach seems to be that, whether or not a UK branch meets the test for a fixed establishment, its protection of the revenue powers can be exercised in circumstances where, in HMRC's view, the branch is set up in order to remove from a charge to UK VAT substantial supplies that are provided from outside the UK. The facts in any given case will again be key here, but the UT's decision that HMRC's protection of the revenue powers can be exercised in the absence of any abusive practice may make it easier for HMRC to defend decisions to terminate VAT group membership on that basis.

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