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Current Notes

Subsequent changes to the OECD Commentaries

In *Fowler v HMRC* (*Fowler*) the Supreme Court finally gave its sanction to reference being made to the OECD Commentaries that post-date a particular treaty (referred to here as "subsequent Commentaries").[1]

Paragraph 18 of the Supreme Court's judgment says:

> "The OECD Commentaries are updated from time to time, so that they may (and do in the present case) post-date a particular double taxation treaty. Nonetheless they are to be given such persuasive force as aids to interpretation as the cogency of their reasoning deserves: see *Revenue and Customs Comrs v Smallwood* (2010) 80 TC 536, para 26(5) per Patten LJ."[2]

Unlike, for example, the French Supreme Administrative Court, which has prohibited reference to subsequent Commentaries, the Supreme Court has in this one paragraph authorised it.[3] However, the Supreme Court has not, by sanctioning reference to subsequent Commentaries, resolved all issues that surround them.

In *Fowler* the treaty in question was the 2002 treaty between the UK and South Africa[4]; the paragraphs in the OECD Commentary on Article 15 of the OECD Model Tax Convention on Income and on Capital that were relied upon had been added in 2010,[5] supplementing existing material in the Commentary; the tax years in question were 2011–2012 and 2012–2013. Thus, the new paragraphs added to the Commentary had been adopted by the OECD before the tax years in question. There also appears to have been no argument over whether the new paragraphs were clarificatory of the prior Commentary or conflicted with it. South Africa has also participated in the tax work of the OECD since the late 2000s and has published its positions with regard to the OECD Model and Commentaries. The Supreme Court never had to consider, therefore, a number of issues relating to reference to subsequent Commentaries: for example, what if the changes do not clarify but appear to contradict the previous Commentary; what about subsequent Commentaries published in years after the tax years in question; what if the other country does not accept the changes?

The decision of the Supreme Court is, of course, in line with the approach taken by the OECD Committee on Fiscal Affairs itself, not that that should necessarily carry any particular weight. Referring to the OECD Commentary as support for reference to the OECD Commentary is

[1] *Fowler v HMRC* [2020] UKSC 22; [2020] STC 1476; (2020) 22 ITL Rep 679.
[2] *Fowler*, above fn.1, [2020] UKSC 22 at [18].
[3] On the position in France, see *SA Andritz* Conseil d'etat, 30 December 2003, case no.233894 (2004) 6 ITLR 604 and many subsequent cases.
[4] Double Taxation Relief (Taxes on Income) (South Africa) Order 2002 (SI 2002/3138).
[5] OECD, *Model Tax Convention on Income and on Capital 2010 (updated 2010)* (OECD Publishing, 2010), available at: *https://dx.doi.org/10.1787/9789264175181-en* [Accessed 25 August 2020].

something of a bootstrap argument. In the Introduction to the OECD Model of 2017, the following is said:

> "33. When drafting the 1977 Model Convention, the Committee on Fiscal Affairs examined the problems of conflicts of interpretation that might arise as a result of changes in the Articles and Commentaries of the 1963 Draft Convention. At that time, the Committee considered that existing conventions should, as far as possible, be interpreted in the spirit of the revised Commentaries, even though the provisions of these conventions did not yet include the more precise wording of the 1977 Model Convention.…
>
> 34. The Committee believes that the changes to the Articles of the Model Convention and the Commentaries that have been made since 1977 should be similarly interpreted."[6]

The issue of reference to subsequent Commentaries remains controversial, and there are further issues that need to be resolved, even after the decision of the Supreme Court.[7] There is a danger going forward that cases on tax treaty interpretation in the UK will become entangled with discussions about whether the subsequent amendments to the Commentaries are clarificatory, or effect changes, or simply add examples, etc. No doubt this will get rolled up into the question of how much weight is to be put on the Commentaries: there is a danger, of course, that a court will give weight to a Commentary if it supports a decision that the court otherwise wishes to reach; and will give no weight if the Commentary runs in the opposite direction. It may be that one will reach the position that the French Supreme Administrative Court was right all along to prohibit references to subsequent Commentaries.

Interestingly enough, the desire to use subsequent Commentaries to interpret existing treaties has also been manifested in UK treaty practice in the last few years. Six of the 12 most recent comprehensive treaties concluded by the UK have included explicit reference to the use of the Commentaries as an aid to interpretation. Generally this is found in a protocol to the Convention, an example being the 2016 protocol to the UK-Colombia Double Taxation Convention which provides as follows:

> "1. In relation to the whole Convention:
> It is understood that both Contracting States will interpret this Convention in the light of the Commentaries to the OECD Model Tax Convention *as they may read from time to time*, having regard to any observations or other positions that they have expressed thereon." (Emphasis added.)[8]

Substantially identical wording is to be found in the protocols to the double taxation agreements with the Isle of Man, Guernsey, Jersey and Gibraltar in 2018 and 2019. In some senses, the

[6] OECD, *Model Tax Convention on Income and on Capital 2017 (Full Version)* (Paris: OECD Publishing, 2019), available at: *https://doi.org/10.1787/g2g972ee-en* [Accessed 26 August 2020], paras 33–34.

[7] There is a whole body of literature on reference to the OECD Commentaries. One of the fullest discussions is in D. Ward (ed.), *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model* (IBFD, 2005).

[8] UK/Colombia Double Taxation Convention, signed on 2 November 2016, entered into force on 13 December 2019, Protocol.

inclusion of this phrase in agreements with the Crown Dependencies and Overseas Territories is not too surprising, given that they are hardly negotiating as independent, sovereign states. On the other hand, it is not thought that officials from any of these territories have ever participated in the work of the OECD, nor have any of those territories ever expressed their positions on the OECD Commentaries. The negotiators appear to have accepted as an aid to interpretation wording over which they have little or no control.

By way of completeness, the protocol to the UK-Austria Double Taxation Convention of October 2018 has a more elaborate provision:

> "7. Interpretation of the Convention
>
> a) It is understood that provisions of the Convention which are drafted according to the corresponding provisions of the OECD Model Convention on Income and on Capital shall generally be expected to have the same meaning as expressed in the OECD Commentaries thereon as they may be revised from time to time. The understanding in the preceding sentence will not apply with respect to the following:
>
> (i) observations to the OECD Commentaries maintained by either Contracting State other than observations made after the signature of this Convention on Commentaries that existed before its signature;
>
> (ii) any contrary interpretations in this Protocol;
>
> (iii) any contrary interpretation in a published explanation by one of the Contracting States that has been provided to the competent authority of the other Contracting State before the signature of the Convention;
>
> (iv) any contrary interpretation agreed by the competent authorities after signature of the Convention.
>
> The OECD Commentaries — as they may be revised from time to time — constitute a means of interpretation in the sense of the Vienna Convention of 23 May 1969 on the Law of Treaties."[9]

The presence of these explicit references to interpretation by reference to the OECD Commentaries, including subsequent Commentaries, coming on top of the decision in *Fowler*, displays the UK Government's clear commitment to interpretation having regard to the subsequent Commentaries. It is worth pausing for a moment and asking: why should this be, and what implications may it entail?

The UK has always been an active participant in the OECD work on double taxation conventions, and has frequently held the chairmanship of Working Party 1, which oversees the updating of the OECD Model. There is an element of loyalty, therefore, in supporting the approach of the Committee on Fiscal Affairs in regard to the later Commentaries. However, there seems also to be something of a geopolitical advantage. The UK officials know that they may be able to exert influence over the development of the Commentaries to a degree that they are not able

[9] UK/Austria Double Taxation Agreement, signed on 23 October 2018, entered into force on 1 March 2019, Protocol, para.7.a).

to exert similar influence, for example, with regard to the United Nations or other international fora. If the UK cannot get its way with regard to the Commentaries, it always has the option of a reservation on the terms of the Model or an observation on the change to the Commentary. In a world where the UK has diminishing influence, the writer can understand the desire of officials from the UK, participating in the work of the OECD, to ensure that the results of their efforts have a clear effect on the interpretation even of existing treaties.

However, there is a constitutional issue here. If the changes to the Commentaries go beyond merely clarifying what is already there in the Model (and if it is already there, perhaps it needs no clarification) and actually alter in some way the meaning of the text, then unelected officials, acting without explicit mandate, through agreement with other officials at OECD meetings, can alter the meaning of international agreements entered into by the UK. That is the potential risk that is taken on by permitting reference to be made to Commentaries subsequent to the conclusion of a tax treaty. It is clearly a risk that the French Supreme Administrative Court did not wish to take on.

One logical corollary to the UK Government's apparent attachment to subsequent Commentaries is that there should be more Parliamentary scrutiny. Up to the present, changes to the OECD Commentaries are not presented to Parliament, and are not debated. Perhaps that should change. The scrutiny given by Parliamentary committees to double taxation conventions is not particularly profound and is sometimes rather laughable. However, at least there is some scrutiny, and a minister may have to explain—aided by officials who presumably know the answer—why particular treaty provisions have been adopted. Going forward, if weight is to be attached to subsequent Commentaries, then perhaps the appropriate minister should appear before a Parliamentary committee at least every time that the OECD Commentaries are updated to explain the position taken by the UK and to provide answers to questions. The scrutiny may not be very profound, but it might focus the minds of the officials responsible for discussion at the OECD.

Philip Baker*

Constitutional law; Double taxation treaties; OECD; Parliamentary scrutiny; Treaty interpretation

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See A. Nikolakakis, P. Blessing, G. Maisto, J. Hattingh and J. Avery Jones, "Fowler v HMRC (Supreme Court): neither fish nor Fowler: tax treaty implications of domestic deeming rules" [2020] BTR 537.

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Finance Act 2020 Notes

Editorial: Finance Act 2020

Limiting one's observations on the Finance Act 2020 (FA 2020) by omitting to comment on the wider societal and economic consequences of Coronavirus would be analogous to commenting only on the quality of the orchestra on the Titanic and omitting to comment on anything else to do with her maiden voyage. Nevertheless, and ignoring the Government amendments introduced at Report Stage,[1] at first sight FA 2020 seems rather "thin" apart from the introduction of digital services tax or "DST"[2] in Part 2 of the Act. There are the usual tweaks to existing legislation that we have come to expect—structures and building allowances in sections 29 and 30,[3,4] inheritance tax (IHT) in sections 73 to 75[5,6] and stamp duty in sections 77 to 79.[7,8]

However, on closer reading it can be seen that FA 2020 is quite revolutionary. First, there is the dog that didn't bark[9]: the writer is referring to the cancelled reduction to 17 per cent in the main rate of corporation tax from 19 per cent in section 5 FA 2020[10] where, given the current discrepancy between this rate and the basic rate of income tax (20 per cent), coupled with the need to repair the public finances—more anon—one wonders if a further change can be expected. Secondly, and similar in its indirect raising of tax, there is the long-anticipated reduction in entrepreneurs' relief from £10 million to £1 million in section 23 and Schedule 3[11,12] commented on by the Chancellor in his Budget Speech.[13] Thirdly there were the changes made to HMRC

[1] HM Treasury, Policy paper, *Finance Bill 2020: Report stage* (published 25 June 2020; last updated 29 June 2020), available at: *https://www.gov.uk/government/publications/finance-bill-2020-report-stage* [Accessed 8 October 2020].
[2] FA 2020 Pt 2 ss.39–72. J. Vella, "Finance Act 2020 Notes: Part 2 Sections 39–72: the UK's digital services tax" [2020] BTR 469.
[3] FA 2020 ss.29 and 30.
[4] G. Loutzenhiser, "Finance Act 2020 Notes: Section 29: structures and buildings allowances: rate of relief; Section 30: structures and buildings allowances: miscellaneous amendments" [2020] BTR 449.
[5] FA 2020 ss.73–75.
[6] E. Chamberlain, "Finance Act 2020 Notes: Section 73: excluded property etc; Section 74: transfers between settlements etc" [2020] BTR 483.
[7] FA 2020 ss.77–79.
[8] R. Collier, "Finance Act 2020 Notes: Section 77: stamp duty: transfers of unlisted securities and connected persons; Section 78: SDRT: unlisted securities and connected persons; and Section 79: stamp duty: acquisition of target company's share capital" [2020] BTR 488.
[9] Sir Arthur Conan Doyle, "The Adventure of Silver Blaze", first published in the Strand Magazine (1892).
"Gregory (Scotland Yard detective): Is there any other point to which you would wish to draw my attention?
Holmes: To the curious incident of the dog in the night-time.
Gregory: The dog did nothing in the night-time.
Holmes: That was the curious incident."
[10] FA 2020 ss.5 and 6.
[11] FA 2020 s.23 and Sch.3.
[12] P. Rayney, "Finance Act 2020 Notes: Section 23 and Schedule 3: entrepreneurs' relief" [2020] BTR 427.
[13] HM Treasury and The Rt Hon Rishi Sunak MP, *The Budget 2020 Speech* (11 March 2020): "The Institute for Fiscal Studies have criticised it. The Resolution Foundation called it 'the UK's worst tax break'."

preference in insolvency in sections 98 and 99,[14,15] although as a result of COVID-19 concerns, these changes were deferred from their original implementation date.

In one way, the changes to off payroll payments contained in section 7 and Schedule 1, again deferred in implementation because of COVID-19, are not revolutionary as they are broadly similar to the rules brought in with regard to public sector engagers in 2017. Yet persons who are not in direct contractual relations are required to make determinations the principal consequence of which will be to determine a recipient's net level of payments and, in effect, that recipient's deemed employment status without the recipient having a right of appeal against HMRC (the principal beneficiary of such determinations).[16] That is not to criticise HMRC for giving up on IR35 but rather the Government for not engaging in more fundamental reform following the Taylor Review,[17] as opposed to the somewhat cumbersome route of the new legislation.

There were changes both expected and unexpected. One expected change, following Sir Amyas Morse's Report[18] on the loan charge introduced in the Finance Act 2018[19] and effected in sections 15 to 21 FA 2020[20] was to ameliorate its impact.[21] A second expected change, given the increasing hospital waiting lists (even before COVID-19) consequent upon the entirely predictable effect of the ill-judged tapered reduction in the annual allowance (previously referred to in these editorials), was to increase the relevant thresholds.[22] An unexpected change[23] was to bring, in some cases with certain restrictions,[24] more assets into the corporate intangibles rules.[25]

Another unexpected feature, given that the Chancellor had referred to his Budget being the first for nearly 50 years when the UK was not part of the EU, was the inclusion in several sections of provisions intended to cure potentially unlawful infringements of EU freedoms. It might be thought that the Commission would not have had as its highest priority bringing actions against an ex Member State but nevertheless sections 27, 34 and 38 are included.

[14] FA 2020 ss.98 and 99.

[15] M. Shah, "Finance Act 2020 Notes: Section 98: HMRC debts: priority on insolvency; Section 99: HMRC debts: regulations; Section 100 and Schedule 13: joint and several liability of company directors etc" [2020] BTR 500.

[16] H. Collins and J. Freedman, "Finance Act 2020 Notes: Section 7 and Schedule 1: workers' services provided through intermediaries" [2020] BTR 394.

[17] M. Taylor, *Good work: the Taylor review of modern working practices* (Department for Business, Energy & Industrial Strategy, 11 July 2017).

[18] Sir A. Morse, *Independent Loan Charge Review: report on the policy and its implementation* (December 2019), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/854387/Independent_Loan_Charge_Review_-_final_report.pdf* [Accessed 8 October 2020].

[19] FA 2018 s.11 and Sch.1.

[20] FA 2020 ss.15–21.

[21] M. Blackwell, "Finance Act 2020 Notes: Section 15: loan charge not to apply to loans or quasi-loans made before 9 December 2010; Section 16: election for loan charge to be split over three tax years; Schedule 2: the loan charge: consequential amendments; Section 17: loan charge reduced where underlying liability disclosed but unenforceable; Section 18: relief from interest on tax payable by a person subject to the loan charge; Section 19: minor amendments relating to the loan charge; Section 20: repaying sums paid to HMRC under agreements relating to certain loans etc; Section 21: operation of the scheme" [2020] BTR 414.

[22] FA 2020 s.22.

[23] G. Richards, "Finance Act 2020 Notes: Section 31: intangible fixed assets: pre-FA 2002 assets etc" [2020] BTR 450.

[24] FA 2020 s.31.

[25] See CTA 2009 Pt 8.

A reader might have expected more to be included in FA 2020 on Coronavirus but in fact, because of the enabling powers under section 76 of the Coronavirus Act 2020, there are relatively few tax measures. Broadly speaking they fall into two categories: protective and consequential. In the first category section 106 and Schedule 16 FA 2020 effectively treat, principally, payments under the Coronavirus Job Retention Scheme (CJRS) and the Self-Employment Income Support Scheme (SEISS), as taxable income and provide for recovery via tax assessments of inappropriately paid amounts. In the second category, sections 107 and 108 FA 2020 deal with "inappropriate" consequences of the "furlough scheme"; section 109 FA 2020 provides for relief from the impact on personal residence status of restrictions (on movement, "lockdown" and travel disruption); section 110 FA 2020 protects investors in companies benefitting from the "Future Fund" from inadvertent loss of Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) relief; and the potentially extended period for making refund claims for stamp duty land tax (in respect of the 3 per cent surcharge on "second homes" where main residence sales were delayed because of Coronavirus) is contained in section 76 FA 2020.

In his Budget speech the Chancellor referred both to projections on levels of public sector debt and to cutting taxes. However that was before the unprecedented levels of public borrowing assumed by the UK to ameliorate the impact of the "lockdown", in part resulting from the various schemes such as the SEISS, CJRS and other reliefs the tax treatment of which were addressed in sections 106 to 110 FA 2020. While it would be prudent to avoid a premature withdrawal of demand from the economy as a result of bringing in tax increases designed to reduce public borrowing it is clear that in the medium term tax rises will be required. Indeed the Chancellor's request that the Office of Tax Simplification review capital gains tax, a piece in the *Financial Times* posing the question whether it was time to remove tax deduction for corporate debt[26] and the Treasury Select Committee querying the value of tax reliefs[27] suggests change of some sort is likely, even if not in the next Finance Act. Rather like the words attributed to John Maynard Keynes,[28] the Chancellor's views on the desirability of tax cuts may alter.

Gary Richards[*]

[26] V. Fleischer and J. Blake, "Should we end the tax deductibility of business interest payments?", *Financial Times*, 22 July 2020, available at: *https://www.ft.com/content/426c1465-9561-4300-8d3e-2430e4124c93* [Accessed 8 October 2020].

[27] UK Parliament, *Treasury Committee launches "Tax after coronavirus" inquiry* (17 July 2020), available at: *https://committees.parliament.uk/committee/158/treasury-committee/news/115114/treasury-committee-launches-tax-after-coronavirus-inquiry/* [Accessed 8 October 2020].

[28] "When the facts change, I change my mind. What do you do, Sir?"

Coronavirus; Economic conditions; Entrepreneurs' relief; Fiscal policy; Pandemics

[*] Solicitor of the Supreme Court.

Section 7 and Schedule 1: workers' services provided through intermediaries

Deferral not cancellation: need for fundamental reform

The Finance Act 2017 amended the so-called IR35 rules on the taxation of workers'[1] services provided through intermediaries, by shifting responsibility for their operation from the intermediary of the individual providing services to the engager in the case of public sector engagers.[2] This was a disappointing response by the Government to the need for fundamental reform of the tax issues around employment status and tax motivated incorporation.

The Government's failure to deal with the root of the problem has resulted in much comment and unsatisfactory litigation.[3] It might have been hoped that three years on and following a good deal of debate and various reports and reviews,[4] a better solution would have been found to the issues raised by the differential tax and National Insurance contributions (NICs) treatment of taxpayers operating through different legal forms. Unfortunately, section 7 of and Schedule 1 to the Finance Act 2020 (FA 2020) merely extend the unsatisfactory 2017 public sector rules to all medium and large engagers with a UK connection.[5]

A review of the proposals was conducted in January 2020, but this produced only relatively minor changes.[6] The date of commencement of the legislation has been deferred until April 2021 as a response to the difficulties business is experiencing due to the coronavirus pandemic. That may mean that there will be time for further changes to the detail before then, but the Government has been adamant that this is only a deferral and that the legislation will not be cancelled completely.[7] The Finance Bill Sub-Committee of the House of Lords Economic Affairs Committee

[1] The amended legislation is found in ITEPA Pt 2, Ch.8. The word "workers" here is defined in ITEPA s.49, in similar but not identical terms to that used in the Employment Rights Act 1996.

[2] FA 2017 s.6 and Sch.1. For a full discussion see G. Loutzenhiser, "Finance Act 2017 Note: Section 6 and Schedule 1: workers' services provided to public sector through intermediaries" [2017] BTR 518.

[3] e.g. for a useful list of all recent IR35 cases, see *IR35 Court Cases: History of all cases and references to judgments*, available at: *https://www.contractorcalculator.co.uk/ir35_court_cases_judgments.aspx* [Accessed 28 October 2020].

[4] See, for example, Department for Business, Energy and Industrial Strategy, *Good Work: The Taylor Review of Modern Working Practices* (Taylor Review) (2017), available at: *https://www.gov.uk/government/publications/good-work-the-taylor-review-of-modern-working-practices* [Accessed 28 October 2020]; S. Adam, H. Miller and T. Pope, "Tax, Legal Form and the Gig Economy" in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget:2017* (IFS, 2017); D. Tomlinson and A. Corlett, *A tough gig? The nature of self-employment in 21st Century Britain and policy implications* (2017), available at: *https://www.resolutionfoundation.org/app/uploads/2017/02/Self-employment-presentation.pdf* [Accessed 28 October 2020]; A. Adams, J. Freedman and J. Prassl, "Rethinking Legal Taxonomies for the Gig Economy" (2018) 34(3) *Oxford Review of Economic Policy* 475; S. Adam and H. Miller, "Principles and practice of taxing small business" (2019) IFS Working Paper W19/31.

[5] For an excellent history of the discussions around IR35 and subsequent developments see HC Briefing Paper 5976, September 2020, available at: *https://commonslibrary.parliament.uk/research-briefings/sn05976/* [Accessed 28 October 2020].

[6] HM Treasury and HMRC, *Review of changes to the off-payroll working rules: report and conclusions* (February 2020), available at: *https://www.gov.uk/government/publications/review-of-changes-to-the-off-payroll-working-rules-report-and-conclusions* [Accessed 28 October 2020].

[7] HMRC, Promotional material, *Off-payroll working rules: communication resources* (27 February 2020), available at: *https://www.gov.uk/government/publications/off-payroll-working-rules-communication-resources* [Accessed 28 October 2020].

has called for a rethink by the Government of its approach to this legislation.[8] U-turns do happen, especially in current uncertain times, but at the moment there are no signs of one in this case and those affected need to prepare for change.[9] This note first examines the provisions in section 7 and Schedule 1 FA 2020, then considers the policy issues around these provisions in relation to employment status case law generally. The following two sections consider developments in employment law that raise issues for the treatment of employment status in the tax law cases. The note then concludes by doubting the viability of these provisions, relying as they do on unsettled and developing case law, as a way of dealing with fundamental structural difficulties in this area.

The legislation

Section 7 and Schedule 1 FA 2020 were introduced to the Bill at report stage and amend Chapters 8 and 10 of Part 2 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA).[10] Attempts in the Finance Bill Committee to remove the amendment or delay or defer implementation were either not moved or were defeated.[11] The extension to the off-payroll scheme to the private sector is introduced in a convoluted way by amendment to provisions already amended in 2017. As a result, the amendments are lengthy and impossible to understand as a stand-alone exercise.

It would have been preferable for the original IR35 legislation to have imposed responsibility for payment on the client rather than the worker, as argued by one of the writers of this note at the time.[12] However, given that the legislation was not drafted in this way, its subsequent adaptation to achieve this result is cumbersome and results in a burden and uncertainty for the client and the worker.

Paragraph 9 of Schedule 1 FA 2020 amends section 61K ITEPA. It widens the scope of Chapter 10 of Part 2 ITEPA to bring in all public authorities and any client that has a UK connection (as defined in new section 60I ITEPA) and that does not qualify as "small" (as provided for in new sections 60A to 60G ITEPA). That is, the provisions now apply to large and medium organisations as well as an expanded set of public authorities. Large and medium organisations are defined largely by reference to the definition of small companies in the Companies Act 2006, but further provisions are included to prevent avoidance and cover unincorporated firms. Those dealing

[8] House of Lords Economic Affairs Committee Finance Bill Sub-Committee, 1st Report of Session 2019–20, *Off-payroll working: treating people fairly* (27 April 2020), HL Paper 50, available at: *https://committees.parliament.uk/publications/786/documents/4841/default/* [Accessed 28 October 2020].

[9] P. Simmons, "HMRC: prepare for IR35 changes despite Covid-19 challenges", *Pinsent Masons Out-Law News*, 22 September 2020, available at: *https://www.pinsentmasons.com/out-law/news/hmrc-prepare-for-ir35-changes-despite-covid-19-challenges?utm_source=emerge&utm_medium=email&utm_campaign=3492718c-0af1-425c-88f3-22b38d8382f2* [Accessed 28 October 2020].

[10] The Explanatory Memorandum, "New Clause 1 and New Schedule 1: Workers' services provided through intermediaries", available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/886097/Workers__services_provided_through_intermediaries_-_EN.pdf* [Accessed 28 October 2020]. There are also many HMRC guidance notes at HMRC and HM Treasury, *Off-payroll working (IR35): detailed information*, available at: *https://www.gov.uk/topic/business-tax/ir35* [Accessed 28 October 2020].

[11] G. Crozier, *Finance Bill 2020 report stage day 1* (Chartered Institute of Taxation, 1 July 2020), available at: *https://www.tax.org.uk/media-centre/blog/media-and-politics/finance-bill-2020-report-stage-day-1* [Accessed 28 October 2020].

[12] J. Freedman, "Personal service companies — 'the wrong kind of enterprise'" [2001] BTR 2.

with small organisations remain under the old IR35 regime, so no law is swept away; there is simply another layer. As a result, a worker needs to know whether the client is small or not, so a new section 60H ITEPA imposes a duty on the client to confirm whether it is "small" as defined within 45 days. Thus small businesses are not excluded from all burdens, and workers have an additional hoop through which to jump.

Where the new rules do apply, the client or party paying the worker's intermediary (the intermediary is generally a personal services company (PSC), but could also be a partnership or an LLP), is defined as the "fee-payer".[13] The "fee-payer" is treated as an employer for the purposes of income tax and Class 1 NICs. The amount paid to the worker's intermediary for the worker's services is deemed to be a payment of employment income, or of earnings for Class 1 NICs for that worker. Therefore, the fee payer must deduct tax and employers' and employees' NICs in the same way as an employer must do and then remit these payments to HMRC using Real Time Information (RTI). However, these deemed payments do not make the worker an employee, so the fee-payer is not responsible for making statutory payments or automatic pension enrolment. They come via the worker's own intermediary, usually the PSC, which is the employer. The worker also does not gain any rights to holiday pay by virtue of this tax liability.[14]

The lack of matching between the tax and NICs payable and the employment rights obtained may appear unfair, but it is the worker and the client who have set the arrangement up in this way, so that the employer is the intermediary and statutory rights attach to that employment. The answer is to move to a normal employment arrangement as some clients appear to be doing.[15] To the extent this is happening, this may be thought by some to be a good change and one that is in accordance with Government objectives. If employment is resisted due to a desire for flexibility rather than for tax reasons, as sometimes claimed, it should be possible to obtain the desired flexibility through the terms of a contract of employment that would also give appropriate statutory rights.[16] To the extent that cannot be achieved, it is an issue to be tackled by employment law, rather than by distorting tax law.[17]

Under the new provisions, the client is required to determine the employment status of the worker, contract by contract. The determination must be communicated using a Status

[13] The definition of fee-payer is complex and can be found in ITEPA s.61N. There are particular complications where the intermediary is a company and certain conditions are imposed to define when the legislation should apply in ITEPA s.61O. It is not intended that s.61N should apply where a worker would be treated as an employee of an umbrella company in any event. FA 2020 Sch.1 amends those conditions to protect against a perceived avoidance threat but in doing so has widened the provisions to such an extent that some umbrella companies and agency arrangements appear to be caught. HMRC have now confirmed that it is not intended that the ITEPA Ch.10 legislation should apply to such arrangements. It remains to be seen whether this will be dealt with by a further amendment to the legislation in 2021 or left to guidance—see P. Simmons, "IR35: workers already subject to PAYE not caught by new rules", *Pinsent Masons Out-Law News*, 16 October 2020, available at: *https://www.pinsentmasons.com/out-law/news/ir35-workers-already-subject-to-paye-not-caught-by-new-rules* [Accessed 28 October 2020].

[14] HMRC, Guidance, *Fee-payer responsibilities under the off-payroll working rules* (published 22 August 2019; last updated 20 March 2020), available at: *https://www.gov.uk/guidance/fee-payer-responsibilities-under-the-off-payroll-working-rules* [Accessed 28 October 2020].

[15] A. Carrick, "IR35: Businesses welcome delay, but many have already cut contractors", *City A.M.*, 18 March 2020, available at: *https://www.cityam.com/ir35-businesses-welcome-delay-but-many-have-already-cut-contractors/* [Accessed 28 October 2020].

[16] H. Collins, K.D. Ewing and A. McColgan, *Labour Law*, 2nd edn (Cambridge: CUP, 2019), 179–184.

[17] Taylor Review, above fn.4.

Determination Statement (SDS). New section 61NA ITEPA requires the SDS to set out the client's conclusion with respect to the status of the engagement as well as the reasons for reaching that conclusion. The section also requires the client to take reasonable care when reaching its conclusion. There are detailed rules for dealing with disputes in new section 61T ITEPA. Further complex rules are required for cases where there is a supply chain involving an agency or some other arrangement under which the client is not the fee-payer.[18] The bottom line is that if the fee-payer as defined does not make the payment, HMRC can recover from the client, who is the end user. Again, it is not surprising that clients and agencies are complaining about the administrative costs of these new provisions. Although a light touch is promised in the first year of operation, as one of the promises arising out of the Government's review of these changes, there will still be a considerable cost in compliance.[19]

There is encouragement for clients to use HMRC's Check Employment Status for Tax Tool (CEST) when completing the SDS. The output provided by CEST can be used as an SDS and HMRC have stated that they will abide by it, provided accurate information was fed into the program. However, this is going to be difficult to enforce and there is some cynicism about the promise, given that HMRC successfully challenged IR35 status assessments obtained by the NHS.[20] There could be disputes about what is accurate information, given that the questions, being based on employment status case law, are very fact-based and may involve some subject judgements. The process may require detailed knowledge of the worker's circumstances and could be time consuming and costly for all the parties, especially since it has to be a contract by contract determination.

This will give the client an incentive to apply a blanket decision to treat all workers operating through a PSC as being covered by the IR35 tax rules for the purposes of the off-payroll rules in FA 2020. The experience with public authorities has been that there is a tendency to play safe.[21] The workers can dispute this, but they may not feel that they are in a powerful enough position to do this if they need the work, particularly in the post pandemic climate. The workers fear that the extra costs will be borne by them. In theory this should not happen as they can negotiate for higher pay, but in the current environment this may not be easy. On the other hand, it is interesting to note that those workers working for public authorities and therefore covered by the 2017 off-payroll provisions already when the pandemic began were covered by the Coronavirus Job Retention Scheme (CJRS) because they were paying tax through PAYE, whereas

[18] Osborne Clarke, *IR35 update: end user liability where its supply chain fails to pay* (28 September 2020), available at: *https://www.osborneclarke.com/insights/ir35-update-end-user-liability-supply-chain-fails-pay/* [Accessed 28 October 2020].

[19] HM Treasury and HMRC, Policy paper, *Review of changes to the off-payroll working rules: report and conclusions* (February 2020), available at: *https://www.gov.uk/government/publications/review-of-changes-to-the-off-payroll-working-rules-report-and-conclusions* [Accessed 28 October 2020].

[20] K. Dooks, Kemp Little LLP, *Off Payroll Working rules/IR35 — health warning for CEST test users and other latest news* (31 October 2019), available at: *https://www.kemplittle.com/blog/off-payroll-working-ir35-health-warning-cest/* [Accessed 28 October 2020].

[21] House of Lords Economic Affairs Committee Finance Bill Sub-Committee, above fn.8.

many who were operating a PSC and not paying tax on substantial sums through PAYE because they were paying themselves by way of dividends were not well protected by the CJRS.[22]

Policy issues and developing employment status case law

This off-payroll legislation may result in some shifting toward more employment and less use of PSCs, as discussed above. This may be the desired outcome and it should be possible to manage it in such a way that it is a positive development for clients and workers, other than the increased tax and NICs due, which is, of course, the object of the exercise. Even where there is no such behavioural change, the provisions should make IR35 more effective and bring in some useful revenue.[23]

However, there is a major flaw in the plan from the Government's point of view, which is the uncertainty around the operation of IR35. With large sums at stake and major businesses acting as clients and being directly affected by SDSs there will be a stronger incentive than ever to litigate employment status issues, because IR35 continues to rely on case law that continues to develop rapidly in the employment law field as well as in connection with taxation. The case law about employment status is supposed to be the same, although there are some differing statutory modifications to employment law and tax law. The most important of these differences is that employment law has a tripartite classification (employee; worker (with some but not all of the rights of an employee); and the self-employed who is not a worker) whereas tax law only has a bipartite classification: employed; or self-employed. Therefore the tax classification does not map directly and easily onto the employment law definitions of the statutory concept of worker, as has been seen in Supreme Court cases.[24] There may also be differences in emphasis and approach in employment tribunals and tax tribunals, because of the different purposes of the legislation they are applying and because facts will be presented differently. However, there is cross-referencing and cross-fertilisation. In one area, the role of mutuality of obligation as a factor in determining employment status, a highly contentious development in employment law cases is being harnessed by tax lawyers to argue that IR35 does not apply. HMRC have consistently argued that mutuality does not need to be a separate factor in tax cases, since the existence of a binding contract is enough to show that mutuality of obligation exists. Therefore, mutuality of obligation should not be relevant in tax cases.[25] But some recent decisions have suggested otherwise, most notably *HMRC v Professional Game Match Officials Ltd* (*PGMOL*).[26]

[22] Direction under Sections 71 and 76 of the Coronavirus Act 2020 dated 15.4.2020; discussed in J. Freedman, "Employment Status, Tax and the Gig Economy-Improving the Fit or Making the Break?" (2020) 31 *King's Law Journal* 194.

[23] At the 2020 Budget it was estimated that the measure would raise £4.2 billion from 2019–2025 if introduced in 2020. HM Treasury, *Budget 2020: Table 2.2: Measures announced at Budget 2018 or earlier that will take effect from March 2020* (March 2020) (item f). Annual receipts were estimated to be: -£150m (2019/20); £1,190m (2020/21); £705m (2021/22); £710m (2022/23); £800m (2023/24); £870m (2024/25).

[24] *Clyde & Co LLP and another v Bates van Winklehof* [2014] UKSC 32; *Pimlico Plumbers Ltd v Smith* [2018] UKSC 29.

[25] HMRC, *IR35 Forum - HM Revenue and Customs Paper on Mutuality of Obligation (MOO)* (IR35 Forum) (July 2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/722316/HMRC_paper_on_Mutuality_of_Obligation.pdf* [Accessed 28 October 2020].

[26] *HMRC v Professional Game Match Officials Ltd* [2020] UKUT 147 (TCC). See also *RALC Consulting Ltd v HMRC* [2019] UKFTT 702 (TC); *Canal Street Productions Ltd v HMRC* [2019] UKFTT 647 (TC) and *HMRC v Kickabout*

The Government's strategy for dealing with the problem by extending the operation of IR35 and improving enforcement through the new payroll obligations may well fail if taxpayers defeat the application of IR35 in the courts.

With that in mind the next two sections of this note examine employment status issues from an employment law perspective.

Piercing personal service companies in employment tribunals

Although some providers of services prefer to enter contracts for work through PSCs for tax reasons or otherwise, it is known that, at least without the FA 2020 provisions under discussion here, it is often engagers who insist that their workers should form a PSC through which they will supply their services to the engager. This transaction can be done routinely by the engager requiring the worker to sign an elaborate standard form contract that both creates a corporate entity and provides a contract for services between the engager and the PSC. This practice can occur in contexts where the workers are unlikely to read or understand the documentation. In practice the work relationship will be indistinguishable from an employment relationship, including the fact that wages are paid into the personal bank account of the worker, not a newly created account for the PSC. The engager's motivation for this stratagem is likely to be the avoidance of employment law rights, discrimination law, and aspects of immigration law. This stratagem relies on the construction of a separate legal identity for the PSC. The contract between the engager and the PSC cannot be a contract of employment because the company does not provide the work personally itself, but rather through its (only) employee. According to orthodox company law, therefore, as reasserted by the Supreme Court in *Prest (Appellant) v Petrodel Resources Ltd and others (Respondents)* (*Prest*),[27] the corporate form cannot be ignored or pierced except in limited circumstances such as fraud, with the consequence that the engager is deemed not to have a contract of employment with the worker. Is there a way to avoid that conclusion?

One possibility is to develop the reasoning of the Supreme Court in *Autoclenz Ltd (Appellant) v Belcher and others (Respondents)* (*Autoclenz*).[28] In that case the Supreme Court was willing to look behind the formal contractual document signed by the valets in a car wash to ascertain from the practice and expectations of the parties what their true agreement had been. Although the express terms of the formal contract appeared to create a relationship of independent contracting, in practice the agreement functioned in a way that was indistinguishable from a normal contract of employment. Notwithstanding the form of their agreement, the Court held that the true purpose of the parties was to create an employment relationship. The question arises whether this technique can be extended to pierce the corporate veil in the sense that, despite the formal contractual arrangements involving a PSC, a court or tribunal can conclude that the true agreement between the parties did not really involve the use of a PSC and was in practice indistinguishable from a normal employment relationship.[29]

Productions Ltd (*Kickabout*) [2020] UKUT 216 (TCC), where an obligation to provide work was found to exist so that the issue of the meaning of the irreducible minimum for mutuality of obligation was not fully explored at [71].

[27] *Prest (Appellant) v Petrodel Resources Ltd and others (Respondents)* [2013] UKSC 34; [2013] 2 AC 451.

[28] *Autoclenz Ltd (Appellant) v Belcher and others (Respondents)* [2011] UKSC 41; [2011] ICR 1157.

[29] See M. Ford, "The Fissured Worker: Personal Service Companies and Employment Rights" (2020) 49(1) *Industrial Law Journal* 35, 75.

Support for such a development comes from the Court of Appeal in *Protectacoat Firthglow Ltd v Miklos Szilagyi*.[30] As a condition of offering work, the engager required the applicant to find an assistant to help him to do the work of exterior painting on houses together, and then the engager required them to sign a standard form contract that described the workers as a partnership under the Partnership Act 1890 and made provision for the division of the fees paid to the partnership. A separate contract between the partnership and the engager arranged for the provision of painting services as required by the engager at prices to be agreed with the partnership. Payment of fees was in theory supposed to be made to the partnership, but in practice they were made to the personal bank accounts of the applicant and his assistant net of tax. In a further contract, the applicant "hired" a van and all the tools needed for the work from the employer, though in practice no charge was made by the engager. The service contract stated that the partnership could work for other clients, but in practice other work was forbidden. On a claim for unfair dismissal brought by the applicant, the engager argued that there could be no contract of employment with a partnership. In a decision that was subsequently approved by the Supreme Court in *Autoclenz*, the Court of Appeal upheld the decision of the employment tribunal that the contractual documents were a sham and that the true agreement was one of a contract of employment. The case demonstrates how a search for the true agreement between the parties can discount the presence of a partnership agreement as being in practice irrelevant to the transaction. Sedley LJ observed, however, that even if the partnership agreement was genuine, there could have been contracts of employment with the two men, with the partnership merely dividing up their combined income. He seems to have doubted, however, whether direct contracts of employment could co-exist with the interposition of a corporate entity.

Nevertheless, employment tribunals have used the search for the true agreement between the parties, as endorsed by *Autoclenz*, to discover contracts of employment despite the formal documents including the use of a PSC. *Catamaran Cruisers Ltd v Williams and others*[31] provides an early example of a case where the Employment Appeal Tribunal (EAT) found a contract of employment despite the presence of a PSC. The decision was assisted perhaps by the fact that the applicant had formerly been an employee of the employer and had been required by the engager to enter these new contractual arrangements in order to keep his job. In a recent case, *G. Badara v Pulse Healthcare Ltd*,[32] on appointment a care-worker was required by the engager to sign documents that purported to create a PSC through which the applicant would provide his services under a contract for services between the employer and the PSC. On considering claims for unfair dismissal, discrimination, and deduction of wages, the employment tribunal held that contrary to the apparent terms of the service agreement, following the approach in *Autoclenz*, the applicant worked under a contract of employment, though the terms of the service agreement were relevant to the terms of the employment relationship. What is noticeable is that this extension of *Autoclenz* to disregard the interposition of a corporate entity was not challenged or questioned on an appeal by the employer to the EAT.

These decisions therefore indicate that PSCs that are artificial constructions for the purpose of avoiding the legal responsibilities of an employer will be disregarded if in practice the way

[30] *Protectacoat Firthglow Ltd v Miklos Szilagyi* [2009] EWCA Civ 98; [2009] ICR 835.
[31] *Catamaran Cruisers Ltd v Williams and others* [1994] IRLR 386 (EAT).
[32] *G. Badara v Pulse Healthcare Ltd* [2020] ICR 819 (EAT).

the agreement is performed and the expectations of the parties show that the true agreement is a contract of employment. Is this approach inconsistent with the reassertion of the doctrine of a separate corporate entity in *Prest*?[33] The focus of the Supreme Court in that case was on instances where one person had created an artificial corporate entity for some ulterior purpose such as fraud or tax evasion. The Court did not discuss the issue that often arises in employment cases that although the worker appears to have created the PSC, in fact it has been imposed by the engager with a view to minimising its exposure to employment law rights. In enunciating the anti-evasion principle under which a court could pierce the corporate veil, Lord Sumption said:

> "I conclude that there is a limited principle of English law which applies when a person is under an existing legal obligation or liability or subject to an existing legal restriction which he deliberately evades or whose enforcement he deliberately frustrates by interposing a company under his control. The court may then pierce the corporate veil for the purpose, and only for the purpose, of depriving the company or its controller of the advantage that they would otherwise have obtained by the company's separate legal personality."[34]

This principle does not apply to the employment cases discussed above because technically it is not the engager that controls the company but the worker. Nevertheless, the employment cases match the spirit of the exception to corporate personality because the employer compels the formation of a PSC to provide an immunity to the employer against employment law rights and to frustrate their enforcement.

Had it been possible to pierce the corporate veil where intermediary PSCs were inserted for tax purposes, IR35 may never have been required. It is not clear that employment law approaches to looking through the intermediary will translate to tax cases, but it might be possible for them to do so in extreme cases. There is a question mark over the tax implications if a PSC is disregarded by an employment tribunal but was recognised for tax purposes, whether or not IR 35 was applied.

Mutuality of obligation

Assuming that in many cases we shall not be able to disregard the existence of a PSC, are HMRC right to suggest that mutuality should not be significant in tax cases?[35] Or are the courts in these recent cases showing HMRC are wrong, meaning that IR35 will apply in far fewer cases than HMRC think?

This raises two questions:

1. Have recent employment law cases decided the mutuality issue correctly?
2. Whatever the answer is to that, is mutuality in the employment law cases being applied accurately in the tax decisions?

[33] *Prest*, above fn.27, [2013] UKSC 34; [2013] 2 AC 451.
[34] *Prest*, above fn.27, [2013] UKSC 34; [2013] 2 AC 451 at [35].
[35] IR35 Forum, above fn.25.

Recent employment law cases: mutuality and umbrella contracts

What is the function of the concept of "mutuality" in employment law cases? The answer is not straightforward because occasionally the concept has been used in two different senses. In employment law, the issue of mutuality arises primarily in the context of questions about employment status in connection with casual workers and others who only work on an intermittent basis. In such cases, three separate issues arise. 1. When work is actually being performed in return for payment, there is presumably a contract, but it needs to be classified as employment or some other kind of contract for services. 2. In the gaps between performance of intermittent work, does some kind of long-term binding contract exist? 3. If there is a binding long-term contract, it needs to be classified as employment or some other kind of contract for services.

The idea of mutuality was introduced in employment law cases to address the second question about the existence of a long-term contract. As Elias J explained in *Stephenson v Delphi Diesel Systems Ltd*,[36] the significance of mutuality was solely that it "determines whether there is a contract in existence at all". Unfortunately, the idea of mutuality has sometimes been used by employment tribunals as well to address the third question: a mistake that recently seems to have spread like a virus to tax tribunals.

In the context of the second question, the word mutuality is used in employment tribunals merely as a synonym for the general requirement in contract law of consideration to support a binding contract. The requirement of consideration signifies an exchange: in return for what one party has requested the other party agrees to confer a benefit requested by the other. Both parties have to agree to provide something in return for the other's promise. In the context of arrangements for work, the exchange that counts as consideration usually concerns the payment of wages in return for the performance of work (or being available to perform work). In arrangements for intermittent work, other kinds of consideration may be discovered: one party may promise to pay the other a retainer or a minimum sum each month in return for the other promising to perform work in return for further remuneration, if and when called upon. This would be a contractual arrangement because there is an exchange: a promise to pay a retainer in exchange for a promise to perform work if and when required. The exchange may also be constituted by an exclusive dealing arrangement: here the employer promises not to hire anyone else for the work and in return the worker promises to accept a job if and when called upon. If there is consideration, then some kind of long-term framework or umbrella contract exists. On the other hand, a worker's bare promise to perform work if and when required but not in exchange for any kind of undertaking by the employer to provide work or some other benefit would not count as a contract because there is no exchange or consideration. In *Nethermere (St Neots) Ltd v Taverna and Gardiner* (*Nethermere*),[37] when the Court of Appeal first used the terminology of mutuality, a majority upheld the Tribunal's finding of an umbrella contract because there was evidence from the dealings between the parties of a mutual obligation to offer work and to accept it, even though the quantities and timing were flexible. The idea of mutuality was introduced to

[36] *Stephenson v Delphi Diesel Systems Ltd* [2003] ICR 471 (EAT) at [11]. See also: *Cotswold Developments Construction Ltd v Williams* [2006] IRLR 181 (EAT) at [47]–[48] (Langstaff J).
[37] *Nethermere (St Neots) Ltd v Taverna and Gardiner* [1984] IRLR 240; [1984] ICR 612 (CA).

address the question of whether there was a long-term contract in existence, not what type of contract it was.

The third question to ask is what kind of long-term contract exists. In particular, the question will be asked whether the umbrella contract is a contract of employment. This is a much more difficult issue. In *H. O'Kelly and others v Trusthouse Forte plc* (*O'Kelly*),[38] waiters who worked as required at banqueting functions at a hotel claimed that they had been unfairly dismissed for establishing a trade union when on account of their organisational activities they were no longer called to work at functions. The Tribunal had held that the waiters were independent contractors, though without expressly considering the possible difference between the classification of the short-term contracts to serve at a banquet one evening on the one hand and the existence and classification of umbrella contracts on the other. Furthermore, borrowing from *Nethermere*,[39] the Tribunal had used the requirement of mutuality to serve the different purpose of classification when it said:

> "It was a purely commercial transaction for the supply and purchase of services for specific events, because there was no obligation for the appellants to provide further work and no obligation for the respondents to offer their further services."[40]

Although the Tribunal recognised that the classification of contracts requires a multi-factor approach in which one element cannot be decisive, it clearly attached decisive importance to the absence of mutuality in its process of classification between employment and independent contracting.

The Court of Appeal in *O'Kelly* upheld the decision of the Tribunal as disclosing no error of law, but Lord Donaldson MR did revert to the correct use of mutuality as a criterion for answering the second question (that is, in the gaps between performance of intermittent work, does some kind of long-term binding contract exist?) when he said:

> "Although I, like the Employment Appeal Tribunal, am content to accept the Industrial Tribunal's conclusion that there was no overall or umbrella contract, I think that there is a shorter answer. It is that giving the applicants' evidence its fullest possible weight, all that could emerge was an umbrella or master contract *for*, not *of*, employment. It would be a contract to offer and accept individual contracts of employment and, as such, outside the scope of the unfair dismissal provisions."[41]

In *Carmichael and another v National Power plc* (*Carmichael*),[42] in the context of the question of whether a long-term contract existed, giving judgment for a unanimous House of Lords, Lord Irvine LC confirmed that the test of mutuality was directed towards the existence of an umbrella contract, though his precise phrase unfortunately introduced some ambiguity when he described the absence of the "irreducible minimum of mutual obligation necessary to create a contract of service".[43] He added the final two words "of service" which were unnecessary to the decision,

[38] *H. O'Kelly and others v Trusthouse Forte plc* [1984] QB 90 (CA).
[39] *Nethermere*, above fn.37, [1984] IRLR 240; [1984] ICR 612 (CA).
[40] *O'Kelly*, above fn.38, [1984] QB 90 (CA), per Ackner LJ citing the majority decision of the Industrial Tribunal.
[41] *O'Kelly*, above fn.38, [1984] QB 90 (CA) at 125.
[42] *Carmichael and another v National Power plc* [1999] ICR 1226 (HL).
[43] *Carmichael*, above fn.42, [1999] ICR 1226 (HL), per Lord Irvine LC at 1230G-H.

because no-one appeared to doubt that, if an umbrella contract had existed in that case, it would have been classified as a contract of employment.

Have courts and employment tribunals used the idea of mutuality in other employment law cases as one of the factors in the multi-factor test for the classification of contracts for the performance of work? The short answer is no. However, it is true that some tribunals have elided the second and third questions and appear to have used the idea of mutuality to address both issues. In *Stringfellow Restaurants Ltd v Quashie* Elias LJ was forced to admit that mutuality had sometimes been used in two senses: "sometimes it means that there are no obligations of any kind, and sometimes it means there were no obligations of the kind necessary to establish a contract of employment".[44] In that case the Tribunal had concluded that the club was under no obligation to provide the dancer with work and nor was it obliged to pay her a wage when she did work because her income came from payments and tips from clients. On those facts the Tribunal concluded that there was no contract of employment because there was no "mutuality" since the employer did not have to pay some kind of remuneration. This reasoning confused the question of whether there was any contract at all with the issue of whether it was a contract of employment. This confusion was perhaps understandable because the factor that most influenced the Tribunal in its characterisation of the contract was the absence of an obligation to pay wages, which is normally a characteristic and core feature of contracts of employment and part of their consideration. The Court of Appeal upheld the decision, finding, contrary to the decision of the Tribunal, that there was an umbrella contract, but that it was a contract for services. The Court of Appeal agreed that an obligation to pay wages was a normal, though not a necessary, feature of contracts of employment and it was therefore a relevant factor to take into account in the process of classification of the contract. Apart from such slightly confused examples in lower tribunals, in employment cases there has been, the writers suggest, no deviation from the proposition that mutuality goes to the existence of a contract, not its proper classification.

Nevertheless, as demonstrated in *PGMOL*,[45] the Upper Tribunal (Tax) (UTT) has been persuaded to treat mutuality as one of the criteria in the multi-factor test for determining the issue of whether a person performing work is properly classified as an employee or an independent contractor. The case concerned referees who officiated at Football League matches in their spare time as and when required. The central issue was whether the referees were employees, either when they officiated at a particular match or, if there was a long-term umbrella contract for the whole season, whether that umbrella contract was a contract of employment. The UTT posed the question whether the idea of mutuality of obligation concerned only the question of existence of a contract or whether it was a factor to be used in the classification of the contract as one of employment or a contract for services.[46] Contrary to the submissions of HMRC, the UTT concluded that the employment law cases had decided that mutuality was relevant to the question of classification. How did the Tribunal reach this conclusion?

[44] *Stringfellow Restaurants Ltd v Quashie* [2012] EWCA Civ 1735; [2013] IRLR 99 at [42].
[45] *PGMOL*, above fn.26, [2020] UKUT 147 (TCC).
[46] *PGMOL*, above fn.26, [2020] UKUT 147 (TCC) at [36].

The confusion starts with the common practice in tax cases of describing the first criteria for classification of contracts for work famously laid down by McKenna J in *Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* (*RMC*)[47] as the test of mutuality[48]:

> "The servant agrees that, in consideration of a wage or other remuneration, he will provide his own work and skill in the performance of some service for his master."

In fact this first criterion elides two issues: is there consideration to support a contract; and, if so, is this consideration the kind that might be part of a contract of employment, such as the payment of a wage by the employer and the performance of work personally by the worker. In itself, this criterion does not, of course, distinguish between employment and independent contracting, for apart from the antiquated language of master and servant, the first test clearly includes many independent contractors and self-employed workers. The first test in *RMC* is not the test of mutuality that is used in employment law.

Next, it is submitted that unfortunately quotations from judgments in employment law cases were relied upon in the UTT in *PGMOL* without giving sufficient weight to the context in which they were made. The reasoning of the UTT commenced with the quotation from Lord Irvine in *Carmichael* recited above, which was treated as stating that mutuality is relevant to classification of contracts, even though that issue was not in point. The issue in *Carmichael* was whether there was a long-term contract and Lord Irvine answered in the negative because of the absence of mutuality. The question of the proper classification of the putative umbrella contract simply did not arise.

Similarly, the UTT in *PGMOL* relied heavily on a remark by Mummery LJ when he said in *James v Greenwich LBC* (*James*)[49]:

> "The mutuality point is important in deciding whether a contract, which has been concluded between the parties, is a contract of employment or some other kind of contract."[50]

This remark was made in the context of pointing out that the case under consideration concerning an agency worker raised the different question of whether it was possible to imply a contract between the worker and the client by necessity (not the existence of a long-term contract for intermittent employment) and that therefore the mutuality point was irrelevant to the case at hand. Earlier in the judgment Mummery LJ had endorsed the analysis of Elias J in the EAT below, where mutuality had been confined to the question of the existence of a long-term contract for intermittent employment. Nevertheless, the UTT in *PGMOL* treated Mummery LJ's remark as putting the issue that mutuality is relevant to the question of classification "beyond doubt".[51]

As well as apparently misunderstanding the point of some of the earlier judicial dicta, the UTT in *PGMOL* was also persuaded to discount the significance of recurrent statements in

[47] *Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* [1967] EWHC QB 3; [1968] 2 QB 497 at 515C-D.
[48] *PGMOL*, above fn.26, [2020] UKUT 147 (TCC) at [11]; *Kickabout*, above fn.26, [2020] UKUT 216 (TCC).
[49] *James v Greenwich LBC* [2008] EWCA Civ 35; [2008] ICR 545.
[50] *James*, above fn.49, [2008] EWCA Civ 35; [2008] ICR 545 at [45]. The quotation in *PGMOL*, above fn.26, [2020] UKUT 147 (TCC) omitted the words "kind of" but this makes no difference to the point being made here.
[51] *PGMOL*, above fn.26, [2020] UKUT 147 (TCC) at [44].

employment law cases that mutuality only concerns the existence of the contract. For instance, the UTT refers to Elias LJ "rowing back" on his earlier view when he made the statement quoted above in *Stringfellow Restaurants Ltd v Quashie* that mutuality had sometimes been used for classification purposes as well by tribunals. But this observation does not imply an endorsement of this practice, and this approach of the Tribunal in the case was subjected to rigorous criticism. Similarly, in referring to a case where Lewison J expressed the view that mutuality only concerns the existence of the contract,[52] the UTT attached little weight to the remark on the ground that the mutuality point was not relevant to the decision in the case.

The readings of the previous cases by the UTT in *PGMOL* and the weight accorded to the various comments seem highly selective. One can only admire the skill with which counsel for the respondent in the UTT in *PGMOL* undermined the clear and consistent authorities in employment law cases to the effect that mutuality of obligation only concerns the existence of a contract, not its classification. However, it is submitted that on appeal to the Court of Appeal the decision in *PGMOL* ought to be reversed on the mutuality of obligation point, though not necessarily on the final conclusion that the part-time referees were independent contractors.[53] It is interesting to note that in *HMRC v Kickabout Productions Ltd*[54] the UTT explicitly refrained from considering whether HMRC were correct in their contention that an obligation on the employer to provide work is not necessary for the "irreducible minimum" of mutuality to be present and from commenting on the correctness or otherwise of the decision in *PGMOL* on that point.[55] The outcome of the *PGMOL* case in the Court of Appeal will be significant to the effectiveness in future of IR35 and thus the off-payroll rules discussed here.

Conclusion

The off-payroll provisions in FA 2020 are highly complex. In theory they do not change the tax payable or the law applicable, but only the determination and collection procedure. In practice they impose a considerable burden on clients, which often will be met either by reclassifying workers as employees or by a blanket classification of them as being covered by IR35. Despite the rights given to workers in the legislation, in practice it will be very hard for them to challenge such a determination. This will leave some workers paying tax and NICs as if they were employees but without employee statutory rights or other employment rights vis-à-vis the client (though they do have them as against the employing PSC). In theory this could be balanced by the workers charging higher fees to clients, although in the current climate for many this may be difficult. The real solution is to change the underlying system so that all workers pay similar amounts of tax and NICs regardless of legal form. Any distinctions that do need to be drawn between different kinds of suppliers of labour need to be devised with the objectives of the regulation concerned in mind. For employment law the questions raised are regulation and protection issues. In the case of taxation the issues are horizontal equity, efficiency and how to improve administration

[52] *Cornwall CC v Prater* [2006] EWCA Civ 102; [2006] ICR 731 (CA).
[53] *PGMOL* is listed to be heard by the Court of Appeal in July 2021: *Case Tracker for Civil Appeals*, available at: *https://casetracker.justice.gov.uk/getDetail.do?case_id=20201392* [Accessed 28 October 2020].
[54] *Kickabout*, above fn.26, [2020] UKUT 216 (TCC).
[55] *Kickabout*, above fn.26, [2020] UKUT 216 (TCC) at [71]. The same Judge, Zacaroli J, sat in both *PGMOL*, above fn.26, [2020] UKUT 147 (TCC) and *Kickabout* but with different UTT judges in each case.

and compliance. There is no principle that would require employment law and tax to draw lines between different groups in the same place.[56]

However, the position of those caught by this off-payroll legislation can leave an unsuspecting worker getting the worst of both worlds under the current already inequitable system.

Given that this is the case there is a strong incentive for more litigation over the application of IR35, which will involve further discussion of employment status issues. The writers have argued here that though some employment tribunals may have erred in relation to the concept of mutuality, the EAT and the Court of Appeal in employment cases have consistently stated that mutuality is concerned with the existence of a contract, not its proper classification as a contract of employment or a contract for services. Unfortunately, the tax courts have apparently not understood this distinction and have been confused, perhaps, by some selective quotations. It may be that in the tax courts the virus arising in the employment courts is mutating into an even more serious form in which the test of mutuality is displacing the multi-factor test for employment. The mistake is being magnified and rigidly applied in such a way as to limit the operation of IR35. If that continues and is confirmed by higher courts, then the Government's strategy of continuing with IR35 as a solution to the problems surrounding differential tax and NICs treatment depending on choice of legal form will be severely undermined. This will not assist the evolution of the case law on employment status for either tax or employment law purposes. Perhaps the only good thing to be said for such a development is that it might drive home the need to deal with the root problem rather than dealing with it piecemeal by shifting the cost and burden onto clients and workers.

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Section 12: tax treatment of certain Scottish social security benefits

Section 12 of the Finance Act 2020 confirms that three new Scottish social security benefits are exempt from income tax with effect for the tax year 2020–21 and subsequent tax years. The benefits are: Disability Assistance for Children and Young People,[1] Job Start[2] and the Scottish Child Payment.[3] These benefits are paid by the Scottish Government.

[56] J. Freedman and H. Miller for Tax Law Review Committee, *Tax and employment status: myths that are endangering sensible tax reform* (IFS, 2020), available at: *https://www.ifs.org.uk/publications/14957* [Accessed 28 October 2020].

Employment status; Income tax; Intermediaries; Large companies; Mutuality of obligation; Personal service companies; Self-employment; Tax administration; Workers

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[1] Social Security (Scotland) Act 2018 ss.24 and 31.
[2] Employment and Training Act 1973 s.2. The Scotland Act 1998 (Transfer of Functions to the Scottish Ministers etc.) Order 2020 (SI 2020/276).
[3] Social Security (Scotland) Act 2018 s.79.

Background

The Scotland Act 2016 provides the Scottish Parliament with various powers in relation to social security benefits. These include the ability to create new benefits in areas of devolved responsibility,[4] the ability to top-up any reserved benefit[5] and the ability to make one-off discretionary payments for any reason.[6] Responsibility for certain existing Department for Work and Pensions (DWP) benefits also passed to the Scottish Government (these are mainly disability and carer benefits). The Social Security (Scotland) Act 2018 sets out the broad framework for the delivery of devolved social security in Scotland.

Disability Assistance for Children and Young People (DACYP)[7]

Disability Living Allowance (DLA) is a non-taxable benefit administered by the DWP. It helps with the extra costs of looking after a child who has difficulties walking or needs more care than a child of the same age who does not have a disability. Payment of DLA for children in Scotland is transferring from the DWP to Social Security Scotland. Due to the COVID-19 pandemic, the transfer has been delayed and at the time of writing no revised timetable has been published. DACYP is a new benefit which will replace DLA for children in Scotland. Those in receipt of DLA will have their payments transferred.

Job Start[8]

This is a new benefit to help young people, who are out of work and on certain benefits, with the costs of starting a new job. It is a one-off payment of £250 or, if the recipient is the main carer of any children, £400. It applies to young people (aged 16 to 24) and certain care leavers who have been out of paid work for six months or more, who are offered a job on or after 17 August 2020 and who meet certain other conditions at the time they are offered the job.

Scottish Child Payment[9]

This is a new benefit of £10 a week per child, payable every four weeks. The original intention was for payments to be introduced in December 2020 for eligible families with a child under six. Due to COVID-19, the introduction has been delayed. It is now the intention that applications will be possible by the end of 2020 for those with a child under six, with payments being made in 2021. By the end of 2022, it is expected that the payment will be delivered to all eligible families with a child under 16.

[4] Scotland Act 2016 s.28.
[5] Scotland Act 2016 s.24.
[6] Scotland Act 2016 s.26.
[7] Disability Assistance for Children and Young People (Scotland) 2020: draft regulations, available at: *https://www.gov.scot/publications/draft-disability-assistance-for-children-and-young-people-scotland-regulations-2020/* [Accessed 7 October 2020].
[8] Scottish Government, Job Start Payment, available at: *https://www.gov.scot/policies/social-security/job-start-payment/* [Accessed 7 October 2020].
[9] Scottish Government, Scottish Child Payment, available at: *https://www.gov.scot/policies/social-security/scottish-child-payment/* [Accessed 7 October 2020].

Broadly, the payment will be available to those resident in Scotland who are responsible for a child of the relevant age if the applicant, or their partner, is in receipt of certain benefits. The qualifying benefits are universal credit, child tax credit, working tax credit, income support, pension credit, income-based jobseeker's allowance or income-related employment and support allowance.

Tax treatment of social security benefits

Section 677(1) of the Income Tax (Earnings and Pensions) Act 2003 lists social security benefits wholly exempt from income tax. Part 1 of Table B covers benefits payable under primary legislation and Part 2 of Table B covers those payable under regulations. Both parts of Table B have been amended to ensure these three new Scottish benefits are exempt from income tax with effect from 6 April 2020 onwards.

Victoria Todd[*] and Joanne Walker[**]

Section 13: power to exempt social security benefits from income tax

Section 13 of the Finance Act 2020 introduces a new power for the Treasury to exempt social security benefits from income tax by statutory instrument.

This power will be used by the Treasury to confirm the tax treatment of social security benefits introduced by the UK Government as well as any devolved administration. The provision allows the Treasury to amend Chapter 4 or Chapter 5 of Part 10 of the Income Tax (Earnings and Pensions) Act 2003 (which covers the tax treatment of social security benefits) using regulations to exempt social security benefits from tax.[1]

Any regulations made under this new power may make different provision for different cases,[2] retrospective provision,[3] incidental or supplementary provision,[4] and consequential provision.[5] They are also governed by the procedure set out in section 1014 of the Income Tax Act 2007 which confirms that any regulations must be made by statutory instrument and that they are subject to annulment by a resolution of the House of Commons.

Children; Exemptions; Income tax; Scotland; Social security benefits

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[1] FA 2020 s.13(1).
[2] FA 2020 s.13(2)(a).
[3] FA 2020 s.13(2)(b).
[4] FA 2020 s.13(2)(c).
[5] FA 2020 s.13(2)(d).

This new power arguably makes it easier for new benefits to be designated exempt from income tax without having to include them in subsequent Finance Acts. ☞

Victoria Todd[*] and Joanne Walker[**]

Section 14: voluntary office-holders: payments in respect of expenses

Jane Doe is between the ages of 18 and 70, is of good character, has competence in understanding and communication, is socially aware, is mature and calm, has sound judgement and is committed and reliable. Every year Jane dedicates at least 13 full working days to sitting as a magistrate hearing criminal and family law cases in courts in her community.[1] Jane is the paradigm of a "voluntary office-holder"[2]: a person who has been appointed to a position by a voluntary organisation and undertakes voluntary unpaid work for that organisation. Though the precise number of voluntary office-holders in the UK is unknown, what is known is that there are 168,000 registered charities, 7,000 Community Amateur Sports Clubs, 11,500 special constables and 21,500 magistrates.[3]

Such office-holders are in a peculiar tax position by virtue of section 5 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA), which provides the general rule for parity of tax treatment between office-holders and employees. This means that monies received by the voluntary office-holder could be taxable. This is appropriate in those instances where the payments to the office-holder are in reality remuneration—then it is not really voluntary work(!)—but not so where the payments are used to reimburse genuine expenses. In this latter instance, one might expect the tax system to treat the office-holder no differently from any other volunteer. Notoriously, however, expenses are generally only deductible for an office-holder where they are incurred "wholly, exclusively and necessarily" in the performance of the duties of the role.[4] To that end, where a voluntary office-holder is reimbursed for private expenses related to the position, such as travel from home to the organisation,[5] this will strictly give rise to a tax liability. If the person were simply a volunteer without an office and also was not an employee of the organisation, then no such tax liability would arise as there is no taxable "source".[6]

☞ Exemptions; Income tax; Social security benefits; Subordinate legislation

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[1] See HM Government, *Become a magistrate*, available at: *https://www.gov.uk/become-magistrate* [Accessed 2 September 2020].

[2] FA 2020 s.14 and ITEPA s.299B.

[3] HMRC, Policy paper, *Income Tax and the treatment of expenses for voluntary office holders* (11 July 2019), available at: *https://www.gov.uk/government/publications/income-tax-and-the-treatment-of-expenses-for-voluntary-office-holders/income-tax-and-the-treatment-of-expenses-for-voluntary-office-holders* [Accessed 2 September 2020].

[4] See ITEPA s.336 and s.289A.

[5] Travel mandated by the role would be deductible: ITEPA s.337.

[6] See *Pumahaven Ltd v Williams (Inspector of Taxes)* [2002] EWHC 2237 (Ch); [2002] STC 1423 at [19] (Park J). There is no taxing provision which would subject the reimbursement to charge by virtue of the fact that the reimbursement does not derive from a contract of employment (and assuming that the volunteer's activities are not part of a trade, profession or vocation).

HMRC recognise that the payment of such expenses for voluntary office-holders is routine[7] and, by operation of a long-standing[8] concession which existed prior to the Finance Act 2020, do not treat them as taxable. The rationale behind this concessionary treatment does not appear to have been to mitigate the perceived unfairness of the underlying statutory provisions nor to ensure parity of treatment between volunteers. Neither rationale would, in any event, legally justify HMRC's concessionary approach, much as such rationales might be laudable in practice. Rather, as expressed by HMRC, concessions may only lawfully operate in a narrow set of circumstances:

> "Most concessions are made to deal with what are, on the whole, minor or transitory anomalies under the legislation and to meet cases of hardship at the margins of the code where a statutory remedy would be difficult to devise or would run to a length out of proportion to the intrinsic importance of the matter."[9]

This categorisation of concessions comes from the "Introduction" to one of HMRC's published lists of extra-statutory concessions[10] and was notoriously cited by Lord Hoffmann in *R. (on the application of Wilkinson) v IRC* (*Wilkinson*)[11] as delimiting the scope of HMRC's power to issue concessions. The categorisation is incomplete, however, as there is, for instance, another category of lawful concession which is justified on the basis of administrative convenience.[12] An example of such a concession is Flat Rate Expense Allowances (FREA).[13] A FREA agreement obviates the need for the taxpayer to retain all of their receipts in relation to expenses and for HMRC to check these receipts. Indeed, this was the rationale for the concession on reimbursements of voluntary office-holders' expenses, as noted in HMRC's *Employment Income Manual*:

> "If the sums [paid to voluntary office-holders] are small, you should not spend time examining the amounts paid to such officials to compensate them for the extra expenses they incur as a result of holding office."[14]

Though the concession may have been lawful, it has been decided to put it on a statutory footing. Section 14 of the Finance Act 2020 (FA 2020) introduces section 299B to ITEPA, which provides that:

[7] HM Treasury, *Finance Bill Explanatory Notes* (19 March 2020), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/873637/Finance_Bill_2020_Explanatory_Notes.pdf* [Accessed 2 September 2020], 23 (para.8).
[8] HMRC, *Income Tax and the treatment of expenses for voluntary office holders*, above fn.3.
[9] HMRC, *Extra-Statutory Concessions: Concessions as at 6 April 2018* (*Extra-Statutory Concessions*) (2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/733377/Extra_Statutory_Concessions.pdf* [Accessed 2 September 2020], "Introduction", para.2.
[10] HMRC, *Extra-Statutory Concessions*, above fn.9.
[11] *R. (on the application of Wilkinson) v IRC* [2005] UKHL 30 at [21]; [2006] STC 270.
[12] *R. v IRC Ex p. National Federation of Self Employed and Small Businesses Ltd* [1981] UKHL 2; [1982] AC 617 at 663 (Lord Roskill).
[13] S. Daly, "The Life and Times of ESCs: A defence?" in D. de Cogan and P. Harris (eds), *Studies in the History of Tax Law* (Oxford: Hart Publishing, 2017), Vol.8, 179. ESC A1 previously made provision for flat rate allowances for tools and special clothing, though this has now been codified: ITEPA s.367.
[14] HMRC, Internal Manual, *Employment Income Manual* (published 22 May 2014; updated 24 August 2020), EIM71100, "Voluntary organisations: unpaid office holders", available at: *https://www.gov.uk/hmrc-internal-manuals/employment-income-manual/eim71100* [Accessed 2 September 2020].

> "[n]o liability to income tax arises in respect of a payment to a person who holds a voluntary office if the payment is in respect of reasonable expenses incurred in carrying out the duties of that office".[15]

Separately, regulation 2 of The Social Security (Contributions) (Amendment No. 3) Regulations 2020[16] replicates this treatment in respect of Class 1 National Insurance contributions. What is "reasonable" is not specified in the provision, though HMRC do recognise as reasonable "small amounts of travelling and subsistence payments".[17] Meanwhile, section 299A(5) ITEPA limits the organisations to which the exemption relates, essentially requiring that the entity is, or acts as, a not-for-profit.

It is interesting to highlight that it is not entirely necessary to introduce concessions through primary legislation such as the Finance Act, as concessions in existence in 2008 can be legislated through secondary legislation by virtue of the power provided by section 160 of the Finance Act 2008 (FA 2008).[18] This latter route, for instance, was adopted in early 2018 in order to put on a statutory footing a related concession on financial loss allowance (FLA) payments.[19] These are payments made to volunteers and volunteer office-holders to make up for *net* income lost on account of volunteering[20] and concessionary treatment was required in order to ensure that these payments did not amount to taxable income. The reason that FA 2020 is being used in the present circumstances comes down to the pragmatic use of Parliamentary time.[21] For concessions to be introduced through section 160 FA 2008, the statutory instrument has to be laid before the House of Commons for approval. To avoid the unnecessary use of Parliamentary time, HMRC's approach is to group several extra-statutory concessions together in one sitting. In respect of the expenses exemption HMRC were not planning to ask the Government to legislate any other extra-statutory concession and it would have been imprudent therefore to have required a debate in Parliament on this single issue (particularly given the fraught political climate at the time).[22]

Though legislating for the exemption is surely to be welcomed for bringing legal certainty, three broader points about concessions are also illuminated by doing so. First, the fact that the previous concessionary treatment was justified on the basis of administrative convenience makes it likely that the practice was lawful and in that sense the added certainty that has been brought

[15] FA 2020 s.14(1) inserting ITEPA s.299B(1).
[16] The Social Security (Contributions) (Amendment No. 3) Regulations 2020 (SI 2020/320).
[17] HMRC, EIM71100, above fn.14, under "Unpaid office holders."
[18] Recall that according to HMRC, the concession was "long-standing" (HMRC, *Income Tax and the treatment of expenses for voluntary office holders*, above fn.3). Indeed, it is certainly long-standing in respect of pure volunteers. See the reference to the Inland Revenue agreement with the British Universities Finance Directors Group on 13 October 2004 in HMRC, Internal Manual, *Employment Income Manual* (published 22 May 2014; updated 24 August 2020), EIM71105, "Research volunteers, lay participants and participants in clinical trials", available at: *https://www.gov.uk/hmrc-internal-manuals/employment-income-manual/eim71105* [Accessed 2 September 2020].
[19] ITEPA s.299A was introduced through Enactment of Extra-Statutory Concessions Order 2018 (SI 2018/282). The instrument was first laid before the House of Commons on 15 January 2018: House of Commons Votes and Proceedings (15 January 2018).
[20] See ITEPA s.299A(4); HMRC, Internal Manual, *Employment Income Manual* (published 22 May 2014; updated 24 August 2020), EIM01135, "Financial loss allowances: lost employment income: examples", available at: *https://www.gov.uk/hmrc-internal-manuals/employment-income-manual/eim01135* [Accessed 2 September 2020].
[21] Correspondence between the writer and HMRC (11 May 2020).
[22] The plan to legislate the concession was announced on 11 October 2018 at Budget 2018: HM Treasury, *Finance Bill Explanatory Notes*, above fn.7, 24, para.9.

about by legislating for it is that taxpayers can safely assume that such treatment will not be removed in the future. Whilst there is nothing to prevent legislation from being introduced at a later date to reverse the change, it is far more cumbersome to do so than it is for HMRC to simply change their practice.

This links to the second point which is that from the perspective of taxpayers legislation is, in terms of its reliability, preferable to HMRC soft law, such as that found in guidance, extra-statutory concessions and manuals.[23] Where HMRC seek to resile from positions set out in their published soft law, taxpayers can seek to invoke the doctrine of legitimate expectation. But there are myriad reasons why this doctrine does not provide robust protection for taxpayers in practice.[24] For instance, should HMRC believe that there is a mistake in their guidance, then they may lawfully resile from it without falling foul of the doctrine of legitimate expectation.[25] As Greg Weeks has suggested, poorly drafted guidance places risk on the taxpayer.[26]

Following from this is the third point which is that this episode highlights one of the problems arising from HMRC's practice of issuing concessions. HMRC maintain two published lists of extra-statutory concessions (correlating to the functions previously exercised by the Inland Revenue and Customs and Excise).[27] However, the concession in relation to expenses was not to be found on either list, and nor for that matter was the concession in relation to FLA payments. Rather these were to be found in HMRC's *Employment Income Manual*.[28] A prudent taxpayer would be cautious about relying upon concessions, given that this may sometimes place the taxpayer in a position of non-compliance with the law (with a consequence being that the doctrine of legitimate expectation will be of little assistance). But where HMRC produce guidance or manuals, it ought to be reasonable for the taxpayer to assume that what is contained therein merely reflects HMRC's understanding and application of the law, rather than some concessionary elements. Extra-statutory concessions are an imperfect solution in an imperfect system, but as they do exist (and to the extent that not all can be put in legislation)[29] it is far preferable that HMRC actually put them on the published lists so as to at least allow taxpayers to be informed of the risk that they are taking when relying upon HMRC advice.[30] HMRC have shied away from adding concessions to these lists in recent years, something which is not unrelated to the process of regularising concessions which was supposedly brought about by Lord Hoffmann's judgment

[23] Reliability is a key factor in ensuring that HMRC advice advances the rule of law. See S. Daly, *Tax Authority Advice and the Public* (Oxford: Hart Publishing, 2020), Ch.3.
[24] Daly, above fn.23, Ch.6.
[25] See *HMRC v Hely-Hutchinson* [2017] EWCA Civ 1075; [2017] STC 2048.
[26] G. Weeks, *Soft Law and Public Authorities: Remedies and Reform* (Oxford: Hart Publishing, 2016), 118. Weeks made this comment in the context of a discussion of the implications of the case of *R. (on the application of Davies and another) v HMRC; R. (on the application of Gaines-Cooper) v HMRC* (*Davies and Gaines-Cooper*) [2011] UKSC 47.
[27] See HMRC, *Extra-Statutory Concessions*, above fn.9; HMRC, *VAT Notice 48: Extra Statutory Concessions* (updated 12 September 2017), available at: *https://www.gov.uk/government/publications/vat-notice-48-extra-statutory-concessions/vat-notice-48-extra-statutory-concessions* [Accessed 2 September 2020].
[28] See HMRC, EIM71100, above fn.14; HMRC, *Extra-statutory concessions — eighth technical consultation on draft legislation* (14 September 2017), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/644456/Extra-statutory_concessions___eighth_technical_consultation_on_draft_legislation.pdf* [Accessed 2 September 2020], para.1.8.
[29] Daly, above fn.13, 183–185.
[30] Daly, above fn.23, 192.

in *Wilkinson*.[31] But HMRC should instead embrace their practice and equip taxpayers with information to allow them to make informed choices. ☞

Stephen Daly*

Section 15: loan charge not to apply to loans or quasi-loans made before 9 December 2010; Section 16: election for loan charge to be split over three tax years; Schedule 2: the loan charge: consequential amendments; Section 17: loan charge reduced where underlying liability disclosed but unenforceable; Section 18: relief from interest on tax payable by a person subject to the loan charge; Section 19: minor amendments relating to the loan charge; Section 20: repaying sums paid to HMRC under agreements relating to certain loans etc; Section 21: operation of the scheme

Introduction

Sections 15 to 21 of and Schedule 2 to the Finance Act 2020 (FA 2020) modify the Loan Charge, partly implementing Sir Amyas Morse's recommendations in the *Independent Loan Charge Review: report on the policy and its implementation* (the Morse Report).[1]

Few anti-avoidance measures have attracted such polarised and strongly held views as does the Loan Charge. Concerns have been expressed that the "Loan Charge deviates too far from the usual operation of the tax system and therefore undermines taxpayers' rights",[2] especially due to the Loan Charge's perceived retroactive or retrospective[3] operation and that it effectively undermines the normal time limits for assessment. Concern has also been expressed about particular "distress and hardship" among those affected, including "reports of people taking their own lives in cases linked to the Loan Charge".[4] It has been suggested that taxpayers subject to the Loan Charge are victims, mis-sold schemes they often did not understand by unscrupulous promoters.[5] Against this the Government has argued that the Loan Charge is "simply a mechanism which allows HMRC to collect outstanding taxes in an effective way".[6] The writer has discussed these concerns in a current note in an earlier edition of this *Review*.[7]

The Loan Charge is a measure which is designed to tackle the form of tax avoidance known as disguised remuneration. This note begins by recapping the legislative history of the disguised

[31] *Wilkinson*, above fn.11, [2005] UKHL 30. The writer is sceptical that the judgment is what caused the process to begin. See: Daly, above fn.23, 108–112.

☞ Expenses; Extra-statutory concessions; Income tax; Voluntary workers

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[1] Sir A. Morse, *Independent Loan Charge Review: report on the policy and its implementation* (December 2019).

[2] Morse, above fn.1, 3.

[3] As to the distinction, see the discussion in M.C. Blackwell, "The April 2019 Loan Charge" [2019] BTR 240, 247.

[4] Morse, above fn.1, 3.

[5] Blackwell, above fn.3, 252.

[6] Morse, above fn.1, 33.

[7] Blackwell, above fn.3, 240.

remuneration rules (DRR). The note then reviews certain recent case law and other materials, which shed light on some of the schemes against which the Loan Charge has been invoked. The recommendations for the reform of the Loan Charge in the Morse Report are then discussed. Finally, the note discusses how FA 2020 operationalises those recommendations of the Morse Report which the Government has accepted, and includes a consideration of the potential issues which arise from the legislation.

Legislative background

The DRR were introduced in the Finance Act 2011,[8] which inserted Part 7A in the Income Tax (Earnings and Pensions) Act 2003 (ITEPA). Part 7A ITEPA applies where

> "(a) a person ('A') is an employee, or a former or prospective employee, of another person ('B'),
> (b) there is an arrangement ('the relevant arrangement') to which A is a party or which otherwise (wholly or partly) covers or relates to A,
> (c) it is reasonable to suppose that, in essence—
>   (i) the relevant arrangement, or
>   (ii) the relevant arrangement so far as it covers or relates to A,
>   is (wholly or partly) a means of providing, or is otherwise concerned (wholly or partly) with the provision of, rewards or recognition or loans in connection with A's employment, or former or prospective employment, with B,
> (d) a relevant step is taken by a relevant third person, and
> (e) it is reasonable to suppose that, in essence—
>   (i) the relevant step is taken (wholly or partly) in pursuance of the relevant arrangement, or
>   (ii) there is some other connection (direct or indirect) between the relevant step and the relevant arrangement".[9]

As originally enacted, Part 7A ITEPA applied in respect of "relevant steps taken on or after 6 April 2011".[10] "Relevant step" is defined to include the payment (or transfer) of cash to the employee, including by way of loan.[11] But as the "relevant step" was required to be undertaken by a relevant third person, this did not cover loans made directly by the employer to the employee with no third party involvement. The definition of "relevant step" was extended by the Finance Act 2017 to include the release or write-off of a loan by a relevant third party,[12] and also an assignment of a loan by an employer to a third party,[13] where it took place after 6 April 2017.

The Finance Act 2018[14] introduced the "close companies' gateway" into the DRR, with effect from 6 April 2018, which has some similarities to the main case of the DRR. It is designed "to

[8] FA 2011 s.26 and Sch.2. See discussion in D. Cohen, "Finance Act 2011 Notes: Section 26 and Schedule 2: employment income provided through third parties (the 'disguised remuneration' legislation)" [2011] BTR 381.
[9] ITEPA s.554A(1) inserted by FA 2011 s.26 and Sch.2, para.1.
[10] FA 2011 Sch.2, para.52.
[11] ITEPA s.554C.
[12] ITEPA s.554C(1)(ab).
[13] ITEPA s.554C(1)(aa).
[14] FA 2018 s.11 and Sch.1 Pt 2.

put beyond doubt that office holders participating in EBT schemes should be regarded as employees, were within DRR".[15]

The Loan Charge, as introduced in Schedule 11 to the Finance (No.2) Act 2017 (F(No.2)A 2017),[16] expands the reach of the DRR by treating certain loans/quasi-loans as relevant steps for the purposes of Part 7A ITEPA, where a loan, or a quasi-loan, has been made to an employee or director and:

- the loan or quasi-loan was made on or after 6 April 1999; and
- an amount of the loan or quasi-loan is outstanding immediately before the end of 5 April 2019.

The effect of the Loan Charge is to create a one-off charge in the 2019–20 tax year, but often in respect of loans received over a period of many years, sometimes referred to as "income stacking", so individuals would not get to use any personal allowances (or fully utilise the basic rate and, since 2011, the higher rate bands) from earlier years and amounts loaned before the introduction of the additional rate in 2011 may be subject to tax at the additional rate. The Loan Charge was motivated by a desire of the Government for a "quick fix",[17] which roughly approximates to calculation of the tax which it considers should have been paid on the loans.[18] It advantages HMRC by relieving them of the obligation to pursue investigations and litigate each case to prove that taxpayers were chargeable on their loans.[19] It also advantages HMRC by allowing them to pursue claims for years that were closed and unprotected.[20]

The foregoing applies only to employment income; there was no direct equivalent of the DRR for the self-employed. For the self-employed, F(No.2)A 2017[21] introduced somewhat similar provisions to the DRR into the Income Tax (Trading and Other Income) Act 2005 (ITTOIA), by inserting sections 23A to 23H, which have effect in relation to relevant benefits arising on or after 6 April 2017. But F(No.2)A 2017 also created a Loan Charge for the self-employed, with Schedule 12 F(No.2)A 2017 requiring that any loan or quasi-loan that was made between 6 April 1999 and 6 April 2017 and was outstanding on 5 April 2019 was to be deemed to be a "relevant benefit" and so chargeable under section 23E ITTOIA. The rationale for this was that HMRC were concerned taxpayers were circumventing the DRR by recharacterising employees as self-employed.[22]

[15] *R. (on the application of Cartref Care Home Ltd and others) v HMRC* (*Cartref*) [2019] EWHC 3382 (Admin); [2020] STC 516 at [70]. The quote is reproduced verbatim: some words appear to be missing.
[16] See discussion in P. Noble, "Finance (No.2) Act 2017 Notes: Section 34 and Schedule 11: employment income provided through third parties; Section 35 and Schedule 12: trading income provided through third parties; Section 36: disguised remuneration schemes: restriction of income tax relief; Section 37: disguised remuneration schemes: restriction of corporation tax relief" [2017] BTR 605.
[17] D. Southern, "Analysis – Amendments to the 2019 loan charge: work in progress", 21 February 2020, (1476) *Tax Journal*, 14.
[18] See Blackwell, above fn.3, 245 for a discussion of why this is only approximate.
[19] Blackwell, above fn.3, 246.
[20] Blackwell, above fn.3, 253–255.
[21] F(No.2)A 2017 s.35.
[22] Noble, above fn.16, 608.

Subsequent case law on Loan Charge schemes

The seminal decision on Loan Charge schemes is *RFC 2012 plc (In Liquidation) (formerly Rangers Football Club plc) v Advocate General for Scotland* (*Rangers*),[23] on which the writer has published a case note in this *Review*.[24] *Rangers* involved footballers being remunerated both by salary and by payments to an employee benefit trust (EBT). The payment to the EBT was then settled on a sub-trust of which the footballer was protector but not a beneficiary. Loans were then made from the sub- trust to the footballer. The Supreme Court found that payments to the trust were "remuneration or reward for services"[25] and so formed part of the footballers' earnings, applying *Brumby (Inspector of Taxes) v Milner, Day (Inspector of Taxes) v Quick* (*Brumby v Milner*).[26]

Two recent judicial reviews of the Loan Charge are informative in a consideration of FA 2020, both because they provide factual details of the operation of other Loan Charge schemes, and also because they assess the extent to which those schemes may have been considered effective when entered into. This latter point is especially relevant in considering the reforms to the Loan Charge in FA 2020 which create a cut-off date of 9 December 2010.

Cartref

The first judicial review was *R. (on the application of Cartref Care Home Ltd and others) v HMRC* (*Cartref*),[27] which considered two separate schemes: one entered into by Cartref Care Home Ltd (Cartref Care Home) and its directors; the other entered into by Brian Dawson Engineering Services Ltd (DES) and its directors. These were examples of close company schemes.[28]

Both companies invested in and became members of an LLP which was to acquire the distribution rights to films. The opportunity was structured so that the directors loaned the money for the acquisition of the film rights to their respective companies on a fully repayable basis. The directors were themselves put in funds by a loan from a third company, which in turn had been put in funds by the seller of the film rights.[29] In fact, the loans though notionally to the directors, were directed straight to the LLP.

The anticipated result of the scheme was that each of the directors would receive payments from their companies on which they did not pay income tax or national insurance. Also, each company would have a trading loss, which it could set off against its other income in the relevant year. For Cartref Care Home this was the year ending in 2011 and for DES this was the year ending in 2013.[30] Thus, as Cockerill J noted "the particular type of scheme in this case is in many

[23] *RFC 2012 plc (In Liquidation) (formerly Rangers Football Club plc) v Advocate General for Scotland* [2017] UKSC 45; [2017] STC 1556.
[24] M.C. Blackwell, "RFC 2012 plc (in liquidation) (formerly the Rangers Football Club plc) v Advocate General for Scotland: discerning the goal of the legislation" [2017] BTR 398.
[25] *Rangers*, above fn.23, [2017] UKSC 45; [2017] STC 1556 at [35].
[26] *Brumby (Inspector of Taxes) v Milner, Day (Inspector of Taxes) v Quick* [1975] STC 644 (CA); affirmed [1976] STC 534 (HL).
[27] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516.
[28] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [72].
[29] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [3]–[4].
[30] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [5].

ways a combination of two separate schemes, a profit extraction scheme and a sideways loss scheme".[31] The scheme is therefore very different in its structure from the scheme in *Rangers*. The taxpayer had argued that it fell outside the purpose of the Loan Charge, however Cockerill J found that it was not a matter that could be properly determined by way of judicial review, but "ought rather, as a question of statutory interpretation and substantive tax law, [to] be determined by the Specialist Tax Tribunal".[32] Cockerill J found there to be sufficient evidence to support HMRC's claim that the scheme was avoidance, but suggested HMRC's categorisation of the scheme as "aggressive" avoidance "may be over-egging it".[33]

Zeeman and Murphy

The second judicial review was *R. (on the application of Zeeman and another) v Revenue and Customs Commissioners* (*Zeeman and Murphy*).[34] Zeeman was a contractor employed by umbrella companies between 2006 and 2016. He was remunerated for his services by way of a salary supplemented by loans. In some cases, these loans were made direct from an EBT, in other cases the loans were initially made by the umbrella company and subsequently assigned to the trustees of the EBT.

Murphy was a self-employed contractor, who between 2008–10 worked as a consultant engaged by an Isle of Man company, Rathowen Ltd (Rathowen):

> "Rathowen would receive a payment from the end client for Mr Murphy's services, from which it would deduct a fee. The balance would then be used (a) to pay Mr Murphy an annual fee for his consultancy services, which is said to have been calculated on a pro rata basis to the work undertaken, and (b) to fund an EBT…."[35]

Murphy then received loans from the EBT.

A1P1

In both *Cartref* and *Zeeman and Murphy* it was alleged that the Loan Charge breached Article 1 of the First Protocol to the European Convention for the Protection of Human Rights and Fundamental Freedoms (A1P1), which provides:

> "Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.
>
> The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties."[36]

[31] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [72].
[32] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [184].
[33] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [206].
[34] *R. (on the application of Zeeman and another) v Revenue and Customs Commissioners* [2020] EWHC 794 (Admin); [2020] STC 828.
[35] *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [16].
[36] European Convention on Human Rights 1950 as amended by Art.1. Protocol 1, "Protection of property".

This necessitates a two-stage assessment. First, does the taxpayer have a "possession" within the meaning of A1P1?[37] Secondly, was the deprivation both "provided for by law", and also proportionate, striking a "fair balance" between the demands of the general interest and the needs of the community?[38]

Did the taxpayer have a "possession" prior to the Loan Charge?

In determining whether the taxpayer had a "possession" the starting point in both cases was the Court of Appeal decision in *R. (on the application of St Matthews (West) Ltd and others) v HM Treasury and another; sub nom. R. (on the application of APVCO 19 Ltd and others) v HM Treasury and another* (*St Matthews*),[39] which approved the European Court of Human Rights decision in *Kopecký v Slovakia* (*Kopecký*).[40] *Kopecký* established that

> "where the proprietary interest is in the nature of a claim it may be regarded as an 'asset' only where it has a sufficient basis in national law, for example where there is settled case-law of the domestic courts confirming it".[41]

This led Vos LJ in *St Matthews* to find that

> "a possession must either exist or be a claim in respect of which an individual has a legitimate expectation that it will be realised, and such a legitimate expectation cannot be based on just an arguable claim…If it were an answer in a tax case to say that legislation closing a tax avoidance loophole was an interference with the money that the taxpayer would in due course use to pay the tax, that would be applicable in many, if not most, cases, since taxpayers rarely pay tax first and dispute their liability later"[42]

and

> "the money available to pay the SDLT must, in my judgment, be affected by the argument as to whether it is payable to HMRC. Of course, the money is a possession in one sense, but it is a possession impressed with an arguable claim by HMRC, which prevents it being properly regarded as a possession for A1P1 purposes."[43]

Thus, the question for the Court in *Cartref* and *Zeeman and Murphy* was whether, before the introduction of the Loan Charge, HMRC had an arguable claim.[44] However the answer given by

[37] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [127]–[160]; *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [51]–[72].
[38] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [161]–[225]; *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [73]–[97].
[39] *R. (on the application of St Matthews (West) Ltd and others) v HM Treasury and another; sub nom. R. (on the application of APVCO 19 Ltd and others) v HM Treasury and another* [2015] EWCA Civ 648; [2015] STC 2272.
[40] *Kopecký v Slovakia* (Application No.44912/98) (2005) 41 EHRR 43 (ECtHR).
[41] *Kopecký*, above fn.40, (2005) 41 EHRR 43 at [52] cited in *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [132] and in *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [53].
[42] *St Matthews*, above fn.39, [2015] EWCA Civ 648; [2015] STC 2272 at [45].
[43] *St Matthews*, above fn.39, [2015] EWCA Civ 648; [2015] STC 2272 at [46].
[44] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [155] and in *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [59] and [66].

Cockerill J in *Cartref* differed from that given by Andrews J in *Zeeman and Murphy*. For Cockerill J the answer differed as between the two taxpayer companies, due to the loss relief claims made by Cartref Care Home in relation to the year ending 2011 and by DES in relation to the year ending 2013. It was during that period that Cockerill J considered the law had changed giving HMRC a claim. Cockerill J stated that:

> "156. The answer to this question depends on what was known to be of interest to HMRC at the time of the arrangements in question. In the light of the issues considered above, I conclude that the position was certainly different by the end of 2013 compared to the position in 2010; by the end of 2013 the position was not materially dissimilar to that which pertained in *St Matthews*. Accordingly, I would conclude that DES did not have a possession.
>
> 157. So far as Cartref is concerned I would be inclined to say that the position is different. Although Spotlights 5 and 6 were issued, the DRR were not yet in existence; even as they were being consulted upon, the way in which they were being approached was very different to the scheme which Cartref was entering into. To say that there was a claim, when there was no legislation yet in existence which even covered distantly related schemes, would seem to stray too close to an analysis whereby any arrangement is impressed with a potential claim by HMRC."[45]

In *Zeeman and Murphy*, Andrews J took issue with Cockerill J's statement in paragraph 156 observing

> "that I have some difficulty with the concept that an arguable claim to tax does not exist until HMRC takes positive steps to make that claim known. The claim surely arises from the legislation imposing the charge to tax and depends on its interpretation and application to the facts. It seems to me that the real distinction to be drawn is between a situation in which the State imposes an entirely new tax or charge, and a situation in which the taxpayer cannot establish that the money belongs entirely to him, because legislation already exists which HMRC contends is applicable and creates a liability to pay tax."[46]

The test set out by Andrews J would seem preferable. "One should be taxed by law, and not be untaxed by concession."[47] However the reasons given by Cockerill J in paragraph 157 would appear to satisfy Andrews J's test. Applying her test in *Zeeman and Murphy*, Andrews J held neither claimant to have a possession, stating:

> "In the present case, each of the taxpayers was party to an arrangement to receive money as remuneration for his services by a means that he knew was designed and intended to prevent him having to pay the tax that would normally be charged on the same sum if it was paid as part of his salary. For the purpose of ascertaining whether there was a 'possession' in this context I would draw no distinction between DR loans made in the period up to and including the tax year 2009/2010, and loans made thereafter. The proposition

[45] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [156]–[157]: *St Matthews*, above fn.39, [2015] EWCA Civ 648; [2015] STC 2272.

[46] *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [61].

[47] *Vestey v IRC* [1977] STC 414 (Ch) at 439 per Walton J.

> that a payment which is made as a reward for services is taxable was clearly articulated by the House of Lords in *Brumby v Milner* as long ago as 1975. The position of a self-employed trader such as Mr Murphy may have been less clear, perhaps, than that of an employee such as Mr Zeeman, but the nature of the payment as part of the remuneration package was precisely the same."[48]

With regard to Zeeman, this makes perfect sense, but it is unconvincing with regard to Murphy who was self-employed. As an employment income case, *Brumby v Milner* gives guidance on what may be an emolument, but that is irrelevant to whether a charge arises under section 25 ITTOIA, which elsewhere in her judgment Andrews J acknowledges as the correct test.[49] Andrews J concedes that prior to the enactment of sections 23A to 23H ITTOIA in 2017 "[t]he tax position of a self-employed trader in respect of DR schemes, particularly contractor loan schemes, was less clear than the position of an employee".[50] Thus, with regard to Murphy, Andrews J does not give a good reason why HMRC have an arguable claim resulting in Murphy not having a possession. Here Andrews J does not, in contrast to Cockerill J in *Cartref*, suggest that a change occurred between 2010 and 2013. This may be attributable to *Zeeman and Murphy* being substantially on a par with *Rangers*, which was decided without needing to resort to the DRR which were introduced around that period.

Thus the decision in *Cartref* suggests that there was a change between 2011 and 2013 when HMRC developed an arguable case that taxpayers were chargeable, regardless of the Loan Charge, at least with regard to employees. The contrary view in *Zeeman and Murphy* seems difficult to support. The reasoning in *Cartref* would thus provide support for the changes in FA 2020, where the Loan Charge is limited to loans entered into or after 9 December 2010.

"Provided for by law" and striking a "fair balance"

Even if there was a "possession", in both *Cartref* and *Zeeman and Murphy* the Court concluded that A1P1 was not breached as any deprivation was both "provided for by law", and also proportionate, striking a "fair balance"[51] between the demands of the general interest and the needs of the community. The reasoning was similar in both cases.

Lawfulness was not "seriously in issue" in either case.[52] Whilst the courts accepted there was a degree of retrospection to the legislation,[53] that did not prevent any deprivation being "provided for by law". Although the requirement of legal certainty includes the need for the measure to be

[48] *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [62]: *Brumby v Milner*, above fn.26, [1975] STC 644 (CA); affirmed [1976] STC 534 (HL).
[49] *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [45] and [67].
[50] *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [46]. Andrews J claims ITTOIA ss.23A–23H were enacted in "the first Finance Act 2017", in fact they were enacted in F(No.2)A 2017.
[51] *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [73]; *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [17].
[52] *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [74].
[53] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [204]; *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [80].

"sufficiently foreseeable",[54] retrospective/retroactive[55] effects are generally considered to be part of the assessment of proportionality.[56]

In assessing the fair balance, it was noted in both judgments that "when framing and implementing policies in the area of taxation, [a state] enjoys a wide margin of appreciation".[57] Accordingly legislation will only be found to breach A1P1 if it is "manifestly without reasonable foundation".[58] In both cases retrospective legislation was seen to be justified by the objective of combating tax avoidance.[59] Cockerill J did not consider it relevant that parliamentary conventions relating to retrospective legislation may not have been adhered to, since the balancing exercise under A1P1 "turns on the effect of the legislation, not the processes that led to it".[60] The issue was the length of the retrospection, potentially 20 years. Cockerill J noted that any challenge to the length of retrospection would involve balancing "the factors weighting in favour of the legislation with the severity of the consequences".[61] However, she found that on the evidence before her, with regard to both claimants

> "since before either of these schemes was entered into, HMRC were making it clear beyond peradventure that they regarded the overall approach (if not the precise iteration) as invalid. Where this is the case the taxpayer is to some extent on risk…a moderately well-informed taxpayer would know himself to be on risk, distantly in the case of *Cartref* and much more immediately by the time of the DES decision."[62]

Cockerill J had no evidence before her of taxpayers who entered into schemes in earlier years. Whilst the Loan Charge All-Party Parliamentary Group (APPG) *Report on the Morse Review into the Loan Charge* (the APPG Report)[63] referred to the hardships of taxpayers from earlier years, it was "pure *ex post facto* commentary"[64] and "an expression of opinion from which facts are notably lacking",[65] "not a witness statement, provided under the safeguards of the witness statement process".[66] Accordingly Cockerill J found that even if the time period was open to challenge, she had no evidence before her on which to find a breach of A1P1. In *Zeeman and Murphy*, Andrews J based her finding of no breach of A1P1 on the measures being used to

[54] *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [74].
[55] The judgments suggest nothing turns on the distinction in these cases: *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [177]; *Zeeman and Murphy*, above fn.34 [2020] EWHC 794 (Admin); [2020] STC 828 at [75].
[56] *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [75].
[57] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [200]; *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [76]: both citing *Huitson v UK* (*Huitson*) (Application No.50131/12) unreported 13 January 2015 (ECtHR) at [28].
[58] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [199]; *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [79]: both citing *Huitson*, above fn.57, unreported 13 January 2015 at [28]. (*Huitson* itself refers to "devoid of reasonable foundation".)
[59] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [210]–[214]; *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [83]–[84].
[60] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [182].
[61] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [219].
[62] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [217].
[63] Loan Charge All-Party Parliamentary Group, *Report on the Morse Review into the Loan Charge* (March 2020).
[64] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [169].
[65] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [221].
[66] *Cartref*, above fn.15, [2019] EWHC 3382 (Admin); [2020] STC 516 at [171].

combat tax avoidance which therefore fell within the state's margin of appreciation.[67] While Andrews J acknowledged a theoretical possibility of the Loan Charge causing hardship in specific cases, she held "that does not mean the legislation itself is contrary to A1P1".[68]

Thus both *Cartref* and *Zeeman and Murphy* suggest that the Loan Charge, even in its original form that looked back 20 years, is proportionate. Whilst this judgement of proportionality is through the prism of A1P1, which accords states a wide margin of appreciation, it still suggests that the retrospective element of the Loan Charge is a legitimate way of tackling tax avoidance. The divergence of view between the two cases as to whether the taxpayer had a possession might in itself be thought to show the ambiguity as to whether or not Loan Charge schemes were originally effective.

Loan charge users as victims of tax avoiders?

In Parliamentary debate the Government had often suggested that Loan Charge scheme users were tax-dodgers, deserving no sympathy.[69] Others had suggested that at least some users were the victims of unscrupulous promoters, or that they had been coerced into such arrangements by their employers.[70] The recent First-tier Tribunal decision in *Hoey v HMRC* (*Hoey*)[71] presented an example of a Loan Charge scheme user as victim, rather than tax-dodger. In that case Judge Philip Gillett made findings of fact that Mr Hoey's motivation for using the scheme (involving an umbrella company) "was solely to avoid the complexities of running his own company".[72] The cash that he received due to using the scheme was only "slightly better" than he had obtained beforehand, as the various intermediaries charged fees of between 10 per cent and 18 per cent, compared to the 1 per cent usually charged by "a simple UK based umbrella company".[73]

The Morse Report

In response to concern about the operation of the Loan Charge, in September 2019 the Chancellor of the Exchequer commissioned a report by Sir Amyas Morse on the operation of the Loan Charge. This was published in December 2019.[74] Whilst there has been broad cross-party support for the Morse Report's findings,[75] the APPG has issued its own APPG Report[76] critiquing the Morse Report.

The major substantive recommendations of the Morse Report are set out in the Report's Executive Summary as follows:

[67] *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [96]–[97].
[68] *Zeeman and Murphy*, above fn.34, [2020] EWHC 794 (Admin); [2020] STC 828 at [93].
[69] For example, see the comment of The Rt Hon Philip Hammond (Chancellor of the Exchequer), *Hansard*, HC, Vol 660, col 612 (21 May 2019).
[70] Blackwell, above fn.3, 244.
[71] *Hoey v HMRC* [2019] UKFTT 489 (TC); [2019] SFTD 1195. See discussion in R. Thomas, "Stephen Hoey v HMRC and Philip Higgs and others v HMRC: section 684(7A) ITEPA—a load of Hoey?" [2020] BTR 283.
[72] *Hoey*, above fn.71, [2019] UKFTT 489 (TC); [2019] SFTD 1195 at [18].
[73] *Hoey*, above fn.71, [2019] UKFTT 489 (TC); [2019] SFTD 1195 at [18]–[19].
[74] Morse, above fn.1.
[75] *Hansard*, Public Bill Committee (2019–20) Finance Bill Second Sitting (4 June 2020).
[76] The APPG Report, above fn.63.

"The design of the Loan Charge

…

3 the Loan Charge should not apply to loans entered into before 9th December 2010

4 Unprotected Years arising from loans entered into on or after 9th December 2010, where the relevant taxpayer made reasonable disclosure of their scheme usage to HMRC and HMRC did not open an investigation, should be out of scope of the Loan Charge (subject to recommendation 5 below). Other Unprotected Years should remain in scope of the Loan Charge. This will ensure that taxpayers do not benefit from failing to disclose their tax affairs to HMRC. The approach to defining 'reasonable disclosure' should build upon HMRC's ordinary compliance approach in considering the extent to which a Self Assessment return is sufficiently clear about the usage of a loan scheme

5 any Unprotected Years arising from loan schemes entered into during the 2016-17, 2017-18 and 2018-19 tax years should all be included in the scope of the Loan Charge, to ensure that taxpayers who entered into loan schemes after the Loan Charge was announced do not unreasonably benefit from HMRC having ceased protecting years following the announcement

6 HMRC should refund the Voluntary Restitution elements of settlements made since 2016 that were paid to settle Unprotected Years when the relevant loans were entered into:

a) prior to 9th December 2010; or

b) between 9th December 2010 and the start of the 2016-17 tax year, where the scheme user made reasonable disclosure of their scheme usage in their tax return

7 taxpayers should be entitled to opt to spread their outstanding loan balances over three years, to mitigate the impact of taxpayers paying tax at a higher rate than they ordinarily would. This reduces the effect of stacking their outstanding loan balances into a single year, which artificially created an increased exposure to a higher rate of income tax

8 the extent to which the Loan Charge looks back to activity in earlier tax years dating back to 1999-2000, and the manner in which ongoing interest is charged on payment arrangements has given rise to concerns over how policy on interest is applied within the tax system. The government should review future policy on interest rates within the tax system and report the results to Parliament by 31st July 2020

The individual impact of the Loan Charge

…

9 all individuals subject to the Loan Charge should only be asked to pay up to half their disposable income each year and a reasonable proportion of their liquid assets. No one should have to sell their primary residence or use their existing pension pot to pay the Loan Charge

10 individuals with income of less than £30,000 in 2017-18 should additionally not have the Loan Charge hanging over their head for any longer than 10 years, and any amount left outstanding after 10 years of paying the Loan Charge should be written off to genuinely draw a line under any outstanding balance. This will allow people to move on after paying what they can afford

11 HMRC should extend to individuals with income from £30,000 up to £50,000 in 2017-18 the same payment terms that were offered to such individuals who settled their tax affairs rather than pay the Loan Charge. Such individuals should be automatically able to pay the Loan Charge over up to five years without having to provide HMRC with further details of their asset ownership".[77]

All of these recommendations were accepted by the Government, except recommendation 10. The Government's rationale for not accepting recommendation 10 was:

> "HMRC already have robust systems in place for those who need time to pay their tax debts…Allowing some Loan Charge liability to be written off would treat tax avoiders more favourably than other individuals with HMRC debts (including tax credit claimants), would reduce taxpayers' incentive to pay off the debt, and would have unwelcome wider impacts that change how HMRC and those in debt interact."[78]

There are currently 600,000 taxpayers paying HMRC through time to pay arrangements. In the year to June 2019 HMRC agreed 438,000 time to pay arrangements, with over 15,000 for more than 10 years.[79] It is unclear what proportion of these 15,000 are for things other than Loan Charge arrangements. Whilst 10 years is a long time, this is not an unusual period over which to pay a debt. Many student loans are outstanding for over 10 years and mortgages frequently are for more than 10 years. Accordingly, it does not seem unreasonable for HMRC to have rejected recommendation 10.

The Morse Report's rationale for the cut-off of December 2010, is that it was only then when the law "became clear",[80] since "[f]rom early 2010, it was clear that the government would legislate to ensure that loan schemes did not avoid income tax and NICs".[81] This cut-off date is also consistent with the decision of Cockerill J in *Cartref*, as discussed above. As noted earlier for Andrews J in *Zeeman and Murphey* this was not a significant cut-off. The difference may be attributed to *Cartref* involving a close company scheme that was far from the factual matrix of *Rangers*. Similarly, as identified by the APPG Report,[82] a weakness of this cut-off is that it fails to differentiate employed from self-employed schemes, where (as discussed above) legislation was only introduced in 2017.[83] As already noted, the regimes for taxing employment and self-employment are very distinct. Subject to this, there is a sound policy justification for the

[77] Morse, above fn.1, Executive Summary, 9–10.
[78] HM Treasury, *Independent Loan Charge Review: Government response to the Review* (December 2019), paras 2.30 and 2.31.
[79] HM Treasury and HMRC, FOI release, *Independent Loan Charge Review — summary of evidence* (23 April 2020), "Section 14 – debt collection process".
[80] Morse, above fn.1, 4.
[81] Morse, above fn.1, para.2.6.
[82] The APPG Report, above fn.63, 14.
[83] F(No.2)A 2017 s.35 and Sch.12.

approach to subsequent unprotected years. The choice of cut-off date was also influenced by how the self-employed are required to retain detailed financial records and by "how far back HMRC would usually have been able to look in their investigations from the date of the announcement of the Loan Charge in March 2016".[84]

Recommendation 9 has been partly implemented, as an exception is made for those "with very high levels of disposable income", who may be required to repay more than half of their disposable income.[85] This appears consistent with HMRC's normal practice.[86]

The refund of the Voluntary Restitution elements of settlements seems only fair: taxpayers who obeyed the Government's call to settle should not be disadvantaged compared with those who persevered in their struggle against HMRC. However, as the Chartered Institution of Taxation (CIOT) has noted,[87] this leaves those taxpayers that repaid outstanding balances on their loans prior to 5 April 2019 to avoid the operation of the Loan Charge (on HMRC's advice), at a relative disadvantage. Relatedly, it seems that some taxpayers may face the double whammy of having both to pay the Loan Charge and repay the loans[88]: apparently some of the EBTs have sold off their loan books at a fraction of their value.[89] It is unclear how it accords with their fiduciary duties if EBT trustees sold their loan books on this basis.

Finance Act 2020

Section 15 FA 2020 implements recommendation 3 of the Morse Report, so the Loan Charge now only applies to loans made after 9 December 2010, rather than 6 April 1999.

Section 16 FA 2020 allows the taxpayer to make an election for the Loan Charge to be split over three years. This implements recommendation 7 of the Morse Report, mitigating the income stacking effect of the Loan Charge. An estimated 21,000 individuals will reduce their liability under the Loan Charge as a result of this.

Section 17 FA 2020 implements recommendation 4 of the Morse Report, relieving the Loan Charge in respect of loans entered into on or after 9 December 2010, where the relevant taxpayer made reasonable disclosure of their scheme usage to HMRC and HMRC did not open an investigation. The disclosure must be made in a tax return (which includes accompanying documents). "Reasonable disclosure" has been defined in paragraph 1B(5) of Schedule 11 F(No.2)A 2017 (inserted by section 17(1) FA 2020) rather narrowly, as being where the return

"(a) identified the loan or quasi-loan,
(b) identified the person to whom the loan or quasi-loan was made in a case where the loan or quasi-loan was made to a person other than A,
(c) identified the relevant arrangements in pursuance of which or in connection with which the loan or quasi-loan was made, and

[84] Morse, above fn.1, 35, para.4.15.
[85] HM Treasury, above fn.78, 9, para.2.28.
[86] HM Treasury, above fn.78, 9, para.2.29.
[87] Chartered Institute of Taxation, *Finance Bill 2020 — Submission to Public Bill Committee* (FB07) (June 2020), 4.
[88] Chartered Institute of Taxation, above fn.87, 4.
[89] The APPG Report, above fn.63, 43–44, paras 143–144.

(d) provided such other information as was sufficient for it to be apparent that a reasonable case could be made that for the relevant year A was chargeable to income tax on an amount that was referable to the loan or quasi-loan".[90]

Whilst the disclosure must be in a tax return, the disclosure need not be in the return of the recipient of the loan: it could be in their employer's return. Due to the "very extensive" level of disclosure it has been suggested that "very few taxpayers" will meet the requirements of reasonable disclosure.[91]

An estimated 11,000 individuals will be removed from the Loan Charge due to the date the Loan Charge applies being changed to 2010 and the provisions for those who have made reasonable disclosures.[92]

Section 18 FA 2020 removes liability for interest on the Loan Charge, providing payment is made before the end of September 2020. Section 19 FA 2020 makes minor amendments.

Sections 20 and 21 FA 2020 implement recommendation 6 of the Morse Report, allowing HMRC to refund amounts paid under settlement agreements which would not have been subject to the Loan Charge as amended by FA 2020. ☞

Michael Blackwell[*]

Section 23 and Schedule 3: entrepreneurs' relief

Introduction

Schedule 3 to the Finance Act 2020 (FA 2020) provides for the reduction of the entrepreneurs' relief (ER) (renamed as business asset disposal relief (BADR) from 6 April 2020)[1] lifetime gains limit to £1 million for disposals made after 11 March 2020. Thus, from 11 March 2020, qualifying gains exceeding £1 million (reduced by any previous ER claims) will generally be charged at the main capital gains tax (CGT) rate of 20 per cent.

This marks a major scaling back of the previous ER gains limit of £10 million, which has applied since 6 April 2011. The Government justified the reduction on the grounds that the previous relief was expensive, ineffective and unfair.[2] The Chancellor indicated that some 80

[90] F(No.2)A 2017 Sch.11 para.1B(5) inserted by FA 2020 s.17(1). See the equivalent definition in respect of trading income provided through third parties in F(No.2)A 2017 Sch.12 para.1A(5) inserted by FA 2020 s.17(2).
[91] The APPG Report, above fn.63, 51, paras 168–169.
[92] HMRC, Policy paper, *Implementation of recommendations from the independent review of the Loan Charge* (11 March 2020).

☞ Disguised remuneration; Employee benefit trusts; Fair balance; Loan charge; Protection of property; Tax avoidance

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[1] See FA 2020 Sch.3, Pt 2, paras 7 and 8.
[2] HM Treasury and The Rt Hon Rishi Sunak MP, speech, *The Budget 2020 speech as delivered by Chancellor Rishi Sunak* (11 March 2020), available at: *https://www.gov.uk/government/speeches/budget-speech-2020* [Accessed 8 September 2020].

per cent of small businesses would not be affected by this change and it would save the Treasury £6 billion over the next five years.

Given the rumours surrounding the possible abolition of, or restrictions on, ER in the run-up to the 2020 Budget, some business owners sought to "bank" their ER entitlement by implementing one of several "planning" techniques. However, these arrangements will invariably be nullified by the special anti-forestalling provisions laid out in paragraphs 4 and 5 of Schedule 3. This is perhaps a surprising move, given that no similar legislation was put in place to deal with planning in advance of the previous abolition of retirement relief[3] (phased out from April 1999) and business taper relief[4] (abolished in April 2008).

The ER anti-forestalling rules have been criticised as being pernicious and retrospective in nature.[5] However, in recent years, HMRC have always indicated that where (artificial) tax avoidance is involved, retroactive rules are "fair game"![6]

From 6 April 2020, the reduced relief has also been renamed as business asset disposal relief (BADR). There is a view that the Government has renamed the relief to distance itself from the generous old-style ER.[7]

Reduction in lifetime limit

Paragraph 1 of Schedule 3 amends section 169N of the Taxation of Chargeable Gains Act 1992 (TCGA),[8] by providing that the ER/BADR lifetime gains limit is reduced from £10 million to £1 million. Paragraph 2 of Schedule 3 states that this reduction is effective from 11 March 2020 (Budget day 2020).

Example 1

On 21 July 2020, Alan disposed of his 30 per cent holding in Apollo Twelve Golfing Ltd for £1,400,000. He had already claimed ER against a gain on the sale of goodwill at £170,000, when he sold his small sole trader business in November 2006.

He is entitled to claim BADR of £830,000 against the capital gain of £1,400,000 realised on his July 2020 disposal, calculated as follows:

	£
Maximum BADR entitlement	1,000,000
Less: ER used in December 2006 against disposal of goodwill	(170,000)
BADR available on 21 July 2020	830,000

[3] FA 1998 s.140.
[4] FA 2008 Sch.2, paras 23–25.
[5] Chartered Institute of Taxation, *Comments on the Finance Bill 2020: Clause 22 and Schedule 2: Entrepreneurs' Relief (to be renamed Business Asset Disposal Relief)* (2020).
[6] For example, see House of Commons, Briefing Paper, *Retrospective Taxation* (27 August 2020), No.4369.
[7] For example, see Association of Tax Technicians, press release, *Surprise rename of Entrepreneurs' Relief concerns ATT* (20 March 2020).
[8] FA 2020 Sch.3, Pt 1, para.1.

Alan would therefore claim 10 per cent BADR on £830,000. The balance of the gain (ignoring the annual CGT exemption)—£570,000 (£1,400,000 less £830,000)—is taxable at the normal CGT rate of 20 per cent.

Anti-forestalling: unconditional contracts

In the run-up to Budget day 2020, many business owners feared that there would be adverse changes to BADR or even its complete abolition. Some of them sought to "bank" their ER at the pre-Budget 2020 levels by arranging for their shares to be transferred to a related party, typically a settlor-interested trust.

This generally involved entering into an *unconditional* contract to transfer the shares but not completing the contract—often referred to as a rescindable contract. This relied on the precedent established in *Jerome v Kelly* (*Her Majesty's Inspector of Taxes*),[9] which firmly established that a CGT disposal can only arise when a contract is completed. However, if the contract were to be subsequently completed, the CGT disposal date is fixed at the date of the contract.[10] On the other hand, if the contract is never completed, no disposal would be triggered for CGT purposes.

Shareholders that entered into pre-11 March 2020 rescindable contract arrangements would have anticipated retaining flexibility. Their intention would have been to only complete the contract after Budget day if it turned out that ER had been adversely affected by the Budget-as proved to be the case! The expectation would have been that their CGT disposal date would be the (pre-Budget day) contract date, so that the previous £10 million ER gains limit would have been available. The base value of the shares in the related entity would have been rebased to market value.

However, where such arrangements are driven by obtaining a tax advantage by exploiting the "contract date" rule, such shareholders will be thwarted by paragraph 3 of Schedule 3.

Arm's length disposals (that is, those not between connected persons[11]) should not, however, be caught by this rule provided that the contractual arrangements had "no purpose"[12] of obtaining a tax advantage under the "contract date" provision. This "let-out" is clearly intended to deal with normal commercial transactions. However, many such deals were accelerated in the run-up to the 2020 Budget and it is hoped that HMRC will adopt a sensible approach when dealing with these. The transferor/seller can only benefit from this "exemption" provided they make a claim including a statement that the "no section 28 advantage" requirement was met. The normal ER/BADR time limit applies to this claim. This will invariably be 31 January 2022.[13]

Where this exemption is available, the CGT date is governed by the normal "contract date" provision. This would fall before 11 March 2020 and therefore the previous £10 million gains limit would apply. On the other hand, if the exemption does not apply, paragraph 3(3) of Schedule 3 treats the disposal date as taking place at the date the asset (such as qualifying shares) is conveyed or transferred for the purposes of the relevant ER/BADR limit. Consequently, the eligible gain would be subject to the £1 million limit (less any previous ER gains claimed).

[9] *Jerome v Kelly (Her Majesty's Inspector of Taxes)* [2004] UKHL 25; [2004] STC 887.
[10] TCGA s.28.
[11] TCGA s.286.
[12] FA 2020 Sch.3, Pt 1, para.3(3)(b).
[13] TCGA s.169M(2)(3).

Paragraph 3(4) of Schedule 3 contains slightly different “let-out” requirements where the parties to the contract are connected. This stipulates that the contract must be entered into “wholly for commercial reasons”[14] and there must be “no section 28 purpose”.[15] Moreover, the transferor/seller must make a specific claim that both these requirements are satisfied by the 31 January 2022 deadline (for contracts made in 2019–20). In many cases, transactions were being rushed through before the Budget 2020 in anticipation of adverse ER changes, and it is likely to be difficult to prove that there was no tax motive. In the rare cases where these conditions are met the pre-Budget day ER limit of £10 million is available.

Example 2

Virgil is the 100 per cent shareholder of Liberty Bell 7 Ltd (LB7L). In February 2020, he received some informal advice from a friend that—since ER was expected to be abolished on 11 March 2020—he could transfer his shares to a settlor-interested trust to capture his full ER entitlement.

On 1 March 2020, he arranged with a lawyer to transfer 50 per cent of his shares in LB7L for a nominal amount to the trust under an unconditional contract but with completion likely to be deferred until after Budget day 2020, depending on the outcome of any changes to the ER rules. He estimated that the value of his 50 per cent shareholding was around £2.5 million so this would be the consideration value for CGT if the contract was completed.

Fortunately, he told his accountant about this arrangement. His accountant was aware of the anti-avoidance rule in paragraph 3 of Schedule 3 FA 2020 and he advised that the contract should not be completed.

Without his accountant’s intervention, the completion of the contract would have triggered a disposal for CGT purposes at some £2.5 million. This would have created a “dry” tax charge but the ER/BADR would have been restricted to the post-10 March 2020 limit of £1 million.

Anti-forestalling: reorganisations of share capital

The anti-forestalling measures for deemed share reorganisations under the share exchange rules in section 135 TCGA, and the corporate reconstruction rules in section 136 TCGA, are dealt with by paragraph 5 of Schedule 3 (below) (paragraph 4(4)).

Paragraph 4 of Schedule 3 deals with situations where there has been an internal share reorganisation within section 126 TCGA, between 6 April 2019 and 10 March 2020. In such cases, the normal CGT reorganisation treatment applies. Thus, there is no disposal of the old shareholding and the new (that is, post-reorganisation) shareholding “steps into the shoes” of the old shares.[16]

However, shareholders can make a special election under section 169Q TCGA, to treat the share reorganisation as a disposal at market value to capture ER at this point. Such elections might be made where a shareholder was unable to maintain the relevant BADR/ER conditions after the share reorganisation.

[14] FA 2020 Sch.3, Pt 1, para.3(4)(b).
[15] FA 2020 Sch.3, Pt 1, para.3(4)(c).
[16] TCGA s.127.

The rule in paragraph 4 of Schedule 3 only bites where the relevant ER conditions are satisfied *at 11 March 2020*. Thus, the company must be a trading company or the holding company of a trading group.[17] Furthermore, the relevant shareholder must be an officer/employee of the company (or member of a trading group) and it must be their personal company (broadly, they must hold at least 5 per cent of the company's ordinary share capital, voting rights and economic rights).[18]

Where these conditions are satisfied and the section 169Q TCGA election is made after 10 March 2020, paragraph 4(3) of Schedule 3 requires the BADR/ER limit prevailing at the time of the election to be applied (and not the date of the share reorganisation). This will be at the pre-Budget day limit of £1 million.

Anti-forestalling: exchanges of securities, etc.

Paragraph 5 of Schedule 3 deals with the more prevalent form of pre-Budget 2020 ER planning that took place using the share exchange rules. These anti-forestalling provisions only come into play for share exchanges taking place between 6 April 2019 and 10 March 2020. They effectively thwart the planning intention by applying the same treatment as in paragraph 4 of Schedule 3—the rule ensures that the new £1 million BADR/ER limit is applied to pre-Budget day share exchanges.

Paragraph 5(2) of Schedule 3 effectively deals with "mirror-image" type share exchanges, where the acquiring company's shareholders are the same as those of the "target" (that is, acquired) company. Paragraph 5(3) covers cases where the relevant shareholders (taken together) take a greater share of the acquiring company's ordinary share capital than they previously held in the target company and satisfied the relevant ER conditions on 11 March 2010—the same conditions as in paragraph 4 of Schedule 3 (above).[19]

Under the normal operation of the share for share exchange legislation,[20] the deemed "no disposal" rule[21] often results in the seller being unable to benefit from BADR/ER on a subsequent sale of their "consideration" shares in the acquiring company, for example, because they did not satisfy one of the various 5 per cent share ownership, voting or economic right conditions in relation to that company.

Consequently, sellers are able to elect (under section 169Q TCGA) to opt out of the normal "share exchange" provisions. By making this election, the seller is effectively treated as having made a normal CGT disposal with the value of the acquirer's "consideration" shares being reflected as all/part of their taxable sale consideration. The practical effect is that the seller obtains a step-up in the base value of their consideration shares with BADR/ER being available on the "step-up" gain (albeit in the form of a "dry" tax charge!)

In anticipation of adverse changes to, or the complete abolition of, ER expected in Budget 2020, some owner-managers sought to "lock-in" their existing ER entitlements by arranging for an appropriate share exchange. Typically, this was done by inserting a new holding company "above" the existing company. In the event that ER was abolished or restricted in some way,

[17] As defined in TCGA Sch.7ZA and s.165A.
[18] TCGA s.169S(3).
[19] The legislation is worded so that it does not matter whether an advance TCGA s.138 clearance was given for the share exchange. This prevents any subsequent argument that the share exchange gives rise to an actual CGT disposal pre-Budget day 2020 on the grounds that the tax avoidance rule in TCGA s.137(1) applies.
[20] TCGA s.135—these rules also cover company reconstructions within TCGA s.136.
[21] The "new for old" rule in TCGA s.127 is applied by TCGA s.135(3).

they then intended to make an election after Budget day 2020 (11 March 2020) to "bank" their pre-Budget ER levels.

Once again, this type of advance planning had been anticipated. The anti-forestalling rule in paragraph 5 of Schedule 3 counters this by deeming the section 169Q TCGA election to be given effect at the time it is made and would therefore fix the BADR/ER at the £1 million limit. The election would not therefore access the pre-Budget 2020 level of ER. However, for all other CGT purposes, the rules at the normal disposal date apply.

These provisions also apply to non-qualifying corporate bond (non-QCB) loan notes issued in such cases since they are also covered by a section 169Q TCGA election.

On the other hand, these rules do *not* apply to QCB loan notes. Thus, they have no impact on QCBs that were issued as part of a company sale transaction before 11 March 2020.

Example 3

Ed and James have been equal shareholders in Gemini Three Ltd (GTL) since June 1985. They each held 50 shares.

In February 2020, they received some informal advice from a "business colleague" that ER was likely to be "abolished" in the forthcoming Budget. They were also told that they could implement a share exchange, which would enable them to bank their ER entitlements in the event that ER was subsequently abolished.

Therefore on 7 March 2020, they implemented a share for share exchange transaction under which a new holding company—Space Walk Holdings Ltd (Holdings)—acquired 100 per cent of GTL's share capital in consideration of an issue of 998 new Holdings' shares. It was estimated that GTL was worth some £8 million.

Following the reduction in the BADR/ER limit to £1 million in Budget 2020, they asked their accountant to process section 169Q TCGA elections so they could "bank" their prior ER, albeit at a CGT cost of some £800,000 between them. Fortunately, their accountant was vigilant and told them that the election would be imprudent since it would trigger a very substantial "dry" CGT charge, given that the 10 per cent BADR rate was restricted to just £1 million each (the prevailing BADR limit when the elections were intended to be made).

Interpretation

Paragraph 6 of Schedule 3 states that these provisions of this Schedule form part of the ER/BADR legislation in Chapter 3 of Part 5 TCGA. It also contains various definitions.

Re-naming the relief

From 2020–21 onwards, paragraphs 7 and 8 of Schedule 3 stipulate that ER is to be known as business asset disposal relief (BADR), with all relevant consequential amendments being made to the TCGA to reflect this.

Peter Rayney[*]

Section 24: relief on disposal of private residence

Section 24 of the Finance Act 2020 (FA 2020) makes six unrelated amendments to the private residence relief in the Taxation of Chargeable Gains Act 1992 (TCGA). Two of these amendments are of general significance, one relates to transfers between spouses/civil partners, two enact existing extra statutory concessions, and the final one concerns members of the armed forces. Two additional sections are added to TCGA so that the relief is now spread over no fewer than 18 sections.[1]

Calculating the end of the period of occupation (moving out)

Section 223(1) and (2) TCGA provide that occupation of a property as a sole or main residence, a requirement for the relief, is waived for the final period of ownership. This is to allow for a period after moving out for selling the property. That period is reduced, for all disposals after 6 April 2020,[2] from 18 to nine months by section 24(3)(a) FA 2020.[3] The reasoning is that this will reduce the practice of "flipping" and taxpayers being able to claim the exemption on two houses simultaneously. This reduction was first mooted in 2018, followed by a consultation in 2019.[4] The Government's somewhat complacent response to the consultation on this point,[5] was of course pre-COVID-19 and it remains to be seen how that will affect the housing market and the time taken to sell.[6]

Business asset disposal relief; Capital gains tax; Entrepreneurs' relief; Reorganisation of capital; Share transfers

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[1] There were originally six sections in TCGA. The Office of Tax Simplification review of that Act will hopefully reduce much of that complexity.

[2] This was therefore retrospective to disposals from that date.

[3] The 36 month period for disabled persons and those in care homes is unaffected. See TCGA s.225E.

[4] HMRC and HM Treasury, Consultation document, *Capital Gains Tax: Private Residence Relief: changes to the ancillary reliefs* (1 April 2019).

[5] The Government's position in their response to the consultation in July 2019, was as follows: "a 9 month final period exemption strikes the right balance between being long enough to provide relief whilst they go through the process of selling their home, but not so long that they are able to accrue large amounts of relief on two properties simultaneously, or on homes that are no longer used as their main residence". HMRC and HM Treasury, *Capital Gains Tax: Private Residence Relief: changes to the ancillary reliefs: Summary of Responses* (11 July 2019), para.2.8.

[6] See *Hansard*, Public Bill Committee, Third Sitting of the HC Committee on the Finance Bill 2020, cols 73 and 74 (9 June 2020).

Removal of general lettings relief: restriction to shared occupation with tenant

Section 24(3)(b) FA 2020 repeals section 223(4) TCGA which provided a relief where the house was wholly or partly let as residential accommodation for some period during the taxpayer's period of ownership.[7] That period would create a chargeable gain (by a horizontal separation if part of the house was so let and a vertical separation based on time apportionment) but that gain was restricted to the amount of the gain above the lower of the exempt gain or £40,000.[8] Instead section 223B is introduced into TCGA by section 24(5) FA 2020. This new relief (calculated in the same way) only applies if part of a house is the taxpayer's sole or main residence[9] and another part is let out as residential accommodation.[10] That, chargeable, demised part is thus always separated both horizontally[11] and vertically (by time) from the exempt gain.

Transfer of houses between spouses and civil partners

Section 24(2)(b) FA 2020 makes a small but significant amendment to section 222(7)(a) TCGA. Where one spouse/civil partner transfers an interest in any house to the other, the transferee will now acquire[12] the owner occupation history of the transferor, for good or bad. Formerly this was restricted to a house which was their sole or main residence.[13]

Enacting extra-statutory concessions

Section 24(2)(a) FA 2020 replaces extra-statutory concession (ESC) D21[14] which allowed a late nomination as to which of two residences[15] is a taxpayer's main residence[16] where the taxpayer's interest in one of them was of negligible market value.[17] That is now permitted by section 222(5A) TCGA. The reason for this is that the taxpayer may not realise that in such circumstances a nomination needs to be made.[18]

Section 24(4) FA 2020 replaces ESC D49[19] which relates to the calculation of the period of owner occupation as a sole or main residence from the beginning of that period.[20] That is now in section 223ZA TCGA. It applies if the occupation as a sole or main residence requirement is

[7] With effect from 6 April 2020.
[8] That figure has not been updated since 1980. It should now be £172,800.
[9] See TCGA s.223B(5) for spouses and civil partners.
[10] See *Owen v Elliott (Inspector of Taxes)* [1990] STC 469; 63 TC 319 (CA).
[11] See TCGA s.223B(3).
[12] After 6 April 2020.
[13] The relief is limited to one such house between them, unlike cohabitees.
[14] Extra-statutory concession D21, "Private residence exemption: late claims in dual residence cases".
[15] To claim the relief the house must at some stage have been a sole or main residence.
[16] The usual period is within two years of common ownership: TCGA s.22(5).
[17] e.g. a weekly tenancy.
[18] ESC D21, above fn.14, required that the taxpayer was actually unaware of the need and made the nomination within a reasonable time of becoming aware. That is not in the statute.
[19] Extra-statutory concession D49, "Private residence relief: Short delay by owner-occupier in taking up residence".
[20] As contrasted with the end of that period under TCGA s.223, above.

actually fulfilled sometime in the first 24 months[21] of ownership.[22] The time between ownership and occupation, etc. is referred to as the "moving in time".[23] If the section applies, the residence requirement will be regarded as having been fulfilled from the date of ownership. Provided the house has not been anyone else's residence during that time, the section will apply if either the completion of the building, renovation, redecoration or alteration of the house has taken place within the moving in time, or, if within that time, the taxpayer has disposed of an interest in another house which was at the time the taxpayer's sole or main residence.[24]

Armed forces accommodation

Under section 222(8A) TCGA those who are required to live in job-related accommodation may apply the private residence relief to another house which they own. Section 24(2)(c) and (d) FA 2020 now ensure that this will be available[25] to members of the armed forces who instead of living in a service house are in receipt of an armed forces accommodation allowance.

Geoffrey Morse[*]

Section 25 and Schedule 4: corporate capital losses

Background

Section 25 of the Finance Act 2020 (FA 2020) incorporates Schedule 4 FA 2020 (Schedule 4) which introduces a number of changes to carry-forward capital loss relief. These include a new corporate capital loss restriction (CCLR) which is broadly based on the corporation tax income loss restriction (CILR) enacted in Finance (No.2) Act 2017 (F(No.2)A 2017).[1]

[21] ESC D49, above fn.19, allowed 12 months which could be extended if there were circumstances beyond the taxpayer's control.
[22] Interestingly, TCGA s.223ZA(3) provides that this is calculated without reference to TCGA s.28, following the general rejection of HMRC's arguments to the contrary in *Higgins v HMRC* [2019] EWCA Civ 1860; [2019] STC 2312.
[23] TCGA s.223ZA(1)(b).
[24] There is no explicit causal connection between one of those events and the delay in moving in, or as to any time gap between the event and moving in. There was such an explicit connection in ESC D49, above fn.19.
[25] From 6 April 2020.

Armed forces; Extra-statutory concessions; Private residence relief; Service occupancies; Service personnel; Transfer of assets

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[1] A. Greenbank and J. Moncrieff, "Finance (No.2) Act 2017 Notes: Section 18 and Schedule 4: carried-forward losses; Section 19: losses: counteraction of avoidance arrangements" [2017] BTR 547.

The changes were announced at Budget 2018. A consultation on delivery followed (*Corporate Capital Loss Restriction: Consultation on delivery* (Consultation Document)),[2] with draft legislation published for comment as part of "L-day" in July 2019.[3]

During the Public Bill Committee's discussions on Finance Bill 2019–2021, the Financial Secretary to the Treasury was keen to emphasise how, in taking forward these changes, the Government had complied with its Tax Consultation Framework,[4] commenting that

> "…these measures have been regarded within the profession as the model of how to achieve effective tax legislation".[5]

What the Financial Secretary failed to mention was that, because the Consultation started at Stage 2, a key stage of that framework had been missed: that of stating objectives and setting out options. The lack of an opportunity to comment more broadly on possible ways of reforming capital loss relief was, for this member of the profession at least, disappointing: after all, just over two years before, capital losses were expressly excluded from the Government's 2017 reforms of corporate loss relief:

> "…[T]he distinct treatment of capital losses remains appropriate and [the Government] does not intend to change it as part of these reforms."[6]

Surely the appropriateness (or not) of such distinct treatment merited a Stage 1 consultation, particularly given the significant differences between how the UK taxes income and capital gains?[7]

The Government clearly thought not, even though it described the changes as a "major reform".[8] Focused on avoiding what it described as an "undesirable outcome" of businesses not paying tax when they made disposals (because their historic realised losses offset future gains)[9], the

[2] HM Treasury and HMRC, *Corporate Capital Loss Restriction: Consultation on delivery* (29 October 2018), available at: *https://www.gov.uk/government/consultations/corporate-capital-loss-restriction-consultation-on-delivery* [Accessed 9 September 2020].

[3] HMRC, *Corporate capital loss restriction for corporation tax: draft legislation* (issue date of consultation 11 July 2019), available at: *https://www.gov.uk/government/publications/corporate-capital-loss-restriction-for-corporation-tax* [Accessed 27 August 2020].

[4] HM Treasury and HMRC, *Tax Consultation Framework* (March 2011), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/89261/tax-consultation-framework.pdf* [Accessed 9 September 2020].

[5] The Rt Hon Jesse Norman MP, *Hansard*, Public Bill Committee (2019–2021), Third Sitting, col 81 (Tuesday 9 June (morning) 2020), available at: *https://hansard.parliament.uk/commons/2020-06-09/debates/5927b7da-9829-4504-b795-7657d95cdd1a/FinanceBill(ThirdSitting)* [Accessed 9 September 2020].

[6] HM Treasury and HMRC, *Reforms to corporation tax loss relief: consultation on delivery* (May 2016), available at: *https://www.gov.uk/government/consultations/reforms-to-corporation-tax-loss-relief-consultation-on-delivery* [Accessed 26 October 2020], para.2.19.

[7] It seems that the writer is not alone in this view: for example, see the response of the Chartered Institute of Taxation to the initial Consultation on delivery (see CIOT, Technical Team, *Corporate Capital Loss Restriction: Consultation on delivery: Response by the Chartered Institute of Taxation* (7 February 2019), available at: *https://www.tax.org.uk/policy-technical/submissions/corporate-capital-loss-restriction-ciot-comments* [Accessed 9 September 2020], para.1.4).

[8] Consultation Document, above fn.2, para.1.22.

[9] In the Consultation Document, the Government highlighted that in some cases the historic losses that offset (now taxable) gains arose on disposals of assets that would now be exempt from capital gains tax (CGT) (for example, under the substantial shareholding exemption (SSE) or the exemption for real estate investment trusts (REITs)). See Consultation Document, above fn.2, para.2.3.

main objective was to ensure large companies pay tax when they make substantial profits (whether income or capital gains).[10] Unsurprisingly, the Government borrowed from its corporate income loss playbook where a similar mantra had been invoked. As a result, the changes represent a further means of increasing the tax base of larger companies.[11]

The original plan was to create a separate calculation for CCLR.[12] But, as a result of the consultation process, the Government was "persuaded" that this would add even more complexity to the UK tax system. So, instead, CILR has been complicated: a large part of Schedule 4 FA 2020 amends Part 7ZA of the Corporation Tax Act 2010 (CTA 2010) to embed CCLR within the CILR framework.

The remainder of Schedule 4 mainly contains technical changes to the recently rewritten Taxation of Chargeable Gains Act 1992 (TCGA) (mainly, but not exclusively, to deal with transition). It also includes the anti-forestalling provision announced (and taking effect) at Budget 2018.[13]

This note cannot deal in detail with all the provisions in Schedule 4 and so what follows is a summary of the main changes. In particular, this note does not consider the provisions in Schedule 4 that relate to specific sectors such as insurance, oil and gas and banking groups.

CILR to CILR plus CCLR

The starting point for understanding CCLR is the existing CILR rules in Part 7ZA CTA 2010.

CILR imposes a restriction on the use of carry-forward income loss reliefs—or, to be precise, three restrictions on the use of carry-forward income loss relief. The three restrictions follow on from the three main categories of corporation tax income loss relief that result from the F(No.2)A 2017 loss reforms (streamed trading losses, streamed non-trading deficits (NTDs) and flexible losses[14]).

For each category of loss, in broad terms, the applicable CILR restriction limits carry-forward relief to 50 per cent of the relevant profits. However, there are two points to note.

First, the rules provide for a "deductions allowance"[15] of up to £5 million per accounting period[16] allowing unrestricted offset of carry-forward losses to the extent of that allowance provided the allowance is specified in the company's tax return.[17] The purpose of the deductions allowance is to ensure that small and (many) medium sized businesses do not suffer restriction (as CILR only applies to profits in excess of the deductions allowance, companies with profits of less than £5 million should be able to access carry-forward income relief in full).

[10] Here, see Consultation Document, above fn.2, para.1.8 which echoes comments made in the May 2016 *Reforms to corporation tax loss relief: consultation on delivery*, above fn.6, para.1.16.

[11] Other measures that have the same effect are obviously CILR and also the corporate interest restriction (given the £2 million de minimis).

[12] Consultation Document, above fn.2, para.3.3.

[13] FA 2020 Sch.4, para.46.

[14] More precisely, these are: 1. trading losses that offset trading profits of the same trade; 2. non-trading deficits (NTDs) that offset non-trading profits only; and 3. all other losses that offset total profits (which include (most) trading losses and non-trading deficits that arise on or after 1 April 2017).

[15] CTA 2010 s.269ZW (company that is not a member of a group) and s.269ZR (company that is a member of a group).

[16] If a company is a member of a group (defined in CTA 2010 s.269ZZB) the £5 million annual allowance is shared between all group members that are within the charge to corporation tax (CTA 2010 ss.269ZR and 269ZS).

[17] CTA 2010 s.269ZZ.

Because there are three restrictions, the deductions allowance can be shared between the different categories of loss; how it is allocated impacts available capacity for each category of loss.

Secondly, because total profits are made up of trading and non-trading profits, there is double-counting of profits between the different restrictions—which unless corrected could risk doubling up loss capacity. As a result, carry-forward capacity for flexible income losses (those that offset total profits) is worked out by calculating 50 per cent of total profits (subject to the deductions allowance) and then deducting the amount (if any) of any streamed trading losses/NTDs used to offset trading and non-trading profits as allowed under the other restrictions.

For example, assume a company has total profits of 100 of which 80 are trading profits. It has trading losses available for relief under section 45 CTA 2010 of 40, and excess management expenses of 30. Ignoring the deductions allowance, it can use all 40 of its trading losses against its trading profits. It can offset up to 50 of its total profits by carry-forward reliefs generally. However, because it is using 40 of its trading losses, it can only offset 10 of its management expenses that year.

The above may appear very much "old" Finance Act, but because of CCLR, becomes "new" Finance Act again as CILR has had to be tweaked so that, when taken together, the different restrictions ensure that overall the "right" amount of carry-forward losses are restricted. Although this necessitates some very technical amendments to the existing rules, the economy of the drafting used to do this is particularly impressive.[18]

CCLR is contained in one section: new section 269ZBA CTA 2010.[19] Drafting wise, it mirrors each of the income loss restrictions, determining a "relevant maximum" for the amount of carry-forward capital loss relief available for offset against a company's "relevant chargeable gains"[20] (basically current year gains less current year allowable losses). The relevant maximum is basically 50 per cent of those gains (but, as with the income loss restrictions, loss capacity can be increased by allocating (and specifying) an amount as a "chargeable gains deductions allowance").[21]

As CCLR shares in the same deductions allowance (of up to £5 million) available in relation to income losses, there are only limited changes to the deductions allowance rules. These are in the main designed to ensure that specifying an amount as chargeable gains deductions allowance reduces the amount available for allocation to trading and non-trading profits within CILR.[22] This brings with it changes in nomenclature within the existing rules around non-trading deductions allowance,[23] with new definitions adding new complexity to the rules in Part 7ZA CTA 2010.

[18] The extension of CILR to include CCLR takes up no more than five pages of the Schedule (see FA 2020 Sch.4, paras 2–7 and 25–35). If the sections dealing just with non-resident companies are disregarded, the changes to CTA 2010 Pt 7ZA are very limited.
[19] FA 2020 Sch.4 para.2.
[20] See definition of "relevant chargeable gains" in CTA 2010 s.269ZF(2A) (inserted by FA 2020 Sch.4 para.5).
[21] FA 2020 Sch.4 para.2, inserting CTA 2010 s.269ZBA.
[22] In particular, see changes to CTA 2010 ss.269ZB and 269ZF made by FA 2020 Sch.4 paras 25 and 29 respectively.
[23] The former "non-trading profits" becomes "total non-trading profits", which consists of "non-trading income profits" and "non-trading chargeable gains". This re-naming impacts the definitions of "qualifying [profits]", "relevant [profits]" and the different deduction allowance options: see FA 2020 Sch.4 para.29.

During the Consultation on the changes, a number of people asked that the maximum £5 million deductions allowance be increased given it now had to cover a further category of losses.[24] Although intuitively this seems the right answer, Government modelling suggested otherwise: apparently, the "99% of companies will not pay additional tax" line rolled out under CILR still holds true even with capital losses now in the mix.[25]

Finally, the CILR rules in section 269ZF CTA 2010 that deal with computing the profits to which each restriction applies are amended. Chargeable gains are now dealt with as a separate source of profit (rather than as a constituent part of each of non-trading profits and therefore total profits).[26] This ensures that in-year reliefs can be allocated specifically against chargeable gains (or not) when working out the amount of "relevant chargeable gains" used to work out the relevant maximum under CCLR.[27] Given that carry-forward capital losses continue to offset chargeable gains automatically, the allocation of 1. deductions allowance and 2. in-year reliefs are therefore the only means by which a company can influence the "relevant maximum" for these losses.[28]

The remainder of Schedule 4 mainly provides for consequential amendments (most of which are connected with the extension of capital gains tax (CGT) to non-resident owners of UK land in Finance Act 2019 (FA 2019)) and the commencement provisions.

Other changes to capital loss relief?

As well as CILR, F(No.2)A 2017 brought a much needed modernisation to carry-forward loss relief. From 1 April 2017, "new"[29] trading losses and non-trading deficits can offset total profits[30] and groups can benefit from a new carry-forward group relief (that applies to all post 1 April 2017 income losses).[31]

Sadly, no such sweetener was offered to help the medicine of the CCLR go down. Although the Consultation Document referenced a desire to "bring the treatment of capital losses closer to other corporate losses and thus create a more modern loss relief regime in the UK",[32] the Government was unwilling to make any substantive changes. This was not just because of possible Exchequer impact (offsetting capital losses against income profits would result in a

[24] For example, CIOT, Technical Team, *Corporate Capital Loss Restriction: Consultation on delivery: Response by the Chartered Institute of Taxation* (7 February 2019), above fn.7, para.3.1.
[25] Consultation Document, above fn.2, para.2.10. The Government has separately said that around 200 companies will have capital losses restricted under CCLR each year: see HMRC, Policy paper, *Corporate capital loss restriction for Corporation Tax* (11 July 2019), available at: *https://www.gov.uk/government/publications/corporate-capital-loss-restriction-for-corporation-tax/corporate-capital-loss-restriction-for-corporation-tax* [Accessed 9 September 2020].
[26] FA 2020 Sch.4 paras 5 and 6, amending CTA 2010 s.269ZF.
[27] HMRC, Internal Manual, *Capital Gains Manual* (published 12 March 2016; updated 20 August 2020), CG-APP17, "Appendix 17 - Draft guidance on the Corporate Capital Loss Restriction" (CG-APP17), available at: *https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg-app17* [Accessed 9 September 2020].
[28] Examples of applying CCLR in various scenarios are set out in CG-APP17, above fn.27.
[29] "New" means arising on or after 1 April 2017.
[30] CTA 2010 s.45A and CTA 2009 s.463G.
[31] CTA 2010 Pt 5A.
[32] Consultation Document, above fn.2, para.1.23.

"large cost"), but also to maintain symmetry with the position under CGT for individuals and trustees.[33]

The basic rules around capital loss relief are therefore unchanged. Relief is only available against chargeable gains, and then only on a current year and, subject to CCLR, carry-forward basis.[34] Relief remains automatic—there is no ability to claim (or indeed disclaim) capital loss relief.[35]

As a result, CCLR creates a cliff-edge for new capital losses. If a company realises a capital loss in an accounting period, the economic benefit of that loss is now significantly diminished unless a gain is also realised in that period. As it can only be used on a carry-forward basis (the Government specifically rejected introducing a carry-back relief, in part because "[it] would not ensure that large companies pay some tax when making substantial capital gains"[36]), offset against any future gains will be subject to CCLR. Further, for many companies, there is likely to be a significant gap between disposal and so the period over which full relief is obtained is likely to be significantly extended.

Obviously, for companies within a CGT group, there is a possibility of transferring a loss to another group company under section 171A TCGA. But unless the accounting period of gain and loss coincide, CCLR applies as any transferred gain/loss is treated as accruing to the transferee at the time it originally accrued to the transferor.

However, there are some changes to the rules that apply to capital losses that can only be used against particular types of gain: connected party losses under section 18 TCGA and pre-entry losses within Schedule 7A TCGA. These are in response to comments made during the Consultation on the consequences of restricting losses that were already restricted.

For these losses, the legislation offers what is in effect a "loss swap" arrangement.

The relevant provisions are contained in paragraph 17 of Schedule 4 (for connected party losses—newly defined as "clogged losses") and paragraph 18 (for pre-entry losses). Although paragraph 17 is relatively easy to follow, the nature of the pre-entry loss rules means that making sense of paragraph 18, on first read-through at least, is almost impossible.

Despite the drafting differences, both provisions take the same basic approach. If, in the accounting period in which the company makes a gain against which it can offset these streamed losses it also has current year capital losses,[37] it is able to "swap" its carry-forward streamed

[33] HM Treasury and HMRC, *Corporate Capital Loss Restriction: Summary of responses to consultation and the Government's response* (Summary of Responses) (11 July 2019), available at: *https://www.gov.uk/government/consultations/corporate-capital-loss-restriction-consultation-on-delivery* [Accessed 9 September 2020], para.1.23 (the Government response to Question 3). In contrast, the fact that asymmetry now exists because individuals are not subject to any capital loss restriction is clearly seen as acceptable. It is unclear if "symmetry" between the rules for individuals and companies will feature in the recently announced review of CGT by the Office of Tax Simplification: see Office of Tax Simplification, *Capital Gains Tax Simplification Review: Scoping Document* (July 2020), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/900225/CGT_Scoping_document_July_2020.pdf* [Accessed 9 September 2020].

[34] TCGA s.2A.

[35] This is a further differentiation from the 2017 changes to corporation tax income loss relief.

[36] Summary of Responses, above fn.33, 10. Although part of the policy justification for the changes was the use by large companies of historic losses to offset new gains, this comment highlights that, for the Exchequer, CCLR is directed at increasing the tax base (and effective tax rate) of larger companies whilst maintaining a low headline corporation tax rate: after all, a carry-back relief would only benefit capital losses arising after April 2020.

[37] TCGA s.18(1) (inserted by FA 2020 Sch.4 para.6(1A)–(1C)).

losses for an equivalent amount of current year losses. This means the company can use its carry-forward clogged/pre-entry losses to offset the relevant gain without restriction, but the quid pro quo is that an equivalent amount of current year losses become carry-forward capital losses (and so subject to restriction under CCLR).[38] For clogged losses, a claim is needed; for pre-entry losses, it seems that the company simply chooses which losses it wants to offset against its pre-entry gains without restriction.

Insolvent companies: special rules

As with CILR, CCLR should generally only impact the timing of relief. But if a company is wound up before it has used up all its carry-forward losses, the restriction could impose an absolute tax cost. For this reason, the 2017 changes included a new terminal loss relief for trading losses in section 45F CTA 2010 (effectively dis-applying CILR in the final three years of trading). Representations were made that there should be a similar relief for capital losses: the result is paragraph 8 of Schedule 4 FA 2020.[39]

This is explained in the *Finance Bill Explanatory Notes* as follows:

> "A provision was added for companies in insolvent liquation [sic] which can now offset carried-forward capital losses against gains without the restriction being applied."[40]

The result is that, where a company goes into insolvent liquidation in the UK (or the equivalent in another jurisdiction), CCLR is effectively dis-applied.

Whereas the terminal loss relief for trading losses looks backwards from the point at which a trade ends (for a maximum of three years[41]), the insolvent company capital loss rules look forward with a starting point of commencement of winding up (when a new accounting period begins under section 12 CTA 2009). That new period (and all subsequent periods in which the company is being wound up) are defined as "winding up accounting periods",[42] and, in broad terms, new section 269ZWA CTA 2010 means that carry-forward capital losses can be used by the relevant company without any restriction to offset gains arising in any of its winding up period.

It is not quite as simple as this suggests though. CCLR still applies to the insolvent company. Section 269ZWA CTA 2010 simply allows the company to increase its deductions allowance to an amount which means carry-forward capital losses can (in practice) be used without restriction (with any increase capped at the lower of the company's current year net chargeable gains and its carry-forward losses).[43] This means that an insolvent company in theory could end up with a

[38] Examples of how these "loss swaps" work are contained in CG-APP17, above fn.27, ss.2 and 3.
[39] In Summary of Responses, above fn.33, the Government said it was considering the possibility of some form of relief on insolvency. The detail of what was proposed was only made public when Finance Bill 2019–2021 was published in March 2020.
[40] HM Treasury, *Finance Bill Explanatory Notes* (19 March 2020), available at: *https://publications.parliament.uk/pa/bills/cbill/58-01/0114/en/20114en.pdf* [Accessed 9 September 2020], para.97.
[41] CTA 2010 s.45F(3).
[42] FA 2020 Sch.4 para.8 inserting CTA 2020 s.269ZW(5).
[43] The deductions allowance is increased by the lower of either the company's chargeable gains in the relevant winding up accounting period or its carry-forward losses.

deductions allowance significantly in excess of £5 million in a given winding up accounting period.[44]

Secondly, to ensure that other (solvent) group companies do not benefit from this relaxation of CCLR, subsection (3) to section 269ZWA CTA 2010 excludes certain imported gains when working out the company's increased deductions allowance. Imported gains are defined as gains realised by the company on disposing of an asset that was previously transferred to it intra-group (so section 171 TCGA applied) and gains transferred to it pursuant to a section 171A TCGA election—but only where the transfer or, as the case may be, election was made in a winding up period. If however the section 171 transfer or, as the case may be, section 171A election is made by a group company that is itself in insolvent liquidation, this disregard of imported gains does not apply (reflecting the purpose of the provision—mitigating the potential impact of CCLR during insolvency).

Relying on an increased deductions allowance to achieve this objective means that the ability to switch off CCLR in insolvency is subject to the company specifying deductions allowance in its tax return: here, paragraph 9 of Schedule 4 creates a double "specifying" obligation.

A new subsection (1)(aa) to section 269ZZ CTA 2010 is added as a result of which the insolvent company is required to specify both its actual (that is, increased) deductions allowance and the deductions allowance that it would have had absent section 269ZWA.[45] This creates additional compliance complexity and, as the Government rejected the inclusion of a "deductions allowance" box in the company tax return form (CT600), there is clearly potential for this particular requirement to be missed in practice.[46]

Non-resident companies: the problem with one day accounting periods

A number of the provisions of Schedule 4 are directed at companies which, following the extension of CGT to non-resident owners of land in FA 2019, have one day accounting periods for corporation tax purposes.

A non-resident company that disposes of an interest in UK land comes into the charge to corporation tax only because of that disposal. Where they have no other source of profit within the charge to corporation tax (as was the case for most direct disposals until 6 April 2020[47] and will continue to be the case for many indirect disposals), their accounting period ends on the same day.

[44] See CG-APP17, above fn.27, which includes at Example 32 a company that has its deduction allowance increased by £9 million.
[45] CTA 2010 s.269ZZ(1)(aa).
[46] Summary of Responses, above fn.33, para.11.18. See also letter of 5 October 2018 from the Chartered Institute of Taxation to HMRC, available at: *https://www.tax.org.uk/policy-technical/submissions/carried-forward-corporation-tax-losses-compliance-obligations-ciot* [Accessed 9 September 2020].
[47] This is because any profits of a UK property rental business are brought into account to income tax until 5 April 2020.

This gives rise to a number of issues, particularly for companies with multiple one day accounting periods within a short period.[48] CCLR adds further issues (described by HMRC as "unintended consequences") for this particular class of taxpayer.[49]

Not only do one day accounting periods make it very likely that capital losses are always carried forward (subject to CCLR), the rules around the deduction allowance make that restriction even harsher. The maximum deductions allowance of £5 million is based on a 12 month accounting period. Where an accounting period is less than 12 months, that £5 million must be proportionately reduced.[50] The maximum deductions allowance for a one day period would therefore be less than £13,700.[51]

Amending the legislation dealing with corporation tax accounting periods might have allowed all the various issues around one day periods to be resolved in one go. But the Government appears to be taking a piecemeal approach—dealing with specific issues as they are identified, whether by guidance, concession[52] or, in relation to CCLR, rather complex legislation (set out in paragraphs 10, 39 and 45 of Schedule 4).

Given that non-residents with one day accounting periods are unlikely to have much familiarity with the UK tax system, this is perhaps less than ideal.

Deductions allowance and non-residents

Paragraph 10 of Schedule 4, introducing new sections 269ZYA and 269ZYB CTA 2010, addresses the problem of the "one day" deductions allowance.

The aim of these provisions is straightforward enough: it is to "allow companies with one-day accounting periods to be able to access the full £5 million deductions allowance per financial year".[53] The legislation itself is not as straightforward: the first draft (the July 2019 clauses) was completely rewritten and although the rewrite adds clarity, it does not add simplicity.

The provisions work by (in effect) deeming the non-resident to have a 12 month accounting period for the purposes of working out the amount of available deduction allowance. That 12 month period, which runs from 1 April to 31 March (to coincide with the corporation tax financial year),[54] can benefit from the maximum £5 million deductions allowance—but only if this special treatment is claimed.

The provisions only apply to "a company without a source of chargeable income"[55] throughout the entirety of the relevant financial year (basically a company that is only within the charge to corporation tax because of a chargeable gain). So a non-resident that sells its only UK rental

[48] See, for example, the apparently concessionary accounting period practice for funds and companies making more than four disposals in a financial year set out in HMRC, Guidance, *Register a non-resident company for Corporation Tax* (published 8 April 2019; last updated 22 June 2020), available at: *https://www.gov.uk/guidance/register-a-non-resident-company-for-corporation-tax* [Accessed 9 September 2020].
[49] Summary of Responses, above fn.33, para.11.16.
[50] CTA 2002 s.269ZW(3).
[51] And the amount will vary depending on whether or not the accounting period is in a leap year.
[52] For example, in relation to quarterly instalment payments (though now legislated for in FA 2020 s.26).
[53] Summary of Responses, above fn.33, para.11.16 summary.
[54] See CTA 2010 s.1119 for definition of "financial year".
[55] See section heading. However the legislation itself rewrites this as a company that "has no source of chargeable income" (see CTA 2010 s.269ZYA(1) and (2)).

property on 2 April 2021 cannot benefit because the property provided a source of income for corporation tax on 1 April 2021.

If the non-resident is a member of a group, the provisions are only available if no member of the group has a source of chargeable income in the deemed 12 month period. Care is needed here as the condition is drafted by reference to "each other company that is, at any time during the relevant financial year, a member of the group".[56] However, it is not enough that the other group member had no source of chargeable income whilst it was a group member—it must have no such source at any time in the relevant financial year (whether or not it was then a member of the group).

As a result, if a group consists of 20 non-UK companies and just one UK trading company, section 269ZYA CTA 2010 cannot apply. In such a situation, if one of the non-resident companies makes an indirect disposal, its deductions allowance will be limited to just under £13,700. Plus, as it seems that the normal group deductions allowance provisions then apply (as on that one day there are two group members within the charge to corporation tax),[57] there will be a lot of compliance for (if the gain is material) relatively limited benefit.

If paragraph 10 of Schedule 4 applies, the position should be relatively straightforward where there is only one disposal in a financial year—provided the company remembers to make the relevant claim.[58]

Things are a little more complicated if a company makes more than one disposal in a given financial year (and so has two or more one day accounting periods) and wishes to benefit from the full £5 million allowance for at least one of them.[59]

This is because the £5 million annual deductions allowance has to be shared between the various disposals. This "sharing" is provided for in subsections (7) to (11) of section 269ZYA CTA 2010. In broad terms, assuming the non-resident makes a claim for section 269ZYA CTA 2010 to apply to a particular disposal in a financial year (the relevant one day period being defined as a "claim AP" in section 269ZYA(4) CTA 2010), the amount of deductions allowance available for a particular disposal is dependent on the amount of deductions allowance applicable to other disposals in that financial year (whether or not a claim was made for those other disposals). This sharing is not based on a simple time of disposal rule: instead, a table in section 269ZYA(11) CTA 2010 sets out an order of priority between disposals for working out available deductions allowance.[60]

If the non-resident company is a member of a group (as defined within section 269ZZB CTA 2010), the same principle applies, with the maximum £5 million allowance shared between those group companies that make a disposal within the same financial year.[61]

[56] FA 2020 Sch.4, para.10(9)(b)(ii).
[57] CTA 2010 s.269ZR(1).
[58] CTA 2010 s.269ZYA(4). It may also need to make a declaration under CTA 2010 s.269YB and of course will need to specify the deductions allowance in its tax return (as both deductions allowance and chargeable gains deductions allowance). See CG-APP17, above fn.27, Example 23.
[59] CG-APP17, above fn.27, Examples 24 and 25.
[60] CG-APP17, above fn.27, Example 21, shows how this provision works in practice.
[61] CTA 2010 s.269ZYA(9)(b)(ii). See also CG-APP17, above fn.27, Example 20. Note that this is not the same as having a group deductions allowance.

As a claim under section 269ZYA CTA 2010 cannot be made before the end of the relevant financial year, paragraph 10 of Schedule 4 also introduces a new section 269ZYB CTA 2010 to provide for provisional claims for the special deductions allowance. By way of example, a company making a disposal on say 5 April may end up filing its tax return (for its one day 5 April "real" accounting period) before the following 31 March and so it cannot then make a claim under section 269ZYA CTA 2010. This is where section 269ZYB CTA 2010 comes in: the company makes a declaration that it will be making a claim, and on that basis, assesses (and pays) corporation tax.

This does not obviate the need for an actual claim once the financial year has ended (if no claim is made, the declaration falls away and additional tax due). Similarly, if the company (or a group member) subsequently comes within the charge to corporation tax in the relevant financial year, the declaration ceases to have effect (as one of the pre-conditions to making a claim is no longer met)—again, meaning an amended tax return and further tax is payable.[62]

Merging one day accounting periods

Where a non-resident company makes multiple disposals in a financial year (and so has multiple one day accounting periods), paragraph 39 of Schedule 4 means that the company can offset "same" financial year gains and losses against each other without CCLR applying.[63]

Paragraph 39 of Schedule 4 enacts new section 2A(1)(aa) TCGA. This has the effect of allowing a loss accruing to a non-resident company to be both carried forward (without restriction) and carried back to offset gains in different one day accounting periods in the same financial year. Like paragraph 10 of Schedule 4, this only applies to a company that is not otherwise within the charge to corporation tax in that financial year.

Special treatment for non-resident landlords newly within the charge to corporation tax

On 6 April 2020, non-resident companies carrying on a UK property business become subject to corporation tax on income under Schedule 5 FA 2019 and so, within the 2020–2021 financial year, will have a source of chargeable income. Absent special provision, they cannot therefore benefit from paragraphs 10 or 39 of Schedule 4 if they made a disposal between 1 and 5 April 2020. As this seemed harsh, representations were made, and so paragraph 45 was added to the initial draft clauses.

The effect of paragraph 45 of Schedule 4 is to merge the one day accounting period of the disposal (made between 1 and 5 April 2020) with the landlord's first full corporation tax accounting period (starting 6 April 2020) both for the purposes of capital loss relief (so a loss realised in the one day accounting period can be offset against gains realised in the accounting period beginning on 6 April 2020[64] and vice versa[65]) and for determining the maximum available deductions allowance available on the one day disposal (see paragraph 45(4), adapting section 269ZYA CTA 2010).

[62] CG-APP17, above fn.27, Examples 27–29.
[63] TCGA s.2A(3), as inserted by FA 2020 Sch.4 para.39.
[64] FA 2019 Sch.5 para.36.
[65] FA 2020 Sch.4 para.40(3).

Offshore collective investment vehicles and CCLR

Schedule 4 has one further surprise for a particular type of non-resident impacted by the FA 2019 changes; one that is not as helpful as those summarised above.

Paragraph 4 of Schedule 5AAA TCGA deems certain offshore collective investment vehicles to be companies for specified CGT purposes ("relevant purposes" within the legislation—which includes the purpose of applying the provisions of any Act relevant to the application of section 2B(4) TCGA).[66]

It was unclear from the July draft legislation whether such a deemed company would be a "company" for the purposes of CCLR. Although the application of the capital loss provisions is relevant for the purposes of applying section 2B(4) TCGA, the definition of "group" in section 269ZZB CTA 2010 adopts the meaning of "company" that applies generally for corporation tax purposes[67]: a deemed company is not a body corporate.

Clarity was provided in March 2020 in paragraph 11 of Schedule 4. This states that "relevant purposes" within paragraph 4 of Schedule 5AAA TCGA includes the definition of "group" in section 269ZZB CTA 2010[68] (but note not for any other grouping purposes).

So, if a Jersey property unit trust (JPUT) makes a disposal of UK land, the group deductions allowance provisions will potentially apply if any corporate unitholder has the relevant 75 per cent interest in the JPUT (because paragraph 4 of Schedule 5AAA TCGA only applies where the vehicle is tax-transparent for income, the corporate unitholder should as a result have at least one source of chargeable income (the rent from the UK land)).[69]

The result is not only that there is potentially a very different outcome for a "grouped" JPUT to that which would apply if a transparency election was made (where any gain arises directly to unitholders), but also means that a deemed company is treated less favourably than a "real" company (given a real company can benefit from CGT grouping and section 171A TCGA elections).

REITs and CCLR

Specific provision is also made for real estate investment trusts (REITs). This may seem counter-intuitive given that a REIT is exempt from corporation tax on chargeable gains arising in its property rental business.[70] But, as was the case for CILR,[71] something was needed to deal with the calculation of property income dividends (PIDs).

This is because a distribution of gains arising on a disposal of an asset used in a REIT's property rental business is treated as a PID (with shareholders, and not the REIT, taxed on any gain).

[66] S. Squires, "Finance Act 2019 Notes: Section 13: disposals by non-UK residents etc; and Schedule 1, paragraph 21: Schedule 5AAA to the Taxation of Chargeable Gains Act 1992—UK property rich collective investment vehicles etc" [2019] BTR 278.
[67] CTA 2010 s.1121.
[68] TCGA Sch.5AAA para.4 has not been amended.
[69] As a result, the normal deduction allowance rules apply, and not the provisions enacted by FA 2020 Sch.4 para.10.
[70] CTA 2010 s.535.
[71] CTA 2010 s.599(9).

A specific provision—section 550 CTA 2010—identifies whether a dividend is attributable to an exempt chargeable gain (or, as per the legislation, "relevant non-chargeable gains").

The definition of "relevant non-chargeable gains" refers to the main CGT exemptions in sections 535 and 535A CTA 2010 and implies gross gains: losses are irrelevant when a gain is exempt.[72] However, in practice, "relevant non-chargeable gains" appears to be interpreted (purposively perhaps?) as meaning "net" non-chargeable gains (reflecting the fact that, economically speaking, shareholders' profits are based on the net position). HMRC's *Investment Funds Manual* at IFM28035 comments:

> "Note that the amount of gains in this category is the amount as calculated for TCGA purposes, so will be reduced by indexation relief net of losses realised while in the REIT regime."[73]

On this basis, to work out "relevant non-chargeable gains", a REIT presumably undertakes a "shadow" CGT computation—and, if so, does it need to apply CCLR (and on what technical basis[74])? The resultant drafting challenge—to deal with this issue without creating others—was singularly failed at first attempt.[75]

This is now dealt with by paragraph 21 of Schedule 4 which states that CCLR is to be ignored when working out relevant non-chargeable gains: this provides clarity whilst avoiding any need to rewrite the basic CGT exemptions available to REITs.

There is one further dis-application of CCLR for REITs in the context of the new exemption for gains on sales of UK property-rich companies (introduced in FA 2019). If a REIT chooses to offset a pre 6 April 2019 residual business capital loss against any such gain, CCLR does not apply (see paragraph 20 of Schedule 4).

And finally, commencement…

CCLR (and the other related changes) applies to all companies on 1 April 2020. Like CILR, if a company has a "real" accounting period that straddles that date, the commencement rules require that period to be split into two separate (deemed) accounting periods: one (AP1) ending on 31 March 2020; and the other (AP2) beginning 1 April 2020, with CCLR applying in AP2. As gains (and losses) are recognised on a realisation basis, apportionment of amounts between AP1 and AP2 is thankfully a lot more straightforward than it was for CILR.

Again, as was the case for CILR, the commencement rules are not intended to impact same "real" year capital loss relief. The Summary of Responses confirmed this:

[72] Plus, as a technical matter, losses accruing to the property rental business are not "allowable losses" in any event given TCGA s.16(2).
[73] HMRC, Internal Manual, *Investment Funds Manual* (published 5 July 2019; updated 13 October 2020), IFM28035, "Real Estate Investment Trust: Distributions: attribution rules: category (d) - gains of the property rental business: CTA2010/S550(2)(d)".
[74] The prescriptive nature of CTA 2010 Pt 7ZA means that a loss must be within TCGA s.2A to be subject to restriction and for REITs, as the loss is not an allowable loss (technically) it cannot be within TCGA s.2A.
[75] The July 2019 draft legislation, see above fn.3, included a new CTA 2010 s.535(10) which provided that CCLR was to be ignored when working out the amount of a gain arising on a property rental disposal (notwithstanding that under TCGA s.2A losses offset the total gains arising in an accounting period, not individual gains).

> "As previously set out there will be no restriction applied to capital losses arising in the transitional period where these can offset capital gains arising in either of the notional periods."[76]

To enable current "real" year capital losses to be accessed in each of AP1 and AP2 without restriction, paragraph 44 of Schedule 4 modifies both section 2A TCGA and Part 7ZA CTA 2010. It would have been a lot easier to have the rules apply from the start of an actual accounting period (noting that the timing of gains is, in any event, often within the control of the taxpayer), but the Government felt this created a risk of "one company having an unfair advantage over another purely because they have different accounting periods".[77]

Instead, a company that makes one or more disposals in a straddle period has to calculate its net chargeable gains position in relation to each of AP1 and AP2 separately, taking account of both current year and carry-forward capital losses (and, in AP2, CCLR).

If a net loss arises in either AP1 or AP2,[78] it can offset any net gain arising in the other deemed period.[79]

So, if the company has a net loss in AP1, but a gain in AP2, the AP1 loss offsets the AP2 gain under section 2A(1)(a) TCGA and CCLR is irrelevant. If, however, the company has a net loss in AP2, but a gain in AP1, that AP2 loss offsets the AP1 gain on a similar basis (a special "carry back"). The end result determines the amount of chargeable gains to be included in total profits for its "real" accounting period.

The modifications to Part 7ZA CTA 2010 are slightly more challenging to work through (linked to the complexity of CILR). Paragraphs 44(4)(a) and (b) of Schedule 4 ensure CCLR is only relevant to AP2 (and, because of paragraph 44(3)(b) of Schedule 4, only relevant to carried-forward losses from earlier "real" accounting periods). Paragraph 44(4)(c) of Schedule 4 deals with the calculation of modified total profits within CILR given that capital losses are excluded when working out modified total profits for AP2 (see section 269ZF(4) CTA 2010). The easiest way to understand this in practice is to work through the examples included in HMRC's draft guidance on CCLR.[80] No wonder the Government has been in discussion with software providers: after all, in the real world, companies will be heavily relying on their tax software to apply these rules.

The commencement provisions also include an anti-forestalling provision in paragraph 46 of Schedule 4. This is now effectively spent: the legislation can no longer be forestalled.[81] The provision was announced at Budget 2018 and HMRC's draft guidance simply lifts, word-for-word, the very limited examples included in the Consultation Document and so are not likely to be of

[76] Summary of Responses, above fn.33, para.6.2.
[77] Summary of Responses, above fn.33, para.6.1.
[78] FA 2020 Sch.4, para.44 applies only to "allowable losses accruing to the company in the [relevant deemed period] so far as they exceed the chargeable gains accruing to the company in the [relevant deemed period]".
[79] FA 2020 Sch.4, paras 44(3)(a) and (b).
[80] CG-APP17, above fn.27, Examples 7–10.
[81] Going forward, FA 2020 Sch.4 para.23 amends the broadly drafted CILR regime anti-avoidance provision (see F(No.2) A 2017 s.19) to cover capital losses. For commentary on this provision, see Greenbank and Moncrieff, above fn.1, 554–555.

any particular assistance to anyone who, in the last 18 months or so, had to think about these rules. ☞

Sarah Squires*

Section 29: structures and buildings allowances: rate of relief; Section 30: structures and buildings allowances: miscellaneous amendments

As discussed in more detail in the writer's 2019 Finance Act note on the introduction of non-residential structures and buildings allowances (SBA),[1] from 2010 the UK Government embarked on a plan "to create the most competitive corporate tax regime in the G20",[2] and reduced the headline rate of corporation tax from 28 per cent to its present 19 per cent.[3] This rate reduction was financed in part by reducing capital allowances,[4] making the UK one of the least generous Member countries in the OECD in providing tax relief for capital expenditure.[5]

Section 30 of the Finance Act 2019 started to reverse that process by (re)introducing capital allowances for commercial buildings in the form of the SBA in Part 2A of the Capital Allowances Act 2001 (CAA 2001). SBA was given at an annual rate of 2 per cent on a straight-line basis on qualifying expenditure incurred on the construction of a building on or after 29 October 2018 once the property was brought into qualifying use.[6] This was one-half of the 4 per cent allowance previously provided for industrial buildings before that allowance was phased out entirely from 2008 to 2011.[7]

The Finance Act 2020 (FA 2020) continues this policy reversal by increasing the SBA rate to 3 per cent on relevant expenditure from 1 April 2020 for corporation tax purposes and from 6 April 2020 for income tax purposes.[8] The higher rate applies to qualifying expenditure whether incurred before or after April 2020. This reduces the period over which expenditure may be relieved from 50 years to 33 1/3 years.[9] Transitional arrangements are provided in new section 270GD CAA 2001.[10] According to the *Finance Bill Explanatory Notes*, the SBA rate was increased

☞ Accounting periods; Capital losses; Carry-forward reliefs; Collective investment schemes; Corporation tax; Non-resident companies; Real estate investment trusts; Winding-up

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[1] G. Loutzenhiser, "Finance Act 2019 notes: Section 30: construction expenditure on buildings and structures; Section 31: special rate expenditure on plant and machinery; Section 33: first-year allowances and first-year tax credits; Section 34: first-year allowance: expenditure on electric vehicle charge points; Section 35: qualifying expenditure: buildings, structures and land" [2019] BTR 331.

[2] HM Government, *The Coalition: our programme for government* (20 May 2010), 10. See also G. Maffini, "Business taxation under the coalition government", *Tax Journal*, 1 May 2015, 16.

[3] FA 2016 ss.45–46.

[4] Maffini, above fn.2, 16 and CAA 2001 s.104D(1).

[5] See K. Bilicka and M.P. Devereux, "Finance Act 2012 Notes: Section 5: main rate of corporation tax for financial year 2012—the competitiveness of the UK corporation tax rate" [2012] BTR 365, 369; Maffini, above fn.2, 17.

[6] FA 2019 s.30(1) and (2)(c). See also CAA 2001 s.270AA. "Qualifying expenditure" is defined in CAA 2001 s.270BA.

[7] Formerly CAA 2001 Pt 3.

[8] FA 2020 s.29(2), amending CAA 2001 s.270AA(5).

[9] FA 2020 s.29(2), amending CAA 2001 s.270AA(2)(b)(ii).

[10] FA 2020 s.29(5), adding CAA 2001 Ch.7A, s.270GD.

"to further support and incentivise business investment".[11] Other minor amendments to the SBA regime were made in section 30 and Schedule 5 FA 2020; most notably changes aimed at preventing double relief when research and development allowances are also available[12] and clarifying how the regime applies to contributions to public bodies[13].

Glen Loutzenhiser*

Section 31: intangible fixed assets: pre-FA 2002 assets etc

The Finance Act 2002 (FA 2002) rules on intangibles,[1] partly for budgetary reasons but also to permit access to accrued allowable losses to shelter gains on disposals of (what were then) existing intangibles, always drew a distinction between pre FA 2002 intangibles ("old assets") and intangibles created,[2] or purchased from unrelated parties[3] ("new assets"), after 31 March 2002. This distinction between "old assets" and "new assets" was made principally to prevent "old assets" from becoming eligible for corporation tax relief[4] in their owner's hands or following a transfer from a related party.

The principal aim of section 31 of the Finance Act 2020 (FA 2020) is to extend the reliefs available (and, correspondingly, the tax charges potentially applicable) to some but not all post 30 June 2020 acquisitions of "old assets". Different rules apply depending on whether the relevant intangibles are acquired from third parties or from related parties.

What is patently clear, on reading Part 8 of the Corporation Tax Act 2009 (CTA 2009) as amended by section 31 FA 2020, is that the distinction between "old assets" and "new assets" is not being swept away. In broad terms that will not occur until the legislation is changed again or the last business which has goodwill that is in part attributable to activities carried on before 1 April 2002[5] (or the last intangible in existence at 1 April 2002) has been transferred to an unrelated party.[6] Rather, section 31 FA 2020 can be synthesised as reducing the number of "old assets" by enabling some of those assets to be treated fully as "new assets" and others to be treated only partially as "new assets" ("restricted assets"). This in effect limits the amount which is capable of obtaining tax relief to the lower level of the asset's market value when first acquired by a company after 30 June 2020.

To understand the background of what it is that section 31 FA 2020 seeks to achieve (including the reason it was necessary to introduce new Chapters 16A and 16B into Part 8 CTA 2009) one

[11] HM Treasury, *Finance Bill Explanatory Notes* (19 March 2020), cl.28(14).
[12] FA 2020 Sch.5, cl.2, substituting CAA 2001 s.270EC.
[13] FA 2020 Sch.5, cl.3, amending CAA 2001 s.538A.

Corporation tax; Income tax; Structures and buildings allowances

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[1] FA 2002 s.84(1) and Sch.29. Now contained in CTA 2009 Pt 8.
[2] See in particular the exclusion contained in CTA 2009 s.882(1)(a) and (b).
[3] In very limited circumstances "old assets" acquired from related parties came within the "new regime": see CTA 2009 s.882(1)(c).
[4] CTA 2009 Pt 8, Ch.3.
[5] CTA 2009 s.884(1)(a).
[6] See CTA 2009 s.884(1)(b).

needs to focus on the fact that, while generally acquisition costs or disposal proceeds of assets within the intangibles regime are based on amounts recognised in GAAP compliant accounts, in certain circumstances transactions can be treated as occurring on a tax neutral basis[7] or on the basis of the market value being substituted[8] for the accounting entries that would otherwise be used. HMRC were concerned that in certain circumstances transactions or steps would be taken to bring "old assets" within the new regime and so tax relief would in effect be calculated on the basis of fluctuations in value from earlier than 2020.

This is achieved in various ways. First, section 892 CTA 2009 is amended to treat as an "old asset" (in the hands of a group company transferee) an asset that is transferred intra-group.[9] Secondly, the extent to which the new regime can apply to "new assets" that became such as a result of the modifications made to section 882 CTA 2009 by section 31(6) FA 2020, principally new section 882(1C) CTA 2009, and to a lesser extent section 882(1D) CTA 2009, is limited in particular by the first and third class of "restricted asset".[10]

Very broadly, if an asset was acquired from a related party, and either 1. that asset was an "old asset" on 1 July 2020 or 2. the asset was not an "old asset" (because it was not held by a company liable to corporation tax immediately before 1 July 2020) and in either case the asset has not *subsequently* been acquired from an unrelated party[11] then the asset is within the first class. The second class of "restricted asset" essentially updates the restriction contained in section 893 CTA 2009 in relation to "old assets" to prevent grants of sub-interests in "old assets" (such as licences) creating technically "new assets" in the hands of the licensee. The third class of "restricted" asset is a related party acquisition of an "old asset" where again, although there have been post 30 June 2020 transactions, none of those have involved unrelated parties.[12]

The way in which the restrictions operate differs depending on whether the asset is within the first class[13] of "restricted asset" or the second or third classes.[14] As regards section 900B CTA 2009 assets, broadly speaking until the asset has been through the hands of an unrelated party tax relief can only be obtained on falls in value in an asset to the extent that (subsequent to its first acquisition after 30 June 2020) it had initially appreciated in value.[15] As regards section 900C or section 900D CTA 2009 assets broadly the actual acquisition cost of the relevant asset is reduced by a just and reasonable proportion of the amount that would have applied had instead the company acquired the "relevant other asset", as defined in section 900F(5) CTA 2009.

Overall, for a company (for example, a new overseas investor) acquiring intangibles in a third party transaction, the rules as modified are relatively explicable. However, for groups transferring assets within a worldwide group, or acquisitions of assets from related parties (perhaps a joint venture transaction), a detailed analysis will need to be undertaken, together with appropriate

[7] See CTA 2009 s.775(1)(a).
[8] See CTA 2009 Pt 8, Ch.13.
[9] FA 2020 s.31(10).
[10] See new CTA 2009 s.900B and s.900D, inserted by FA 2020 s.31(13).
[11] With a limited exception in CTA 2009 s.900B(4)–(7).
[12] Note the extended definition of "related parties" in new CTA 2009 s.900H.
[13] i.e. CTA 2009 s.900B.
[14] i.e. CTA 2009 s.900C or s.900D.
[15] In other words if the asset has only fallen in value since its first post 30 June 2020 acquisition, no relief for that subsequent fall is available: see CTA 2009 s.900E.

record keeping of the first relevant acquisition value after 30 June 2020 where, although the asset is a "new asset", it is a "restricted asset".

One way of limiting the budgetary cost resulting from complete unification of the intangibles rules, might have been to apply an arbitrary restriction on the percentage of relief to which a taxpayer would otherwise have been entitled in any one year, rather like the 50 per cent restriction on loss carry-forward introduced in 2017.[16] Instead, rather like St Augustine,[17] HM Treasury felt unable fully to embrace simplicity so we have "old assets", "new assets" and, now, "restricted assets". ☞

Gary Richards[*]

Section 32 and Schedule 6: non-UK resident companies carrying on UK property businesses etc

In the Finance Act 2019 (FA 2019)[1] the UK extended the scope of corporation tax to the income of non-resident companies operating UK property businesses. This change came into effect on 6 April 2020. Previously such companies had been subject to income tax, a regime which could give rise to difficulties if the company was also operating a UK trade which was within the scope of corporation tax since HMRC's position was that it was not possible to set trade losses against any income tax profits; a position rejected by the Upper Tribunal in *HMRC v English Holdings (BVI) Ltd*.[2]

HMRC and HM Treasury had launched a consultation on 20 March 2017[3] for moving non-resident companies from income tax to corporation tax to achieve consistency particularly in light of the corporate interest restriction (the new Part 10 of the Taxation (International and Other Provisions) Act 2010) and loss reform rules (see various amendments to the Corporation Tax Act 2009 (CTA 2009) and the Corporation Tax Act 2010) inserted by Finance (No.2) Act 2017 with effect from 1 April 2017. The consultation also proposed bringing non-resident capital gains tax (CGT) gains within the scope of corporation tax at the same time and this was introduced in section 13 FA 2019 as discussed by Giles Clarke in Issue 3 of this *Review* in 2019.[4]

The broad effect of the change from income tax to corporation tax is therefore belatedly to subject non-resident corporate landlords to the same restrictions as apply to other companies

[16] See CTA 2010 Pt 7ZA.
[17] St Augustine is meant to have said: "Oh Master, make me chaste, but not yet" (St Augustine, *Confessions*, Book VIII, Ch.VII).

☞ Intangible fixed assets; Reliefs

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[1] FA 2019 s.17 and Sch.5.
[2] *HMRC v English Holdings (BVI) Ltd* [2017] UKUT 842 (TCC); [2018] STC 220.
[3] HMRC and HM Treasury, *Non-resident companies chargeable to Income Tax and non-resident CGT: Consultation document* (20 March 2017), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/601032/Non-resident_companies_chargeable_to_Income_Tax_and_non-resident_CGT_-_consultation.pdf* [Accessed 8 September 2020].
[4] G. Clarke, "Finance Act 2019 Notes: Section 13: disposals by non-UK residents etc; and Schedule 1: chargeable gains accruing to non-residents etc" [2019] BTR 268.

subject to corporation tax. The interest restriction may be particularly relevant here and for many the reduction from an income tax rate of 20 per cent to a corporation tax rate of 19 per cent (for 2020–21) will not compensate for this.

Against this background, section 32 of and Schedule 6 to the Finance Act 2020 (FA 2020) do some tidying up in a few respects (leaving aside clarificatory changes):

1. a new section 330ZA CTA 2009[5];
2. a new section 607ZA CTA 2009[6];
3. amending provisions concerning notification of chargeability[7]; and
4. amending provisions concerning election under regulation 6A of the Disregard Regulations.[8]

The commencement for the new provisions is retrospective: changes 1 to 3 are treated as having always been included in Schedule 5 FA 2019. Change 4 has effect in relation to disposals made on or after 6 April 2019.

Changes 1 and 2 concern loan relationships and derivative contracts respectively and provide generous treatment in so far as the following are satisfied:

(a) a loan relationship or derivative contract which was entered into for the purposes of the UK property business;
(b) within seven years of the commencement of the UK property business; and
(c) those debits are not otherwise brought into account;
(d) had the company been carrying on the business at an earlier stage, the debits would have been recognised in determining profit or loss and brought into account under the loan relationship/derivative regime.

If these conditions are met then the debits, to the extent that they exceed "relevant credits" (that is, had the company been carrying on the business at an earlier stage, credits that would have been recognised in determining profit or losses, would have been brought into account and would not otherwise have been brought into account), are treated as being debits for the accounting period in which the company starts to carry on the UK property business.

Change 3 concerns a tightening of an exception already provided for in Schedule 5 FA 2019. The previous sets of provisions avoided the need to notify chargeability to corporation tax (both on first coming within the scope of corporation tax, see section 55 of the Finance Act 2004 (FA 2004), and for any accounting period where a notice to complete a return has not been received, see paragraph 2 of Schedule 18 to the Finance Act 1998) in so far as the relevant income was reasonably expected to be (for section 55 FA 2004 purposes) or had been subjected to income tax withholding. The change in FA 2020 now requires not simply that income tax will be deducted but that such deducted tax will *equate* to any corporation tax liability.

[5] FA 2020 Sch.6 para.3.
[6] FA 2020 Sch.6 para.4.
[7] FA 2020 Sch.6 para.6.
[8] FA 2020 Sch.6 para.8.

This exception from having to register for corporation tax is, of course, useful for non-UK resident companies operating UK property businesses to the extent that withholding applies under the UK's non-resident landlord scheme.

Note that HMRC have updated the Taxation of Income from Land (Non-residents) Regulations 1995[9] (the 1995 Regulations) to reflect the fact that if a UK agent is to deduct financing costs *paid by that agent* when calculating income tax withholding, they will now have to apply a corporate interest restriction. The agent either has the option of satisfying themselves as to the full workings of the corporate interest restriction (which may be difficult in practice) or irrevocably electing under new regulation 9(4)(b) of the 1995 Regulations to use the "financing costs allowance"—essentially a simplified corporate interest restriction capped at 30 per cent of the rental income less expenses (other than interest). An election will obviously not be attractive for those companies whose interest deduction is less than £2 million since this would automatically be allowable under the corporate interest restriction.

Change 4 relates to the fact that chargeable gains in relation to UK land are now within the scope of corporation tax. To the extent that a disposal occurs before 6 April 2020 (that is, when the disposal is within the charge to corporation tax but the UK property business is not), the company will not be prejudiced by being considered a "new adopter" for the purposes of the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004[10]. ☞

David Yates[*]

Section 34 and Schedule 7: CT payment plans for tax on certain transactions with EEA residents

Background and context to the provision

The UK's domestic tax legislation has sought to allow intra-group asset disposals between UK resident group companies on a tax neutral "no gain no loss" basis, subject to certain conditions (in particular, see section 171 of the Taxation of Chargeable Gains Act 1992 (TCGA)). Such provisions allow a UK transferor to assume a UK transferee's base cost in an asset. Assets can move intra-group without incurring an immediate tax charge, which instead crystallises at the time the asset leaves the group.

The "no gain no loss" rule applies to UK resident group companies only. As such, where assets are transferred intra-group to a transferee outside the UK a tax charge crystallises and the rules which deem the transferor to inherit the transferee's base cost are ignored.

[9] The Taxation of Income from Land (Non-residents) Regulations 1995 (SI 1995/2902).
[10] The Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004 (SI 2004/3256).

☞ Charge to tax; Corporation tax; Derivative contracts; Loan relationships; Non-resident companies; Property businesses

[*] QC, Pump Court Tax Chambers.

In *Gallaher Ltd v HMRC* (*Gallaher*),[1] the appellant sought to challenge this geographical application in reliance upon EU law. The relevant issue, for present purposes, was whether section 171 TCGA and sections 775 and 776 of the Corporation Tax Act 2009 (CTA 2009) (together, the Group Transfer Rules) were compatible with EU law. Due to the geographical restrictions within the Group Transfer Rules the appellant could not rely on their application to avoid an immediate liability to pay corporation tax on certain disposals, including to the Netherlands. Interestingly, the appellant did not seek to argue that the Group Transfer Rules should apply to its intra-group disposals to non-UK group members. Instead, the appellant submitted that there was a deficiency in the Group Transfer Rules which should be remedied to allow for a corporation tax deferral on intra-group overseas asset disposals. In essence, there was no dispute that a gain that had crystallised on the asset transfer should be subject to UK tax; the question was *when* that gain should be taxed.

The freedom of establishment[2] was found to apply to the appellant's 2014 disposal to a Netherlands group company. The Group Transfer Rules created a restriction on the basis that the disposal led to an immediate liability to pay tax. If the transferee had been UK resident it would have assumed the appellant's base cost in the shares and no tax liability would have arisen at the time of the disposal. Although the restriction was justified to secure the balanced allocation of taxing powers, it was considered to go beyond what was necessary, and therefore failed on proportionality.

The First-tier Tribunal (FTT) considered whether the appropriate remedy, for the 2014 disposal, was either: 1. to apply a conforming construction to the Group Transfer Rules; or 2. to disapply the restriction in the legislation.

As discussed in *Gallaher*, it is not uncommon for deferrals of tax to be provided for. There are instances of tax deferrals within EU case law and domestically in the exit tax provisions. The judge appeared to prefer extending the exit taxes regime to overseas intra-group disposals as this would be consistent with the grain of the legislation. In particular, he stated:

> "In this case, the UK legislation already includes a detailed set of provisions which provide for an option to pay exit taxes on a deferred basis. Since the parallel between those exit taxes and the taxes crystallising on an intra-group disposal to a transferee outside the UK tax net but within a Member State is obvious, I believe that a conforming interpretation of the existing [Taxes Management Act] provisions in a way which extends their application to encompass the latter circumstances would be relatively straightforward."[3]

There was seen to be a clear parallel between exit taxes (which arise where the holder of an asset pregnant with gain migrates) and intra-group disposals outside the EU. The UK imposing tax by reference to the market value of assets when they left the UK was consistent with the balanced allocation of taxing powers.

However, the FTT felt unable to apply a conforming construction to the Group Transfer Rules. It was noted that as the instalment and payment possibilities were numerous it was beyond the competence of the Tribunal to apply the doctrine of conforming interpretation to remedy the

[1] *Gallaher Ltd v HMRC* [2019] UKFTT 207 (TC).
[2] Treaty on the Functioning of the European Union Art.49.
[3] *Gallaher*, above fn.1, [2019] UKFTT 207 (TC) at [186], per Judge Tony Beare.

existing disproportionate restriction. As a result, the legislation had to be disapplied in part. The exclusion for intra-group disposals to transferees outside the UK tax net[4] was disapplied in circumstances where the freedom of establishment applied. This gives rise to an asset leaving the UK without the UK tax charge crystallising, and a potential loss of tax.

Although *Gallaher* is under appeal, the FTT's decision went further than the appellant argued, resulting in section 171 TCGA applying to create a "no gain no loss" transfer for UK to EU/EEA intra-group disposals.

The legislation

The FTT judgment in *Gallaher*[5] was published on 25 March 2019. On 11 July 2019 draft clauses for the Finance Bill 2019–20 were published.[6] This included reference to the introduction of a deferred payment option following *Gallaher*. The legislation is contained in section 34 of and Schedule 7 to the Finance Act 2020 (FA 2020). These set out the deferred payment option for corporation tax payments for intra-group transfers to recipients in the EU or EEA. Schedule 7 inserts a new schedule 3ZC into the Taxes Management Act 1970 (TMA 1970). The provisions allow for tax to be deferred over a period of up to five years (six instalments of equal amounts).[7] The deferral is subject to interest charged at the usual late payment rate.[8] The change has effect from 11 July 2019 for transactions occurring in accounting periods ending on or after 10 October 2018.

A taxpayer must opt-in to the deferral in order to use it. An application should be made to HMRC before the end of the period of nine months beginning immediately after the accounting period.[9] The content of the application is dictated by paragraph 7 of Schedule 3ZC TMA 1970 and requires confirmation of the state of residence of the EEA company to which the asset is transferred.

Qualifying transactions are set out at paragraph 3 of Schedule 3ZC TMA 1970. They cover disposals or realisations of assets, loan relationships or derivative contracts where a recipient is a group member resident elsewhere in the EEA and is outside the charge to UK corporation tax in respect of the item to which the qualifying transaction relates. Paragraph 3 refers to the instances in the tax code where similar transactions are subject to tax neutral transfers when both group companies are within the UK. The specific provisions listed in paragraph 3 are:

- sections 139 and 171 TCGA, relating to the transfer of chargeable gains assets on a "no gain no loss basis"[10];
- section 340(3) CTA 2009, concerning loan relationships and the replacement of one group company for another as a party[11];

[4] TCGA s.171(1A)(b).
[5] *Gallaher*, above fn.1, [2019] UKFTT 207 (TC).
[6] HMRC, Policy paper and Documents, *Deferral of Corporation Tax payments on EU group asset transfers* (published 11 July 2019; last updated 11 March 2020), available at: *https://www.gov.uk/government/collections/finance-bill-2019-20* [Accessed 9 September 2020].
[7] TMA 1970 Sch.3ZC para.9(1).
[8] TMA 1970 Sch.3ZC para.8(3) and (5).
[9] TMA 1970 Sch.3ZC para.5.
[10] TMA 1970 Sch.3ZC para.3(2)(c).
[11] TMA 1970 Sch.3ZC para.3(3)(c).

- section 625(3) CTA 2009, concerning derivative contracts and the replacement of one group company for another as a party[12]; and
- section 775(1) CTA 2009, relating to the transfer of intangible fixed assets.[13]

There are instances where all or part of the deferred tax becomes payable before the end of the instalment period. All of the tax may become payable where there are insolvency events, a failure to meet the instalment payments or if the transferor company is no longer within the UK corporation tax charge.[14] Part of the deferred tax may become due if the transferee ceases to be EEA resident, leaves the group or sells or disposes of the item (including in part) to which the qualifying transaction related.[15]

Paragraph 5 of Schedule 7 FA 2020 creates a power to withdraw the facility to enter into corporation tax payment plans by Statutory Instrument. The Explanatory Notes to the Finance Bill 2020[16] indicate that the power is intended to be used if the Government determines that corporation tax payment plans are no longer required.

There is some interesting commentary in *Hansard* about the inclusion of the power to withdraw the provision. In particular, it appears aligned to the UK's imminent withdrawal from the EU and a time when the freedom of establishment is no longer relevant. As such, it is entirely possible that the provision could be repealed, even in the near future.

During the Committee Debate on the Finance Bill the Financial Secretary to the Treasury noted as follows[17]:

> "We are making this change not to comply with European law, but to provide certainty to UK businesses and ensure that there is no risk to the Exchequer while the case before the UK courts remains unresolved. Once the risks and the uncertainty are resolved, this deferred tax payment facility will no longer be required.
>
> …
>
> Certainty could come, as I said, at the successful conclusion to litigation in favour of Revenue and Customs, or when the EU treaty freedom of establishment rules no longer apply to the UK. Those are the circumstances under which we would expect the Treasury to repeal the facility. It is done by regulation simply because it is completely uncontroversial and would be much better handled that way, rather than through the primary legislative process."

Businesses may wish to consider the impact of any repeal and be aware that the provision may not, should the commentary in *Hansard* be indicative of ongoing Government policy, remain part of UK domestic legislation indefinitely. The impact of such an approach on wider EU law

[12] TMA 1970 Sch.3ZC para.3(4)(c).
[13] TMA 1970 Sch.3ZC para.3(5)(c).
[14] TMA 1970 Sch.3ZC para.10.
[15] TMA 1970 Sch.3ZC paras 11 and 12.
[16] HM Treasury, *Finance Bill Explanatory Notes* (19 March 2020), available at: *https://www.gov.uk/government/publications/finance-bill-2020-legislation-and-explanatory-notes* [Accessed 9 September 2020].
[17] *Hansard*, Public Bill Committee, Finance Bill (Fourth Sitting), col 105 (9 June 2020).

compliance and legislative provisions is perhaps of additional interest beyond this specific provision.

Angela Savin[*] and Nicola Hine[**]

Section 35: changes to accounting standards affecting leases

Background and context to the provision

Schedule 14 to the Finance Act 2019 (FA 2019) contained significant new provisions to govern the approach of UK tax law to leases which are accounted for under International Financial Reporting Standard (IFRS) 16 as right-of-use leases. The writer contributed a piece to Issue 3 of this *Review* in 2019,[1] and interested readers are referred to that for more background.

Schedule 14 FA 2019 dealt with accounting adjustments which arose (in the case of some companies) on transition to IFRS 16.

The majority of companies adopted IFRS 16 in their first period of account commencing on or after 1 January 2019. For those companies paragraph 13 of Schedule 14 FA 2019 provides the tax rule for calculating the spreading period over which a tax deduction is given for a transitional accounting net debit (or over which income is taxed in respect of a transitional accounting net credit).

Some companies adopted IFRS 16 in an earlier period of account (usually their last period of account to have commenced prior to 1 January 2019 but in a small minority of cases in yet earlier periods). For those companies, section 53 of the Finance Act 2011 (FA 2011) continued to apply to the periods of early adoption of the new standard, meaning that tax continued to apply on the assumption that IFRS 16 had not been adopted in those periods.

Paragraph 11 of Schedule 14 FA 2019 repealed section 53 FA 2011 for accounting periods commencing on or after 1 January 2019. Paragraph 14 of Schedule 14 then deemed for tax purposes that:

- the company had adopted IFRS 16 in the first such period[2]; and
- the right-of-use assets (previously recognised in the accounts) were first recognised in the first such period.[3]

A consequence of this provision was that a transitional accounting adjustment would almost certainly arise for tax purposes in the case of an early adopter even where there was no such adjustment on the actual adoption of IFRS 16 in an earlier period.

Capital gains tax; Corporation tax; Deferred payments; European Economic Area; Intangible fixed assets; Intra-group transfers

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[1] M. Everett, "Finance Act 2019 Notes: Section 36 and Schedule 14: leases: changes to accounting standards etc" [2019] BTR 335.
[2] FA 2019 Sch.14, para.14(2)(a).
[3] FA 2019 Sch.14, para.14(2)(b).

The legislation

The legislation is contained in section 35 of the Finance Act 2020 (FA 2020).

Paragraph 13 changes: non-early adopters

Paragraph 13(1) of Schedule 14 FA 2019 has been amended retrospectively to ensure that the paragraph 13 spreading calculation rules apply to transitional adjustments where a right-of-use asset is first recognised in *any* period of account commencing on or after 1 January 2019. Without this amendment paragraph 13 would only have applied to cases where a right-of-use asset was first recognised in *the first* such period.

This represents a small change of law, which is not obvious from the commentary in the Explanatory Notes on clauses.[4] Applying the original wording of FA 2019, the spreading principle would not have applied to taxpayers which adopted IFRS 16 as a result of moving to International Accounting Standards (IAS) in a period of account after their first period of account commencing on or after 1 January 2019. Such taxpayers' transitional accounting adjustments would therefore have been dealt with under the standard tax approach to changes of accounting basis.[5] As a result any deductible debit or taxable credit would have been relieved or taxed in full in the year of transition.

Prior to the section 35 FA 2020 changes, the writer had surmised that the above treatment was the intention of Parliament and that this was reasonable because, having spread the transitional adjustments of the first wave of IFRS 16 adopters in 2019–2020, the Treasury could live with the consequences of subsequent stragglers enjoying an upfront deduction (or suffering upfront taxation).

It now appears that this was not the intention as the law is being changed retrospectively. Few taxpayers should be disappointed by the outcome, and any who are affected received due warning. To be affected they would need to have transitioned to IAS in their second or subsequent period of account commencing on or after 1 January 2020, that is, at the very earliest on 1 January 2020. The section 35 FA 2020 legislation was published in draft on 11 July 2019 together with an HMRC note including clear wording as follows:

> "This measure makes minor amendments to the spreading rules to put beyond doubt that they apply to all lessees adopting the new accounting standard for any period of account."[6]

Paragraph 14 changes: early adopters

This change seems to be clarificatory and not to involve law change. Paragraph 14 of Schedule 14 FA 2019 is amended to spell out with clearer drafting that if a right-of-use asset was first recognised for accounts purposes in a period of account commencing prior to 1 January 2019, then for tax purposes:

[4] HM Treasury, *Finance Bill Explanatory Notes* (19 March 2020), 88, cl.34.

[5] CTA 2009 Pt 3 Ch.14 and ss.261 and 262 and ITTOIA Pt 2 Ch.17 and Pt 3 Ch.7.

[6] HMRC, Policy paper, *Income Tax and Corporation Tax rules for spreading transitional adjustments on new lease accounting* (11 July 2019), under "General description of the measure."

- there is deemed to be a change in accounting policy in the first period of account commencing on or after 1 January 2019[7]; and
- the right-of-use asset is deemed to have been first recognised for accounts purposes in the first period of account commencing on or after 1 January 2019.[8]

The original wording in paragraph 14 of Schedule 14 FA 2019 referred to "the first period of account", which took its meaning from the definition in paragraph 13(1) of Schedule 14 FA 2019, namely the first period of account beginning on or after 1 January 2019. The amended paragraph 14 wording removes the cross-reference to the paragraph 13(1) definition and creates temporal reference points independently within paragraph 14. Possibly it had been felt by some readers that application of the paragraph 13(1) definition was predicated on the right-of-use asset being first recognised in the first period of account beginning on or after 1 January 2019 as this could be a possible reading of paragraph 13(1) (both before and after the FA 2020 amendments). This would of course make a nonsense of paragraph 14, and seems an odd reading to the writer. That all said, the new wording is easier to follow and may be applauded from a "simplification" viewpoint.

The FA 2020 changes are deemed to have had effect from the introduction of FA 2019[9].

Michael Everett[*]

Section 36: enterprise investment scheme: approved investment fund as nominee

The Finance Act 2020 (FA 2020) enacts the Enterprise Investment Scheme (EIS) knowledge-intensive fund provisions, first announced at Autumn Budget 2017, consulted on in March 2018, re-announced at Budget 2018, confirmed at Spring Statement 2019, and then published in draft that summer.[1] In addition, there are two other measures with implications for EIS relief.[2] First, in his inaugural March 2020 Budget the Rt Hon Rishi Sunak MP, Chancellor of the Exchequer, declared a steep reduction in the lifetime allowance for entrepreneurs' relief

[7] FA 2019 Sch.14, para.14(2)(a).
[8] FA 2019 Sch.14, para.14(2)(b).
[9] FA 2020 s.35(4).

Accounting periods; Corporation tax; International financial reporting standards; Leases; Retrospective effect

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[1] HM Treasury, *Financing growth in innovative firms: consultation response* (November 2017), 11, para.3.11, "A new knowledge-intensive EIS approved fund structure will be consulted upon, with further incentives provided to attract investment"; HM Treasury, *Financing growth in innovative firms: Enterprise Investment Scheme knowledge-intensive fund consultation* (13 March 2018); HMRC and HM Treasury, *Overview of Tax Legislation and Rates* (29 October 2018), 20, para.2.2; HM Treasury, *Financing growth in innovative firms: one-year on* (October 2018), 17, para.4.8; HM Treasury and The Rt Hon Philip Hammond, *Spring Statement 2019: Written Ministerial Statement*, 7; and HM Treasury and HMRC, *Draft legislation published for Finance Bill 2019-20* (11 July 2019).

[2] There has been some debate, both in the traditional press and online, about whether raising to £200,000 (FA 2020 s.22) the threshold at which the tapered annual allowance for pensions commences constitutes a third relevant measure, but the writer would argue that due to the level of risk EIS investments should not form a significant part of a pension holding.

(ER) that an individual may claim from £10 million to £1 million—the level at which it was first introduced by the Finance Act 2008.[3] Secondly, at Report stage, the Government proposed a new clause to the Bill said to safeguard the entitlement to EIS and the Seed Enterprise Investment Scheme (SEIS) relief of an investor who lends money to the issuing company via a Future Fund convertible loan agreement under the scheme operated by the British Business Bank.[4] This latter is the subject of a separate note.[5]

The provisions

i) Approved knowledge-intensive funds

Section 36 FA 2020 creates approved knowledge-intensive funds. It achieves this by narrowing the scope of the existing approved funds structure found in section 251 of the Income Tax Act 2007 (ITA 2007) so that henceforth a fund may be approved only where it is

> "…established for the purpose of investing wholly, or substantially wholly, in shares in companies which are knowledge-intensive companies at the time the shares are issued…".[6]

The fund must also meet such other conditions as HMRC consider appropriate and these share the common heritage of the former approved funds regime, requiring investment in a minimum of four companies, prohibiting investment until the fund closes, and with an expectation that the total amount subscribed will go to qualifying companies.[7] The newly focussed criteria for approval have effect from 6 April 2020 in relation to funds which close on or after that date.[8] There are some important consequential amendments for both the fund and the investors. Managers are given a new extended timetable for investment. In essence they have two years to invest 90 per cent of an individual's subscription to the fund, in contrast to the 12 months previously granted, and the proportion of an individual's outlay that they must have invested after one year is cut to 50 per cent. At 24 months 80 per cent of the individual's investment in the fund must have been placed in knowledge-intensive companies.[9] These relaxed time limits are aimed at maintaining the quality of investment decisions by recognising the difficulties of finding suitable investees in a discrete sub-group of the risk capital market. They will also give time for a fund-raising company to invite HMRC to "comment" that in their opinion such an investee is indeed a knowledge-intensive company, as this confirmation is not routinely forthcoming, but must be sought when necessary for eligibility for relief.[10] With a requirement

[3] Rt Hon Rishi Sunak MP (Chancellor of the Exchequer), *Hansard*, HC, Vol 673, cols 285–286 (11 March 2020); FA 2020 s.23 and Sch.2; FA 2008 s.9 and Sch.3 para.2 introducing TCGA s.169N. The curtailing of ER relief is noted in detail in this Issue at P. Rayney, "Finance Act 2020 Notes: Section 23 and Schedule 3: entrepreneurs' relief" [2020] BTR 427.
[4] House of Commons amendment paper, Thursday 2 July 2020, 9–10, NC 22.
[5] See A. Harper, "Finance Act 2020 Notes: Section 110: Future Fund: EIS and SEIS relief" [2020] BTR 530.
[6] New ITA 2007 s.251(1A)(a) inserted by FA 2020 s.36(3).
[7] HMRC, *The Enterprise Investment Scheme: draft guidelines for the approval of knowledge-intensive funds* (11 July 2019), paras 9–11.
[8] FA 2020 s.36(12).
[9] New ITA 2007 s.251(1)(d) and (e) inserted by FA 2020 s.36(2)(e).
[10] HMRC, Internal Manual, *Venture Capital Schemes Manual* (published: 9 March 2016; updated 14 September 2020), VCM60130, "Venture Capital Schemes Manual: venture capital schemes: the Enterprise Investment Scheme: advance

of 80 per cent investment in knowledge-intensives managers will have little latitude and, conceivably, should even one investee be non-qualifying the authorised status of the fund could be compromised. The investor is permitted to carry back the EIS relief to the tax year previous to the one in which the fund closes.[11] This concession gives approved knowledge-intensive fund investors parity with an individual who invests directly in an EIS company.[12] The precise mechanics enabling the investor to obtain the relief may well involve re-opening a previously submitted tax return, since an investor in an approved fund must wait until their investment is itself invested by the fund manager in knowledge-intensive companies and this could take as long as two years from closure of the fund.[13]

The construction of the amendments made by section 36 FA 2020 admits of few ambiguities save that the volume of investment in knowledge-intensives required to constitute a fund established for the purpose of investing "substantially wholly" in such companies seems capable of giving rise to some debate. There is no elucidation in either the statutory language or, so far as it may be of influence, the accompanying HMRC guidance. Research failed to uncover any pertinent authority except the decision of the First-tier Tribunal in *Assem Allam v HMRC* where it was remarked of the unelaborated phrase "to a substantial extent" in the ER definition of a trading company that the words must be given their "…ordinary and natural meaning in their statutory context".[14] On that basis the requirement on managers to invest 80 per cent of an individual's subscription in knowledge-intensive firms at 24 months offers some statutory background for interpretation. It would seem that the purpose is an intention to be held by the fund manager at the time that the fund is inaugurated rather than necessarily a continuing condition.

The Exchequer impact of restricting approved funds to knowledge-intensive investment is forecast to be negligible.[15]

ii) Entrepreneurs' relief

This may be dealt with briefly. The Finance Act 2015 included amendments to the Taxation of Chargeable Gains Act 1992 to enable an investor to claim ER on capital gains when they choose to defer a gain on a "relevant business disposal" and re-invest it in an EIS company.[16] ER can then be claimed if the gain ultimately becomes chargeable. The policy was explicitly to encourage investment in EIS and also undertakings eligible for Social Investment Tax Relief.[17] Just how many investors will have already deferred and re-invested a gain of more than £1 million into an EIS company, such that they will now lose out, is difficult to determine. Tax at the ER rate of 10 per cent was commonly paid rather than deferred, so the specific impact on EIS investment

assurance requests: no speculative applications", available at: *https://www.gov.uk/hmrc-internal-manuals/venture-capital-schemes-manual/vcm60130* [Accessed 22 September 2020], penultimate paragraph.

[11] New ITA 2007 s.251(2A) inserted by FA 2020 s.36(5).

[12] ITA 2007 s.158(4) as amended by FA 2009 s.27 and Sch.8 para.2.

[13] ITA 2007 s.251(4) and (5) as amended by FA 2020 s.36(6) and (7).

[14] *Assem Allam v HMRC* [2020] UKFTT 26 (TC) especially at [157].

[15] HMRC, Policy paper, *Income Tax relief and the Enterprise Investment Scheme approved knowledge-intensive fund* (11 July 2019).

[16] FA 2015 s.44(1) inserting new TCGA ss.169T–169V.

[17] HMRC, TIIN, *Capital gains tax: allowing entrepreneurs' relief on deferred gains* (10 December 2014).

of the cut-back in the lifetime ER ceiling to £1 million is hard to assess. EIS investment was not, of course, the Chancellor's target and any impact can correctly be seen as collateral damage. One only has to read his comments made at the Despatch Box on Budget day to appreciate that ER as a whole may be a relief on borrowed time.[18]

Theory/policy

i) Approved knowledge-intensive funds

In the opening sentence of this note the writer explained that the new knowledge-intensive fund has its roots in the Patient Capital Review of 2017, which urged that more be done to assist knowledge-intensives, and the writer sets out the chronology of the fund's evolution from policy through consultation to legislation.[19] Against this background the enactment of section 36 FA 2020 can be seen simply as tidying up unfinished business. However, one could be forgiven for thinking that it is a missed opportunity, because many more steps could have been taken to help knowledge-intensive companies to fund-raise. First and foremost knowledge-intensive companies tend to have very long-term requirements for patient capital garnered in successive funding rounds. This is why such companies are able to use the EIS to raise up to £20 million rather than the usual £10 million over their lifetime. Additionally the first EIS investment is allowed to be within 10, as opposed to seven, years of their first commercial sale, and there can then be further EIS funding after the initial investing period under Condition A of the permitted maximum age limit.[20] Yet it is difficult to see how the new approved fund structure will support them in this. In particular, once the fund has closed and been invested, it is not easy to see how the manager can offer scale-up capital or "follow a winner", that is, continue to invest in an early success. There is also a limit of 50 per cent of the fund that may be invested in a single company.[21] Not only that, but with a requirement to invest 90 per cent of subscribed funds at two years, residual liquidity will be insufficient to afford any significant follow-on funding. From the point of view of the investor the delay in waiting to claim relief until the fund is invested is one inherited from the original approved fund structure, but, of course, now exacerbated by the elongated investment timetable. It remains to be seen how much of a comfort or inducement the introduction of the entitlement to carry-back relief will be, but it would have been much simpler to incentivise investors directly by granting relief up-front.

The writer believes that the section 36 FA 2020 amendments reflect a policy held in check by political constraints, both domestically and in terms of the UK's relationship with the EU during the transition period, the UK having formally left the bloc on 31 January 2020. Changes to EIS (and Venture Capital Trusts (VCT)) are subject to EU state aid approval. One explanation

[18] Rt Hon Rishi Sunak MP (Chancellor of the Exchequer), *Hansard*, HC, Vol 673, cols 285–286 (11 March 2020); the Conservative Manifesto pledge was to "review and reform" ER: see *Get Brexit Done Unleash Britain's Potential: The Conservative and Unionist Party Manifesto 2019*, available at: *https://assets-global.website-files.com/5da42e2cae7ebd3f8bde353c/5dda924905da587992a064ba_Conservative%202019%20Manifesto.pdf* [Accessed 23 September 2020], 34 col.3.
[19] *Patient Capital Review Industry Panel Response* (October 2017), 20, para.4.10.
[20] ITA 2007 ss.173AA, 175A(2)(a) and 175A(3).
[21] HMRC, *The Enterprise Investment Scheme: draft guidelines for the approval of knowledge-intensive funds* (2019), para.11.

for making limited adaptations to the old approved fund structure, rather than creating a new one, may simply be that by the time that the proposals came to be published in the summer of 2019 Government was, to say the least, distracted, if not almost paralysed by the Brexit debate. The torrid political climate of Brexit which has pervaded all aspects of Government over the 2017–19 Parliament needs no elaboration here. An application for state aid may have been untenable as a matter of domestic politics, and given the difficult track record of securing risk capital permissions from the Commission even before the 2016 referendum, some disdain for any application might well have been reasonably anticipated on the European side.

Pathfinding

i) A review of EIS

The Government intends to examine EIS (and seemingly also SEIS and VCT) in advance of the current EIS and VCT sunset in 2025. In Public Bill Committee the Financial Secretary to the Treasury, answering calls from the Scottish National Party to lay a report before the House analysing the economic effects and geographic distribution of EIS investment, indicated a "full review" of EIS later in this Parliament with this statement:

> "Let me say one final thing. Hon Members want us to review the EIS more generally, and I am happy to confirm that we are going to do that. As with all tax reliefs, the EIS is kept under review to ensure that it meets its policy objectives, but it is also a state aid whose current status expires in 2024 [sic]. We therefore have a specific cause and purpose to conduct a full review of the EIS and how it is used, ahead of decisions on whether to renew it."[22]

It would be easy to view this as much too restrained. EIS and indeed VCT each have the potential to play a role in the UK's recovery from the COVID-19 pandemic. The dramatic and unheralded change in economic fortunes, on the face of it, warrants a review sooner. It appears that the so called "equity gap" has increased significantly and a widening of EIS would be welcome. Apart from meeting challenges arising from COVID-19, the writer has previously drawn attention to a variety of pressing candidates for reform.[23] The Government itself views the schemes in a positive light. The Conservative Party Manifesto at the December 2019 General Election referred to EIS and SEIS as having been "spectacularly successful".[24] Since then the schemes have received the endorsement of the National Audit Office in its report *The management*

[22] Rt Hon Jesse Norman MP Financial Secretary to the Treasury, *Hansard*, Public Bill Committee (2019–20), Fourth Sitting, col 112 (9 June 2020). The reference in this quotation to 2024 is a mistake, either of the minister or of those transcribing him for *Hansard*, see ITA 2007 s.157(1)(aa) (EIS) and s.261(3)(za) (VCT) "…before 6 April 2025"; 2024 is, of course, significant for UK state aid in that it is the year in which the democratic consent of Northern Ireland is required to continue the Protocol on Ireland/Northern Ireland to the *Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community* (Withdrawal Agreement) [2019] OJ C384 I/1 (12 November 2019), as to which see below.

[23] See A. Harper, "Finance Act 2018 Notes: Section 14: EIS, SEIS and VCT reliefs: risk to capital; Section 15: EIS, SI and VCT reliefs: relevant investments; Section 16 and Schedule 4: EIS and VCT reliefs: knowledge-intensive companies; Section 17 and Schedule 5: VCTs: further amendments; Venture Capital Trust (Exchange of Shares and Securities) (Amendment) Regulations 2018" [2018] BTR 272, 281–282.

[24] Conservative Manifesto, above fn.18, 34 col.2.

of tax expenditures, which deems the venture capital reliefs to be having a positive impact on investment behaviour and to be "generally working as intended".[25] One could be forgiven for thinking that this is a review that should be expedited. Yet as the minister said, the schemes are state aid for EU purposes. At the time of the minister's statement there was, as now at the time of writing, complete uncertainty about the shape of the post Brexit transition regulatory framework.[26] Whilst it is true that with the Government sticking hard and fast to the 31 December 2020 end date for transition this issue would resolve within the timeframe of all but the most immediate review, the critical question is: in what way?

ii) The shadow of EU state aid

The Withdrawal Agreement, as re-negotiated in October 2019 contains the Northern Ireland Protocol, designed to protect the soft border between Northern Ireland and the Irish Republic, which remains an EU Member State.[27] The Protocol is a legally binding international treaty which remains in place indefinitely and the continuance of which is subject to democratic consent from the Northern Ireland Executive and the Assembly.[28] Essentially Article 10 of the Protocol continues to apply the "full panoply" of state aid to *any UK measure* that affects trade between Northern Ireland and the EU states, most obviously the Irish Republic.[29] Articles 106 (in part), 107, 108 and 109 of the Treaty on the Functioning of the European Union (TFEU) are each applied by Article 10(1) and Annex 5, paragraph 1 of the Protocol. The Risk Capital Guidelines are incorporated by paragraph 5.6 of Annex 5. These obligations could, of course, be varied or superseded consequent on a successfully negotiated trade deal between the UK and EU, but not inevitably so. Article 184 of the Withdrawal Agreement expresses no more than the aspiration of concluded "agreements governing the future relationship", and as noted above the Protocol has its own independently enduring status. At the time of writing the stated intention of the UK Government remains that it wishes to negotiate a bespoke deal. In spite of that it has declined the chance to extend the transition period beyond 31 December 2020.[30] Also, it has not just failed to propound any detailed draft of the post-Brexit state aid rules which it would propose that the UK adopt, but it has actively refused to do so.[31] Such a stance is no doubt consistent with the view that the UK's future regime is no business of the EU, but equally it has irked Brussels and its negotiators.[32] Much therefore depends on the outcome of negotiations in the comparatively

[25] NAO, Report by the Comptroller and Auditor General, HMRC and HM Treasury, *The management of tax expenditures* (NAO, 14 February 2020), HC 46, (Session 2019–20), 40.
[26] The last draft of this note was written on 7 October 2020.
[27] Withdrawal Agreement, above fn.22, C384 I/92 and following.
[28] Withdrawal Agreement, above fn.22, Protocol Art.18.
[29] G. Peretz QC in evidence to the EU Internal Market sub-committee of the House of Lords European Union Committee: see House of Lords Select Committee on the European Union, Internal Market Sub-Committee, *Corrected oral evidence: The level playing field and state aid* (5 March 2020); *The Protocol on Ireland/Northern Ireland* House of Lords European Union Committee 9th Report of Session 2019–21, paras 188 and 189; Withdrawal Agreement, above fn.22, Protocol on Ireland/Northern Ireland Annex 5.
[30] Withdrawal Agreement, above fn.22, Art.132.
[31] Statement of the Rt Hon Alok Sharma MP Secretary of State for Business, Energy and Industrial Strategy in press release, *Government sets out plans for new approach to subsidy control* (9 September 2020), available at: *https://www.gov.uk/government/news/government-sets-out-plans-for-new-approach-to-subsidy-control* [Accessed 27 October 2020].
[32] J. Pickard and J. Brunsden, "Delayed state aid plan irks Brussels", *Financial Times*, 10 September 2020, 3.

short time remaining. This is simply impossible to predict at the moment. The two sides' rival draft trade agreements each promote opposing perspectives: the EU very much promulgating its state aid regime on the basis of the level playing field; whereas the UK's adopts the "subsidy" language of the World Trade Organization (WTO).[33] This is much more than a mere semantic or linguistic distinction. It is one of substance both of the scope and the enforceability of the rules.

In these circumstances it appears sensible to point out the key issues that could arise in the absence of a definitive treaty by the 31 December 2020 deadline. The Protocol applies the EU state aid provisions to UK measures that "affect" trade. When is trade "affected" by a state aid measure? The writer has long argued in vain that the state aid rules should adopt a competition focused approach, based on the discernible effect of the aid upon an investee's market share, but this is far away from how Article 107 of the TFEU operates.[34] This being only a note, the writer assumes, without discussing, that the EIS, SEIS and VCT schemes are "measures which affect that trade between Northern Ireland and the Union which is subject to this Protocol".[35] On that footing, first, the EIS and VCT schemes as they operate in Northern Ireland will presumably have to remain fully EU state aid compliant, because of EIS companies and VCT investees based in the province trading with the Irish Republic, or the wider EU. Secondly, following from that, barring the UK Government being prepared to countenance two separate systems within the UK, then the EIS and VCT schemes as they apply to England, Wales and Scotland will be difficult to modify. Thirdly, if, post transition, these schemes were to diverge as between Northern Ireland and the rest of the UK what is the position in the case of (say) an English EIS company raising scheme funding that would be in excess of that sanctioned under EU rules, if that English company then sends its goods to Northern Ireland where they could potentially be traded with the south or with other EU states? At the time of writing, the Government's solution has been to advance some very controversial clauses in the UK Internal Market Bill, allowing Parliament to disregard parts of the Protocol in future, if it so votes.[36] The EU reaction to that has been to threaten legal action on the basis of a breach of the good faith provisions in the Withdrawal Agreement.[37] From a venture capital perspective the bind, of course, is that the Government rightly has ambitions for UK start-ups to become players on the global stage, particularly those in the technology sector, where the major competition will be the US and China each of whose Treasuries are constrained in the support they provide only by the WTO rules.

[33] Compare the UK's Draft working text for a comprehensive free trade agreement between the United Kingdom and the European Union Art.21 with the EU Draft text of the Agreement on the New Partnership with the United Kingdom UKTF (2020) 4 (18 March 2020) Chapter 2 Section 1. For a comparison of EU state aid principles with those of the WTO in the EIS/VCT context see A. Harper, "Finance Act 2016 Notes: Section 28: EIS, SEIS and VCTs: exclusion of energy generation; Section 29: EIS and VCTs: definition of certain periods; Section 30: EIS and VCTs: election; Section 31: VCTs: requirements for giving approval" [2016] BTR 529, 531–537.

[34] A. Harper, "Finance Act 2012 Notes: Section 39 and Schedule 7: Enterprise Investment Scheme; Section 40 and Schedule 8: Venture Capital Trusts" [2012] BTR 411, 416; A. Harper, "Finance (No.2) Act 2015 Notes: Section 25 and Schedule 5: enterprise investment scheme; Section 26 and Schedule 6: venture capital trusts; Section 27: EIS, VCTs etc: excluded activities; Section 28: EIS, VCTs and EMI: meaning of 'farming'" [2015] BTR 614, 621.

[35] Withdrawal Agreement, above fn.22, Protocol on Ireland/Northern Ireland Art.10(1).

[36] UK Internal Market Bill as sent to the House of Lords, cll.44–47.

[37] Withdrawal Agreement, above fn.22, Art.5. J. Brunsden, "Brussels rejects changes to 'illegal' bill", *FT Weekend*, 19/20 September 2020, 2.

An entirely separate issue might concern the status of the risk to capital condition.[38] The two main schemes, EIS and VCT, reiterated in 2015 with structural alterations enjoy EU state aid permission lasting to 5 April 2025.[39] However, this is not so certain in respect of the supplementary risk to capital condition added to both reliefs by the Finance Act 2018. Paragraph 72 of the decision letter conferring approval for the risk to capital condition was drafted so that the permission expired on 31 January 2020 when the UK ceased to be a Member State of the EU.[40] That expiry was expressed to be without prejudice to the terms of the Withdrawal Agreement and, arguably, the permission is preserved in force during the transition period. This argument is premised on a combination of Article 2(a)(iii), Article 6 and Article 127 of the Protocol which, read together, and assuming the decision letter is an act of an institution that has been adopted, is sufficient until 31 December 2020. Be that as it may, what happens to its validity, and by extension, the propriety of the condition itself, for Protocol purposes if no deal is agreed by the end of the transition?

COVID-19 has rightly taken up all thinking of late, but aside from it, there is much else to be concerned about.

Andrew Harper[*]

Section 37: gains from contracts for life insurance etc: top slicing relief

Section 37 of the Finance Act 2020 (FA 2020) is the latest attempt at an equitable tax treatment of the accumulation of income included within the gain arising on a chargeable event on maturity, surrender or assignment of a life policy or capital redemption policy.

Save in the case of part disposals, top slicing relief seemed to achieve this acceptably for many years. However, the introduction of the tapered personal allowance in section 35(2) of the Income Tax Act 2007 (ITA 2007) (effective from 20 October 2011) led to inequities.

Section 37 FA 2020 addresses the problem of the tapering of the personal allowance when a taxpayer's income exceeds £100,000, when calculating top slicing relief. Subsections (3) and (4) of section 37 simply state that, in determining the taxpayer's personal allowance, the gain(s) from the chargeable event(s) is or are taken to be equal to the annual equivalent(s). The "annual equivalent" is the amount of the gain divided by the number of complete policy years.

Thus, if the taxpayer's other income is £70,000 and they realise a gain on a chargeable event of £300,000 on a policy held for 10 years, their income for the purpose of determining their personal allowance is £100,000 (£70,000 plus one-tenth of £300,000).

[38] ITA 2007 s.157A (EIS), s.257AAA (SEIS) and s.286ZA (VCT) inserted by FA 2018 s.14.
[39] Letter from Commissioner M. Vestager to Rt Hon P. Hammond 9 October 2015 C (2015) 6841 Final (published in redacted form 15 December 2015), paras (18)i, (22) and (144). SEIS operates within the General Block Exemption Regulation: Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty [2014] OJ L187/1.
[40] European Commission, State Aid cases, SA 49923 (2018).

Enterprise investment scheme; Entrepreneurs' relief; Fund managers; Investment funds; Nominees

[*] Barrister, New Street Chambers, Leicester. Thanks are due to Philip Hare of Philip Hare & Associates LLP who read and commented upon an earlier draft.

The HMRC Policy Paper says: "The measure will have effect for all relevant gains occurring on or after announcement at Budget 2020.""[1]

However, the section does not quite say this. It says that the provision is to apply in relation to the tax year 2019–20 and subsequent tax years,[2] save that it does not apply for the tax years 2019–20 and 2020–21 in the case of a taxpayer who is only liable to tax for the year in question in respect of gains from chargeable events before 11 March 2020.[3]

Thus, as worded, the measure will apply to all of an individual's gains for 2019–20 only if he or she realises gains from chargeable events that occur before 11 March 2020 *and* later in 2019–20.

However, HMRC said they will apply the new rules to all gains arising in 2019–20, as a concessionary treatment.[4] Later, HMRC advised that the new rules would apply to 2018–19 as well.[5]

It is assumed that individuals who are liable to tax in respect of gains from chargeable events arising before 2018–19 will have their top slicing relief calculated on the basis agreed in *Marina Silver v HMRC*.[6] However, clarification on HMRC's attitude is still awaited.

The possible problems with "part disposals" were vividly illustrated in *Joost Lobler v HMRC* (*Lobler*).[7] The obvious inequity led to the introduction in Finance (No.2) Act 2017[8] of sections 507A and 512A of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA), which offer relief in the sort of circumstances which arose on a part disposal such as that in the *Lobler* case, but statutorily only from 16 November 2017. The provisions enable a taxpayer to seek relief on the grounds that the statutory calculation produces a result that is wholly disproportionate to the economic gain. If this is accepted, the taxable amount is recalculated on a "just and reasonable basis". There is no provision for the insurance company to be told of any such change, which will result in any subsequent chargeable gain being misquoted.

The High Income Child Benefit Charge (HICBC) introduced by section 8 of and Schedule 1 to the Finance Act 2012 (from 7 January 2013), the savings allowance introduced by section 12B ITA 2007 (from 2016–17) and the tapered annual pension allowance in section 228ZA of the Finance Act 2004 (FA 2004) introduced by section 23 of and Schedule 4 to the Finance (No.2) Act 2015 (also from 2016–17) can also lead to inequities.

The income figure adopted in determining whether there should be a HICBC includes the full amount of the gains from chargeable events.

The adjusted income figures used for the tapered pension annual allowance in section 228ZA(4) and (5) FA 2004 also include the full amount of the gains from chargeable events.

[1] HMRC, Policy paper, *Changes to Top Slicing Relief on life insurance policy gains from 11 March 2020* (11 March 2020), under "Detailed proposal/Operative date."
[2] FA 2020 s.37(5).
[3] FA 2020 s.37(6).
[4] HMRC, *Agent Update*, issue 78 (2020).
[5] Chartered Institute of Taxation, *News service for CTAs* (24 July 2020).
[6] *Marina Silver v HMRC* [2019] UKFTT 263 (TC).
[7] *Joost Lobler v HMRC* [2015] UKUT 152 (TCC); [2015] STC 1893.
[8] F(No.2)A 2017 s.9(2) and (3).

The significance of the tapered personal allowance has now been dealt with statutorily. The comparable distortion of HICBC and tapered pension annual allowance remains. Perhaps that is acceptable, but one wonders if it has actually been considered.

Notably, in determining whether capital gains are taxed at either 10 per cent or 18 per cent, which depends on whether an individual has "unused basic rate band", a form of top-slicing relief is given in respect of gains accruing on or after 23 June 2010, if the individual's income includes gains from chargeable events.[9]

One further point on these rules worth noting is that the tax treated as deducted in reaching the gain on a chargeable event under section 530(1) ITTOIA for onshore policies does not count towards the tax notionally deducted when the individual has made a cash gift to charity under gift aid. If there is a shortfall, a liability arises under section 424 ITA 2007.

Ray Magill*

Part 2 Sections 39–72: the UK's digital services tax

Part 2 of the Finance Act 2020 (FA 2020) introduced a digital services tax (DST): a 2 per cent tax on the revenues of large businesses providing a social media platform, search engine or online marketplace to UK users. The DST is not a tax on online sales[1]—such a tax is also being considered by the UK at the time of writing.[2] The DST's purported target is the value created for these businesses by UK users. For example, the tax would be due from a foreign company providing a social media platform, if it generates revenues by selling online space for adverts viewed by UK users to businesses located in a third country. From a policy perspective there are benefits in levying a tax on businesses in the country where users are located, because users are relatively immobile. But DSTs also raise a number of concerns.

The UK's DST is intended as a temporary response to perceived flaws in the international corporate tax system. However, the timing of its introduction is somewhat controversial, as are its objectives and design.

Timing

A tax on certain highly-digitalised businesses has some immediate political attraction. Digital giants, such as Amazon, Google and Facebook,[3] have been a target for tax and other[4] policymakers

[9] TCGA s.1J(4) and (5).

High income child benefit charge; Insurance policies; Life insurance; Personal allowances; Taper relief; Top slicing relief

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[1] See the definition of "user" in FA 2020 s.44 and HMRC, Internal Manual, *Digital Services Tax Manual* (HMRC Digital Services Tax Manual) (published 19 March 2020; updated 5 August 2020), DST18200–18600.

[2] HM Treasury, *Business Rates Review: Call for Evidence* (July 2020).

[3] To give some perspective, as of 27 August 2020 the combined market capitalisation of Amazon, Google and Facebook was US$3.6 trillion while the combined market capitalisation of the FTSE 100 was US$2.1 trillion.

[4] On 29 July 2020, for example, the chief executives of Google, Amazon, Apple and Facebook were grilled in a hearing at the US Congress on a host of issues, following a year-long investigation by a bipartisan panel from the House of

for a number of years. And the COVID-19 crisis further exacerbated concerns which were troubling policymakers—including the increasing success of some such businesses at the expense of their bricks and mortar competitors—while also increasing the need for tax revenues.[5] Nevertheless, the UK Government's decision to press ahead with its DST at this specific point in time remains somewhat controversial.

For a start, the introduction of a DST may have a negative impact on negotiations between the UK and the US over a post-Brexit trade deal. The US has been unequivocal in its opposition to DSTs as it appears likely that they will primarily hit a number of US headquartered multinationals. In a letter to the Finance Ministers of the UK, France, Italy and Spain dated 12 June 2020, US Secretary of the Treasury, Steven Mnuchin, reiterated this opposition and the accompanying threat that the US stands ready to "respond with appropriate commensurate measures".[6] A few days earlier—on 5 June—the Office of the US Trade Representative (USTR) started an investigation under section 301 of the Trade Act of 1974[7] into whether the UK DST, as well as DSTs adopted or under consideration in nine other trading partners,[8] are "unreasonable or discriminatory and burden or restrict U.S. commerce".[9] The US may impose trade sanctions if the investigation leads to a positive answer. The adoption of a DST may thus spark a trade war with the US. France appeared to have narrowly avoided such a prospect after the USTR concluded that its DST discriminated against US businesses a few months ago,[10] but this possibility has re-surfaced at the time of writing.[11] One can only speculate as to whether the UK's adoption of a DST could be part of a strategy to give itself something to concede to the US in its post-Brexit trade negotiations. But it has certainly vexed, even antagonised, the US administration.

The timing of the UK's DST is also controversial because it is a unilateral measure to address perceived flaws in the international tax system adopted as 137 countries—constituting the OECD/G20 Inclusive Framework—are engaged in a process aiming at collaborative reform. Blueprints of the proposed reform were released in October 2020,[12] and work will continue in

Representative: "Bezos, Zuckerberg, Cook and Pichai told they have 'too much power'", *Financial Times*, 29 July 2020.

[5] Note, however, that the DST's expected revenue is relatively low: around £2.1 billion over six years. HMRC, *Digital Services Tax: Policy Paper* (11 March 2020).

[6] "US upends global digital tax plans after pulling out of talks with Europe", *Financial Times*, 17 June 2020.

[7] Office of United States Trade Representative, *Initiation of Section 301 Investigations of Digital Services Taxes*—Notice of 5 June 2020.

[8] Office of United States Trade Representative, above fn.7, under "Supplementary Information: I. Digital Services Taxes". The other trading partners are Austria, Brazil, the Czech Republic, the EU, India, Indonesia, Italy, Spain and Turkey.

[9] Office of United States Trade Representative, above fn.7, under "Supplementary Information: II. Initiation of Section 301 Investigations": "An act, policy, or practice is unreasonable if the act, policy, or practice, while not necessarily in violation of, or inconsistent with, the international legal rights of the United States, is otherwise unfair and inequitable."

[10] S. Soong Johnston, "France, U.S. Find Common Ground for OECD Digital Tax Progress", *Tax Notes International*, 23 January 2020.

[11] S. Soong Johnston, "U.S. to Hit Back at French Digital Tax With New Tariffs in 2021", *Tax Notes International*, 13 July 2020.

[12] OECD/G20 Base Erosion and Profit Shifting Project, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS* (OECD, *Report on Pillar One Blueprint*) (Paris: OECD Publishing, 2020), available at: *https://doi.org/10.1787/beba0634-en* [Accessed 22 October 2020]; and OECD/G20 Base Erosion and Profit Shifting Project, *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive*

the coming months with the aim of reaching a consensus-based solution by mid-2021.[13] Why, then, did the UK adopt a unilateral measure intended as "temporary, pending a comprehensive global solution",[14] when the project aiming at this global solution is at such an advanced stage? Domestic political considerations may offer a partial explanation, given the continued public and media concern over multinationals' perceived failure to pay their "fair share" of tax.[15] The UK's decision may also reflect hard-nosed realism. Despite the extensive work and good intentions, achieving a consensus-based solution among 137 countries by mid-2021—or at all—is certainly not a foregone conclusion.[16] The original deadline (end of 2020) has already been missed, and there remains open disagreement among countries on political and technical aspects of the reform being considered.[17] Furthermore, the US—whose support is critical to the process' success—at times has been less than fully supportive of the process. The US twice threw considerable and somewhat unexpected spanners in the works in recent months. In December 2019 US Secretary of the Treasury Mnuchin seemed to take many by surprise[18] when he declared that the US had "serious concerns" about the departure from the existing system in one of the two proposals under consideration. He called for a "safe harbour" which would make the new rules in this proposal optional. This was deemed to be unacceptable by most other countries, meaning that US insistence on a safe harbour would effectively kill off the prospect of a global tax deal.[19] In June 2020 the US again caused a stir by claiming that an "impasse" had been reached on the same proposal and calling on the OECD to pause discussions.[20] At the time of writing there is further uncertainty on the US position due to the upcoming presidential election.

The UK may well be driven by its stated concern to plug a perceived policy gap in the existing system until a consensus-based agreement is reached, but all the major players in this international negotiation may also be jostling for negotiating advantage here. In his June letter, US Secretary of the Treasury Mnuchin bristled on the subject of DSTs.[21] In their response, the Finance Ministers of the UK, France, Italy and Spain reiterated their commitment to the collaborative process and expressed their hope that this would be continued with the US on board. They also suggested a

Framework on BEPS (OECD, *Report on Pillar Two Blueprint*) (Paris: OECD Publishing, 2020), available at: *https://doi.org/10.1787/abb4c3d1-en* [Accessed 22 October 2020].

[13] OECD/G20 Inclusive Framework on BEPS, *Cover Statement by the Inclusive Framework on the Reports on the Blueprints of Pillar One and Pillar Two* (*Cover Statement*) (OECD, 2020).

[14] HM Treasury, *Budget 2018: Digital Services Tax* (2018).

[15] The UK Government admits that "revenue-based taxation has a purpose, in demonstrating the importance that the government attaches to this issue": HM Treasury and HMRC, *Digital Services Tax: Consultation* (*Consultation Document*) (November 2018), para.1.14.

[16] In 2018 the UK noted that while it continues to work toward a co-operative solution, agreement should not be taken for granted because this "will be a challenging process given the fundamental nature of the issues being addressed, and the different country perspectives on those issues" (HM Treasury and HMRC, *Consultation Document*, above fn.15, para.1.11). Of course, significant progress has been made since then.

[17] OECD/G20 Inclusive Framework on BEPS, *Cover Statement*, above fn.13, 1.

[18] The Secretary-General of the OECD is reported to have said that this letter "came out of nowhere": A. Shalal and L. Thomas, "U.S. floats 'safe harbor' proposal in global taxation reform drive", *Reuters*, 4 December 2020.

[19] "Brussels steps up pressure on US over global digital tax deal", *Financial Times*, 5 December 2019.

[20] *Financial Times* (17 June 2020), above fn.6.

[21] "During that process, the United States has consistently made clear that we object to the adoption of measures that focus solely on digital business, especially gross-basis digital services taxes that fall predominantly on US-based enterprises. During this period, France, Spain, Italy and the United Kingdom have all proceeded to adopt such digital services taxes." Letter by Steven Mnuchin dated 12 June 2020.

phased approach that could lead to a consensus being achieved and could also "pave the way for possible transitional solutions to be discussed with the United States, notably with respect to existing or upcoming national digital service taxes".[22] DSTs may thus be cards on this broader negotiating table; however, countries playing these cards cannot be sure of the impact they will have. The threat and increasing adoption of DSTs may encourage countries to reach a collaborative solution, but it may also make it harder for such a solution to be reached.

The OECD has itself used existing DSTs, and the threat of further DSTs, to encourage collaboration. Time and again,[23] it reminded countries of the risk that "failure to reach agreement would greatly increase the risk that countries will act unilaterally, with negative consequences on an already fragile global economy".[24] These consequences could include an increase in tax and trade disputes,[25] a decrease in tax certainty,[26] excessive compliance burdens,[27] double taxation, and high tax burdens on loss making businesses.[28] In July 2020, the OECD's Secretary-General warned that failure to reach a consensus-based solution and the consequences that would follow could "deepen the COVID-19 economic crisis and hinder the post-crisis recovery",[29] and the threat posed by DSTs was again front and centre when the Blueprints were released in October 2020. Based on its Economic Impact Assessment, the OECD claimed that if a consensus-based solution is not reached, the repercussions of uncoordinated and unilateral measures, including DSTs, could in the "worst-case scenario" lead to a reduction of global GDP by more than 1 per cent.[30]

[22] Letter by R. Sunak, B. le Maire, R. Gaultieri and M. Jesús Montero Cuadrado dated 17 June 2020.
[23] In fact, the OECD resorted to this strategy in an early BEPS document: "[I]f the Action Plan fails to develop effective solutions in a timely manner, some countries may be persuaded to take unilateral action for protecting their tax base, resulting in avoidable uncertainty and unrelieved double taxation. It is therefore critical that governments achieve consensus on actions that would deal with the above weaknesses." OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at: *http://dx.doi.org/10.1787/9789264202719-en* [Accessed 30 October 2020], 11.
[24] *OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors, Riyadh, Saudi Arabia* (OECD, February 2020), available at: *http://www.oecd.org/tax/oecd-secretary-general-tax-report-g20-finance-ministers-riyadh-saudi-arabia-february-2020.pdf* [Accessed 30 October 2020]. In February 2020 the General Secretary of the OECD rang a clear warning: "During the second half of 2019, political tensions around unilateral measures mounted and provided a glimpse of the difficulties that would arise should progress on finding a global solution by the end of 2020 hit a standstill."
[25] *OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors* (February 2020), above fn.24.
[26] *OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors* (February 2020), above fn.24, 12.
[27] *OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors* (February 2020), above fn.24, 27.
[28] *OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors, Saudi Arabia* (OECD, July 2020), available at: *http://www.oecd.org/tax/oecd-secretary-general-tax-report-g20-finance-ministers-july-2020.pdf* [Accessed 30 October 2020], 20.
[29] *OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors* (July 2020), above fn.28, 20.
[30] OECD/G20 Base Erosion and Profit Shifting Project, *Tax Challenges Arising from Digitalisation – Economic Impact Assessment: Inclusive Framework on BEPS* (Paris: OECD Publishing, 2020), available at: *https://doi.org/10.1787/0e3cc2d4-en* [Accessed 22 October 2020]. This possibility made the headlines in news media around the world. See, for example: S. Amaro, "Digital tax conflicts could wipe more than 1% off global GDP every year, OECD warns", *CNBC*, 12 October 2020; and L. Thomas, "A collapse of global tax talks could cost $100 billion, OECD says", *Reuters*, 12 October 2020.

Broader context

DSTs comprise just one element in the current international tax policy debate, and they should be understood in this broader context. The international community has been engaged in an unrelenting process of tax reform since the launch of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project in 2013.[31] While ambitious relative to previous reform projects, the BEPS Project primarily aimed at narrowing some loopholes in the existing system which allowed multinationals to shift profit to low tax jurisdictions. It did not address—and was not meant to address—structural issues which were arguably more problematic and certainly harder to resolve.[32] One issue is dissatisfaction with the current allocation of taxing rights among countries, another is the destabilising effect of tax competition among countries. The reform currently being discussed by the OECD/G20 Inclusive Framework set out to address these structural issues,[33] as well as remaining profit shifting concerns.[34]

DSTs fit into this broader debate as they are intended to address the first of these two structural issues: the allocation of taxing rights among countries. Some countries, especially developing countries, have long argued for the need to reform the current allocation. In recent years other countries made the case for reform, albeit on different grounds, but these countries differed among themselves on the rationale for and type of reform they favoured. These differences were set out candidly in the OECD's March 2018 Interim Report *Tax Challenges Arising from Digitalisation*.[35] In particular, the Report noted that one group, which included the UK, favoured reforming the allocation of taxing rights only in so far as it applies to certain highly-digitalised

[31] OECD, *Addressing Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013), available at: *https://dx.doi.org/10.1787/9789264192744-en* [Accessed 22 October 2020].

[32] See M.P. Devereux and J. Vella, "Are we heading towards a corporate tax system fit for the 21st century?" (2014) 35 *Fiscal Studies* 449.

[33] Interestingly, while previous documentation on Pillar II expressly included the objective of addressing tax competition among states, this objective was removed from the Blueprint of Pillar II released in October 2020 (OECD, *Report on Pillar Two Blueprint*, above fn.12). The proposal's stated objectives now include ensuring that all large internationally operating businesses pay at least a minimum level of tax. As there are clear tax sovereignty issues at play under this proposal, this change may be due to political sensitivities. That said, although addressing tax competition is no longer among the explicit objectives of the proposal, it is not clear to what extent this reflects a real policy change.

[34] It is more significant reform than BEPS, however, some, including the present writer, have argued that it does not go far enough and have called for more ambitious and comprehensive reform. See, for example, M.P. Devereux and J. Vella, "Implications of digitalisation for international corporate tax reform" in S. Gupta, M. Keen, A. Shah and G. Verdier (eds), *Digital Revolutions in Public Finance* (International Monetary Fund, 2017), and more generally, M.P. Devereux, A. Auerbach, M. Keen, P. Oosterhuis, W. Schön and J. Vella, *Taxing Profit in a Global Economy* (OUP, forthcoming).

[35] OECD/G20 Base Erosion and Profit Shifting Project, *Tax Challenges Arising from Digitalisation — Interim Report 2018: Inclusive Framework on BEPS* (Paris: OECD Publishing, 2018), available at: *https://doi.org/10.1787/9789264293083-en* [Accessed 5 October 2020].

BEPS Action 1 had reviewed these challenges, but no consensus could be reached by 2015, when the Final Reports were produced. The G20/OECD countries made a commitment to work towards a consensus-based solution by 2020 with an interim report to be published in 2018. In this respect, the current work in the Inclusive Framework is a continuation of BEPS.

businesses, while another group, which included the US,[36] favoured reforming the allocation over the profits of all businesses.[37]

The UK justified its preference on the grounds that the existing system does not take account of the value created by users for certain highly-digitalised businesses. This, it argued, poses a "fundamental challenge to the fairness, sustainability and public acceptability of the corporate tax system".[38] The other group, which included the US, justified its preference for broader reform on the grounds that "the ongoing digital transformation of the economy, and more generally trends associated with globalisation, present challenges to the continued effectiveness of the existing international tax framework for business profits".[39] The UK and the US thus put forward their respective preferred reforms as proposed amendments to the Permanent Establishment (PE) nexus and profit attribution rules. The UK's proposal granted taxing rights over the profit of certain highly-digitalised businesses to countries where users are found (the "user participation" proposal),[40] while the US's proposal allocated some taxing rights over the profits of all companies to market countries (the "marketing intangibles" proposal). In time, these two proposals, and a third put forward by the G24 (the "significant economic presence" proposal), were superseded by a compromise proposal by the OECD, known as the Unified Approach. In its latest version, the Unified Approach, allocates a portion of the profit of consumer-facing and highly-digitalised businesses to market (or "consumer" or "destination") countries. As explained above, at the time of writing this proposal is being considered by the Inclusive Framework.[41]

During this process, the UK and others also supported DSTs as short-term responses to address their particular concerns, and which, they argued, could be introduced unilaterally without the need to amend existing treaties.[42] The UK and the European Commission both put forward proposals for DSTs alongside their proposals for long-term reform in March 2018.[43] Over the following months, it became clear that the Commission's proposal for a harmonised EU DST did not enjoy the support of a number of EU Member States, and after some discussion on

[36] In his response to US Secretary of the Treasury Mnuchin's December 2019 letter, the OECD Secretary General noted that it was Mnuchin's "involvement as well as that of your delegates that steered the international community away from seeking a narrow digital solution and introduced innovative proposals into the discussions". Letter by A. Gurría dated 4 December 2019.

[37] A third group of countries argued that there was no immediate need for further reform.

[38] HM Treasury and HMRC, *Consultation Document*, above fn.15, para.1.6.

[39] OECD/G20 Base Erosion and Profit Shifting Project, *Tax Challenges Arising from Digitalisation — Interim Report 2018: Inclusive Framework on BEPS*, above fn.35, 172.

[40] See M.P. Devereux and J. Vella, "Taxing the Digitalised Economy: Targeted or System-Wide Reform?" [2018] BTR 387; and I. Grinberg, "User Participation in Value Creation" [2018] BTR 407.

[41] The Inclusive Framework is considering proposals for reform under two pillars. Pillar I is the Unified Approach. Pillar II is the Global Anti-Base Erosion proposal (GloBE)—essentially a minimum tax. See OECD, *Report on Pillar One Blueprint*, above fn.12 and OECD, *Report on Pillar Two Blueprint*, above fn.12. On the latter, see M. Devereux, F. Bares, S. Clifford, J. Freedman, İ. Güçeri, M. McCarthy, M. Simmler and J. Vella, Oxford University Centre for Business Taxation Report, *The OECD Global Anti-Base Erosion Proposal* (2020).

[42] HM Treasury and HMRC, *Consultation Document*, above fn.15, Ch.10.

[43] HM Treasury, *Corporate tax and the digital economy: position paper update* (Position Paper update) (March 2018); EU Commission, *Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services* (Brussels: 21.3.2018, COM(2018) 148 final); and EU Commission, *Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence* (Brussels: 21.3.2018, COM(2018) 147 final); EU Commission, *Commission Recommendation of 21.3.2018 relating to the corporate taxation of a significant digital presence* (Brussels: 21.3.2018, C(2018) 1650 final).

narrowing its scope, it was dropped in early 2019. The UK and other individual Member States persevered with their plans. The UK announced its DST in the budget of October 2018. A consultation on the DST, the *Digital Services Tax: Consultation* (the Consultation Document),[44] ran between November 2018 and February 2019—79 responses were received covering both high-level issues and more detailed questions on design. In July 2019, HM Treasury published a document with responses to the consultation,[45] essentially explaining why the DST would be introduced along the lines set out in the Consultation Document of November 2018. Draft legislation and guidance were also released in July 2019. The legislation was included in Finance Bill 2020 (and updated guidance was released) and it received Royal Assent on 22 July 2020. The tax is effective from April 2020. As noted above, the UK's preference is for long-term reform, and, therefore, the DST is intended as a temporary measure. A formal review is envisioned in 2025[46] but the tax could be disapplied even earlier if an "appropriate global solution is successfully agreed and implemented".[47]

At the time of writing, about 25 countries have adopted or are contemplating the adoption of DSTs based on turnover, but only six have effectively implemented such a regime.[48] In May 2020, the EU Commission included an EU-wide DST in a list of possible own resources to repay the costs of its COVID-19 recovery package.[49]

Objective

The UK DST's objective is to "ensure certain digital businesses pay tax reflecting the value they derive from UK users".[50] In other words, it is meant to address the mismatch between where business profits are taxed and where value is created, when certain highly-digitalised businesses derive value from the participation of UK users.[51] This objective is controversial on a number of grounds.

First, it is grounded in the questionable view that the underlying principle of the international tax system is, and should be, that profit is taxed where value is created (the "value creation" principle). The UK is a staunch exponent of this principle.[52] However, this principle is questionable

[44] HM Treasury and HMRC, *Consultation Document*, above fn.15.
[45] HM Treasury, *Digital Services Tax: response to the consultation* (July 2019), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/816389/DST_response_document_web.pdf* [Accessed 5 October 2020].
[46] FA 2020 s.71.
[47] HM Treasury and HMRC, *Consultation Document*, above fn.15, para.1.19. The adjective "appropriate" could prove to be critical here.
[48] *OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors* (July 2020), above fn.28.
[49] EU Commission, *Financing the recovery plan for Europe* (27 May 2020).
[50] HM Treasury and HMRC, *Consultation Document*, above fn.15, "Foreword" by The Rt Hon Mel Stride MP.
[51] HM Treasury and HMRC, *Consultation Document*, above fn.15, para.1.5.
[52] In their June 2020 response to US Secretary of the Treasury Mnuchin, the Finance Ministers of the UK, France, Italy and Spain faithfully repeated the mantra when making the case that: "It is fair and legitimate to expect that they [digital giants] pay their fair share of tax within countries where they create value and profit." Letter by Sunak, le Maire, Gaultieri and Jesús Montero Cuadrado dated 17 June 2020, above fn.22.

on positive and normative grounds.[53,54] There are many examples of where the existing system does not follow the value creation principle thus challenging the positive claim.[55] Clearly, the GloBE proposal being considered by the Inclusive Framework under Pillar II—and championed by some of the very countries that champion the value creation principle—also departs from the principle as it grants taxing rights to country A, where a parent company is located, if the profit in a subsidiary located in country B is taxed below an agreed threshold. The taxing rights granted to country A cannot be justified on the grounds that value was created there. The principle fares equally badly on normative grounds. It cannot be justified on economic efficiency or fairness grounds, be it the benefit principle or the ability to pay principle.[56]

Secondly, even if one were to accept the value creation principle as a normative guide to the allocation of taxing rights among countries, the practical problem then arises that it is very hard, if not impossible, to measure how much value is created by users in a particular country. According to the UK, users create value for the businesses targeted by its DST through four main channels: the generation of content; depth of engagement with the platform; network effects and externalities; and contribution to the brand. Through these channels "users can be seen participating in a non-traditional value chain and performing supply-side functions that would historically have been undertaken by the business itself".[57] But the UK has itself acknowledged the difficulty involved in measuring this value.[58]

Finally, this objective is based on questionable distinctions. One can agree that users create value for certain highly digitalised businesses; user-created content and data, for example, clearly create value for a social media business. But users and consumers of other businesses also create value for these businesses, as the UK Government itself concedes.[59] For example, online vendors of goods clearly derive value from the data collected from consumers and from consumer reviews. The UK's position seems to distinguish between the two cases. It argues that the value created by users of certain highly-digitalised businesses should be taken into account in allocating taxing rights over business profit, but value created by users/consumers of any other business should

[53] See for example M.P. Devereux and J. Vella, ETPF Policy Paper, *Value Creation as the Fundamental Principle of the International Corporate Tax System* (2018).

[54] In recent years, OECD officials and documentation appeared to be moving away from this principle. During the 2019 London IFA congress, which this writer attended, high-ranking OECD officials noted that this principle is useful in indicating where profit should not be taxed, but less useful in indicating where profit should be taxed. However, the principle made a noticeable return in the Blueprints released in October 2020. See for example, OECD, *Report on Pillar Two Blueprint*, above fn.12, 3 ("Weaknesses in the current rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created.")

[55] See, R. Collier, "The Value Creation Mythology" in W. Haslehner and M. Lamensch (eds), *Taxation and Value creation*, EATLP International Tax Series, Vol.19 (Amsterdam: IBFD, 2021), forthcoming.

[56] Devereux and Vella, *Value Creation as the Fundamental Principle of the International Corporate Tax System*, above fn.53.

[57] HM Treasury, Position Paper update, above fn.43, 9, para.2.30.

[58] This was done in the context of the user participation proposal but is equally applicable here. HM Treasury, Position Paper update, above fn.43, paras 3.16 and 3.17, concedes that "there would be challenges in coming up with a suitable approach to measuring that value directly" and that while "[t]here may be indirect indicators of the value of a user base to a business…it would be difficult to use those indicators to calculate an appropriate reward". See also HMRC Digital Services Tax Manual, above fn.1, DST18100 where HMRC concede that in the context of an online marketplace "[i]t would not be possible to reliably measure the value or contribution of user created value to the service."

[59] HM Treasury and HMRC, *Consultation Document*, above fn.15, 7, para.2.9.

not. The rationale and criteria for distinguishing between the two are not discussed at any length. It is simply claimed that, for certain highly-digitalised businesses, user participation "can reasonably be considered a central value driver, critical to the success or failure of the business",[60] but the value created by other users/consumers falls somewhat below this mark.[61]

The distinction drawn here between businesses in which users/consumers create value falling above the mark and those in which they create value falling below the mark, is unclear, unprincipled, and unpersuasive. It appears to reflect the UK's policy preferences of granting taxing rights over the profits of certain (mainly US based) highly-digitalised businesses to countries where users are found, while resisting calls for granting taxing rights to market countries more generally.[62]

As noted, as a matter of principle and policy, this position was justified on the questionable value creation principle, in particular a "supply-side" version of the principle.[63] However, in recent months, the UK appears to have had to make some concessions on this front. As noted above, the Unified Approach, which the UK appears to support, would constitute a limited but broader move of the international corporate tax system towards taxation in market countries, even if casuistic attempts may be made to justify the move in terms of the value creation principle.[64]

A policy objective which distinguishes between the contribution of users and consumers, and indeed, users who are deemed to create sufficient value and those who are not, is difficult to defend conceptually. As discussed below, this conceptually problematic distinction is also the source of a number of practical problems relating to the design and enforcement of the DST. As digitalisation spreads and deepens over time, the line between the two will be even harder to maintain, let alone justify.

Design

A forthcoming book, co-authored by this writer, argues that there are significant benefits in terms of economic efficiency, robustness to profit shifting and incentive compatibility in the taxing of businesses where relatively immobile factors are located.[65] Users, like consumers, are relatively

[60] HM Treasury and HMRC, *Consultation Document*, above fn.15, 7, para.2.10.
[61] "By contrast, user participation may be less central, intrinsic or material for other types of business models, which are nonetheless digital": HM Treasury and HMRC, *Consultation Document*, above fn.15, 8, para.2.12.
[62] "It [the UK Government] does not, for example, believe that another country should have a general right to tax profits that a UK business generates from a product that is designed in the UK, manufactured in the UK, marketed in the UK and then sold remotely to that country's customers. Equally it does not believe that the UK should have a general right to tax the profits that a foreign business generates from a product that is designed in another country, manufactured and marketed in that country and then sold remotely to a UK consumer" (HM Treasury, *Corporate tax and the digital economy: position paper* (November 2017), paras 2.5 and 2.6).
[63] According to a supply-side value creation principle, consumers do not create value and therefore taxing rights should not be allocated to a country because consumers are located there. See Devereux and Vella, *Value Creation as the Fundamental Principle of the International Corporate Tax System*, above fn.53.
[64] One also notes that the UK is considering the introduction of an online sales tax, which, while separate from corporation tax, would lead to further tax revenues being collected by the UK qua market country. HM Treasury, *Business Rates Review: Call for Evidence* (July 2020), paras 6.6–6.16.
[65] Devereux, Auerbach, Keen, Oosterhuis, Schön and Vella, *Taxing Profit in a Global Economy* (forthcoming), above fn.34. This insight led this group of authors to design and evaluate two systems which move towards a destination basis of taxation: Residual Profit Allocation by Income (which can be seen as a purer and more comprehensive version

immobile. They are clearly less mobile than other factors, including intellectual property (IP) or even research and development (R&D) facilities. A multinational operating a social media platform can move its IP or even its R&D facilities to a favourable tax jurisdiction, but it cannot easily move its users there. This should reduce the economic distortions caused by, and the profit shifting opportunities available under, a DST. It should also mean that the DST enjoys some degree of incentive compatibility in that countries that adopt a DST need not be concerned that they will lose their DST tax base to countries that do not—again because multinationals cannot easily move their users to non-adopting countries. Levying DSTs in countries where users are located thus endows the tax with a number of attractive properties.

Other features of DSTs are problematic.[66] In particular, their gross basis can create significant economic distortions and questions arise about their compatibility with EU and World Trade Organization (WTO) law.[67] DSTs' compatibility with bilateral tax treaties has also come under question. In the UK context, HM Treasury and HMRC have insisted that the UK's DST is not incompatible with existing UK treaties.[68] But this view is open to challenge. The question is whether the UK's DST falls within the ambit of existing treaties. In turn, this depends on the interpretation of treaty provisions modelled on Article 2 of the OECD Model which sets out the taxes covered by each treaty. It may be argued that the UK's DST is "identical or substantially similar"[69] to corporation tax, thus falling within the ambit of Article 2(4), particularly due to the alternative basis of charge described below. Some commentators have argued instead that the UK's DST probably falls within the ambit of Article 2(2) as a tax on "elements of income".[70] If either of these arguments is correct, then the UK's DST would certainly breach existing treaties as it would apply in excess of the limitations on UK taxing rights provided for in UK tax treaties. As Dan Neidle argues,[71] a distinction should then be made between the domestic and the international law consequences of such a breach. It would have no domestic law consequences because the UK is a dualist state and UK domestic law (Taxation (International and Other

of the Unified Approach being discussed under Pillar I) and the Destination Based Cash Flow Tax. See also Devereux and Vella, "Implications of digitalisation for international corporate tax reform" in Gupta, Keen, Shah and Verdier (eds), *Digital Revolutions in Public Finance*, above fn.34.

[66] See for example, K. Russo, "Superiority of the VAT to Turnover Tax as an Indirect Tax on Digital Services" (2019) 72(4) *National Tax Journal* 857 and G. Kofler and J. Sinnig, "Equalization Taxes and the EU's 'Digital Services Tax'" in W. Haslehner, G. Kofler, K. Pantazatou and A. Rust (eds), *Tax and the Digital Economy: Challenges and Proposals for Reform* (Wolters Kluwer, 2019). For a more favourable take on DSTs see W. Cui, "The Superiority of the Digital Services Tax over Significant Digital Presence Proposals" (2019) 72(4) *National Tax Journal* 839.

[67] These important issues are not considered further in this note. For recent analysis see: Russo, above fn.66, and Kofler and Sinnig, above fn.66; R. Goulder, "The futility of challenging DSTs under international law", *Tax Notes International*, 22 June 2020; R. Ismer and C. Jescheck, "Taxes on Digital Services and the Substantive Scope of Application of Tax Treaties: Pushing the Boundaries of Article 2 of the OECD Model?" (2018) *Intertax* 46(6/7) 573; R. Mason and L. Parada, "Company Size Matters" [2019] BTR 610; and C. Forsgren, S. Song and D. Horvath, *Digital Services Taxes: Do They Comply with International Tax, Trade, and EU Law?* (The Tax Foundation, June 2020); R. Shiers and J. Stoel, "Is the DST compatible with the UK's international obligations?" [2019] (1463) *Tax Journal* 12.

[68] HM Treasury and HMRC, *Consultation Document*, above fn.15, Ch.10.

[69] OECD, *Model Tax Convention on Income and on Capital (Full Version)* (OECD Model) (OECD Publishing, 2019), available at: *https://doi.org/10.1787/g2g972ee-en* [Accessed 22 October 2020], Art.2(4).

[70] OECD Model, above fn.69, Art.2(2). See for example Shiers and Stoel, above fn.67 and D. Neidle's Twitter thread at: *https://twitter.com/DanNeidle/status/1303312711665815554?s=20* [Accessed 22 October 2020].

[71] See D. Neidle's Twitter thread at: *https://twitter.com/DanNeidle/status/1303312711665815554?s=20* [Accessed 22 October 2020].

Provisions) Act 2010) does not extend the application of treaties to the DST, however it could certainly have international law and political consequences.

In its 2018 Report,[72] the OECD identified a number of issues with DSTs and listed suggestions to minimise these issues. The UK acknowledged "the limitations and challenges of revenue-based taxes"[73] and sought to address them through design. It conceded, however, "that those challenges can only be partly addressed through the tax's design".[74]

The UK's DST applies only to groups[75] with at least £500 million in global annual revenues from digital services activities and £25 million in annual revenues from digital services activities attributable to UK users.[76] The first £25 million of UK taxable revenues are not taxable.[77] These two features alleviate concerns about the impact of the tax on relatively small businesses, but they heighten concerns that the tax is effectively targeted at a small group of digital giants which mostly happen to be American,[78] with the political and legal (including WTO and EU law[79]) issues to which that gives rise.

Concerns about the DST's impact on businesses in loss positions, or with very low profit margins on their UK digital services activity, are addressed through a safe harbour that allows such businesses to elect an alternative basis of charge.[80] As a result, qualifying businesses in a loss position will not have to pay the DST, and those with low margins will have to pay the DST at a somewhat reduced rate of tax. The availability of this alternative basis of charge ought to reduce the economic distortions caused by the DST relative to a pure tax on gross revenues, but, of course, it does not eliminate them.

The DST is not creditable against UK corporate income tax liability, but it may be deductible as an expense following standard corporate tax rules.[81] Groups, which are subject to the DST but do not include UK corporation tax paying entities will, thus, be generally unable to benefit from this deduction.

Some negative features of the UK's DST—including its distortive economic effect and enforcement issues—would arise in the context of other digital taxes on revenues. They would arise, for example, under an online digital sales tax currently under consideration in the UK. But the particular objective of the UK's DST creates further design and enforcement problems.[82] As a result of this objective, for revenues to fall within the ambit of the UK's DST, a group must engage in "digital services activities", revenues must arise from these activities, and the revenues must be attributable to UK users. Each of these three tests can create difficulties.

[72] OECD/G20 Base Erosion and Profit Shifting Project, *Tax Challenges Arising from Digitalisation — Interim Report 2018: Inclusive Framework on BEPS*, above fn.35.
[73] HM Treasury and HMRC, *Consultation Document*, above fn.15, 4.
[74] HM Treasury, *Digital Services Tax: response to the consultation*, above fn.45, 8.
[75] Defined in FA 2020 ss.57–60.
[76] FA 2020 s.46.
[77] FA 2020 s.47(3).
[78] Although HM Treasury do not know how many companies will be caught by the UK DST, they believe it will be a relatively small number. S. Foley, T. Kolish, I. Novos and C. Myers, "Her Majesty's Treasury Department Discusses the UK's Proposed Digital Services Tax", *What's News in Tax* (KPMG, 2019).
[79] On the latter point see Mason and Parada, above fn.67.
[80] FA 2020 s.48. HMRC Digital Services Tax Manual, above fn.1, DST43400.
[81] HMRC Digital Services Tax Manual, above fn.1, DST47100.
[82] For further detail on these issues see J. Vella, "Digital Services Taxes: Principle as a double-edged sword" (2019) 72(4) *National Tax Journal* 821.

Digital services activities are defined as the provision of a social media service, an internet search engine or an online marketplace.[83] According to HM Treasury, these are the business activities "for which the participation of a user base can reasonably be considered a central value driver, critical to the success or failure of the business".[84] An internet search engine is not defined in the legislation, but the other two services are defined[85] and further explanation on all three is provided in HMRC guidance.[86] While some cases clearly fall within these definitions, others appear to be on the borderline. The simple examples set out in HMRC guidance provide a glimpse into the difficulties that can be expected to arise here.[87]

For illustrative purposes this writer will expand on the test and guidance for "social media services". Consider a business selling physical goods online. Selling goods to UK consumers would not bring it within the ambit of the tax, but if the business also provides a platform for consumers to interact, it may be caught by the DST as providing a social media service, depending on the precise circumstances of the case. Two conditions have to be satisfied to qualify as a "social media service". The first is that "the main purpose, or one of the main purposes, of the service is to promote the interaction between users (including interaction between users and user generated content)".[88] HMRC guidance explains that the main purpose test "is a question of fact and depends on the particular facts and circumstances of the case", and admits that while this should usually be clear "there will sometimes be more difficult cases".[89] The second condition is that "making content generated by users available to other users is a significant feature of the service".[90] Again, HMRC acknowledge that while in many cases it should be clear whether this condition is satisfied, it will be less clear in others.[91] Difficult borderline cases may arise in the context of different business models, but HMRC single out online games as being "particularly challenging" because "the significance of interaction between users and user content will vary significantly depending on the game".[92] This leads HMRC to the conclusion that each game should be tested to determine whether or not it satisfies the conditions of a social media platform. The difficulties created by these borderline cases are a cause for concern, particularly as the tests are vague, and much will depend on facts that may change rather rapidly. Ultimately, judgements will have to be made and similar businesses may reach different conclusions. More generally, it can be assumed that the number of businesses facing these decisions on the borderline will increase over time given the direction in which business is developing.

If a digital services activity that falls within the definition of section 43 FA 2020 is identified, the UK DST is applied to any third-party revenue stream[93] that is connected to the activity and linked to UK users. Examples include revenues arising from online advertising, subscription

[83] FA 2020 s.43(2)(a), (b) and (c). FA 2020 s.45 exempts online financial marketplaces. See also HMRC Digital Services Tax Manual, above fn.1, DST18700.
[84] HM Treasury and HMRC, *Consultation Document*, above fn.15, 7, para.2.10.
[85] FA 2020 ss.43(3) and (5).
[86] HMRC Digital Services Tax Manual, above fn.1, DST12000–DST19000.
[87] HMRC Digital Services Tax Manual, above fn.1, DST12500, 14800 and 18600.
[88] FA 2020 s.43(3)(a).
[89] HMRC Digital Services Tax Manual, above fn.1, DST14400. Further guidance is available on this test in DST14500.
[90] FA 2020 s.43(3)(b).
[91] HMRC Digital Services Tax Manual, above fn.1, DST14600.
[92] HMRC Digital Services Tax Manual, above fn.1, DST14700.
[93] See HMRC Digital Services Tax Manual, above fn.1, DST23000. Digital services revenues "is a very broad concept".

fees, commissions, data sales, and delivery fees.[94] Whether the revenues are realised in a UK entity or not is irrelevant for the applicability of the tax. Indeed, the tax could be due even if a business has no physical presence in the UK whatsoever. Of course, enforcement would be harder in such a situation.[95]

The particular objective of the DST may cause some difficulty here too. As it is only meant to tax business activities where user contribution is deemed to be of significant value, revenues from these activities will have to be distinguished from revenues from other activities, if both are present in a business. This may arise, for example, if a business earns revenues for adverts displayed on its website both when selling goods directly to consumers (outside the scope of the DST) and when acting as a platform between a consumer and third-party seller (within the scope of the DST). In such a case, section 40(3) FA 2020 provides that a "just and reasonable" apportionment is to be undertaken.[96] Tax law often relies on taxpayers' judgement, however, that does not make this test less troubling. Different taxpayers will collect different amounts of data and will have different views on what is "just and reasonable", meaning that—again—similar businesses could end up with different DST outcomes. It is also difficult to see how the tax authorities will be able to audit, let alone challenge, such judgements.

Finally, the revenues must be attributable to UK users. Section 41 FA 2020 sets out five Cases where revenue is attributable to a UK user—the first four apply to special types of revenues (three relating to online marketplaces and one to online advertising) and the fifth is a general sweep-up Case.[97] Examples include revenues arising from online advertising viewed or otherwise consumed by UK users and revenues arising in connection with a transaction on an online marketplace in connection with UK accommodation or land. Together these five Cases create a wide net with which to attribute revenues to UK users. The simple examples provided in HMRC guidance again show the difficulty that can arise in this exercise.[98] Section 41(9) FA 2020 then addresses the situation when a business may not be able to identify easily the revenues linked to UK users, for example because the business receives advertising revenues for advertisements displayed to both UK and non-UK users. In such situations, businesses are again asked to make a "just and reasonable" apportionment.[99]

A critical question here, of course, is how to define UK users. Users are UK users if it is "reasonable to assume", in the case of individuals, that they are "normally in the UK" and, in the case of businesses, that they are "established" in the UK.[100] HMRC guidance explains that

[94] HMRC Digital Services Tax Manual, above fn.1, DST24000.
[95] HM Treasury dismissed concerns by noting that the UK has "significant experience of collecting tax from businesses with no physical presence in the UK in areas such as VAT" and concluding that it "does not therefore see collection as a significant issue": HM Treasury, Position Paper update, above fn.43, paras 4.49 and 4.50.
[96] HMRC Digital Services Tax Manual, above fn.1, DST25000 explains that "the relevant test is not that the method used is the most accurate or most just and reasonable basis, it simply has to be a basis which an objective and informed person would consider just and reasonable having regard to the circumstances".
[97] Cross-Border relief is available for DST due for online marketplace transactions between a UK user and a foreign user normally located in a jurisdiction which applies a similar tax to DST. In such a case the UK digital services revenues arising from these transactions is reduced by 50%. See FA 2020 s.50 and HMRC Digital Services Tax Manual, above fn.1, DST43000.
[98] HMRC Digital Services Tax Manual, above fn.1, DST20000.
[99] Guidance is provided in HMRC Digital Services Tax Manual, above fn.1, DST26000 and 29000.
[100] FA 2020 s.44(3).

this test is not as "prescriptive as concepts like citizenship"—it "simply tests where the user is located most of the time" and "[i]n most cases, this will be synonymous with the jurisdiction where the user lives".[101] Note that the test does not depend on whether an individual is normally in the UK, but on whether it is reasonable to assume so. Taxpayers' compliance burden is further alleviated as groups are expected to make a determination of who is a UK user based on the information available to them.[102] HMRC explain: "some groups may not have enough information to objectively determine beyond doubt where a user is normally located or established. The 'reasonable to assume' test is a pragmatic test which is intended to reduce the compliance burden on groups and prevent them from needing to obtain more information from users than they collect in the course of their commercial activities."[103]

This may be seen as a practical solution to the problems previously raised by the business community. In fact, some businesses might not have the data to determine whether users are UK users or otherwise. If a business does not believe that the location of its users drives value, then it is unlikely to collect it, but, of course, this does not necessarily mean that it will not be caught by the DST. The data that will be available is unlikely to be held in the company's accounting systems—it is likely to come out of other sources and, therefore, will not be tied to figures in audited accounts.[104] However, this solution is also problematic from a horizontal equity perspective. Should a business's tax liability depend on the information it holds? Why should a business benefit because it has poorer information than a fellow taxpayer? In any event, it certainly will be a tall order for the revenue authorities to audit certain businesses' lists of UK users.

Conclusion

Time will tell if the UK's DST will in fact be a temporary measure. Even with hindsight, we may never know if it helped or hindered the UK's pursuit of a post-Brexit trade deal with the US, and a consensus-based global solution to perceived problems in the international tax system.

The DST reflects the UK's policy on international business tax reform as repeatedly stated in recent years. The UK favoured taxing certain highly-digitalised businesses in the location of their users to reflect the value created by such users, but opposed shifting the corporate tax system more generally towards a destination basis. Both limbs of this policy are based on the deeply questionable value creation principle. Value created by UK users—the DST's target—is elusive conceptually and hard to identify practically. It is thus unsurprising that this target leads to such a complex tax. Characteristics of a "good" tax include having a base that: is simple; is based on readily available information that is easy to verify and hard to manipulate; is not based on arbitrary and difficult distinctions; and requires minimal (if any) taxpayer judgement to compute. The DST fails on all these grounds, and this failure is a direct consequence of its objective and target.

There are compelling reasons for taxing businesses where users are located, as the DST does, due to their relative immobility. These reasons also support moving the corporate tax system in a more comprehensive and systematic way towards a destination basis, but this goes against the

[101] HMRC Digital Services Tax Manual, above fn.1, DST32000.
[102] HMRC Digital Services Tax Manual, above fn.1, DST32000.
[103] HMRC Digital Services Tax Manual, above fn.1, DST32000 and 33000.
[104] Chartered Institute of Taxation, *CIOT Response to UK Government's Consultation on a Digital Services Tax* (London: Chartered Institute of Taxation, 2019).

second limb of the UK's oft-reiterated policy preferences for international tax reform. It is this writer's hope that support of the OECD's Unified Approach suggests a softening of the UK's stance against a more general shift in this direction, and that the current consideration of an online sales tax suggests recognition of the benefits of such a shift. ☞

John Vella[*]

Section 73: excluded property etc; Section 74: transfers between settlements etc

These relatively short sections introduce some exceedingly complex changes to the inheritance tax (IHT) treatment of excluded property trusts. Prior to the changes in the Finance Act 2020 (FA 2020), excluded property trusts was defined to mean trusts settled by individuals who were, at the time when the settlement "was made",[1] non-UK domiciled. Such trusts were not subject to IHT even if the settlor later became UK domiciled provided no UK situated property was held directly by the trustees.[2]

The changes affect two types of transaction, whether done in the past or future but only in respect of IHT charges arising after Royal Assent on 22 July 2020:

1. Where a settlor adds to an excluded property settlement after becoming UK domiciled. Example 1: Amber sets up a trust with $1 million when domiciled in the US. Shortly after becoming deemed domiciled in the UK Amber adds another $500,000. What is the IHT status of the $500,000?[3]
2. Where trustees move property from one trust to another after the settlor becomes domiciled in the UK what is the status of the property in the new trust? See Example 2, below. The settlor may have had no involvement or even knowledge of this transaction between trustees but nevertheless past transfers to a transferee trust will be affected by FA 2020.

☞ Digital services tax; Digital technology; Online intermediaries; Online marketplaces; Search engines; Social media

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[1] See later discussion in text for meaning of when a settlement is made.

[2] Or from 6 April 2017 no UK residential property held in foreign companies was held by the trustees. See BTR 2017 Finance Act commentary. IHTA Sch.A1.

[3] Note: Amber could become domiciled in the UK either because Amber has decided to settle in the UK permanently and has therefore acquired a domicile of choice or Amber has been tax resident in the UK for longer than 15 out of the last 20 years and is therefore deemed domiciled in the UK. References to UK domicile in this note embrace either or both of these possibilities.

Background

The changes follow a longstanding disagreement with HMRC on the status of:

- additions to trusts of the sort set out in Example 1, above, where the trust was made when the settlor was foreign domiciled but an addition is later made after the settlor has become UK domiciled; and
- transfers between trusts which were made after the settlor has become UK domiciled. See Example 2, below.

Additions to trusts

Until FA 2020, section 48(3) of the Inheritance Tax Act 1984 (IHTA) simply tested the settlor's domicile at the time the settlement "was made". The settlement was treated as made when property first became comprised in it. Read literally, this meant that property added many years later by Amber in Example 1, above, to a settlement made when Amber was foreign domiciled would always be excluded property irrespective of Amber's domicile at the time of the addition. HMRC disagreed with this view: their view was that, in relation to any particular asset, "a settlement was made" for the purposes of section 48(3) each time an asset was transferred to the trustees to be held on the declared trusts.[4] HMRC argued that every addition to an existing settlement therefore constituted the making of a new settlement in relation to that property and that addition was a separate settlement for the purposes of working out whether it was excluded property or not. This view did not jeopardise the excluded property status of the original property but did not fit easily with the wording either in section 43(2) IHTA, which defined settlement as meaning "any disposition or dispositions of property"; or in section 44(2) IHTA, which provides for separate settlements where two settlors add property to the same settlement. Such a section would be largely unnecessary if every disposition of property was treated as a separate trust. The case of *Rysaffe Trustee Co (CI) Ltd v IRC*[5] was also unhelpful for HMRC. Ultimately HMRC's view was found to be wrong in *Barclays Wealth Trustees (Jersey) Ltd and Another v HMRC*[6] and this led to the 2020 changes outlined below.

Where property has been or is in future added to an existing settlement, the domicile of the settlor will be considered for the purposes of the excluded property rules at the time of the addition, rather than at the time the settlement was first created. Even if property was added to an excluded property trust before 22 July 2020 (when FA 2020 came into effect), it will not be protected from *future* IHT charges arising after that date (including on the settlor's death) if the settlor was domiciled in the UK at the date of addition.[7] (See section 73(1)).

Section 73 FA 2020 achieves this broadly by amending section 48(3)(a) IHTA to remove references to "when the settlement was made". Instead

[4] HMRC, Internal Manual, *Inheritance Tax Manual* (published 20 March 2016; updated 23 September 2020), IHTM27220, "Foreign property: property excluded from Inheritance Tax: foreign settled property with non-UK domiciled settlor".

[5] *Rysaffe Trustee Co (CI) Ltd v IRC* [2003] EWCA Civ 356; [2003] STC 536.

[6] *Barclays Wealth Trustees (Jersey) Ltd and Another v HMRC* [2015] EWHC 2878 (Ch); and *Barclays Wealth Trustees (Jersey) Ltd and Another v HMRC* [2017] EWCA Civ 1512; [2017] STC 2465.

[7] FA 2020 s.73(1).

> "property comprised in [the] settlement…is excluded property unless the settlor was domiciled in the United Kingdom at the time the property *became comprised* in the settlement…".[8]

Loss of excluded property status only affects the added property ($500,000 in Example 1, above), not the property originally settled when the settlor was foreign domiciled although it may not always be possible to keep additions separate. There are no rules determining how any tracing exercise is to be done when the original and added property have become intermingled. If the settlor is a beneficiary of the settlement, the change will mean not only that future 10 year charges are payable on that added property (maximum 6 per cent) but also that there is a 40 per cent IHT charge under the reservation of benefit provisions on the added property on the settlor's death.

What is the position if trustees accumulate income rather than distributing the income after 22 July 2020? On the basis that accumulated income "becomes comprised" in the settlement when it is accumulated, a change in the domicile status of the settlor from non-UK domiciled to UK domiciled between the date of the settlement and the date when income is accumulated would result in such accumulations becoming relevant property comprised in the settlement at the time when the settlor was UK domiciled, even though arising out of excluded property. Fortunately, section 73 FA 2020 provides that accumulations of income are treated as having become comprised at the same time as the original property (producing that income) became comprised in the settlement. Therefore, accumulations of income from property that was originally settled when the settlor was foreign domiciled remain excluded property for all IHT purposes whenever such accumulations are made.

Transfers between trusts

FA 2020 also deals with transfers between trusts where the position is somewhat more complicated as not only section 48(3) but also sections 81 and 82 IHTA are engaged.

Example 2: assume that trustees of Trust 1 transfer property from Trust 1 (made when Mr X was foreign domiciled) to a new Trust 2 (made when Mr X was UK domiciled). Does the requirement that the settlor is not UK domiciled at the time "the settlement was made" focus on the settlor's domicile at the time Trust 1 is created or on the domicile of the settlor when Trust 2 is created? What happens if Trust 2 then transfers to Trust 3 made after Mr X has died? Dead settlors cannot have a domicile. Does this mean the property becomes excluded property on entry into Trust 3 even if the settlor was UK domiciled throughout his life and Trusts 1 and 2 had never been excluded property?

In these circumstances, not only section 48(3) but also sections 81 and 82 IHTA were in point under the old legislation. Section 81 provided that when property passed from one settlement to another, it was treated for the purposes of the relevant property regime *only* as remaining comprised in the first settlement. Section 82 provided that the property transferred to Trust 2 was not excluded property for the purposes of the relevant property regime unless the settlor of Trust 2 was neither domiciled nor deemed domiciled in the UK when Trust 2 was made. In

[8] IHTA s.48(3)(a) as amended by FA 2020 s.73(2)(a).

Example 2, Trust 2 would therefore have not held excluded property even under the pre-2020 rules. The transfer to Trust 2 lost that favoured treatment. However, HMRC accepted in correspondence that was published in *Dymond's Capital Taxes* that where both trusts were settled when the settlor was foreign domiciled but the transfer was made by the trustees when the settlor was UK domiciled, it nevertheless remained excluded property for all IHT purposes. Again one looked not at when the property *becomes comprised in the settlement* but when each settlement "was made". Going forward section 82 IHTA has no application on trust to trust transfers on or after 22 July 2020.

Section 82A IHTA as inserted by section 74 FA 2020 now covers the position. The settlor's domicile is now, from 22 July 2020, retested on each occasion when the settled property moves between and becomes comprised in a new settlement: this is termed "a qualifying transfer". It is not just the date when each trust is "made" that matters. If on any of those occasions the settlor has an actual or a deemed UK domicile, any excluded property status resulting from the settlor's foreign domicile at the time the property became comprised in the original settlement is lost. However, the settlor's domicile at the time of the original settlement remains relevant due to sections 48(3) and 81 IHTA. Hence, even though a dead settlor does not have a UK domicile,[9] the subsequent loss of UK domicile due to death does not enable a trust to trust transfer to create an excluded property trust where such status did not previously exist.

However, if the settlor set up Trust 1 when foreign domiciled which transferred to a new trust set up after the settlor became UK domiciled, the second trust would not be excluded property under either section 82 or section 82A IHTA, that is, under either the old or new regimes. But if the settlor then died, a transfer from Trust 2 to Trust 3 would restore excluded property status under section 82A IHTA.

The change will not affect resettlements made before 22 July 2020 where both trusts were set up when the settlor was foreign domiciled but the transfer took place after the settlor acquired UK domicile and before 22 July 2020, except in one respect. If the settlor is a beneficiary of the transferee trust the assets transferred will be included in the settlor's estate on death under the reservation of benefit rules after FA 2020. This would not have been the case if the settlor had died before July 22 2020.

Example 3: Ivy set up two trusts when foreign domiciled with £1 million in each. In 2016, when Ivy was deemed domiciled for IHT purposes, the trustees transferred all the property from Trust 1 to Trust 2 and ended Trust 1. Trust 2 now holds all the property.

There are no relevant property charges going forward for Trust 2 if no UK situated property is held by the trustees at that time, as the transfer was done prior to Royal Assent of FA 2020 and both trusts were actually funded when the settlor was foreign domiciled. The property in Trust 2 remains excluded property for the purposes of the relevant property regime and no exit or 10 year charges should arise.

However, the transfer to Trust 2 is no longer excluded property for reservation of benefit purposes, as property has become comprised in a trust at a time when Ivy was domiciled. Therefore, if Ivy is a beneficiary of Trust 2, there is IHT payable on death on the added property at 40 per cent.

[9] IHTA s.82A(7).

Note that if the transfer between these two trusts had taken place on or after 22 July 2020 the second trust would not have been excluded property for any IHT purposes (including reservation of benefit purposes or for the purposes of the relevant property regime).

Loans

There have been suggestions that property becomes comprised in a settlement every time a loan is made to a trust. This seems misconceived. The "property comprised in the settlement" as referred to in the legislation at section 48(3)(a) as amended by FA 2020 must refer to the net value of the property. Hence, if trustees later borrow after the settlor is UK domiciled but the settled property was placed into trust when the settlor was foreign domiciled, the borrowing is not added property. It should make no difference if the loan is interest free as no property becomes comprised in the settlement simply because interest is foregone. Even if the value of the settled property is increased by the lender not charging the trust interest, the omission to charge something is not, as such, added property. How would such an increase in value ever be quantified because the actual value increase may be completely different to the interest foregone?

Other anomalies

The legislation refers to property becoming comprised in the settlement but does not deal with additions of *value*. Unlike the legislation in Schedule 8 to the Finance (No.2) Act 2017 on tainting for income tax and capital gains tax purposes, there are no express provisions covering additions of value for IHT purposes.

Example 4: Rosie set up and funded an excluded property trust made many years ago. The trust owns a foreign company and, after becoming UK domiciled, Rosie decides to make a gift not to the trust but to the company Holdco owned by the *trust*. This would be a chargeable transfer for IHT purposes under both the old and new regimes. But the property comprised in the settlement is still Holdco. The company has just become more valuable but nothing has been added to the trust. In these circumstances is the full value of the company still excluded property going forward even after 22 July 2020? It appears possible that this point has been missed although on a purposive interpretation the Court may decide that additions of value do constitute property becoming comprised in the settlement.

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Excluded property trusts; Foreign domiciliaries; Inheritance tax; Loans

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Section 77: stamp duty: transfers of unlisted securities and connected persons; Section 78: SDRT: unlisted securities and connected persons; and Section 79: stamp duty: acquisition of target company's share capital

Sections 77 and 78 of the Finance Act 2020 (FA 2020) extend an anti-avoidance measure that was first enacted in the Finance Act 2019 (FA 2019). Two separate sections of FA 2020 are required for this purpose because the amended approach needs to be reflected for the purposes of both stamp duty[1] and stamp duty reserve tax (SDRT).[2]

As the Treasury Explanatory Notes make clear,[3] these changes are intended to target "contrived arrangements" involving the transfer of unlisted securities to connected companies. Though not explained further in the Treasury Explanatory Notes, the arrangements are in particular relevant to "share swamping" arrangements, which are designed to mitigate stamp taxes due where shares are used as the consideration on which stamp duty or SDRT is due. Broadly, these arrangements involve the creation of a large number of issued shares, with a very small fraction of those shares only being used as consideration on which stamp tax is payable, the idea being that the value of the shares used would be very low by virtue of the large number of shares created. The new rule seeks to defeat such arrangements. Where the required conditions are met, the amount of the consideration in respect of the transfer of the unlisted shares is to be treated as equal to the higher of the value of the consideration and the market value of the unlisted securities that are transferred. The relevant market value is identified, broadly, at the time of the transaction (for stamp duty purposes it is the time the relevant instrument of transfer is executed and for the purposes of SDRT it is the time the relevant agreement is entered into). The provisions of sections 272 to 273 of the Taxation of Chargeable Gains Act 1992 (TCGA) are to be applied in determining the appropriate "market value" of the unlisted securities for the purposes of this amendment. There are three conditions required for the rule to operate. First, there must be an instrument transferring (stamp duty) or an agreement to transfer (SDRT) unlisted securities to a company (or its nominee) for consideration. Secondly, the parties must be connected. Thirdly, some or all of the consideration must consist of the issue of shares. The requirement for an issue of shares means that the new rules will not apply to capital contributions, distributions in specie and transfers of shares for nil consideration.

The new provisions extend a similar rule introduced by FA 2019 which applies to transfers involving listed securities. The measures now introduced by FA 2020 extending the application of the market value rule to unlisted securities are inserted into FA 2019 (to sit alongside the original 2019 changes that target transfers of listed securities) as new section 47A and section 48A FA 2019.

[1] FA 2020 s.77.
[2] FA 2020 s.78.
[3] HM Treasury, *Finance Bill Explanatory Notes* (19 March 2020), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/873637/Finance_Bill_2020_Explanatory_Notes.pdf* [Accessed 25 September 2020], 142, para.16.

The introduction of the new measures follows a Government consultation exercise on the consideration rules relating to stamp taxes on shares.[4] That consultation also considered the possibility of aligning the stamp duty and SDRT definitions of "consideration" and also aligning the treatment of contingent, uncertain and unascertainable payments. However, for now no changes are to be made in relation to these matters.

Section 79 FA 2020 is concerned with arrangements relating to the acquisition of a target company's share capital for which a stamp duty relief is available under section 77 of the Finance Act 1986 (FA 1986). That provision in FA 1986 provides relief on instruments transferring shares in one company (the target company) to another company (the acquiring company) where the acquiring company issues shares as consideration for the transfer to all the shareholders of the target company for the whole of the issued share capital of the target company. The shareholders in the acquiring company after the share-for-share exchange must mirror those in the target company immediately prior to that exchange. Anti-avoidance legislation was introduced in the Finance Act 2016 to withdraw the relief where arrangements are in existence at the time the instrument is executed by virtue of which any person alone or persons together could acquire control of the acquiring company.[5] This was prompted by the concern on the part of HMRC that the relief is intended for reconstructions of share capital where there is no real change in ownership, rather than for company takeovers where there is a change of control. The anti-avoidance provision would apply on a share-for-share exchange that is followed by a capital reduction demerger resulting in one of the existing owners acquiring control of the acquiring company. However, the measure now introduced by section 79 FA 2020 relaxes this anti-avoidance provision in such a case. Specifically, the new measure prevents the share-for-share relief in section 77 FA 1986 being denied where there is an arrangement for a person to obtain control of the acquiring company and that person previously held at least 25 per cent of the issued share capital of the target company for a period of at least three years prior to the share-for-share exchange. Given that a double charge to stamp duty can arise on capital reduction demergers, the new provision will prevent this from happening provided the relevant conditions are met.

The provisions in sections 77 to 79 FA 2020 will have effect for instruments of transfer executed (stamp duty) or agreements entered into (SDRT) on or after Royal Assent.

Richard Collier[*]

[4] See HMRC, *Stamp Taxes on Shares: Consideration Rules: Summary of Responses* (11 July 2019), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/816291/Stamp_taxes_on_shares_rules_consideration_-_summary_of_responses.pdf* [Accessed 25 September 2020].
[5] See FA 2016 s.137 inserting a new s.77A into FA 1986.

Connected persons; Reliefs; Securities; Stamp duty; Stamp duty reserve tax; Tax avoidance; Transfer of securities; Unlisted companies

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Section 95 and Schedule 12: carbon emissions tax; Section 96: charge for allocating allowances under emissions reduction trading scheme

The UK is considering two main options to maintain carbon pricing in line with its commitments to reach net-zero emissions by 2050 in case it leaves the EU with no deal. These two options are aimed at allowing as smooth as possible a transition out of the EU Emissions Trading Scheme (EU ETS),[1] which is the EU's main climate policy instrument. The first option is to introduce a UK ETS that could, if both parties agree, be linked to the EU ETS.[2] The second option is to replace the UK participation in the EU ETS by a carbon emissions tax.[3] The UK Government and the devolved administrations have expressed their preference for a UK ETS.[4] Nevertheless, both options remain on the table. This "twin-track approach" has been justified as a way to "ensure that, whatever the circumstances, the UK will have an effective carbon pricing regime in place".[5] Consequently, provisions are being introduced to support the establishment of either a UK ETS or a carbon emissions tax.

Sections 69 to 78 of the Finance Act 2019 (FA 2019) introduced the main design features of the carbon emissions tax.[6] Section 95 of and Schedule 12 to the Finance Act 2020 (FA 2020) include amendments to some of these provisions in order to make the carbon emissions tax operational as of 1 January 2021, if need be.[7] Moreover, section 96 FA 2020 provides the legal

[1] Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a system for greenhouse gas emission allowance trading within the Union and amending Council Directive 96/61/EC [2003] OJ L275/32 (25 October 2003), as amended.

[2] European Commission, Task Force for the Preparation and Conduct of the Negotiations with the United Kingdom under Article 50 TEU, *Revised text of the Political Declaration setting out the framework for the future relationship between the European Union and the United Kingdom as agreed at negotiators' level on 17 October 2019*, para.70. See also HM Government, *The Future Relationship with the EU: The UK's Approach to Negotiations* (February 2020, CP211), 22, Pt 2, para.14.

[3] HM Treasury, *Budget 2018* (October 2018), 47. See also HMRC, Policy paper, *Carbon Emissions Tax* (29 October 2018), available at: *https://www.gov.uk/government/publications/carbon-emmisions-tax/carbon-emmisions-tax* [Accessed 23 September 2020].

[4] UK Government, press release, *New Emissions Trading System proposal would see UK go further in tackling climate change* (1 June 2020), available at: *https://www.gov.uk/government/news/new-emissions-trading-system-proposal-would-see-uk-go-further-in-tackling-climate-change* [Accessed 23 September 2020]; Department for Business, Energy & Industrial Strategy, The Scottish Government, Welsh Government, and Department of Agriculture, Environment and Rural Affairs (Northern Ireland), *The future of UK carbon pricing: UK Government and Devolved Administrations' response* (June 2020), available at: *https://www.gov.uk/government/consultations/the-future-of-uk-carbon-pricing* [Accessed 23 September 2020]. See also Vivid Economics, *The Future of Carbon Pricing in the UK: Report prepared for the Committee on Climate Change: Final Report* (August 2019), 101. This report presents the UK carbon tax as a "fallback option".

[5] Second Reading of the Finance Bill, *Hansard*, HC, Vol 675, cols 129–130 (27 April 2020), comment by The Financial Secretary to the Treasury (Jesse Norman), available at: *https://hansard.parliament.uk/commons/2020-04-27/debates/C37146D2-C2C0-4146-A015-E038C1E439DA/FinanceBill#contribution-D4645A63-BC79-477E-96C7-4E812F836290* [Accessed 23 September 2020].

[6] See also HMRC, Policy paper, *Changes to tax provisions for Carbon Emissions Tax* (11 March 2020), available at: *https://www.gov.uk/government/publications/changes-to-tax-provisions-for-carbon-emissions-tax/changes-to-tax-provisions-for-carbon-emissions-tax* [Accessed 23 September 2020].

[7] See HM Treasury, *Finance Bill Explanatory Notes* (Explanatory Notes) (19 March 2020), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/873637/Finance_Bill_2020_Explanatory_Notes.pdf* [Accessed 2 September 2020], cl.92, Sch.11, Resolution 52, para.1, 170. See also letter of

basis for the introduction of a UK ETS. It authorises HM Treasury to make regulations which provide for the auctioning of allowances and the introduction of market stability mechanisms to limit price volatility.[8]

This short note first briefly describes the main features of the carbon emissions tax. Secondly, it highlights that the carbon emissions tax would mimic many design features of an ETS, which blurs the line between carbon taxation and emission trading. Thirdly, it discusses how such a carbon emissions tax could be the first step towards a simplified approach to carbon pricing in the UK. Finally, it concludes.

1. The main design features of the carbon emissions tax

The UK carbon emissions tax differs from traditional carbon taxes, which are usually designed as excise taxes levied on fuels by weight, volume or on actual emissions (the so-called "fuel approach").[9] The carbon emissions tax relies on an alternative approach, which is based on the measurement of the actual emissions of installations (the so-called "direct emissions approach").[10] The carbon emissions tax is an annual tax, which is charged, in relation to regulated installations, "if the amount of reported carbon emissions for a reporting period exceeds the emissions allowance for the period".[11] In many ways, its design mimics the approach of the EU ETS, under which installations are required to surrender allowances to cover their total annual emissions. Under the EU ETS, most of the allowances are allocated through an auctioning system but some are allocated for free. In particular, the energy-intensive sectors at risk of carbon leakage benefit from free allowances.[12] The carbon emissions tax can be compared to the EU ETS in terms of its scope, its approach to carbon leakage and its carbon price.

First, installations to be subject to the carbon emissions tax should be broadly the same as those that are currently part of the EU ETS, with two main exceptions.[13] First, power generators located in Northern Ireland would, in principle, remain part of the EU ETS.[14] Secondly, the carbon emissions tax would not cover the aviation sector. This is not surprising given the legal

4 June 2020 from the Financial Secretary to the Treasury to the Public Bill Committee, available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/890311/FST_Letter_to_PBC_Chairs_-_delegated_powers.pdf* [Accessed 23 September 2020], regarding the clauses that introduce the power to make secondary legislation.

[8] The Explanatory Notes, above fn.7 (Finance Bill 2020 cl.93, Resolution 53, para.12, 174) indicate that such a charging clause is necessary given that "Paragraph 5 of Schedule 2 of the Climate Change Act 2008 does not permit regulations made under section 44(1) to provide for allowances to be allocated in return for consideration."

[9] See the draft chapter on the design of a carbon tax for the *United Nations Handbook on Carbon Taxation*: United Nations, Committee of Experts on International Cooperation in Tax Matters, Twentieth session, Ch.3, "Designing a Carbon Tax — Carbon Taxation Handbook" (21 April 2020, E/C.18/2020/CRP.17), 16.

[10] *United Nations Handbook on Carbon Taxation*, above fn.9, 26–27.

[11] FA 2019 s.70(1).

[12] See the consolidated text of Directive 2003/87/EC, above fn.1, Art.10b (as inserted by Directive (EU) 2018/410 of the European Parliament and of the Council of 14 March 2018 amending Directive 2003/87/EC to enhance cost-effective emission reductions and low-carbon investments, and Decision (EU) 2015/1814 [2018] OJ L76/3 (19 March 2018)).

[13] FA 2019 s.77(1); HM Treasury, *Finance (No. 3) Bill Explanatory Notes* (7 November 2018), cl.68, para.5, 211.

[14] The Single Electricity Market would remain operational in Northern Ireland as provided for in the Ireland/Northern Ireland Protocol. See Department for Business, Energy & Industrial Strategy, Guidance, *Meeting climate change requirements from 1 January 2021* (updated 9 September 2020), available at: *https://www.gov.uk/government/publications/meeting-climate-change-requirements-if-theres-no-brexit-deal/meeting-climate-change-requirements-if-theres-no-brexit-deal* [Accessed 23 September 2020].

limits that apply to the taxation of this sector under international law.[15] Therefore, in order to meet the UK's commitment to tackle the emissions of the aviation sector, additional ad hoc measures would need to be established.[16] For the installations subject to the carbon emissions tax, current reporting requirements for installations should be maintained and be based on existing emissions reporting arrangements.[17]

Secondly, the threshold for the determination of the taxable emissions—the so-called "emissions allowance"—should play a similar role to that of the allowances that are allocated for free under the EU ETS.[18] Its objective is to allow "the government to maintain similar arrangements to the EU ETS for industrial installations deemed to be exposed to significant risk of carbon leakage, to support their competitiveness".[19] The "emissions allowance" for the carbon emissions tax remains to be defined. The Finance Act 2019 provides that the "emissions allowance" should be determined by reference to an amount of emissions to be "specified by or under, or determined in accordance with, regulations made by the Commissioners for Her Majesty's Revenue and Customs".[20] Setting the threshold of emissions subject to the tax or the EU ETS at the "right" level is key under both mechanisms. Under an ETS, if the allocation of free allowances is too generous, installations might be able to benefit from windfall profits without having to reduce the amount of carbon emissions that they generate. Similarly, under a carbon emissions tax, if the threshold of "emissions allowance" is set too "high", very few installations would end up being subject to the tax, which would make it ineffective (no emissions would be taxable).

To the extent that the method used to determine the threshold of taxable emissions is comparable to the methods used under the EU ETS to set out the levels of free allowances, the two mechanisms will achieve comparable outcomes for the installations with reported emissions higher than their allocated free allowances or "emissions allowance" threshold. However, for the installations with lower reported emissions, the mechanisms could lead to different outcomes. Under an ETS, these firms would, in principle, be rewarded: they would be incentivised to cut their emissions further in order to be able to sell their excessive free allowances. In comparison, a carbon emissions tax would not have this incentive effect, given that the tax would not be "credited or repaid" if the "emission allowances were unused".[21] To compensate for the absence of such an incentive effect, the Government is now considering the introduction of a payments

[15] See the provisions on the exemptions of aviation fuel on board an aircraft in the Convention on International Civil Aviation done at Chicago, 7 December 1944 (Chicago Convention) (Art.24) and the similar provisions that are included in bilateral air transport agreements.

[16] In the hypothesis of a UK ETS, the aviation sector would be included in the scheme (see *The future of UK carbon pricing: UK Government and Devolved Administrations' response*, above fn.4, Ch.3).

[17] FA 2019 ss.71 and 72.

[18] HMRC and HM Treasury, *Carbon Emissions Tax: Consultation* (21 July 2020), 11, point 2.22.

[19] *Finance (No. 3) Bill Explanatory Notes*, above fn.13, cl.68, para.5, 211.

[20] FA 2019 s.73.

[21] HMRC, *Technical Note - Carbon Emissions Tax* (published 29 October 2018; last updated 3 September 2019), available at: *https://www.gov.uk/government/publications/carbon-emissions-tax-technical-note* [Accessed 23 September 2020] (in particular Ch.3, 6). Please note that this publication was withdrawn on 8 June 2020. A new technical note should be published before January 2021.

system to "reward decarbonization from main scheme installations" as well as special arrangements for small emitters.[22]

Thirdly, the tax rate of the carbon emissions tax has been set at £16 per tonne of carbon dioxide equivalent[23] in order to "maintain a stable carbon price for the installations that were subject to the EU ETS" and "replace the revenue lost from the auctioning of EU allowances".[24] This tax rate was established in 2018 on the basis of an average of the carbon price under the ETS over a period of six months and a forecast for the next six months.[25] The tax rate has not been updated since 2018, which is problematic given the high volatility of carbon prices under the EU ETS. At the very least, the tax rate should have been updated in FA 2020 to better reflect the higher average carbon price under the EU ETS in 2019 in comparison to 2018 prices. Moreover, if the carbon emissions tax is introduced and maintained, its tax rate should be reassessed in the coming years, independently of the EU ETS carbon price. The UK should aim for a carbon price sufficiently high to meet its commitment to reach a net-zero emissions target by 2050 and the proposed £16 does not seem to meet this objective.[26] If the objective is to encourage investments in low carbon technologies, it is key that it is sufficiently credible that the carbon price will increase and remain high.

FA 2020 contains several amendments to FA 2019. Some of these amendments are just minor technical corrections and updates to FA 2019 but some others are substantial. For example, FA 2020 provides the Treasury with the power to exclude certain installations from the carbon emissions tax,[27] such as power generators located in Northern Ireland.[28] Moreover, FA 2020 extends the power of HMRC to make further provision about the carbon emissions tax, such as the power to make provision for "the imposition of civil penalties" in case of non-compliance.[29] It also adds a penalty for failure to make payments on time.[30]

2. A carbon emissions tax versus a standalone UK emissions trading scheme

The UK's twin-track approach raises the question of the advantages and disadvantages of a carbon emissions tax in comparison to a standalone UK ETS. This section highlights that the

[22] See *Carbon Emissions Tax: Consultation*, above fn.18, 17, points 2.45–2.50.
[23] FA 2019 s.70(3).
[24] HMRC, Policy paper, *Changes to tax provisions for Carbon Emissions tax* (11 March 2020), available at: *https://www.gov.uk/government/publications/changes-to-tax-provisions-for-carbon-emissions-tax/changes-to-tax-provisions-for-carbon-emissions-tax* [Accessed 23 September 2020] (see under the section on "policy objective").
[25] See House of Lords, Select Committee on the European Union, Sub-Committee on Energy and Environment, *Corrected oral evidence: Post-Brexit carbon pricing* (27 February 2019) (see R. Jenrick's answers to questions 25 and 29).
[26] The carbon price support (CPS) should be added on top of the carbon emissions tax to determine the total carbon price but, even then, the rate seems insufficient to meet the UK's climate commitments. See J. Burke, R. Byrnes and S. Fankhauser, *Policy report, How to price carbon to reach net-zero emissions in the UK* (May 2019), available at: *http://www.lse.ac.uk/GranthamInstitute/wp-content/uploads/2019/05/GRI_POLICY-REPORT_How-to-price-carbon-to-reach-net-zero-emissions-in-the-UK.pdf* [Accessed 23 September 2020]. This report indicates that "a shadow price consistent with a net-zero target would start at £50 per tonne of carbon dioxide (tCO2) (with a range of £40–100) in 2020" (4).
[27] FA 2020 Sch.12, para.3.
[28] For power generators located in Northern Ireland, see fn.14.
[29] FA 2020 Sch.12, para.4(2).
[30] FA 2020 Sch.12, para.9.

general arguments usually put forward in favour of either of these instruments might not apply to the UK's proposals. Given their common objective of ensuring a stable carbon price in case the EU ETS no longer applies in the UK as of January 2021, the two options differ less from each other than they generally do.

The general advantages and disadvantages of carbon pricing in comparison with emissions trading are well known.[31] First, the design and administration of carbon taxes is usually considered to be relatively simple in comparison to emissions trading.[32] Secondly, carbon taxation and emissions trading are considered to provide different levels of certainty in terms of price and emission targets. Carbon taxes provide certainty with regard to the abatement cost of carbon emissions. Under a carbon tax, the tax rate defines the abatement cost whereas, for emissions trading, the cost of permits is defined by the market on the condition that it is competitive. In contrast, emissions trading schemes provide certainty with regard to the reduction in emissions levels that can be achieved: the total emissions generated on a yearly basis should correspond to the amount of emissions allowances that have been allocated by the authority, either for free or through auctioning. Thirdly, emissions trading systems are considered more cost-efficient because they allow for an efficient allocation of emissions abatement between firms on the condition that a competitive carbon market is in place.[33] Fourthly, both mechanisms differ with regard to the institutional provisions that apply to their adoption and implementation. For example, at the EU level, unanimity is required for the adoption of taxes, but qualified majority voting requirements apply to the adoption of environmental regulation, including the emissions trading scheme. In the UK, a carbon emissions tax would be a reserved matter for the UK Government, which has raised some concerns in Wales and Scotland.[34]

Aside from the institutional aspects, the differences that generally distinguish carbon taxes from emissions trading schemes do not fully apply to the UK proposals for a carbon emissions tax or a standalone UK ETS. First, although most carbon taxes are generally simpler to administer than emissions trading schemes, it might not hold true for a carbon emissions tax. Indeed, the "direct emissions approach" that underlies the carbon emissions tax is characterised by an administrative complexity similar to that which characterises emissions trading.[35] Secondly, both a carbon emissions tax and a standalone UK ETS could provide for some level of certainty both in respect of the level of carbon price and emissions reduction. Under a well-designed carbon tax, the tax rate could be modified to achieve the desirable emissions reduction levels in case the initial tax rate was too low to achieve it. Similarly, a well-designed standalone ETS could include an "auction reserve price" ensuring a "minimum carbon price signal" or other mechanisms allowing for adjustments to be made to the supply of allowances in case the price level is

[31] This entire paragraph is based on D. Fullerton, A. Leicester and S. Smith, Ch.5, "Environmental Taxes" in S. Adam, et al. (eds), *Dimensions of Tax Design: The Mirrlees Review* (Oxford: OUP, 2010), s.5.2.4, 436–439.
[32] This point is mentioned in Vivid Economics, above fn.4, 4–5.
[33] Fullerton, Leicester and Smith, above fn.31, 438.
[34] Welsh Government, press release, *EU Emissions Trading System (EU ETS)* (15 October 2018), available at: *https://gov.wales/eu-emissions-trading-system-eu-ets* [Accessed 23 September 2020]. See also House of Lords, Select Committee on the European Union, Sub-Committee on Energy and Environment, *Corrected oral evidence: Post-Brexit carbon pricing*, above fn.25, question 31.
[35] *United Nations Handbook on Carbon Taxation*, above fn.9, 26–27 and 33.

considered too low.[36] Thirdly, the alleged advantage of emissions trading systems in terms of cost-efficiency might not apply to a standalone UK ETS. Such advantage is conditional upon the existence of a competitive market and the UK market for carbon emissions might be too small for that.[37] Finally, the two UK proposals for carbon pricing present additional differences due to their specific design features. In particular, their scope would be slightly different: a UK standalone ETS would include the aviation sector, which would be excluded under the carbon emissions tax.

The choice to be made between the carbon emissions tax and the standalone UK ETS should be informed by their distinguishing features, which do not always match the textbook example of carbon taxes and emissions trading. Although the two mechanisms differ on several grounds, the carbon emissions tax differs less from a standalone UK ETS than would a traditional carbon tax based on a "fuel approach". Therefore, the decision on which of these two instruments should prevail in the case of a no-deal Brexit might not be as crucial as the decision on how to reform the UK carbon pricing policy in the long run. This question is analysed in the next section.

3. Brexit: a way to simplify the UK's carbon pricing policy?

The UK's approach to carbon pricing has been based on a complex "set of interlocking mechanisms", including taxes and emissions trading instruments.[38] In addition to the EU ETS, a carbon tax is levied on electricity generation (the so-called "carbon price support" (CPS) rate introduced by Schedule 32 to the Finance Act 2012). Moreover, other taxes are imposed on the use of energy. For example, the climate change levy (CCL), introduced in 2001, is also imposed on the non-domestic use of electricity, gas, liquefied petroleum gas and solid fuels.[39]

As a member of the EU, the UK had to comply with EU law requirements and could not easily change the design of the EU ETS. In this context, its complex and multi-layered approach to carbon pricing might have been justified.[40] The CPS has been adopted on top of the EU ETS in order to guarantee a sufficiently high carbon price (referred to as the "carbon price floor")

[36] The Explanatory Notes, above fn.7, (cl.93, Resolution 53, para.13, 174) indicate that Finance Bill 2020 cl.93 allows for the implementation of such "market stability mechanisms", which could "include a Cost Containment Mechanism (CCM) to respond to any significant short-term price spikes and an Auction Reserve Price (ARP)". See also the observation on "supply adjustment mechanisms" in Vivid Economics, above fn.4, 89–90. See also F. Flues and K. van Dender, "Carbon pricing design: Effectiveness, efficiency and feasibility: An investment perspective" (2020) OECD Taxation Working Papers No.48.

[37] See the observations regarding market stability, competitiveness, exposure to shocks and carbon market liquidity in Vivid Economics, above fn.4, 3–4. See also J. Burke, B. Doda, L. Taschini and L. Mattauch, *The future of carbon pricing: A joint submission to the UK Government by the Grantham Research Institute on Climate Change and the Environment, the Institute for New Economic Thinking at the Oxford Martin School, and the Environmental Change Institute* (August 2019), available at: *http://www.lse.ac.uk/GranthamInstitute/wp-content/uploads/2019/07/GRI_Consultation-response-on-the-future-of-carbon-pricing.pdf* [Accessed 23 September 2020].

[38] S. Smith and J. Swierzbinski, "Assessing the performance of the UK Emissions Trading Scheme" (2007) 37 *Environmental and Resource Economics* 131, 133. See also J. Mirrlees, et al., Ch.11, "Tax and Climate Change" in J. Mirrlees, et al. (eds), *Tax by Design: The Mirrlees Review* (Oxford: OUP, 2011).

[39] FA 2000 s.30 and Sch.6.

[40] Pollitt and Chyong explain that "[f]rustration with the lack of tightness of the EU ETS prompted the UK to introduce an additional carbon tax on fossil fuels for electricity production in 2013 (the carbon price floor)": see M.G. Pollitt and K. Chyong, *Brexit and its implications for British and EU Energy and Climate Policy, Project Report, Centre on Regulation in Europe* (22 November 2017), 41.

against the background of a "too low" carbon price under the EU ETS.[41] Although the CPS has added complexity to the UK's carbon pricing policy, it has played a key role in sustaining a relatively high carbon price in relation to electricity in the UK, which has allowed for a boost in "low-carbon investments".[42]

The introduction of either a standalone UK ETS or a carbon emissions tax will not necessarily lead to a simplification of the UK's complex carbon pricing policy. However, the opportunity for such a simplified approach should be taken seriously if the UK's climate policy becomes independent from the EU ETS.[43]

If the UK chooses to adopt a standalone UK ETS as of January 2021, the CPS could be abandoned. The UK would be able to design its ETS independently of the EU. This standalone ETS could include a supply adjustment mechanism that would provide for a minimum carbon price and, thus, fulfil the same role as the CPS.[44] Such a design would simplify the UK's carbon pricing policy by integrating two of its key instruments that apply to emissions from non-domestic energy use. Carbon taxes could nevertheless remain a relevant tool for carbon pricing, for example to cover emissions that are traditionally left out of the scope of an ETS, such as the emissions related to domestic energy use (for example, those linked to heating) or the emissions generated by small and medium-sized businesses.

Based on the hypothesis that the carbon emissions tax is to be introduced in January 2021, carbon pricing in the UK would no longer include a mix of emissions trading and tax instruments but would rely only on tax instruments. Such a system of carbon pricing would still be complex, including as it would a carbon emissions tax, a CPS and other taxes on energy use. Therefore, over the longer term, the UK could consider integrating its different carbon taxes and taxes on energy use into a simpler environmental tax on energy.[45] The CPS and the carbon emission tax could be merged into either a carbon emissions tax with a higher tax rate or into a broad carbon tax based on a "fuel approach". Given that the latter option is relatively simple in comparison to the former, a reform in favour of a broad-based carbon tax on energy use based on a "fuel approach" would have the highest potential for simplifying the UK's carbon pricing policy.

[41] On the CPS and carbon price floor, see D. Hirst, *Carbon Price Floor (CPF) and the price support mechanism*, House of Commons Library, Briefing Paper No.05927 (8 January 2018).

[42] On the effects of the CPS, see Vivid Economics, above fn.4, 39, referring to G. Perino, R.A. Ritz and A. van Benthem, "Understanding Overlapping Policies: Internal Carbon Leakage and the Punctured Waterbad" (2019) EBER Working Paper No.25643. See also A. Varma, "UK's climate change levy: cost effectiveness, competitiveness and environmental impacts" (2003) 31 *Energy Policy* 60.

[43] Hepburn and Teytelboym have also suggested that the UK carbon pricing policy might become stronger after Brexit: "…action on climate change in Britain is more likely to be weaker than stronger. The exception, perhaps, might be carbon pricing": see C. Hepburn and A. Teytelboym, "Climate change policy after Brexit" (2017) 33(1) *Oxford Review of Economic Policy* 144, 145. Similarly, Sorrell has described Brexit as "an opportunity (a policy window) for radical policy change in this area" (see S. Sorrell, *Is Brexit an opportunity to rethink UK carbon pricing?* (Centre on Innovation and Energy Demand, 20 September 2016), available at: *http://www.cied.ac.uk/blog/is-brexit-an-opportunity-to-rethink-uk-carbon-pricing/* [Accessed 23 September 2020].

[44] It has also been suggested that the CCL might no longer be necessary if the scope of the standalone ETS is sufficiently broad. See Vivid Economics, above fn.4, 77.

[45] See Vivid Economics, above fn.4, 4 and 77. Hepburn and Teytelboym, above fn.43, 149, have suggested that one way forward would be to "simply transition the Carbon Price Floor into a carbon tax". Note that legal limits apply to the taxation of the aviation sector. It might be easier to internalise the emissions of the aviation sector through a non-fiscal instrument.

Conclusion

The UK has been a frontrunner of carbon pricing with the adoption of a UK emissions trading scheme in the early 2000s in anticipation of the introduction of the EU ETS. One objective of this early move was to provide UK businesses with a first-mover advantage. Twenty years later, the UK is anticipating the reverse situation, namely a potential abrupt end of the EU ETS in the case of a no-deal scenario. The UK has adopted a precautionary approach with two main proposals. However, a choice between these two proposals should be made to avoid additional confusion regarding the future of the UK's carbon pricing policy. Moreover, many aspects of the two proposals need to be clarified. There are a few months left for the UK to make these two proposals operational. It might be better to concentrate on the details of one or other of these two options rather than come up with two blurry proposals. Finally, in the case of a no-deal, the UK will not just need to prepare for the transition out of the EU ETS but it will also have to anticipate how new European proposals on carbon pricing, including border carbon adjustments, might affect its climate change policy[46]. ☞

Alice Pirlot*

Section 97: international trade disputes

Section 97 of the Finance Act 2020 (FA 2020) amends section 15(1)(b) of the Taxation (Cross-border Trade) Act 2018 (TCTA 2018). Section 15 TCTA 2018 sets out some of the UK's rules of engagement in international trade matters once it is free to pursue a trade policy independently of the EU. The way any country conducts itself in such matters says a great deal about how that country sees the international trading system and international law. In setting the stage for the UK's conduct of international trade matters, therefore, section 97 FA 2020 has an importance belied by its brevity.

Section 15(1) TCTA 2018 gives the Secretary of State the power to make regulations varying the amount of import duty applicable to goods, or the description of goods, originating from a country or territory if "a dispute or other issue"[1] has arisen between the UK Government and the government of the country or territory in question. Section 15(2) TCTA 2018 sets out the

[46] On the interaction between the EU Green deal and the UK's climate policy, see House of Lords, Select Committee on the European Union, Sub-Committee on Energy and Environment, *Corrected oral evidence: EU Green* Deal (4 March 2020), available at: *https://committees.parliament.uk/oralevidence/118/default/* [Accessed 23 September 2020]. See also Lords Select Committee, News, *What does the EU's carbon border adjustment mean for the UK?* (26 February 2020), available at: *https://committees.parliament.uk/committee/335/eu-energy-and-environment-subcommittee/news/111614/what-does-the-eus-carbon-border-adjustment-mean-for-the-uk/* [Accessed 21 October 2020].

☞ Brexit; Emissions trading; Environmental taxation; Penalties

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[1] TCTA 2018 s.15(1)(a).

conditions that apply to the exercise of the Secretary of State's power "in the case of a dispute"[2] affecting any goods. Section 97 FA 2020 is not concerned with these latter conditions.

As section 15(1)(b) TCTA 2018 was originally formulated, the Secretary of State was given power to act pursuant to section 15(1) only if the UK Government was "authorised under international law"[3] to deal with the issue by varying the amount of import duty. That sets the bar to action rather high and does so intentionally.

The Explanatory Notes to clause 15 of the Taxation (Cross-border Trade) Bill,[4] give three examples of when the Secretary of State may use the power in question.

The first example is "where the UK may be authorised to impose retaliatory trade measures" in relation to a respondent territory "which fails to comply with a dispute ruling".[5] The second example is where "the UK may be required to offer compensation to complainants" where "it has lost a dispute and has not brought itself into compliance within the required period of time".[6] The third example is where there is a rebalancing of trade of concessions "when another Member of the WTO or a party to a trade agreement has taken action which undermines trade concessions to which it has previously committed".[7] Clearly, action within a dispute settlement procedure was of great importance to the draftsman.

Section 97 FA 2020 amends section 15(1)(b) TCTA 2018 in a way which broadens its effect significantly. The Secretary of State now has power not merely where "authorised" under international law but where the Secretary of State

> "…considers that (having regard to the matters set out in section 28 and any other relevant matters) it is appropriate to deal with the issue by varying the amount of import duty…".[8]

By virtue of section 28(1) TCTA 2018, the Secretary of State, when exercising a function under Part 1 of the Act in which section 15 appears, "must have regard to international arrangements to which Her Majesty's government in the United Kingdom is a party that are relevant to the exercise of the function".[9]

The Explanatory Notes to clause 94 of the Finance Bill 2020 include the following comments on the amendment made by, what is now, section 97 FA 2020:

> "…The amendment will enable the UK to take any necessary action in the face of growing trade protectionism and challenges in the World Trade Organisation's dispute settlement system, whilst having regard to its international obligations in exercising this power."[10]

[2] TCTA 2018 s.15(2).
[3] TCTA 2018 s.15(1)(b).
[4] See *Taxation (Cross-border Trade) Bill Explanatory Notes* (as brought from the House of Commons on 17 July 2018 (HL Bill 125) prepared on 17 July 2018), available at: *https://publications.parliament.uk/pa/bills/lbill/2017-2019/0125/18125en.pdf* [Accessed 11 September 2020], cl.15, paras 92 and 93.
[5] *Taxation (Cross-border Trade) Bill Explanatory Notes*, above fn.4, para.92.
[6] *Taxation (Cross-border Trade) Bill Explanatory Notes*, above fn.4, para.92.
[7] *Taxation (Cross-border Trade) Bill Explanatory Notes*, above fn.4, para.93.
[8] TCTA 2018 s.15(1)(b) as amended by FA 2020 s.97.
[9] TCTA 2018 s.28(1).
[10] HM Treasury, *Finance Bill Explanatory Notes* (19 March 2020), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/873637/Finance_Bill_2020_Explanatory_Notes.pdf* [Accessed 11 September 2020], "Clause 94: International trade disputes", para.2.

> "One of the circumstances in which this power may be exercised is in the context of international trade disputes, where the UK may impose retaliatory trade measures, including higher import duties, against the imports of goods of a respondent territory which fails to bring itself into compliance."[11]

These observations indicate that the current disarray in the World Trade Organisation's dispute settlement procedure is a factor in the thinking behind the widening of the Secretary of State's power. It should be borne in mind, however, that section 15(1)(b) TCTA 2018 is not concerned only with disputes. Unlike section 15(2) TCTA 2018, it is concerned with "a dispute or other issue". The widening of the Secretary of State's powers is, therefore, far-reaching.

Some will see this amendment as a simple and unexceptional exercise in ensuring that the UK is adequately prepared for its role as an independent trading state. Others may consider that it also suggests a change in the attitude of the UK Government to international law in relation to the international trading system. If the bar to action by the Secretary of State was previously set high, it seems now to be considerably lower. The Secretary of State may vary the amount of import duty where, "having regard to" the relevant international arrangement to which the UK is a party, and other relevant matters, he or she considers it "appropriate" to deal with the issue arising in that way. By how much the bar has been lowered may be, in due course, a matter for the courts to determine.

On 9 September 2020 the United Kingdom Internal Market Bill was published.[12] It contains provisions which allow international law generally, including the provisions of the Ireland/Northern Ireland Protocol to the Withdrawal Agreement,[13] to be disregarded.[14] Perhaps, then, the provisions of section 97 FA 2020 should not be regarded as indicative of the attitude of the UK Government to international law in the context of the international trading system alone. Rather they may be indicative of the Government's attitude to international law more generally. Let us hope that this short section is given the attention it deserves.

Timothy Lyons*

[11] HM Treasury, above fn.10, "Clause 94: International trade disputes", para.4.
[12] United Kingdom Internal Market Bill 2019–21, available at: *https://services.parliament.uk/Bills/2019-21/unitedkingdominternalmarket.html* [Accessed 11 September 2020].
[13] See Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community, Protocol on Ireland/Northern Ireland [2019] OJ C384 I/92, available at: *https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12019W/TXT(02)&from=EN* [Accessed 11 September 2020].
[14] See in particular, United Kingdom Internal Market Bill 2019–21 cl.42(4) and (5), cl.43(2) and (3) and cl.45(4).

Brexit; Customs duties; Imports; International trade; Tax administration

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Section 98: HMRC debts: priority on insolvency; Section 99: HMRC debts: regulations; Section 100 and Schedule 13: joint and several liability of company directors etc

Overview

The Finance Act 2020 (FA 2020) introduces significant reforms to the UK's insolvency regime, through the reintroduction of Crown preference for certain tax debts, alongside the introduction of joint and several liability for company directors and certain other individuals in cases of corporate insolvency.

Changes to Crown preference

Background

Crown preference was originally a feature of the UK insolvency landscape, but was abolished under the Enterprise Act 2002,[1] which introduced certain reforms intended to promote a "rescue culture".[2]

This abolition responded to sentiments expressed at the time that the Inland Revenue and HM Customs and Excise (as they then were), protected by Crown preference in respect of relevant tax debts, were inflexible in supporting corporate restructurings and too quick to move to a winding up petition. It was also felt that the Government, rather than smaller creditors who could themselves be forced into insolvency, would be better able to deal with any lost tax revenues that might arise were Crown preference removed.

However, in Autumn Budget 2018,[3] the Government announced a change in approach, with the proposed re-introduction of Crown preference for certain tax debts. The measures, consulted upon in 2019, were ultimately enacted in sections 98 and 99 FA 2020, with secondary regulations under section 99 FA 2020 subsequently being made. The reforms, originally proposed to take effect from 6 April 2020, will now come into effect on 1 December 2020.[4]

Operation of the new legislation

Section 98 FA 2020 makes changes to relevant UK insolvency legislation (section 386 and Schedule 6 to the Insolvency Act 1986, together with equivalent legislation in Scotland[5] and Northern Ireland[6]), by making HMRC a "secondary preferential creditor" for certain tax debts. The effect of giving HMRC such status is that they will rank ahead of floating charge holders and non-preferential unsecured creditors in an insolvency, reducing potential recoveries for those

[1] Enterprise Act 2002 s.251.
[2] See, for example, Department of Trade and Industry, *Insolvency – A Second Chance* (The Stationery Office, 30 July 2001), Cm.5234, para.2.1.
[3] HM Treasury, *Budget 2018* (October 2018), HC 1629.
[4] FA 2020 s.98(7).
[5] The Bankruptcy (Scotland) Act 2016 s.129(2) and Sch.3, Pt 1.
[6] The Insolvency (Northern Ireland) Order 1989 (SI 1989/2405 (N.I. 19)) Art.346 and Sch.4.

creditors. Holders of fixed charges and higher ranking preferential creditors will still be entitled to recover ahead of HMRC.

HMRC will not become a secondary preferential creditor in respect of all tax debts. Instead, the principle behind the reforms is that HMRC will only have this beneficial status in respect of tax debts which have in effect been collected by the insolvent business on HMRC's behalf from customers, suppliers and employees of the business. This would extend to tax liabilities such as value added tax (VAT), income tax deducted under PAYE, employee National Insurance contributions (employee NICs) and amounts deducted under the construction industry scheme (CIS). For other tax debts, such as income tax, capital gains tax, corporation tax and employer National Insurance contributions (employer NICs), HMRC will remain a non-preferential creditor.

The primary legislation as enacted in section 98 FA 2020 only makes specific reference to VAT.[7] For other taxes, HMRC must be able to prove that the relevant tax debt is an amount owed in respect of a "relevant deduction".[8]

For these purposes, a relevant deduction will arise where the debtor is required to make the deduction from a payment made to another person, and to pay an amount to HMRC on account of the deduction, the payment made is credited against any liabilities of the other person and the deduction is of a kind specified in regulations under section 99(3) FA 2020.[9]

Under section 99 FA 2020, in addition to being able to specify relevant deductions,[10] regulations may also limit the amounts in respect of which HMRC are secondary preferential creditor to certain periods.[11] In this regard, it is interesting to note that under the pre-Enterprise Act 2002 regime, Crown preference only attached to tax debts that, broadly, arose within the 12 months prior to the insolvency. However, under the new regime, there is no time limit set out in the primary legislation, and so on the face of it, any relevant tax debts which are outstanding on 1 December 2020 will be within the scope of the new Crown preference should a relevant insolvency occur.

Secondary regulations under section 99 FA 2020

Secondary regulations have been made: the Insolvency Act 1986 (HMRC Debts: Priority on Insolvency) Regulations 2020, that come into force on 1 December 2020. These specify the following amounts as being "relevant deductions":

- deductions from contract payments within the scope of the CIS;
- deductions of employee NICs;
- deductions of income tax under PAYE; and
- deductions in respect of student loan repayments.[12]

Notwithstanding the ability to limit the periods for which secondary preferential creditor status applies, the draft regulations as published do not specify any such period.

[7] See, for example, Insolvency Act 1986 Sch.6 para.15D(1)(a).
[8] See, for example, Insolvency Act 1986 Sch.6 para.15D(1)(b).
[9] See, for example, Insolvency Act 1986 Sch.6 para.15D(3).
[10] Under the power in FA 2020 s.99(3).
[11] Under the power in FA 2020 s.99(1).
[12] The Insolvency Act 1986 (HMRC Debts: Priority on Insolvency) Regulations 2020 (SI 2020/983), para.2(2).

Criticism of the reforms

A number of criticisms have been levelled at the changes, both from a macro perspective and also regarding the detail of the legislation. These include:

- that the evidence that HMRC have put forward to justify the changes does not measure the potential impact appropriately—whilst the Autumn Budget 2018 Red Book estimated that returning HMRC's Crown preference for relevant tax debts would raise up to £195 million per annum in the periods under consideration,[13] UK Finance has estimated the indirect impact on the ability of financing (in particular floating charge financing) to be well over £1 billion per annum[14];
- that the change goes against international norms, leaving the UK an outlier compared to peer jurisdictions;
- that pushing the cost of insolvencies onto unsecured private creditors, including small suppliers, risks a domino effect;
- that the application of Crown preference to all VAT liabilities does not fit with the broad scheme of the legislation, in particular that VAT arising under the "reverse charge" mechanism should not be viewed as a tax liability collected by the insolvent business on behalf of another person;
- that the application of the new regime to existing security arrangements, in particular floating charges, means lenders may be impacted by a change of law that they could not have anticipated when advancing the original financing;
- that the regime does not adequately cater for securitisations and other structured finance arrangements, which should have been excluded from the scope of the reforms given the need for a certain tax position for companies involved in such arrangements.

Practical impact on financing arrangements

So what effect will the reforms have on financing arrangements? The writer anticipates a number of developments, including:

- that lenders may seek to take fixed security rather than floating charges—however, where the security taken does not limit the borrower's ability to deal with the charged assets effectively, there is a risk that it may in any event be re-characterised as a floating charge. Particular issues arise when seeking to take fixed security over assets such as trading stock, book debts and general business bank accounts;
- that lenders who provide floating charge or rescue financing may be less willing to provide such financing, or may only be prepared to provide a lower amount of financing at a higher cost to reflect their increased risk, in the new environment;

[13] See HM Treasury, *Budget 2018* (October 2018), HC 1629, 38, line 69.
[14] R3 Association of Business Recovery Professionals, *Finance Bill: Concern around insolvency proposal impact* (7 May 2020), available at: *https://www.r3.org.uk/press-policy-and-research/r3-blog/more/29398/store/491539/page/1/finance-bill-concern-around-insolvency-proposal-impact/* [Accessed 23 October 2020].

- that lenders may require additional comfort regarding borrowers' tax positions, through obtaining additional representations and undertakings to mitigate the amount of relevant tax debts incurred by a business;
- that for businesses which have taken advantage of certain COVID-19 related business support measures, for example the ability to defer VAT liabilities until 31 March 2021 or the extended "time to pay" scheme, certain of those liabilities will fall within the scope of the new Crown preference, increasing the risk to floating charge holders and unsecured creditors;
- that for certain stretched businesses, lenders may seek to commence insolvency proceedings prior to 1 December 2020, so that the new Crown preference does not apply.

In addition, concerns have been expressed that the reforms shift the balance of power in insolvencies too far in favour of HMRC. For example, in a company voluntary arrangement, there are limits on compromising preferential debts unless the preferential creditor consents.[15] Furthermore, HMRC will still share in the "prescribed part" (that is, the part of the company's assets set aside from floating charge realisations and made available for unsecured creditors) in respect of their non-preferential tax debts such as corporation tax, giving them a second bite of the cherry to recover unpaid tax.

Directors' joint and several liability

Overview

Section 100 FA 2020[16] also represents a significant development, permitting HMRC to hold directors personally liable in cases where HMRC are of the view that avoidance or evasion has arisen, or where "phoenixism" can be established.

The implications of this proposal, which breaches the principle of limited liability upon which the UK's company law framework is based, are significant. Accordingly, the legislation in section 100 and Schedule 13 FA 2020 include certain protections to ensure that "innocent" directors whose companies find themselves in genuine financial difficulties are not brought within the scope of the new rules. Whether such protections are adequate, however, remains a matter of debate.

It is also noteworthy that unlike the measures in sections 98 and 99 FA 2020, tax liabilities which relate to a period ending before Royal Assent to FA 2020,[17] or which arise from an event or default occurring before that day, together with relevant penalties, are not subject to potential joint and several liability.[18] Perhaps it was felt that to introduce such retrospective joint and several liability would be a bridge too far?

[15] Insolvency Act 1986 s.4(4).
[16] With the substantive legislation set out in FA 2020 Sch.13. The numbering of the schedule may be ironic, given the unlucky consequences for those who find themselves in its scope
[17] Royal Assent (*Hansard*) 22 July 2020.
[18] FA 2020 s.100(2).

Scope of new joint and several liability regime

Under the new regime, an authorised HMRC officer[19] can issue a joint liability notice in specified circumstances. These include, to summarise in broad terms:

- where a company has entered into tax-avoidance arrangements[20] or tax-evasive conduct[21]; the company is subject to an insolvency procedure, or there is a serious possibility of the company becoming subject to an insolvency procedure; the individual was responsible for or received a benefit from the arrangements when the individual was a director, shadow director or participator or took part in, assisted with or facilitated the arrangements or conduct when a director, shadow director or concerned in management of the company; a tax liability arises or is likely to arise from the relevant arrangements or conduct and there is a serious possibility that some or all of that tax liability will not be paid[22];
- where "phoenixism" occurs, such that there are at least two companies with which the individual had a relevant connection in the five years prior to the giving of the notice, which were subject to an insolvency procedure and which did not meet certain tax obligations; there is a new company which is or has carried on the same or a similar trade; the individual has had a relevant connection with that company in the relevant five year period and when the notice was given and the relevant tax liabilities of the old companies are more than £10,000 and more than 50 per cent of the total amount of those companies' liabilities to their unsecured creditors[23];
- where a penalty arising under certain avoidance or evasion related provisions has been imposed on a company, or proceedings have been commenced before the First-tier Tribunal (FTT) for a penalty to be imposed on that company; that the company is subject to, or there is a serious possibility of the company being subject to, an insolvency procedure; the individual was a director, shadow director or participator in it at the time of the act or omission giving rise to the penalty or proceedings and there is a serious possibility that some or all of the penalty will not be paid. Relevant penalties include penalties for breach of the disclosure of tax avoidance schemes (DOTAS) rules, under the promoters of tax avoidance schemes (POTAS) rules, or for enablers of offshore tax evasion or non-compliance or of defeated tax avoidance.[24]

Effect of notice

The effect of the notice differs depending on which of the three specified circumstances applies, but broadly renders the individual jointly and severally liable for the relevant tax liability of or penalty imposed upon the company[25]. However, in the case of phoenixism, in addition to the

[19] To be determined by the Commissioners, FA 2020 Sch.13, para.19.
[20] FA 2020 Sch.13, para.6.
[21] FA 2020 Sch.13, para.7.
[22] FA 2020 Sch.13, para.2.
[23] FA 2020 Sch.13, para.3.
[24] FA 2020 Sch.13, para.5.
[25] FA 2020 Sch.13, paras 2(12), 3(7) and (8) and 5(11).

current tax liabilities of the new and old companies, joint and several liability will also apply for future tax liabilities of the new company which arise in the following five years, provided that the notice remains in effect.[26]

It is possible for joint liability notices to be issued to more than one individual if they meet the relevant conditions, in which case all those individuals, together with the original taxpayer company, will be jointly and severally liable for the tax or penalty concerned.

Affected persons

Whilst much of the discussion regarding these measures has concerned the position of company directors, as noted above, the persons to whom a joint liability notice may be issued include shadow directors, those concerned in management and also "participators".[27] This latter term is given the meaning it has in the close company legislation, and therefore could extend to shareholders and loan creditors (including lenders) to the company concerned.

Credit is available for certain penalties to which individuals may be subject under existing penalty legislation.[28]

Relevant insolvency procedures

The legislation covers a broad range of insolvency procedures,[29] including schemes of arrangement, liquidation, administration, company voluntary arrangements, receivership, administrative receivership and corporate strike off processes, together with corresponding foreign procedures and schemes. The recently introduced restructuring plan procedure[30] is not, however, currently addressed.

Application to LLPs and their members

Although the legislation is framed by reference to companies, the provisions also apply to limited liability partnerships (LLPs).[31] For these purposes, references to directors, shadow directors or participators are to be read as references to members or shadow members of the LLP.[32]

Appeal rights

Given the severe consequences that can arise from the issue of a joint liability notice, the individual concerned has the right to request a review of the decision to give the notice.[33] In

[26] FA 2020 Sch.13, para.3(7)(b).
[27] Corporation Tax Act 2010 s.454.
[28] FA 2020 Sch.13, para.9, although note that this only applies in respect of liabilities arising under FA 2020 Sch.13, paras 2 or 3.
[29] FA 2020 Sch.13, para.8.
[30] Corporate Insolvency and Governance Act 2020 s.7 and Sch.9.
[31] FA 2020 Sch.13, para.1(3).
[32] FA 2020 Sch.13, para.18.
[33] FA 2020 Sch.13, paras 11 and 12—the scope of any review is limited to the decision to give the notice, rather than any underlying tax liability or penalty in respect of which joint and several liability may be imposed, and the nature and extent of the review are only "to be such as appear appropriate to HMRC in the circumstances", thus providing questionable protection to individuals.

addition, the individual may appeal the giving of a notice to the FTT.[34] There are strict time limits to request a review or make an appeal.[35]

In addition to appealing the issue of a joint liability notice, an individual that is the subject of such a notice is also entitled[36] to join any ongoing appeal by the company in respect of the underlying tax liability where the company is subject to a relevant insolvency procedure, including the entitlement to take over conduct of the appeal where the company does not appeal, or is not willing to continue the appeal, again, with strict time limits for the taking of such actions. Similar rights apply in respect of a joint liability notice issued in respect of a penalty.[37]

Concerns

Whilst HMRC's underlying purpose in introducing joint and several liability can be understood, the form of the final legislation has given rise to several concerns. As with much recent legislation, the conditions for the regime to apply are broadly drawn.

Whilst it is hoped that HMRC guidance will be issued which will limit the application of the regime to the most egregious circumstances, a concern must exist that once on the statute book, there is the potential for the rules to be applied more widely.

Some of the aspects that it is hoped will be clarified in guidance include:

- the position of business turnaround professionals, who, on the face of the legislation, might inadvertently be caught given a "track record" of involvement with insolvent companies;
- the absence of definitions of certain key terms in the legislation, such as "potential insolvency" and when a "serious possibility" of an insolvency procedure exists, or of "relevant tax liabilities" or "penalties not being paid";
- how issues around constructive knowledge and the quantification of any "benefits" that individuals may derive from tax-avoidance arrangements or tax-evasive conduct will be addressed in practice; and
- how HMRC will apply the new regime in practice, given the already extensive powers that they have to pursue and secure payment of tax debts.

Conclusion

Sections 98 to 100 FA 2020 introduce significant changes to the UK insolvency regime alongside risks for directors and other persons involved in connection with insolvent or potentially insolvent companies. Given the general economic climate at the current time, and the expected increase

[34] FA 2020 Sch.13, paras 13 and 14, again with limited grounds for the individual to seek to set aside the notice, and without the opportunity for a substantive hearing as part of such an appeal as to the existence or amount of the underlying tax liability.
[35] Generally 30 days from the giving of a joint liability notice, subject to the ability to seek an extension, and with the ability to seek a review and then appeal to the Tribunal.
[36] FA 2020 Sch.13, para.15.
[37] FA 2020 Sch.13, para.16.

in corporate and other insolvencies, it seems clear that these sections will become the subject of much focus from HMRC, taxpayers and tax professionals in coming months and years.

Martin Shah*

Section 101 and Schedule 14: amendments relating to the operation of the GAAR

"Minor procedural changes" or a circumvention of crucial safeguards?

The Rt Hon Jesse Norman MP, Financial Secretary to the Treasury (Mr Norman), described clause 98 and Schedule 13 to the Finance Bill 2020 as making "minor procedural and technical changes" designed to "ensure that the policy operates as originally intended", and to "help to protect over £200 million in tax revenue by ensuring that the General Anti-Abuse Rule (GAAR) works effectively".[1] This note explains what these changes are and how they actually circumvent crucial safeguards to the operation of the GAAR. It questions the asserted financial impact and discusses evidence pointing to undesirable consequences.

Context

The GAAR was enacted in Part 5 of the Finance Act 2013 (FA 2013). It applies to "abusive" "tax arrangements" which the taxpayer asserts give rise to a tax advantage. Arrangements are "tax arrangements" if

> "having regard to all the circumstances, it would be reasonable to conclude that the obtaining of a tax advantage was the main purpose, or one of the main purposes, of the arrangements".[2]

And

> "tax arrangements are 'abusive' if they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions, having regard to all the circumstances including-
> (a) whether the substantive results of the arrangements are consistent with any principles on which those provisions are based (whether express or implied) and the policy objectives of those provisions,
> (b) whether the means of achieving those results involves one or more contrived or abnormal steps, and
> (c) whether the arrangements are intended to exploit any shortcomings in those provisions".[3]

Corporate insolvency; Directors' liabilities; Joint and several liability; Preferences; Priorities; Unpaid tax

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[1] *Hansard*, HC, Finance Bill, Eighth Sitting, col 228 (16 June 2020).
[2] FA 2013 s.207(1).
[3] FA 2013 s.207(2).

In its original form, prescriptive procedural rules which included safeguards had to be adhered to by HMRC before the GAAR could operate.

The GAAR has unusual and draconian consequences where it applies. First, very high penalty rates apply as a result of rules enacted in the Finance Act 2016 (FA 2016), namely 60 per cent of the counteracted tax advantage.[4] Secondly, it may trigger the issue of an accelerated payment notice (APN) or partner payment notice (PPN) by HMRC under the rules enacted in 2014 for the purposes of removing the cash flow advantage for taxpayers of entering into a tax avoidance scheme.[5] These notices carry their own penalties for non-compliance in addition to the GAAR penalties and other penalties which may apply under self-assessment (see for example Schedule 55 to the Finance Act 2009 (FA 2009), penalties under the Taxes Management Act 1970 and penalties for non-compliance with information notices issued under Schedule 36 FA 2009). Thirdly, the rules enacted in Schedule 16 to the Finance (No.2) Act 2017 ("the enablers rules"), may apply.[6] These rules are intended to penalise, name and shame enablers of tax avoidance schemes, and the conditions are largely based on the GAAR. They operate in addition to the penalty regimes under the disclosure of tax avoidance schemes (DOTAS) rules first enacted in the Finance Act 2004,[7] and promoters of tax avoidance schemes rules (POTAS rules) enacted in the Finance Act 2014.[8]

Proposals to further broaden each of these sets of rules were announced on 21 July 2020.[9] There is a further still, and far worse, cause for concern on the part of tax advisers: in July 2020 Dame Margaret Hodge, Chairwoman of the Public Affairs Accounts Committee, recommended in a paper that there be a criminal offence without an element of dishonesty for tax advisers enabling tax avoidance schemes.[10] The test she proposes is also based on the GAAR.

It is as a result of the potentially very broad application and the draconian consequences of its application, that the GAAR carries its own unique safeguards. Much discussion took place as to whether these safeguards were adequate at the time the GAAR was enacted and the safeguards did not go as far as the GAAR Committee recommended. Moreover, they have been significantly eroded by FA 2016 in the creation of "provisional counteraction notices",[11] which could be issued by HMRC without any of the safeguards being adhered to but which had a narrower application than the notices introduced by the Finance Act 2020 (FA 2020). The two main safeguards enacted by FA 2013, were the Designated Officer requirement and the GAAR Advisory Panel requirement.[12] The former requirement is that only a "Designated Officer", namely an officer of HMRC designated for the purposes of the GAAR, as opposed to any officer of HMRC, would have the power to issue a counteraction notice under the GAAR. The latter requirement is that three members of an "independent" panel (appointed by HMRC) would give

[4] FA 2016 s.158(2) inserting FA 2013 s.212A(2).
[5] FA 2014 Pts 4 and 5.
[6] F(No.2) A 2017 Sch.16.
[7] FA 2004 ss.306–319.
[8] FA 2014 Pt 5 ss.234–283 and Schs 31–36.
[9] HMRC, *Tackling Promoters of Tax Avoidance: Consultation* (publication date: 21 July 2020; closing date for comments: 15 September 2020).
[10] Anti-Corruption & Responsible Tax (appg) and the Policy Unit King's College London, *Ineffective tax avoidance: targeting the enablers* (July 2020).
[11] FA 2016 s.156(1) inserting FA 2013 ss.209A–F.
[12] FA 2013 s.209 and Sch.43.

their opinions on whether or not the entering into or carrying out of the tax arrangements was a reasonable course of action in relation to the relevant tax provisions, having regard to all the circumstances (including the circumstances described in section 207(2)(a) to (c) and (3) FA 2013). These procedures are contained in Schedule 43 FA 2013 and have since been supplemented by Schedules 43A and 43B.[13]

The key procedural rules to note in order to make sense of the changes are as follows.

Schedule 43 FA 2013 sets out key procedural rules and safeguards. A notice of a proposed counteraction is issued under paragraph 3 of Schedule 43 FA 2013 ("a paragraph 3 notice"). A final GAAR counteraction notice can be issued under paragraph 12 of that Schedule if and when the correct procedures have been followed. A paragraph 3 notice can be issued where a designated HMRC officer considers that a tax advantage has arisen to a person from arrangements that are abusive and that it ought to be counteracted under section 209 FA 2013. The notice given to the taxpayer under this paragraph has to explain specific procedures relating to the GAAR application, which include the application of the main safeguard, the requirement of a GAAR Advisory Panel opinion. The procedures to be explained in the notice include that the taxpayer has 45 days within which to make representations in response to the notice, that if none are made then the officer must refer the matter to the GAAR Advisory Panel and if they are made that the officer must consider them, and if the officer is still of the view that the advantage should be counteracted, only then should the matter be referred to the GAAR Advisory Panel.

Final GAAR counteraction notices can also be issued under Schedule 43A and Schedule 43B FA 2013, in each case under paragraph 8 after different procedures have been met (these relate to notices of binding or pooling).

Section 209 FA 2013 is the section giving effect to adjustments made under a final GAAR counteraction notice. That is, a notice issued under one of Schedules 43, 43A or 43B FA 2013 where the safeguards and other procedural requirements have been complied with.

Changes enacted by the Finance Act 2020: protective GAAR notices

A new section 209AA FA 2013 provides that a written notice can be issued by HMRC, stating that an officer of HMRC considers "that a tax advantage might have arisen to the person from arrangements that are abusive", and on the assumption that it does, "it ought to be counteracted under section 209".[14] These notices replace the provisional counteraction notices which had been introduced by FA 2016.

Stopping there for a moment, it must first be noted that this type of notice can be issued by any officer of HMRC: it is not a requirement that such a notice be issued by a "Designated Officer", which is a requirement in order for a final counteraction notice to be issued under Schedule 43 FA 2013, as well as for a paragraph 3 notice. In this regard, it must also be noted that section 103(1) FA 2020 provides:

> "Anything capable of being done by an officer of Revenue and Customs by virtue of a function conferred by or under an enactment relating to taxation may be done by HMRC (whether by means involving the use of a computer or otherwise)."

[13] FA 2013 Schs 43A and 43B inserted by FA 2016 s.157(2) and (3).
[14] FA 2020 Sch.14 para.3.

It may therefore be that HMRC will automate the issue of protective GAAR notices in the same way as they have done for other notices which the legislation states must be issued by an officer of HMRC (see for example *HMRC v Rogers, Shaw*).[15] That there is a decision to be taken or a discretion to be exercised is unlikely to affect whether HMRC automate the process. For example, daily penalties for late filing under paragraph 4 of Schedule 55 FA 2009 are issued automatically by a computer although there is a legislative condition for HMRC to decide that a penalty is payable.

Thus, it can readily be seen that the issue of a protective GAAR notice is not subject to the safeguards mentioned. Indeed, the only procedural right given to a person who receives a protective GAAR notice is the right to give a notice of appeal against the notice.[16] Where a person who receives a protective GAAR notice does not give a notice of appeal, or where they do give one but then either they withdraw it or they settle with HMRC, the protective notice has effect for all purposes (except the penalty provision in section 212A FA 2013) as though it had been given as a final GAAR notice (defined in section 209AC FA 2013), and as though all of the procedural requirements, including all the safeguards, had been complied with.[17]

In the writer's view this is much more than a "minor procedural change": protective GAAR notices circumvent the safeguards altogether.

The only requirements specific to this notice are those stated in section 209AA subsections (2) to (4) FA 2013[18]: under subsection (2), "the protective GAAR notice must be given within the ordinary assessing time limit applicable to the proposed adjustments", so unless there is an open enquiry the time limit is likely to be four years, six years or 12 years.[19] Under subsection (3) this is limited where

> "(a) a tax enquiry is in progress into a return made by the person, and (b) the return relates to the tax in respect of which the specified adjustments under the protective GAAR notice are made".[20]

In that case the protective GAAR notice must instead be given no later than the time when the enquiry is completed. Under subsection (4)

> "the protective GAAR notice must (a) specify the arrangements and the tax advantage, and (b) specify the adjustments that, on the assumption that the advantage does arise from tax arrangements that are abusive, the officer proposes ought to be made".[21]

Once a protective GAAR notice has been issued by HMRC, the adjustments have effect as though they were made under section 209 FA 2013. However, section 209 FA 2013 is amended by a substituted subsection (6) so that where the taxpayer does give a notice of appeal against a protective notice (or is otherwise outside the terms of section 209AA(8) FA 2013), then the adjustments are in effect suspended unless and until HMRC issue a final GAAR counteraction

[15] *HMRC v Rogers, Shaw* [2019] UKUT 406 (TCC); [2020] STC 220.
[16] FA 2013 s.209AA(6) as inserted by FA 2020 Sch.14 para.3.
[17] FA 2013 s.209AA(8) as inserted by FA 2020 Sch.14 para.3.
[18] FA 2013 s.209AA(2)–(4) as inserted by FA 2020 Sch.14 para.3.
[19] TMA 1970 ss.34, 36 and 36A.
[20] FA 2013 s.209AA(3) as inserted by FA 2020 Sch.14 para.3.
[21] FA 2013 s.209AA(4) as inserted by FA 2020 Sch.14 para.3.

notice. This does not, though, prevent the adjustments in the protective notice meeting the time limit requirements in new section 209(6)(b).[22]

The appeal made by the giving of a notice of appeal under section 209AA(6) FA 2013 is stayed for a period of either: 1. 12 months from the day on which the protective GAAR notice is given; or 2. if a final GAAR counteraction notice is given before that time, then until the day on which final GAAR counteraction notice is given.[23]

Where there is no appeal, protective GAAR notices do not take effect so as to bring the taxpayer within the GAAR penalty regime: section 212A FA 2013 is expressly excluded from the deeming effects which follow on from a taxpayer failing to appeal against a protective notice.[24] But, as regards penalties, a tax adviser meeting the definition of an enabler in paragraph 7 of the enablers rules[25] could have cause for concern if a taxpayer fails to give a notice of appeal against a protective GAAR notice. In the event that a protective GAAR notice were to take effect in the same way as a final GAAR counteraction notice, it is likely to have an impact on the application of the enablers rules. These rules penalise the facilitators of abusive tax arrangements which have been defeated (not necessarily by the GAAR), by imposing penalties on them equal to the fee charged for their services. A penalty is payable by each enabler of abusive tax arrangements, where a person enters into abusive tax arrangements and incurs a defeat in respect of the arrangements. For this purpose abusive tax arrangements are defined in the same way as for the GAAR.

Changes are made to the effects of a paragraph 3 notice by new section 209AB FA 2013, which also circumvents crucial safeguards. Section 209AB applies where a paragraph 3 notice has been issued (or a notice under Schedule 43A FA 2013), mirroring section 209AA(8) FA 2013 as discussed above. This applies where a protective GAAR notice (or provisional counteraction notice issued prior to the commencement of FA 2020) has not been given in relation to the relevant adjustments.

It is puzzling, to say the least, that on top of the procedural requirements specified in paragraph 3 of Schedule 43 FA 2013, in particular the brief period allowed for the taxpayer to make representations, there is now a requirement for the taxpayer to give a notice of appeal against a paragraph 3 notice, and if the taxpayer does not do so, then, instead of a referral to the GAAR Advisory Panel being made without the taxpayer's representations, the notice will take effect as though it was given as a final GAAR counteraction notice and all of the procedural requirements had been complied with. It seems to the writer to defeat the very purpose of the paragraph 3 notice, which is to set in motion the process of referral to the GAAR Advisory Panel, being the key safeguard for the application of the GAAR.

It is important to see these changes for what they are: they are not minor procedural changes but an increase in HMRC's already vast and draconian powers in relation to tax avoidance and a circumvention of the safeguards of the GAAR.

Finally, the writer must question whether further avoidance measures are necessary to reduce the tax gap, or even desirable. There is ample evidence to suggest they are not. For example,

[22] FA 2013 s.209AA(9)(b) as inserted by FA 2020 Sch.14 para.3.
[23] FA 2013 s.209AA(7) as inserted by FA 2020 Sch.14 para.3.
[24] FA 2013 s.209AA(8) as inserted by FA 2020 Sch.14 para.3.
[25] F(No.2)A 2017 Sch.16, above fn.6.

HMRC's Research Report 581 into the role of tax advisers (carried out in 2017 and published in April 2020) (the Research Report)[26] makes three very pertinent findings.

The first finding is that HMRC's actions have been successful in shutting down incentives to operate in the tax avoidance marketplace.[27] This is supported by HMRC's latest report on the tax gap, showing that for the tax year 2018–2019 the unpaid tax attributable to tax avoidance is 0.02 per cent of the total tax revenue (£1.7 billion) and it has been on the decline for the past few years.[28] In the writer's view this neatly evidences the conclusion in the Research Report that by 2017 tax avoidance had been stamped out of the "above ground" market.[29] By contrast, the tax gap attributable to other matters was:

- evasion: £4.6 billion;
- failure to take reasonable care: £5.5 billion;
- legal interpretation: £4.9 billion;
- criminal attacks: £4.5 billion;
- non-payment: £4.1 billion;
- error: £3.1 billion; and
- the hidden economy: £2.6 billion.[30]

Mr Norman considered that the FA 2020 changes to the GAAR would help to protect over £200 million in tax revenue but it is not clear what the source of this information is. He recommended that clause 12 of Finance Bill 2020, in the name of the Scottish National Party, be rejected. Clause 12 if adopted, would have required a review of the impact of these changes within six months. He stated:

> "HMRC already publishes the 'Measuring the tax gap' report annually which shows how the tax gap has changed year on year….HMRC also publishes an annual report and accounts that provide specific information on the impacts of the GAAR, including the number of GAAR opinion notices issued."[31]

That is incorrect: yes, the Annual Report and Accounts for 2018–2019 do mention the number of GAAR opinion notices issued by the GAAR Advisory Panel (that number is four) and the resulting number of counteraction notices to customers (2,300), but they do *not* state the value of the tax revenue. Nor do the tax gap reports state the financial impact of the GAAR. Indeed the estimated exchequer impact from 2020–2021 onwards of the measures announced on 21 July 2020 (referred to at the start of this note) is zero for all years.

The second finding of the Research Report is that the stamping out of tax avoidance in the market was not down to the GAAR. The Research Report states, and this writer agrees, that the main reason given by the individuals questioned was the enactment in 2014 of the APN and PPN

[26] HMRC and Kantar Public, *Understanding the evolving role of tax advisers and agents in the avoidance marketplace: Research Report 581* (carried out March 2017; published 2020).
[27] HMRC, Research Report, above fn.26, 2.
[28] HMRC, *Measuring tax gaps 2020 edition: Tax gap estimates for 2018 to 2019* (An Official Statistics release, 9 July 2020), 6.
[29] HMRC, Research Report, above fn.26, 28.
[30] HMRC, *Measuring tax gaps 2020 edition*, above fn.28, 13.
[31] *Hansard*, HC, Finance Bill, Eighth Sitting, col 227 (16 June 2020).

rules mentioned above. The Research Report notes that the APNs and PPNs removed the cash flow incentive for taxpayers to enter into schemes,[32] which is indeed the purpose of these notices. Before 2014, although tax advisers were well aware of the hostile attitude of the courts to tax avoidance, this did not deter them from promoting tax avoidance schemes. This is because, even if it was likely that HMRC would litigate the scheme and also likely that the tribunal would hold that the scheme did not work, until that happened—and it could be many years before it did—the scheme would have given the taxpayer the cash flow advantage of not having to pay the tax which would otherwise have been payable. For example, the transactions in the *Rangers* case took place in 2001, but the tax did not become payable until 2015 when the Inner House of the Court of Session held that the scheme failed.[33] Additional reasons for the stamping out of tax avoidance schemes, in the writer's view, are the DOTAS, POTAS and enablers rules mentioned above.

The third finding of the Research Report is that the changes already made prior to FA 2020 had "created the risk of alienating some within the agent community".[34] The Report notes that tax advisers felt that HMRC have been overactive in policing the market, and have failed to communicate with the market in the way that they used to, including specifically in relation to their use of new legislative powers. It was noted for example that there are no meetings with Inspectors anymore. Furthermore, there are no clearance procedures in place to obtain a formal view from HMRC in relation to most transactions. Clearance may be obtained from HMRC as to the tax treatment of a transaction prior to it being carried out, but only where there is uncertainty as to the interpretation of new legislation or where there is a specific statutory clearance procedure. Clearance will not be given that the GAAR does not apply. According to the Research Report, tax advisers who do not advise on tax avoidance schemes, felt that they had been aligned with tax avoidance scheme promoters as a result of the uncertainty in the law created by the courts' approach to construing tax legislation in *UBS AG and another v HMRC* in the Supreme Court in 2016,[35] and the changing attitude towards what constitutes tax avoidance.[36] It must be recalled that this was HMRC's appeal to the Supreme Court and that the tax advantage arising from the arrangements had been upheld by a strong Court of Appeal and a strong Upper Tribunal (UT) (although it is fair to say that the arguments HMRC ran in the Supreme Court differed from those run in the courts below). Indeed, the writer noted whilst reviewing HMRC's Annual Report and Accounts 2018–19 that HMRC had won 100 per cent of their tax avoidance cases in the Supreme Court, whilst the figures for HMRC's success rates for tax avoidance cases in all of the courts below are significantly lower.[37] But someone on a higher pay grade than the writer may dare to wonder why that is the case. The uncertainty of treatment by HMRC is further compounded by evidence of HMRC's tendency in recent times to fail to apply their own published guidance. For

[32] HMRC, Research Report, above fn.26, 27.
[33] The decision of the Upper Tribunal was reversed by the Court of Session (Inner House): *Murray Group Holdings Ltd v HMRC* [2015] CSIH 77; [2016] STC 468. The decision of the Court of Session was upheld by the Supreme Court: *RFC 2012 plc (In Liquidation) (formerly Rangers Football Club plc) v Advocate General for Scotland* [2017] UKSC 45; [2017] 1 WLR 2767; [2017] STC 1556.
[34] HMRC, Research Report, above fn.26, 2.
[35] *UBS AG and another v HMRC* [2016] UKSC 13; [2016] 1 WLR 1005; [2016] STC 934.
[36] HMRC, Research Report, above fn.26, 1.
[37] HMRC Annual Report and Accounts 2018–19 (for the year ended 31 March 2019), 110, Figure 22.

example, the changes to the Manuals in relation to speciality debt situs.[38] This is so even where there is no alleged tax avoidance, for example in *HMRC v Sippchoice Ltd*, in which the UT noted that HMRC had not followed their own Manuals.[39] Whilst the GAAR Guidance does have to be taken into account under the GAAR rules, there is no legislative requirement for it to be followed, and most situations are unlikely to be included in the GAAR Guidance in any event. It therefore provides limited comfort to taxpayers or their advisers on how the arrangements or transaction(s) will later be perceived by HMRC, the GAAR Advisory Panel or the tribunals and courts. So it seems to the writer that the changes made by FA 2020 and others currently being mooted, will only make the third finding in the Research Report even more of an issue.

Conclusion

In this writer's view the changes made to the GAAR by FA 2020 are not minor procedural changes; they go far beyond that and circumvent crucial safeguards to the GAAR which were designed to protect the taxpayer from the GAAR's potentially very wide application and draconian consequences. These changes give HMRC unsupervised discretion to apply the GAAR and put the burden on the taxpayer to appeal against the new types of notice which have been introduced. As a consequence, the GAAR can apply where a computer automatically issues a notice and there is a failure by the taxpayer to appeal it, which failure may even be an administrative one, or a misunderstanding by the taxpayer as to the procedures applicable and a lack of means to obtain representation. There does not seem to the writer to be a justification for these changes (or indeed the future changes proposed in July 2020). HMRC's reports demonstrate that tax avoidance has been all but stamped out by virtue of existing powers. Those powers, and the uncertainty in their application, had already left tax advisers feeling alienated.

Finally, these effects are contrary to the aims of the GAAR when it was recommended in 2011 by the committee led by Graham Aaronson QC, which concluded that introducing a narrowly-focused GAAR would "contribute to providing a more level playing field for business", "reduce legal uncertainty around tax avoidance schemes", "help build trust between taxpayers and HMRC" and "offer opportunities to simplify the tax system".[40] It seems to the writer that

[38] HMRC, Internal Manual, *Inheritance Tax Manual* (published 20 March 2016; updated 9 October 2020), IHTM27079, "Foreign property: specialty debts: bonds and debentures under seal": "HMRC has revised its previous approach to the Inheritance Tax (IHT) treatment of such debts, which was that where the debt is situated depends on where the relevant document is to be found."

[39] *HMRC v Sippchoice Ltd* [2020] UKUT 149 (TCC); [2020] 4 WLR 80.

[40] G. Aaronson, *GAAR Study: A study to consider whether a general anti-avoidance rule should be introduced into the UK tax system* (the Aaronson Report) (11 November 2011); HM Treasury and The Rt Hon David Gauke, press release, *Independent Study on General Anti Avoidance Rule* (21 November 2011).

the extensive powers given to HMRC since 2011 have achieved the very opposite of each of these aims. ☞

Rebecca Murray*

Section 103: HMRC: exercise of officer functions

The Technical Note

The writer argues that section 103 of the Finance Act 2020 (FA 2020) is the result of a fundamental misunderstanding by HMRC (or rather some officers) of the issues and the decisions on them in two cases heard by the First-tier Tribunal (FTT) and then the Upper Tribunal (UT).

On 31 October 2019 HMRC published a Technical Note called *Automated Decisions* (TN).[1] The first sentence of the part headed "Overview and Aim" says:

> "1.1 HMRC uses large-scale automated processes to carry out routine tasks such as to give statutory notice, where making individual decisions on individual cases would be impractical, resource intensive, or simply unnecessary in light of published guidance or underlying legislation.…"[2]

Paragraph 1.2 goes on to set out the mischief that HMRC perceived as justifying the legislative proposal they set out:

> "This long-established use of automation has been challenged in the courts on the basis that it is not supported by legislation."[3]

The TN does not identify what decisions of what "courts" HMRC had in mind where a challenge was made by a taxpayer to the legality of an automated decision. The timing of the TN and the reference to giving statutory notice suggests that they were the decisions in June 2018 of the FTT in *Rogers v HMRC* (*Rogers*)[4] and *Shaw v HMRC* (*Shaw*).[5] It is though difficult to see why those decisions should be characterised by HMRC as involving challenges in court to the use of automation. First, they did not involve challenges by the taxpayer. The point was raised in both cases of his own motion by Judge Nigel Popplewell who was deciding the cases on the papers.

☞ General anti-abuse rule; Protective GAAR notices; Tax administration

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[1] HMRC, *Automated Decisions: Technical note October 2019* (2019), available at: *https://www.gov.uk/government/publications/securing-the-tax-base-affirming-the-legislative-framework-for-hmrc-to-use-automated-processes* [Accessed 13 October 2020].

[2] HMRC, above fn.1, para.1.1.

[3] HMRC, above fn.1, para.1.2.

[4] *Rogers v HMRC* [2018] UKFTT 312 (TC).

[5] *Shaw v HMRC* [2018] UKFTT 381 (TC).

Secondly, the point raised by Judge Popplewell was not a challenge to automated processes: he merely suggested that the law in section 8(1) of the Taxes Management Act 1970 (TMA 1970) seemed to require a named officer to issue the notice to make and deliver the return, as delivery was required to be to "the officer", who could only be the officer of Revenue and Customs who issued the notice.[6] The actual appeal in each case was against a penalty for failure to deliver an income tax return, but, in considering whether there had been a penalisable failure, the validity of the notice to file was an issue and to establish which HMRC had the burden of proof. The FTT decided that HMRC had not met that burden because there was no mention of any particular officer in the papers the FTT had been given by HMRC. Nowhere does the FTT suggest that it was HMRC's use of automated processes to select those taxpayers to issue a notice to and to print the notice that invalidated it.

Another case which more closely fits the description of what the TN is apparently about is *Khan Properties Ltd v HMRC* (*Khan Properties*), a decision of the FTT (Judge Richard Thomas, the writer of this note).[7] In that case the terms of section 100 TMA 1970 were in issue and the point directly concerned the validity of a penalty determination for a failure to file a corporation tax (CT) return.

Section 100(1) TMA 1970 requires that any penalty determination must be made by an officer of Revenue and Customs who is authorised to do so and who must determine the penalty in "such amount as, in his opinion, is correct or appropriate". The FTT's decision did not decide that the use of a computer to make a determination without human inputting of figures was unlawful, though it queried the absence of anything in tax law sanctioning such an automated decision. Nor did the FTT object to the issue by the computer of the determination; indeed section 113(1D) TMA 1970 sanctioned that. The FTT found that no evidence had been given that any authorised officer of Revenue and Customs had formed an opinion of the correct or appropriate amount of the penalty, and so held that HMRC had not met the burden of proof on them.

The second part of the TN, actually headed "Automated Decisions", explained that:

> "The proposed new legislation will provide that for certain functions [listed below] anything capable of being done by an officer may be done instead by HMRC through the use of a computer or other electronic means, whether automatically or not."[8]

It then listed five provisions, two of which, section 8 TMA 1970 (with sections 8A and 12AA TMA 1970) and paragraph 3 of Schedule 18 to the Finance Act 1998 (FA 1998), were about notices to file (as in *Rogers* and *Shaw*) not requiring a decision. The other three, section 100 TMA 1970 (as in *Khan Properties*) and Schedule 14 to the Finance Act 2003 (the stamp duty land tax (SDLT) equivalent of section 100 TMA 1970) and section 9ZB TMA 1970 (corrections to returns by HMRC) do require a decision by an officer.

The Finance Bill clause

Clause 100(1) in the Finance Bill (published on 18 March 2020) contained the main proposition:

[6] In fact, in FA 1998 Sch.18, para.3 (the corporation tax equivalent of TMA 1970 s.8) the point is explicitly made that it is the officer who issued the notice to whom the return is to be delivered.
[7] *Khan Properties Ltd v HMRC* [2017] UKFTT 830 (TC); [2017] 11 WLUK 470.
[8] HMRC, above fn.1, para.2.2.

> "Anything capable of being done by an officer of Revenue and Customs by virtue of a function conferred by or under an enactment relating to taxation may be done by HMRC (whether by means involving the use of a computer or otherwise)."[9]

It did not remove the officer's power to do those things, but supplemented it.

Subsection (2) contained a non-exhaustive list of six things that could as a result now be done by HMRC as well as by an officer. Five were the same as in the TN, the new one being an assessment to which section 30A TMA 1970 applies (this applies chiefly to a "discovery" assessment under section 29 TMA 1970).[10]

Subsection (3) provided that anything done by HMRC has the same legal effect as a thing done by an officer of Revenue and Customs, even if the function is one conferred on a particular kind of officer such as an authorised one.

The Explanatory Note on the clause adds no further enlightenment.[11]

Parliamentary proceedings

The clause was the subject of a memorandum by the Financial Secretary to the Treasury (FST), the Rt Hon Jesse Norman MP, to the Rt Hon Harriet Harman MP, chair of the Joint Committee on Human Rights (JCHR) dated 21 April 2020.[12] The part of the memorandum about this clause specifically refers to the decision of the UT (published on 30 December 2019, that is, after the TN) of Zacaroli J and Judge Jonathan Richards in *HMRC v Rogers and Shaw* (*Rogers & Shaw*).[13]

The memorandum says that the clause codifies that decision and that the UT had decided that "HMRC" and an "officer of Revenue and Customs [sic]" were synonymous and, despite a function being given by the law "to an 'officer of Revenue and Customs [sic]' it could be carried out by HMRC at large rather than a named flesh and blood officer", and in this way the grossly disproportionate exercise of having an officer issue the notice manually would be avoided.[14]

The clause was also the subject of debate at Committee stage on 18 June 2020. The FST said:

> "That long-standing practice [of using automated processes to issue a notice] has been challenged in the courts on the basis that the legislation states that some tasks are to be carried out by
>
> > 'an officer of the Board.'
>
> …
>
> The changes made by the clause will clarify that tasks being done by an individual officer of HMRC may be carried out by HMRC using a computer or other means."[15]

[9] Finance Bill (HC Bill 114) cl.100(1).
[10] Finance Bill (HC Bill 114) cl.100(2)(c).
[11] HM Treasury, *Finance Bill Explanatory Notes* (19 March 2020), available at: *https://www.gov.uk/government/publications/finance-bill-2020-legislation-and-explanatory-notes* [Accessed 14 October 2020].
[12] HM Treasury and HMRC, *Memorandum on the Finance Bill Provisions with Retrospective Effect* (21 April 2020), available at: *https://publications.parliament.uk/pa/bills/cbill/58-01/0114/20200421%20JCHR%20Memorandum%20-%20Finance%20Bill.pdf* [Accessed 14 October 2020].
[13] *HMRC v Rogers and Shaw* [2019] UKUT 406 (TCC).
[14] HM Treasury and HMRC, above fn.12, 3.
[15] *Hansard*, HC, Public Bill Committee, Finance Bill (Ninth Sitting), cols 239–240 (18 June 2020).

And in response to opposition speeches the FST said:

> "I recognise that there is a distinction between the automated exercise of a decision and the capacity to make a decision itself."[16]

No further discussion of the clause took place at Report Stage or in the Lords. Clause 100 became section 103 FA 2020.

Automated decisions—or was it?

It was the writer's reaction when he read the TN that, by referring in the title and a sub-heading to "automated decisions", HMRC were using the term to be consistent with section 14 of the Data Protection Act 2018,[17] that is decisions made without human intervention even if humans (whether or not officers of Revenue and Customs) supplied data and wrote algorithms that enabled the computer to come to a decision. The making of a determination under section 100(1) TMA 1970 (at issue in *Khan Properties*) is an excellent example of such a decision, as are assessments of penalties under Schedules 55 and 56 to the Finance Act 2009.

The writer then assumed that HMRC would be taking a leaf out of the Department for Work and Pensions (DWP) book and enacting something like section 2 of the Social Security Act 1998 (SSA).[18]

That section provides, irrelevant material being removed:

> "2.— Use of computers.
>
> (1) Any decision, determination or assessment falling to be made…by the Secretary of State under or by virtue of a relevant enactment…may be made…not only by an officer of his acting under his authority but also—
>
> (a) by a computer…."

When *Rogers & Shaw* was published it was also thought by the writer (and others) that it had made the need for amendments to section 8 TMA 1970 unnecessary. Indeed it is difficult to reconcile the remarks in the JCHR memorandum made about the case with what the UT actually said.[19] The UT had said:

> "In our judgment, properly construed, s8 does not impose a requirement that an officer of the Board is identified in the notice as the giver of the notice. Rather, it imposes a substantive requirement that the giving of a notice must have been under the authority of an officer of HMRC.…"[20]

And it added:

[16] *Hansard*, above fn.15, cols 241–242.

[17] And therefore GDPR Art.22 (Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation) [2016] OJ L119/1).

[18] The writer referred to this provision in his decision in *Khan Properties*, above fn.7, [2017] UKFTT 830 (TC); [2017] 11 WLUK 470 at [43] and [44].

[19] Text after fn.13, above.

[20] *Rogers & Shaw*, above fn.13, [2019] UKUT 406 (TCC) at [32].

> "The FTT considered that s8(1)(a) of TMA requires a return to be delivered to 'the officer', being the same officer who gives the s8 notice and relied on this conclusion as supporting its decision that the s8 notice had to be given by an identified 'flesh and blood' officer. However, the statutory scheme as a whole does not justify this approach. By virtue of s2 of the Commissioners for Revenue & Customs Act 2005 ('CRCA'), the 'officers' of HMRC are those staff that the Commissioners of Revenue & Customs have appointed for the purposes of exercising the Commissioners' functions. Section 2(4) of CRCA provides that anything commenced by one officer can be continued by another.…"[21]

When itself remaking the decisions the UT headed its consideration:

> "Whether, applying the right test, s8 notices were given by an officer of the Board."[22] (Emphasis added.)

And:

> "The fact that a computer performed the task of identifying taxpayers who met the criteria does not alter the conclusion that HMRC *officers* authorised the giving of notices to taxpayers who were so identified.…It is enough that *officers* have decided the criteria to be satisfied for a taxpayer to receive a s8 notice leaving the implementation of that decision to administrative staff and contractors."[23] (Emphasis added.)

The words of officers of HMRC which are attributed to the FST in the JCHR memorandum are a travesty of what the UT said. The UT did not refer to "HMRC at large": it was the respondents (HMRC) who referred to a distinction between HMRC as an institution (which the writer assumes to be the same as "at large") and their officers, and immediately after the UT had described that argument it said: "We reject that argument."[24]

It seems to the writer that it was this false understanding of what the UT decided that led to the approach taken in subsection (1) of section 103 FA 2020. But that subsection, when construed using definitions in subsection (4) of section 103 FA 2020, CRCA and the Interpretation Act 1978, can be seen as saying no more than:

> "Anything capable of being done by an officer of Revenue and Customs…may be done by an officer of Revenue and Customs (whether by means involving the use of a computer or otherwise)."

Since it is clear from *Rogers & Shaw* and from provisions such as section 113(1B) and (1D) TMA 1970 that the officer referred to in section 8 TMA 1970 and elsewhere can use a computer to automate mechanical tasks the words in parenthesis are unnecessary even as rhetorical emphasis (which is all they are).

It is thus very difficult to see what the point of section 103 FA 2020 is and why HMRC thought they were achieving something about validating automated processes. It might have been a

[21] *Rogers & Shaw*, above fn.13, [2019] UKUT 406 (TCC) at [33]. The rest of para.33 is omitted as it seeks to use TMA 1970 s.113(1A) in support of its decision but misreads that subsection.
[22] *Rogers & Shaw*, above fn.13, [2019] UKUT 406 (TCC) before [55].
[23] *Rogers & Shaw*, above fn.13, [2019] UKUT 406 (TCC) at [57].
[24] *Rogers & Shaw*, above fn.13, [2019] UKUT 406 (TCC) at [35].

sensible bit of tidying up to modernise pre-2005 provisions about the management of certain direct taxes by substituting "HMRC" for "officer of the Board" and cognate expressions wherever they appear.

In this context it is important to note that provisions which require an individual flesh and blood person to have an opinion on the appropriateness of something or to use judgement can just as easily be covered by the use of "HMRC" as by "officer". One only has to look at Schedule 24 to the Finance Act 2007 (penalties for incorrect returns) to see the use of "HMRC" in such situations.

It is difficult to see what if anything section 103 FA 2020 is seeking to do about automated decisions, something separate from automated processes, as the FST noted.[25] Automated decisions such as are mentioned in section 2 SSA are not to be found in section 8 TMA 1970 or in paragraph 3 of Schedule 18 FA 1998.

The position is different with the other provisions in subsection (2) of section 103 FA 2020. They do involve a decision requiring an officer to have an opinion or exercise judgement, even if, as in *Khan Properties*, the amount of a determination is fixed in law. It may be that because there has been no direct challenge in tribunals or courts to the use of automated decision making HMRC saw no need to address the issue and their use of the term "automated decisions" in the TN was simply clumsy and unintended.

But what alarmed many about the clause was the addition of discovery assessments to the list of tax provisions, as the case law shows that such an assessment involves a decision by an officer to assess the amounts they determine as being in their judgement appropriate and correct. This alarm was the reason why questions about discretion were raised by opposition members at Committee stage.

Replacement of an officer's discretion to make an assessment by a computer using algorithms and artificial intelligence is something which should not be introduced by the back door under the guise of what was said to be a mere confirmation of past practices. Fortunately section 103 FA 2020 does not seem to permit it.

Finally, what cannot go unremarked is the statement by the FST in the debate on the clause. He said (no doubt using words supplied to him by an officer of HMRC):

> "The relevant legislation in the Taxes Management Act 1970 is 50 years old and was designed to support a paper-based manual tax system."[26]

Oh no it isn't! TMA 1970 is 50 years old, but the actual text of the relevant provisions dates from no earlier than 1989 and most are much later. And on 29 May this year the first mention

[25] *Hansard*, above fn.15, col 244.
[26] *Hansard*, above fn.15, col 239.

of "computer" in tax law (in section 113(1B) TMA 1970[27]) celebrated its 50th anniversary! What HMRC said is, at the least, unforgivably ignorant.

Richard Thomas[*]

Section 104: returns relating to LLP not carrying on business etc with view to profit

Introduction

It has long been assumed by HMRC and practitioners that limited liability partnerships (LLPs) should be assessed to tax using the partnership provisions in the Taxes Management Act 1970 (TMA 1970). As with many such assumptions, everyone operates perfectly happily on the basis of the assumed state of affairs until someone starts questioning its technical basis. Those questions were first raised directly by the First-tier Tribunal (Tax Chamber) (FTT) in *Mr Martin Margott as representative member of MDL Property Consultants LLP v HMRC* (*MDL Property*),[1] and then in *Inverclyde Property Renovation LLP, Clackmannanshire Regeneration LLP v HMRC* (*Inverclyde (FTT)*).[2]

Section 104(1) of the Finance Act 2020 (FA 2020)[3] (which introduces a new section 12ABZAA TMA 1970) is meant to clarify the situation and to "put beyond doubt that LLPs should be treated as general partnerships under income tax rules".[4] However, at the time of writing,[5] it is unclear whether this section goes as far as promised. In particular, it appears not to address the main issues raised by the FTT's decisions in *MDL Property* and *Inverclyde (FTT)*. Fortunately, clarity on those issues has now been provided by the Upper Tribunal's (UT) decision in *HMRC v Inverclyde Property Renovation LLP, Clackmannanshire Regeneration LLP* (*Inverclyde (UT)*),[6] (released on 27 May 2020), albeit that that decision was, of course, made on the basis of the law prior to the introduction of the new section 12ABZAA TMA 1970.[7]

[27] Inserted by FA 1970 Sch.4, para.10.

Automated decisions; HMRC officers; HMRC powers; Notices; Tax assessments

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[1] *Mr Martin Margott as representative member of MDL Property Consultants LLP v HMRC* [2017] UKFTT 894 (TC).

[2] *Inverclyde Property Renovation LLP, Clackmannanshire Regeneration LLP v HMRC* [2019] UKFTT 408 (TC).

[3] FA 2020 s.104(1).

[4] HM Treasury, *Budget 2020* (March 2020), HC 121, available at: *https://www.gov.uk/government/publications/budget-2020-documents* [Accessed 16 October 2020], para.2.262; see also HMRC, Policy paper, *Tax treatment of limited liability partnerships* (11 March 2020), available at: *https://www.gov.uk/government/publications/tax-treatment-of-limited-liability-partnerships/tax-treatment-of-limited-liability-partnerships* [Accessed 16 October 2020].

[5] Time of writing October 2020.

[6] *HMRC v Inverclyde Property Renovation LLP, Clackmannanshire Regeneration LLP* [2020] UKUT 161 (TCC); [2020] STC 1348.

[7] Subject to an onward appeal to the Court of Appeal.

Legislation

LLPs are bodies corporate.[8] However, section 863 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA), contains the following deeming provisions:

> "(1) For income tax purposes, if a limited liability partnership carries on a trade, profession or business with a view to profit—
> (a) all the activities of the limited liability partnership are treated as carried on in partnership by its members (and not by the limited liability partnership as such),
> (b) anything done by, to or in relation to the limited liability partnership for the purposes of, or in connection with, any of its activities is treated as done by, to or in relation to the members as partners, and
> (c) the property of the limited liability partnership is treated as held by the members as partnership property.
> References in this subsection to the activities of the limited liability partnership are to anything that it does, whether or not in the course of carrying on a trade, profession or business with a view to profit.
> (2) For all purposes, except as otherwise provided, in the Income Tax Acts—
> (a) references to a firm or partnership include a limited liability partnership in relation to which subsection (1) applies,
> (b) references to members or partners of a firm or partnership include members of such a limited liability partnership…."[9]

There are two parts to this. First, if the LLP carries on a trade, etc. with a view to profit, its activities, actions and property are deemed, for income tax purposes, to be those of its members. In other words, the LLP is treated as transparent and its profits and losses are allocated proportionately among its members as if it were a general partnership.[10] Second, references in "the Income Tax Acts" to partnerships and firms include LLPs which fall within the scope of the first deeming provision, and references to members or partners of a firm or partnership include members of such an LLP.[11] Section 1273 of the Corporation Tax Act 2009 (CTA 2009) contains parallel provisions for corporation tax.

TMA 1970 provides for the assessment of general partnerships. In particular:

1. sections 12AA to 12AD TMA 1970 make provision for the submission of returns by partnerships and the making of enquiries into those returns;
2. section 12AA(2) TMA 1970 empowers HMRC to give notice to the partners requiring a person identified in the notice to submit a partnership return;

[8] Limited Liability Partnerships Act 2000 s.1(2).
[9] ITTOIA s.863(3) and (4) provide that subs.(1) continues to apply to an LLP that is no longer carrying on a trade, profession or business with a view to profit if either (a) the cessation is only temporary or (b) it is in the course of being wound up (otherwise than by a liquidation) following a permanent cessation, provided that the winding up is not for reasons connected with tax avoidance and the period of winding up is not unreasonably prolonged.
[10] ITTOIA s.863(1).
[11] ITTOIA s.863(2).

3. the return must, pursuant to section 12AB TMA 1970 include a partnership statement showing the amount of income that has accrued to the partnership and each partner's share of that income;
4. where a partnership has submitted a return, section 12AC TMA 1970 empowers HMRC to enquire into it within the relevant time, provided they give notice to the partner who delivered the return;
5. any such enquiry is completed when, under section 28B TMA 1970, HMRC issue a closure notice to the person to whom the notice of enquiry was given;
6. alternatively, in certain circumstances, HMRC can make a discovery amendment in respect of the partnership return under section 30B TMA 1970; and
7. any conclusion or amendment made by closure notice under section 28B TMA 1970, and any amendment under section 30B TMA 1970, may, under section 31 TMA 1970, be appealed to the FTT.

The statutory provisions governing company tax returns and enquiries are found in Schedule 18 to the Finance Act 1998 (FA 1998). These generally mirror the self-assessment rules applicable to individuals and partners in TMA 1970.

As noted above, it has long been assumed that the partnership provisions in TMA 1970 apply to LLPs. By way of example, the Supreme Court in *HMRC v Tower MCashback LLP 1 and another* (*Tower MCashback LLP 1*)[12] took the view that an LLP should be "taxed as if it were an ordinary non-incorporated partnership" and that the "most important provisions of the self-assessment regime, as it applies to LLPs, are to be found in sections 12AA, 12AB, 12AC, 28B, 31 and 31A of TMA 1970".[13] There are, however, two potential problems with that assumption.

First, the deeming provision in section 863(2) ITTOIA, applies to references in "the Income Tax Acts". It is not immediately obvious that the TMA 1970 is one of those Acts:

1. The Tax Acts are defined in Schedule 1 to the Interpretation Act 1978 (IA 1978) as "the Income Tax Acts and the Corporation Tax Acts".
2. Schedule 1 IA 1978, defines the Income Tax Acts as "all enactments relating to income tax, including any provisions of the Corporation Tax Acts which relate to income tax".[14]
3. Section 118(1) TMA 1970 defines "the Taxes Acts" as "this Act [that is, the TMA 1970] and…the Tax Acts". In so doing, the TMA 1970 appears to draw a distinction between itself (on the one hand) and the Tax Acts (which, pursuant to IA 1978, include "the Income Tax Acts") (on the other). In other words, the definition of the Taxes Acts in section 118 TMA 1970, read together with the definitions in IA 1978, appears to indicate that TMA 1970 is not one of the Income Tax Acts.

[12] *HMRC v Tower MCashback LLP 1 and another* [2011] UKSC 19; [2011] STC 1143.
[13] *Tower Mcashback LLP 1*, above fn.12, [2011] UKSC 19 at [7]–[8]. The same assumption was made in cases such as *R. (on the application of Amrolia) v HMRC* [2020] EWCA Civ 488 at [8]; *R. (on the application of Cobalt Data Centre 2 LLP and Cobalt Data Centre 3 LLP) v HMRC* [2019] UKUT 342 (TCC); [2020] STC 23 at [121]; and *R. (on the application of Reid and Emblin) v HMRC* [2020] UKUT 61 (TCC); [2020] STC 622 at [31]–[37].
[14] TMA 1970 was enacted before IA 1978. However, IA 1978 Sch.2, para.4(1)(b) (and the lack of a date in the relevant paragraphs of IA 1978 Sch.1) has the effect that the definition of "the Tax Acts" in IA 1978 applies to TMA 1970.

If TMA 1970 is not one of the Income Tax Acts for the purposes of section 863(2) ITTOIA, then references to partnerships, firms and partners in TMA 1970 do not include references to LLPs and their members. In particular, the partnership provisions in TMA 1970 referred to above would not apply to LLPs at all.

The second potential problem is that the deeming provision in section 863(1) ITTOIA only applies where the LLP carries on a trade, profession or business with a view to profit. Where the LLP does not carry on a trade, etc. with a view to profit, then: 1. the first deeming provision does not apply; and so 2. the second deeming provision (in section 863(2) ITTOIA) cannot apply because it only applies to LLPs that fall within the first deeming provision. It follows that where an LLP does not carry on a trade, etc. with a view to profit, then references in "the Income Tax Acts" to partnerships do not apply to such an LLP.

Therefore, even if TMA 1970 is one of the Income Tax Acts, difficulties may arise where it is uncertain whether the LLP in question meets the view to profit test. Suppose an LLP submits a return under the partnership provisions of TMA 1970 on the understanding that it was carrying on business with a view to profit during the relevant period of assessment. HMRC open and close enquiries into that return under the partnership provisions, and then successfully argue, on appeal, that the LLP has not been carrying on business with a view to profit. In those circumstances it would seem that the deeming provisions in section 863(2) ITTOIA do not apply to that LLP and so any references in TMA 1970 to partnerships, etc. do not apply to that LLP. Does that mean that the LLP and HMRC have used the wrong assessment procedure?

Spring Salmon

As regards the first of the two problems outlined above, the definition of the Tax Acts was discussed by Lady Smith in the Outer House of the Court of Session in *Spring Salmon & Seafood Ltd v Advocate General for Scotland* (*Spring Salmon*).[15]

That case concerned an application for judicial review of a decision by HMRC to open an enquiry under paragraph 24 of Schedule 18 FA 1998, into the corporation tax affairs of the petitioner. The petitioner argued (amongst other things) that the enquiry notice was invalid because it had not been given in writing. In support of that argument, the petitioner relied on section 832(1) of the Income and Corporation Taxes Act 1988 (ICTA 1988), which stated (at the relevant time): "In the Tax Acts…'notice' means notice in writing…." The Tax Acts were defined in section 831(2) ICTA 1988, for the purposes of that Act, as "…this Act and all other provisions of the Income Tax Acts and the Corporation Tax Acts".

In response, HMRC argued that section 832 ICTA 1988, did not apply to TMA 1970. In particular, section 118 TMA 1970 provided that it and the Tax Acts "were two separate entities". It was further argued that that approach was "demonstrated diagrammatically in the 'family tree' of tax legislation that is set out in the 43rd edition of Tolley's Yellow Tax Handbook, from which it is clear that the expression 'Tax Acts' does not include TMA".[16] Lady Smith agreed, concluding

[15] *Spring Salmon & Seafood Ltd v Advocate General for Scotland* [2004] STC 444 (Court of Session (Outer House)).
[16] *Spring Salmon*, above fn.15, [2004] STC 444 at [22].

that section 832(1) ICTA 1988 did not apply to TMA 1970: "It seems clear that TMA is separate and distinct from the group of statutes referred to as 'the Tax Acts' in that section."[17]

Bartram

Another case to consider the definition of "the Tax Acts" was *Bartram v HMRC* (*Bartram*).[18] The issue before the UT (Judge John Clark) was whether an appeal could be made to the Tribunal against a determination under section 28C TMA 1970 (a determination of tax where no return has been delivered). The taxpayer's primary submission was that section 197 of the Finance Act 1994 (FA 1994), which inserted section 28C into TMA 1970, somehow defined a determination as an assessment and that a right of appeal against a determination consequently existed under section 31(1)(d) TMA 1970, because the determination is "any assessment to tax which is not a self-assessment".

The UT rejected that argument. Further, the UT held that even if the taxpayer were correct, section 197(1) FA 1994 only applies for the purposes of "the Tax Acts" and "the Gains Tax Acts" and TMA 1970 was not included in the definition of those Acts. The UT reached that conclusion on the grounds that: 1. section 831(2) ICTA 1988 defined "the Tax Acts" as ICTA 1988, the Income Tax Acts and the Corporation Tax Acts, whereas ICTA 1988 refers to TMA 1970 elsewhere as "the Management Act" (which is not referred to in the definition of the Tax Acts); and 2. section 118(1) TMA 1970 indicates that TMA 1970 itself recognised that it did not form part of the Tax Acts. Consequently, the term "assessment" in section 31(1)(d) TMA 1970 did not include a "determination" made under section 28C TMA 1970, even if the taxpayer were right on his primary submission.

MDL Property

The first case to tackle head on the question of which assessment procedure is appropriate for LLPs was *MDL Property*.[19]

In that case, HMRC had issued a notice under section 12AA TMA 1970 requiring the appellant (the representative member of the LLP) to file a partnership return for the tax year 2011–12 by 31 January 2013.[20] On 12 February 2013, HMRC assessed the members of the LLP to penalties under paragraph 25 of Schedule 55 to the Finance Act 2009 (FA 2009) for failure to file the partnership return by the due date. Further penalties were then assessed for the continued failure to file.

On appeal, the FTT (Judge Richard Thomas) expressed surprise at HMRC's failure to address the question of why it was appropriate to issue an LLP with a section 12AA TMA 1970 notice to file a partnership return in the first place. The FTT went on to question whether TMA 1970 was in fact part of the Income Tax Acts, referring to the definition of "the Taxes Act" in section 118 TMA 1970 and its apparent distinction between TMA 1970 and the Tax Acts (including,

[17] *Spring Salmon*, above fn.15, [2004] STC 444 at [23].
[18] *Bartram v HMRC* [2012] UKUT 184 (TCC); [2012] STC 2144.
[19] *MDL Property*, above fn.1, [2017] UKFTT 894 (TC).
[20] If filed electronically; the earlier date of 31 October 2012 applied if the return was filed in paper form.

by virtue of IA 1978, the Income Tax Acts) and *Spring Salmon*.[21] The FTT concluded[22] that it was bound by Lady Smith's decision in *Spring Salmon* and that, accordingly, the deeming in section 863(2) ITTOIA did not apply to TMA 1970. As a result, the section 12AA TMA 1970 notice to deliver a return served on the members of the LLP was invalid; there could therefore be no failure to file a partnership return so the penalties fell away.

Nevertheless, Judge Thomas was not entirely comfortable with the conclusions in *Spring Salmon* and set out his own views on the definition of the Income Tax Acts in an appendix to the decision.[23] There he noted that, had it not been for *Spring Salmon*, he would have found that the reference to the Income Tax Acts in section 863(2) ITTOIA *does* include TMA 1970. This was on the grounds that: 1. the phrase "relating to income tax" in the definition of the Income Tax Acts in IA 1978 is extremely wide and there is no clear reason for distinguishing between substantive law (for example, in ITTOIA) and "adjectival law" in TMA 1970, the provisions of which relate to income tax; and 2. the definition in section 118 TMA 1970 applies exclusively for the purposes of TMA 1970 and should not be taken to affect ITTOIA.

***Inverclyde* in the FTT**

Around a year and a half later,[24] the issue was raised again in a preliminary hearing before the FTT (Judge Ruthven Gemmell) in *Inverclyde (FTT)*.[25]

In that case, the appellant LLPs had submitted returns under TMA 1970 partnership provisions. HMRC then issued enquiry notices and closure notices, also under TMA 1970 partnership provisions, and sought to amend the partnership returns on the basis that the LLPs were not, in fact, carrying on business with a view to profit.[26] It followed, HMRC said, that the deeming provision in section 863(1) ITTOIA did not apply and that the LLPs should be taxed as corporate entities. Whilst, strictly, this meant that the LLPs ought to have filed company tax returns, HMRC maintained that, having received a partnership return from the LLPs, they were perfectly entitled to open and close their enquiries under the partnership provisions as well.

The LLPs argued that, regardless of whether they met the view to profit test, HMRC should have assessed them using the corporation tax provisions in paragraph 24 of Schedule 18 FA 1998, and that if HMRC had wanted to challenge the returns of any of the LLPs' members they should have opened enquiries into those returns under section 9A TMA 1970.[27] This, argued the LLPs, solved the problem of determining which provisions an LLP should be assessed under where HMRC contend that the LLP is not carrying on a business, etc. with a view to profit (so that the first deeming, in section 863(1) ITTOIA, does not apply), because the corporation tax assessment provisions would apply to LLPs in all circumstances.

[21] *Spring Salmon*, above fn.15, [2004] STC 444.
[22] *MDL Property*, above fn.1, [2017] UKFTT 894 (TC) at [47] by reference to *National Exhibition Centre Ltd v HMRC* [2015] UKUT 23 (TCC) at [30]–[34].
[23] *MDL Property*, above fn.1, [2017] UKFTT 894 (TC) at [107]–[128].
[24] *MDL Property*, above fn.1, [2017] UKFTT 894 (TC) was released in December 2017; *Inverclyde (FTT)*, above fn.2, [2019] UKFTT 408 (TC) was released in June 2019.
[25] *Inverclyde (FTT)*, above fn.2, [2019] UKFTT 408 (TC).
[26] The substantive appeal concerned a dispute between the LLPs and HMRC regarding the quantification of the LLPs' claims for Business Property Renovation Allowance under CAA 2001 Pt 3A.
[27] *Inverclyde (FTT)*, above fn.2, [2019] UKFTT 408 (TC) at [21].

Ultimately, the LLPs succeeded with that argument on the basis that the deeming provision in section 863(2) ITTOIA applies only to the "Income Tax Acts" and TMA 1970 is not one of those Acts. Like the Tribunal in *MDL Property*, the FTT in *Inverclyde (FTT)* relied on Lady Smith's conclusions in *Spring Salmon*, albeit that the FTT in *Inverclyde (FTT)* did not reach a view about whether or not it was bound by decisions of the Outer House of the Court of Session, but simply concluded that it agreed with Lady Smith's judgment and considered it to be good law. The FTT did, however, conclude that it was bound by the UT's decision in *Bartram*, relying on Judge John Clark's statements to the effect that the definition of the Taxes Acts in section 118 TMA 1970 clearly indicated that TMA 1970 itself was not one of the Taxes Acts.

It seems that the FTT was particularly persuaded by the notion that the LLPs' interpretation made the statutory framework workable in circumstances where it might not always be clear whether a given LLP meets the view to profit test (and so falls within the scope of the section 863 ITTOIA deeming). The judge concluded that HMRC should always conduct enquiries into LLPs using the company provisions in FA 1998 and that HMRC would have to issue separate enquiries under section 9A TMA 1970 to individual members.[28]

It seems to be a common misconception that this case hinged on whether the LLPs were carrying on business with a view to profit. In fact, as noted above, the FTT found that their conclusion applied *regardless* of the entities' activities; the central point was whether the TMA 1970 was one of the Income Tax Acts.

Section 104 of the Finance Act 2020

The Budget 2020 announced the introduction of clause 101 of the Finance Bill 2020 (FB 2020) (now section 104 FA 2020) as a provision that would clarify that "HMRC can continue to amend LLP members' tax returns where the LLP operates without a view to profit".[29] HMRC's Policy Paper states that the measure "preserves…the status quo for the vast majority of [LLP] customers that operate with a view to profit who will not experience any change at all".[30] The measure came into force from the date of Royal Assent to FB 2020 and will apply both prospectively and retrospectively. The description below is based on the version of the Bill presented to the House of Lords which became FA 2020.

Section 104 FA 2020 introduces a new section 12ABZAA into TMA 1970. That section applies where: 1. a person delivers a "purported partnership return"[31] on the basis that the activities of the LLP are treated, under section 863 ITTOIA or s.1273 CTA 2009, as carried on in partnership by its members; but (ii) the LLP does not actually carry on business with a view to profit in the relevant period. Where the section applies, for the purposes of sections 12AC and 28B TMA 1970 (enquiries into partnership returns) and Part 4 FA 2014 (follower notices and accelerated payment notices), and "any enactment relating to, or applying for the purposes of"[32] those enactments, the return is to be treated as a partnership return and the terms "partnership" and "partners" are to include LLPs that fall within section 12ABZAA and such LLPs' members.

[28] *Inverclyde (FTT)*, above fn.2, [2019] UKFTT 408 (TC) at [125]; see also [130].
[29] HM Treasury, *Budget* 2020, above fn.4, para.2.262.
[30] HMRC, Policy paper, above fn.4, under "Background to the measure".
[31] FA 2020 s.104(1) inserting TMA 1970 s.12ABZAA(1)(a).
[32] FA 2020 s.104(1) inserting TMA 1970 s.12ABZAA(3)(b).

The amendment is to be treated as "always having been in force".[33] However, there is a carve out for cases where: 1. before 11 March 2020, a court or tribunal determined, in proceedings to which an LLP was party, that the purported partnership return was not a return under section 12AA TMA 1970[34]; and 2. at the beginning of 11 March 2020, the order of the court or tribunal giving effect to that determination had not been set aside or overturned on appeal.[35]

In addition, amendments are made to Part 1 of Schedule 14 to the Finance (No.2) Act 2017 (F(No.2)A 2017) (digital reporting and record keeping for income tax, etc.), extending the new section 12ABZAA TMA 1970 so that it applies to returns purportedly made under Schedule A1 TMA 1970. Those amendments take effect from the date of the commencement of Schedule 14 F(No.2)A 2017.[36]

Although there is no reference to it in the Budget 2020,[37] the Treasury impact note,[38] or the Explanatory Notes to FB 2020,[39] it is widely believed that this provision is being enacted in response to the FTT's decisions in *Inverclyde (FTT)* and *MDL Property*.[40] However, section 104 FA 2020 does not address one of the main issues raised in those cases, namely whether the reference in section 863(2) ITTOIA to "the Income Tax Acts" includes TMA 1970. In addition, it appears that section 104 FA 2020 fails to address the situation where HMRC issue a notice to deliver a return under section 12AA TMA 1970 on the understanding that the LLP was carrying on a trade, etc. with a view to profit during the assessment period when, in fact, it was not (the issue in *MDL Property*[41]): section 12ABZAA TMA 1970 will only apply where a "purported partnership return" has been delivered, and so it does not rule out the possibility of challenging a notice to submit a partnership return on the basis that the LLP is not trading, etc. with a view to profit. Fortunately, the UT's decision in *Inverclyde (UT)*, released on 27 May 2020,[42] appears to provide some guidance on those issues.

Inverclyde **in the UT**

The UT (Lord Tyre and Judge Raghavan) confirmed that the central issue on appeal was the proper interpretation of section 863(2) ITTOIA and, in particular, whether the phrase "the Income Tax Acts" is capable of including provisions in TMA 1970 concerned with income tax. The UT went on to answer that question in the affirmative. In particular, the UT held as follows:

[33] FA 2020 s.104(2).
[34] FA 2020 s.104(3)(a).
[35] FA 2020 s.104(3)(b).
[36] No date has yet been appointed for the commencement of F(No.2)A 2017 Sch.14 and so the amendments made to that schedule by FA 2020 s.104 have yet to come into effect: see F(No.2)A 2017 s.61(6).
[37] HM Treasury, *Budget 2020*, above fn.4.
[38] HM Treasury, *Impact on households: distributional analysis to accompany Budget 2020* (March 2020).
[39] HM Treasury, *Finance Bill Explanatory Notes* (19 March 2020).
[40] *Inverclyde (FTT)*, above fn.2, [2019] UKFTT 408 (TC); *MDL Property*, above fn.1, [2017] UKFTT 894 (TC). See, for example, Chartered Institute of Taxation (CIOT), *Representation to the Finance Bill 2020 Public Bill Committee* (2020), available at: *https://www.tax.org.uk/sites/default/files/FB2020%20CIOT%20PBC%20Submission%20Clauses%20100-101%20Tax%20Administration%20FINAL.pdf* [Accessed 23 October 2020], para.4.1 where the CIOT refers to *Inverclyde (FTT)*.
[41] *MDL Property*, above fn.1, [2017] UKFTT 894 (TC).
[42] *Inverclyde (UT)*, above fn.6, [2020] UKUT 161 (TCC).

1. Section 1 IA 1978[43] states "that every section of an Act takes effect as a substantive enactment without introductory words". This section, read together with *The Wakefield and District Light Railways Co v The Wakefield Corp*,[44] indicates that the concept of an enactment is not limited to whole Acts, parts or even sections of an Act. Instead, any provision, regardless of length, which achieves a distinctive objective, may be "an enactment".
2. It follows that the definition of the Income Tax Acts in IA 1978, which refers to "all enactments relating to income tax", should be read as referring not only to whole Acts relating to income tax, but also to any section of an Act relating to income tax, for example, the income tax provisions of TMA 1970.
3. The definition of the Tax Acts in section 118(1) TMA 1970 does not indicate a distinction between TMA 1970 and the Taxes Acts. As the reference to "the Tax Acts" in section 118(1) TMA 1970 includes sections of TMA 1970 relating to income tax, any overlap with the scope of the reference to "this Act" is of no practical significance. Further, TMA 1970 contains provisions capable of applying to other taxes (for example, capital gains tax), so the reference to "this Act" is not otiose.

This provides an answer to the question considered by the FTT in both *Inverclyde (FTT)*[45] and *MDL Property*[46] about the scope of the phrase "Income Tax Acts" in section 863(2) ITTOIA and confirms that references in TMA 1970 to partnerships and partners include references to LLPs and their members (provided that the LLP meets the view to profit test).

The UT went on to consider the practical implications of that conclusion and how section 863(1) ITTOIA operates in light of it. In doing so, the UT explored the following scenarios:

1. Where an LLP is carrying on trade, etc. with a view to profit, section 863(1) and (2) ITTOIA apply. The LLP is treated as transparent and returns should be submitted under section 12AA TMA 1970, with enquiries opened under section 12AC TMA 1970 and closed under section 28B TMA 1970.
2. Where an LLP is not carrying on a trade, etc. with a view to profit, section 863(1) and (2) ITTOIA do not apply to it. The LLP is not treated as transparent and is liable to corporation tax on its profits. TMA 1970 does not apply to the LLP and the process for the submission of company tax returns, enquiries and closure notices in Schedule 18 FA 1998 should be followed.
3. Where an LLP submits a partnership return on the basis that section 863 ITTOIA applies to it, but it is subsequently found (during an enquiry or on appeal) that it is not carrying on a trade, etc. with a view to profit, that finding does not retrospectively invalidate the notice to submit a return, the submission of the return, or the opening or closing of the enquiry under the partnership provisions. The UT

[43] And its predecessor the Interpretation Act 1889 s.8.
[44] *The Wakefield and District Light Railways Co v The Wakefield Corp* [1906] 2 KB 140. In that case, Ridley J stated that "[t]he word 'enactment' does not mean the same thing as 'Act'. 'Act' means the whole Act, whereas a section or part in an Act may be an enactment" (at 145–146).
[45] *Inverclyde (FTT)*, above fn.2, [2019] UKFTT 408 (TC).
[46] *MDL Property*, above fn.1, [2017] UKFTT 894 (TC).

relied on the broad scope of section 12AC(4) TMA 1970, which extends the enquiry to "anything contained in the return", which, in the UT's view, is capable of encompassing a conclusion that the wrong return has been submitted. If the conclusion is reached that the LLP is not carrying on a trade, etc. with a view to profit, then the officer may begin what s/he regards as the correct process by issuing a notice under paragraph 3 of Schedule 18 FA 1998 requiring the delivery of a company tax return. Going forward, this type of scenario should be covered by the new section 12ABZAA TMA 1970 (introduced by section 104(1) FA 2020).

4. When a notice requiring a return to be submitted is due to be issued, but it is unclear whether or not the LLP was carrying on business with a view to profit during the relevant period, it is reasonable for the officer requiring the submission of a return to proceed on the basis that the LLP falls within section 863(1) ITTOIA. This provides an answer to the question in *MDL Property*,[47] which section 104 FA 2020 does not appear to address.

Conclusion

Section 104 FA 2020 does provide some clarity in situations where an LLP has submitted a partnership return on the mistaken basis that it is carrying on a trade, profession or business with a view to profit during the relevant assessment period. The UT's decision in *Inverclyde (UT)*[48] provides answers to some of the issues not addressed by that section.

Emma Pearce[*]

Section 110: Future Fund: EIS and SEIS relief

This Report stage amendment is intended to assist an individual who already holds "eligible" or "relevant" shares in an Enterprise Investment Scheme (EIS) or Seed Enterprise Investment Scheme (SEIS) company at a time when they enter into a convertible loan agreement (CLA) with that company under the scheme run by the British Business Bank plc on behalf of the Secretary of State, known as the Future Fund. The Future Fund is a COVID-19 business interruption support measure; a "temporary and targeted programme" open initially until the end of September 2020—at the time of writing the window for applications has been extended until 30 November 2020.[1] It is not suggested that this development heralds any import for venture capital policy. Most COVID-19 support measures are (hopefully) to be of relatively short lifespan

[47] *MDL Property*, above fn.1, [2017] UKFTT 894 (TC).
[48] *Inverclyde (UT)*, above fn.6, [2020] UKUT 161 (TCC).

General partnerships; Income tax; Limited liability partnerships

[*] Pump Court Tax Chambers.

[1] British Business Bank, *Future Fund, Scheme Overview*, available at: *https://www.uk-futurefund.co.uk/s/* [Accessed 23 September 2020] and British Business Bank, *FAQs for Investors: Future Fund*, available at: *https://www.british-business-bank.co.uk/ourpartners/coronavirus-business-interruption-loan-schemes/future-fund/faqs-for-investors/* [Accessed 27 October 2020]. The final draft of this note was written on 6 October 2020.

and inevitably will present anomalies. However, section 110 of the Finance Act 2020 (FA 2020) merits being noted here because of the potentially unexpected long-term significance for EIS/SEIS investors who enter into a CLA.

The CLA is a tripartite document[2] in which a company receives a loan financed by matched funding provided as to 50 per cent from the Future Fund and as to the other 50 per cent from one or more "other lenders".[3] There is an investment cap of £5 million on the contribution from the Fund but the private investors can "over-match" this figure without limit.[4] Monies raised cannot be used by the company to pay off borrowing, pay dividends, or pay bonuses.[5] Simple interest accrues to the outstanding balance of the loan at a minimum of 8 per cent, without compounding.[6]

The CLA, which is in a prescribed form, provides for the loan to be converted into shares in the company upon any of four stipulated conversion events.[7] These comprise the happening of a funding round for either qualified or non-qualified funding, an arm's length sale of the company or its assets, including a stock market float, and maturity of the loan itself. The Frequently Asked Questions (FAQs) repeat that the CLA is a "fixed, standard form document" and there is only very limited room for varying its terms.[8] The FAQs indicate that the interest rate and conversion discount are negotiable above floors of 8 per cent and 20 per cent respectively. Headroom amount and valuation cap can be agreed but if not they will default to zero and void.

The new section 110 FA 2020 preserves EIS and SEIS relief from being withdrawn or reduced where, subsequent to entering the CLA, at any time during Period C (EIS income tax relief), Period A (SEIS income tax relief) or the "period of restriction" (EIS capital gains tax relief) that individual receives value from the issuing company as a result of the working out of the CLA.[9] This contingency will be fulfilled merely by the accruing interest under the CLA being paid to the investor upon a conversion triggered, for example, by a financing round, if nothing else.[10] If that, or any other receipt of value were to occur during Period C (EIS income tax relief), Period A (SEIS income tax relief) or the period of restriction (EIS capital gains tax relief) as respects the investor's pre-CLA eligible or relevant shareholding, then ordinarily, and but for section 110 FA 2020, this would entail a withdrawal of capital gains tax relief and/or a reduction of the

[2] Convertible Loan Agreement (CLA), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/885821/convertible-loan-agreement.pdf* [Accessed 27 October 2020].
[3] British Business Bank, *What we are and what we do*, available at: *www.british-business-bank.co.uk/* [Accessed 23 September 2020].
[4] British Business Bank, *FAQs for Investors: Future Fund*, above fn.1, Question: "Can Other investors oversubscribe/overmatch?"
[5] CLA, above fn.2, Sch.1 cl.3.
[6] CLA, above fn.2, Sch.1 cl.7 and Sch.1 cl.4.
[7] CLA, above fn.2, Sch.1 cl.5.
[8] British Business Bank, *FAQs for Investors: Future Fund*, above fn.1, Question: "Are any terms of the CLA negotiable?"
[9] ITA 2007 s.213 (EIS income tax relief) and s.257FE (SEIS income tax relief), TCGA Sch.5B para.13(1)(b) (EIS capital gains tax relief).
[10] CLA, above fn.2, Sch.1 para.4(a) and (c), ITA 2007 s.216(2)(h) (EIS income tax relief) and s.257FH(2)(h) (SEIS income tax relief), TCGA Sch.5B para.13(2)(i) (EIS capital gains tax relief).

investor's EIS or SEIS income tax relief.[11] Both Period C (EIS income tax) and the period of restriction (EIS capital gains tax) are defined as the period commencing one year before the shares were issued and ending immediately before the termination date relating to those shares and in the majority of cases this is three years from issue.[12] Period A (SEIS income tax relief) is the period beginning with the incorporation of the issuing company and ending immediately before the termination date.[13] To this extent the investor is shielded by the FA 2020 amendment.

There is, however, no statutory provision made to ameliorate the other risks that might cause previously claimed EIS and SEIS income tax relief to be withdrawn following entry into a CLA or the issue of conversion shares to the investor pursuant to that CLA.[14] Perhaps the most conspicuous danger is that for EIS income tax relief purposes the investor might easily become a "person interested in the capital of the company", or for SEIS income tax relief a "person having a substantial interest in the company" by reason of the conversion issue increasing the investor's ordinary shareholding, or voting rights, beyond the permitted 30 per cent.[15] However, it is arguable that this situation might arise *immediately* on due execution and exchange of the CLA. An investor is a person interested in the capital of the company (EIS), or a person having a substantial interest in the company (SEIS) if the investor "…directly or indirectly possesses or is entitled to acquire more than 30% of…" the ordinary shares, the issued share capital or the voting rights of the issuing company or any subsidiary of the company.[16] The difficulty is the words "entitled to acquire". This is because it has been held that unless the context otherwise requires, the ordinary meaning of the word "entitled" is apt to include a contingent interest.[17] Another catch is that the investor must not directly or indirectly possess or be entitled to acquire the rights to more than 30 per cent of the company's assets in a winding up.[18] This is an historic complication arising from short-term financing of EIS and SEIS companies pointed out by this writer as long ago as 2012 at the time the Finance Act 2012 modified section 170(1)(b) of the Income Tax Act 2007 to remove loan capital from the control calculation.[19] In the case of EIS these lacunae subsist at any time before the termination date relating to the investor's existing shareholding.[20] In the case of SEIS they last throughout Period A.[21] These tripping hazards are likely to be a major disincentive to participation in Future Fund loans by existing EIS/SEIS investors, and an elephant trap for the unwary, but the problems do not end there.

[11] ITA 2007 s.213 (EIS income tax relief) and s.257FE (SEIS income tax relief), TCGA Sch.5B para.13(1) (capital gains tax relief). Note the differences between TCGA Sch.5B para.13(1) and ITA 2007 ss.213 (EIS) and 257FE (SEIS) which are the corresponding provisions for income tax purposes as to withdrawal and reduction.
[12] ITA 2007 s.159(4) (EIS income tax relief), TCGA Sch.5B para.19(1); ITA 2007 s.256 (termination date).
[13] ITA 2007 s.257AC.
[14] This note, of course, only seeks to address EIS and SEIS related aspects of entry into the CLA. Participating in a CLA is very likely to have other tax and accounting consequences for an investor and no attempt can be made to address those here.
[15] ITA 2007 s.170 (EIS) and s.257BF (SEIS).
[16] ITA 2007 s.170(1) (EIS) and s.257BF(1) (SEIS).
[17] See, e.g. *In Re Maryon-Wilson's Will Trusts, Blofield v St Hill* [1968] Ch 268 per Ungoed Thomas J at 281A; [1967] 3 WLR 1476 (Ch) at 1483B.
[18] ITA 2007 s.170(2) (EIS) and s.257BF(2) (SEIS).
[19] A. Harper, "Finance Act 2012 Notes: Section 39 and Schedule 7: Enterprise Investment Scheme; Section 40 and Schedule 8: Venture Capital Trusts" [2012] BTR 411, 414–415.
[20] ITA 2007 ss.163 and 170(1).
[21] ITA 2007 ss.257BB and 257BF.

A CLA is not a recognised EIS or SEIS investment, so that no relief can be claimed by the investor on signing the CLA. When the Future Fund was launched there was speculation in the press that the EU Commission had refused a state aid application.[22] Much would depend on the terms of any such application (which the writer has not seen) but conceivably one could understand how a risk finance application might be questionable as a matter of policy, since EIS and SEIS relief are intended to be used to promote growth, whereas COVID-19 measures can be rescue aid but are more generally an aid to remedy a serious disturbance in the economy of a Member State.[23] Be that as it may, for scheme purposes, upon conversion, the conversion issue shares are neither "eligible shares" (EIS) nor "relevant shares" (SEIS). This is because it was held in *Optos plc v HMRC* that conversion shares are not issued "in order to raise money".[24] It follows, in respect of EIS, that as soon as an investor holds conversion shares, then until they have disposed of all of them, on such second-hand market as there may be, they will not be able to participate in any further issues that the company might make because they will not satisfy the EIS existing shareholdings requirement.[25]

Given the (at present) short-term availability of the measure, time will not allow a legislative solution to mitigate the consequences of falling foul of these restrictions. Nevertheless, should access to the Future Fund be prolonged beyond November 2020, then statutory savings similar in operation to section 110 FA 2020 would be the preferable way of overcoming the pitfalls. The alternative is to permit wider modification of the CLA. At present not only is the substance of the agreement non-negotiable but, in contrast to the Fund, which is granted the right to a meeting with the company to discuss, in good faith, the "…suite of shareholder governance rights…" to be attached to their shares, the private investors have no equivalent opportunity to influence the terms of the conversion issue.[26] In order for a negotiation with the "other lenders" to be feasible within the CLA process it would have to be made permissible to vary or cap the conversion by agreement so that a given investor does not breach 30 per cent. Since the 30 per cent test proceeds by reference to nominal share value, not market value, the problem is not solved simply by reducing voting rights.[27] The "entire agreement" clause in the CLA and the mutual covenants given in it would all demand very careful consideration by any parties looking for a solution outside of the CLA, for example to circumvent the standard form with (say) a side letter.[28] Even if it was concluded that a collateral contract might not be prohibited the case law suggests that any such contract must be very clearly "supplemental" to the main agreement.[29]

[22] H. Boland, "Start-up bailout package readies to launch without hoped-for tax relief", *The Telegraph*, 18 May 2020; and M. Field, "Future Fund expansion 'fails to hit the mark', claim business leaders", *The Telegraph*, 30 June 2020.
[23] See the EU Temporary Framework C2020 1863 adopted on 19 March 2020 and subsequently amended on 3 April, 8 May and 29 June 2020. For a discussion see House of Commons European Scrutiny Committee, *Seventh Report of Session 2019–21* (14 May 2020), HC 229-iv, Ch.2, available at: *https://committees.parliament.uk/publications/1078/documents/9029/default/* [Accessed 27 October 2020].
[24] ITA 2007 s.174 (EIS) and s.257CB (SEIS); *Optos plc v HMRC* [2006] 8 WLUK 179; [2006] STC (SCD) 687 at [139].
[25] ITA 2007 s.164A.
[26] CLA, above fn.2, Sch.1 cl.5(c).
[27] *HMRC v Taylor and Haimendorf* [2010] UKUT 417 (TCC) at [17] and [27].
[28] CLA, above fn.2, Sch.1 cll.8e(ii)(B), 8e(ii)(D) and 20. Detailed consideration is beyond the ambit of this note. A good starting point for legal research is D. McLauchlan, "The entire agreement clause: conclusive or a question of weight?" [2012] LQR 521, and reference should be made to the standard works on contract.
[29] e.g. *Ryanair Ltd v SR Technics Ireland Ltd* [2007] EWHC 3089 (QB) at [137]–[143].

This indicates that some modesty will be required in the terms that are agreed so as to ensure that they are truly ancillary in their nature and operation. Every investor, as well as the company and the Future Fund, would have to be parties to any rearrangement, so that it would be the intention of all concerned to change the otherwise fixed form.[30] There may be formal or informal constraints on what the Fund is able to sanction, if indeed it were prepared to entertain the principle. In any event, relying on freedom of contract to effect (say) variations of the conversion share issue, whether to be brokered inside or outside the umbrella of the CLA, is much less desirable than simply providing statutory absolution. First, investors may well harbour competing ambitions as regards their putative equity holdings resulting in tension in any talks. For instance, as distinct from an EIS investor who is potentially harmed by an increase in their shareholding, an investor hoping for entrepreneurs' relief might be anxious to preserve (or grow) an existing 5 per cent stake, and therefore be concerned about a possible dilution of their holding. Secondly, depending on the nature and terms of the proposed variation it may be thought prudent to obtain HMRC approval but whether and in what circumstances that would be forthcoming must be a matter for conjecture.

Navigating this COVID-19 business support measure brings into sharp focus the intricacies of the EIS and SEIS reliefs. ☞

Andrew Harper*

Section 111: preparing for a new tax in respect of certain plastic packaging

Plastic litter constitutes an important environmental, economic and health problem.[1] To tackle it, policymakers have two main options: they can either regulate the use of plastic (or even ban it); or they can adopt market-based instruments, including tax measures, in order to internalise its environmental costs. Many countries have already introduced bans or charges on plastic bags.[2] In the UK, shops are required to levy a charge on consumers for single-use plastic bags.[3] This charge cannot be assimilated to a tax as its proceeds remain at the disposal of retailers, who usually donate the money to charitable purposes.[4] The UK Government is now considering the

[30] Law Commission, *Law of Contract: the Parol Evidence Rule* (1986), Report No.154, Cm.9700, para.2.15.

☞ Coronavirus support payments; Enterprise investment scheme; EU law; Loan agreements; Northern Ireland; Reliefs; Seed enterprise investment scheme; State aid

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[1] See United Nations Environment Programme (UNEP), *Single-Use Plastics: A Roadmap for Sustainability* (Rev. ed., 2018). See also United Nations Environment Assembly of the United Nations Environment Programme, Resolution 4/6 on "Marine plastic litter and microplastics" adopted by the United Nations Environment Assembly on 15 March 2019 (28 March 2019), UNEP/EA.4/Res.6.

[2] The UNEP Report on *Single-Use Plastics*, above fn.1, gives an overview of the measures that have been adopted by different countries (27–44).

[3] The Single Use Carrier Bags Charges (England) Order 2015 (SI 2015/776). Note that, in England, the measure only applies to retailers who have 250 or more employees.

[4] In England and Scotland, retailers are expected to do so. In Wales, retailers are required to donate the net proceeds from the sale of single-use bags to "charitable purposes which relate to environmental protection or improvement and, which directly or indirectly benefit the whole or any part of Wales" (Environment (Wales) Act 2016 s.57(1)).

introduction of additional measures, including the adoption of a tax, to reduce plastic waste as of 2022.[5] The Finance Act 2020 enables HMRC to prepare "for the introduction of a new tax to be charged in respect of certain plastic packaging".[6] The Government's intention is to "transform financial incentives for manufacturers to produce more sustainable packaging".[7] This should lead to higher recycling levels and reduce plastic waste.[8]

A Policy Paper, *Plastic packaging tax*, published in March 2020, clarifies the general features that would characterise this new plastic packaging tax.[9] The new tax would apply to plastic packaging produced in, or imported into the UK that does not contain at least 30 per cent recycled plastic.[10] Only packaging that is "predominantly plastic by weight" should qualify as "plastic packaging".[11] Producers and importers of small amounts of plastic packaging should benefit from an exemption.[12] Concerning the tax rate, the plan is to have a flat rate of £200 per tonne for packaging with less than 30 per cent recycled plastic.[13] With regard to the tax liability, the tax should become chargeable at the point of production and import.[14] Exports would be excluded in order to prevent risks of loss of competitiveness for UK manufacturers.[15]

Many aspects of the Government's approach still need to be defined or confirmed. HM Treasury launched a first consultation on the tax in February 2019, which helped the Government to refine its plan.[16] A second consultation was launched in March 2020, which will—hopefully—allow light to be shed on the key aspects of the tax that remain unclear.[17] For example, the types of plastic subject to the tax still need to be confirmed.[18] Moreover, the treatment of imports lacks clarity. The initial idea was to include only unfilled packaging.[19] However, the Government is now considering a broader approach, including both filled and unfilled packaging.[20] For unfilled packaging, the treatment of imports seems fairly straightforward as it would simply replicate the treatment of packaging produced in the UK.[21] However, the way the tax will be imposed on imported filled packaging is unclear. It could lead to significant administrative costs, which

In Northern Ireland, the regime is different. The proceeds of the levy need to be paid to the Department of Agriculture, Environment and Rural Affairs (DAERA).

[5] This was announced at Budget 2018 (HM Treasury, *Budget 2018* (October 2018), HC 1629, 48–49).

[6] FA 2020 s.111. See also Finance Bill 2020 cl.102: Preparing for a new tax in respect of certain plastic packaging.

[7] HM Treasury, *Budget 2018*, above fn.5, 48.

[8] HM Treasury, *Budget 2018*, above fn.5, 48. See also HMRC, Policy paper, *Plastic packaging tax* (Policy paper) (11 March 2020).

[9] HMRC, Policy paper, above fn.8, "General description of the measure".

[10] HMRC, Policy paper, above fn.8, "General description of the measure".

[11] HMRC, Policy paper, above fn.8, "General description of the measure".

[12] HMRC, Policy paper, above fn.8, "Proposed revisions".

[13] HMRC, Policy paper, above fn.8, "Proposed revisions". See also HM Treasury, *Plastic packaging tax: consultation* (Consultation Document 2019) (February 2019), paras 5.1–5.4. HMRC, *Plastic Packaging Tax: Consultation Document* (Consultation Document 2020) (11 March 2020), paras 1.3 and 1.4; HM Treasury, *Budget 2020* (March 2020), HC 121, para.2.214.

[14] HM Treasury, Consultation Document 2019, above fn.13, para.6.1.

[15] HM Treasury, Consultation Document 2019, above fn.13, para.7.2; HMRC, Consultation Document 2020, above fn.13, Ch.7, "Exports".

[16] HM Treasury, Consultation Document 2019, above fn.13.

[17] HMRC, Consultation Document 2020, above fn.13.

[18] HMRC, Consultation Document 2020, above fn.13, paras 3.1–3.9.

[19] HM Treasury, Consultation Document 2019, above fn.13, para.6.13.

[20] HMRC, Policy paper, above fn.8.

[21] HM Treasury, Consultation Document 2019, above fn.13, para.6.13.

could, potentially, amount to discrimination against imported products under international trade law.[22]

A tax charged on certain plastic packaging could be a positive addition to the UK's strategy to reduce plastic waste. However, as always with taxation, the devil will lie in the detail. The tax should be designed carefully to avoid unexpected adverse effects. For example, although the exclusion of exports can be justified on economic grounds, it might not be consistent with the environmental objective of the tax if it leads to an increase in the export of unsustainable plastic packaging.[23] The preparation for the introduction of the new plastic packaging tax should take these potential negative effects into account. Finally, the UK Government should pay attention to discussions on the same topic at the level of the EU. Indeed, the EU is also considering the introduction of a charge on "non-recycled plastic packaging waste" to be introduced as of January 2021[24].

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[22] The General Agreement on Tariffs and Trade (GATT 1947) Art.III "National Treatment on Internal Taxation and Regulation" requires WTO members not to discriminate between "like" domestic and imported products. The 2019 consultation states as follows: "There may be greater administrative costs associated with complying with the tax, if it applied to imported filled packaging" (HM Treasury, Consultation Document 2019, above fn.13, para.6.14).
[23] From an environmental perspective, one of the only ways to justify the exemption of exports is to argue that such exemption is necessary to prevent "pollution leakage" (e.g. on the hypothesis that UK producers would relocate to jurisdictions with lower environmental standards).
[24] European Council, *Special meeting of the European Council (17, 18, 19, 20 and 21 July 2020) — Conclusions* (Brussels: 21 July 2020 (OR. en) EUCO 10/20 CO EUR 8 CONCL 4), paras A29 and 146.

Environmental taxation; HMRC; Packaging; Plastics; Tax administration
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Case Notes

Fowler v HMRC (Supreme Court): neither fish nor Fowler: tax treaty implications of domestic deeming rules

The decision of the Supreme Court in *Fowler v HMRC* (*Fowler*)[1] illustrates that domestic law deeming rules may in certain cases neither affect the meaning or interpretation of a term, nor the legal qualification of facts, but rather fall into yet a third category for the purposes of applying a tax treaty. This third category consists of rules that direct a domestic law tax treatment "as if" it is something that it is not (even though the current deeming, in contrast to its predecessor, does not say "as if"; it actually says "treated…as the carrying on of a trade"), without thereby necessarily affecting the application of a tax treaty.

The dispute has been ongoing for many years, and has been the subject of several commentaries[2] as it has worked its way through the courts. Essentially, Mr Fowler was a resident of South Africa who was employed[3] as a diver in the North Sea. Pursuant to section 15 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA), if certain conditions are satisfied

> "the performance of the duties of employment is instead treated for income tax purposes as the carrying on of a trade in the United Kingdom".

(This will be referred to as "the divers deeming".)

Thus, the question was whether or not section 15 ITTOIA had any effect on the application of the UK-South Africa Double Tax Treaty (2002) (the Treaty)[4]—in particular, shifting the applicable treaty Article from 14 (income from employment) to 7 (business profits), such that the UK would be precluded from taxing his income in the absence of a permanent establishment. The Court held that the deeming rule did not have such an effect. In so doing, the Court made a number of statements of considerable interest, as discussed below in greater detail.

The decision

The decision can be summarised in the following propositions:

[1] *Fowler v HMRC* [2020] UKSC 22; [2020] STC 1476.

[2] See, for example, J. Avery Jones and J. Hattingh, "Fowler v HMRC: divers and the dangers of deeming" [2016] BTR 417; J. Avery Jones, "HMRC v Fowler: more on divers" [2017] BTR 385; J. Avery Jones, "Commentary, Fowler v Revenue and Customs Commissioners" (2018) 21 ITLR 388, 390; A. Jupp and J. Atkinson, "Fowler v. HMRC and the Murky Waters of Treaty Interpretation" (2019) 73 *Bulletin for International Taxation* 347; J. Avery Jones and J. Hattingh, "Commentary, Fowler v Revenue and Customs Commissioners" (2020) 22 ITLR 679, 681–688; A. Nikolakakis, "Interpretation vs Qualification" in G. Maisto (ed.), *Current Tax Treaty Issues* (Amsterdam: IBFD, 2020), 334–343.

[3] As the case was decided on a preliminary issue this was an assumed fact.

[4] Double Taxation Relief (Taxes on Income) (South Africa) Order 2002 (SI 2002/3138).

1. "Nothing in the Treaty requires articles 7 and 14 to be applied to the fictional, deemed world which may be created by UK income tax legislation."[5]
2. It is required to determine for what purposes and between whom is a fiction created, and whether it is for the purpose of rendering a person immune from tax in the UK, or adjudicating between the Contracting States as the potential recipient of tax.
3. To apply such a deeming provision so as to alter the meaning of terms in the Treaty with the result of rendering a qualifying diver immune from UK taxation would produce an anomalous result, and would be contrary to the purposes of the Treaty.

These propositions should be viewed considering the Court's departure point that deeming rules can be interpreted "to point in many directions".[6] This note will not review the general legal position of deeming rules but will focus on the treaty interpretation issue of whether the deeming changed the meaning of treaty terms in domestic law, including whether there needs to be an intention for the deeming to affect treaties, after which the issue is a treaty one of whether the context otherwise requires a different meaning. Each of the above propositions is discussed below. The note also does not discuss the question of reference being made to the OECD Commentaries that post-date a particular treaty, which is discussed in Philip Baker's current note in this issue of the *Review*.[7]

Nothing in the Treaty requires Articles 7 and 14 to be applied to the fictional, deemed world which may be created by UK income tax legislation

The Court states that the Treaty requires Articles 7 and 14

> "to be applied to the real world, unless the effect of article 3(2) is that a deeming provision alters the meaning which relevant terms of the Treaty would otherwise have".[8]

If this is another way of saying that Article 3(2) requires the application of domestic law when it alters the meaning of an undefined term, it is unexceptional; this is the precise issue in the case. But it is an odd use of "real world" which is normally used either in tax avoidance cases, as in "the capital gains tax was created to operate in the real world, not that of make belief",[9] or to distinguish between tax law and non-tax law.[10] Treaties themselves depart from the real world, as in the definition of "dividend" to include "income from other corporate rights which is subjected to the same taxation treatment as income from shares…"[11] with the consequential exclusion for example, of such income from being interest which it would be in the real world.[12] It could be that the Court is referring to the *definition* of employment to include "any employment under a

[5] *Fowler*, above fn.1, [2020] UKSC 22 at [30].
[6] *Fowler*, above fn.1, [2020] UKSC 22; [2020] STC 1476 at [27].
[7] P. Baker, "Subsequent changes to the OECD Commentaries" [2020] BTR 387.
[8] *Fowler*, above fn.1, [2020] UKSC 22; [2020] STC 1476 at [30].
[9] *WT Ramsay Ltd v IRC* [1981] STC 174 (HL) at 182.
[10] *Project Blue Ltd (formerly Project Blue (Guernsey) Ltd) v HMRC* [2018] UKSC 30; [2018] STC 1355.
[11] OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (OECD Model) (Paris: OECD Publishing, 2017), available at: *https://doi.org/10.1787/mtc_cond-2017-en* [Accessed 18 August 2020], Art.10(3).
[12] Dividends and interest being defined expressions, the Treaty Art.3(2) is not relevant.

contract of service…"[13] which is a clear reference to general law presumably existing in the real world. Chargeability is dealt with in a different section of the statute that charges different types of employment income (for example "general earnings" which includes "any amount treated as earnings" by virtue of deeming, for example agency workers who are treated as employed by the agency when they are self-employed), and ends by saying that employment income is not charged to tax under this Part if it is within the charge to tax under the divers deeming.[14] In other words, this exclusion is from the charge to tax and does not purport to change the definition of what is an employment.[15]

It may be useful to look here at the possible ways of deeming. Assume that dogs are taxable and the legislature intends to tax parrots in the same way as dogs.[16] It has four main options:

1. It can say tax is imposed on "every dog and every parrot". That is neither a modification of meaning nor a deeming of legal qualification of facts. One would not say that this approach changes the meaning of "dog" for the purposes of applying a tax treaty nor for any other purposes.
2. It can say, "for tax purposes every parrot is deemed to be a dog", where "dog" is the term in question. That is a deeming of a legal qualification of facts. It would be the same if it said "every parrot is deemed to have four legs, no wings, fur rather than feathers, etc". It is just shorthand to say "every parrot is deemed to be a dog". (It may, however, be intended as a change in meaning of the word "dog".)
3. It can say "for tax purposes the word 'dog' means either a dog or a parrot". That is a modification of meaning of the word "dog" that potentially has effect for treaties by virtue of Article 3(2) of the 2017 OECD *Model Tax Convention on Income and on Capital* (OECD Model).[17]
4. It can also say a "parrot shall be taxed as if it were a dog". That is neither a deeming of legal qualification of facts nor a modification of meaning, but merely a statement about how something is to be taxed. This is how the decision categorises the divers deeming.

One might think that it does not matter which approach is used, as the result in domestic tax law is that parrots are taxed in the same way as dogs. But it matters for treaties because Article 3(2) of the OECD Model provides that (unless the context otherwise requires) an undefined term shall

[13] ITEPA s.4.
[14] ITEPA s.6 and s.6(5) in particular.
[15] Although the Court did not refer to the legislative predecessor of the current form as did the Court of Appeal, if it had done so it would have found that what is now ITEPA s.6(5) followed the deeming words "…the Income Tax Acts shall have effect as if the performance by that person of those duties constituted the carrying on by him of a trade…" preceded by "and accordingly," (ICTA 1988 s.314) and were designed to prevent a charge to tax as employment income as well as trading.
[16] This assumption is made to avoid the possibility that the deeming is only for computational or administration purposes. The example reflects the existence of taxes on dogs in the UK, South Africa, Europe and many other areas from as early as the 18th century until the 1980s. The parrot addition is to illustrate the extremes of deeming. It was used in M.N. Kandev and J.J. Lennard, "Interpreting and Applying Deeming Provisions of the ITA" (2012) 60(2) *Canadian Tax Journal* 275.
[17] OECD Model, above fn.11.

> "have the meaning that it has at that time under the law of that State for the purposes of the taxes to which this Convention applies".[18]

Therefore it most clearly applies to the option 3 type of deeming, and it is not clear whether it might also apply to option 2, because the courts have not distinguished clearly between deeming that modifies the meaning of a term and deeming that modifies legal qualification of facts.[19] The OECD Model itself when dealing with defined expressions always changes the definition ("the term [immovable property] shall in any case include…livestock"[20]), but sometimes does this on the basis of taxability ("the term 'dividends' means income from shares…as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares…"[21]).

Domestic law in different countries is naturally less consistent. Civil law states, where tax legislation has more connection with the real world (relying more heavily on general law), have a preference for tax fictions which change the qualification of facts often at the boundaries, so that the more extreme departure from the general law reflected by the divers deeming would be unlikely to occur. In the UK there is a tendency towards what Bennion has called "asifism".[22] Sometimes deeming is hard to categorise. Is there any real difference between "farming…is treated for income tax purposes as the carrying on of a trade"[23] and "'trade' includes every…adventure or concern in the nature of trade"?[24] If the divers deeming had been added to the latter definition of trade (together with a corresponding exclusion from the definition of employment, rather than from employment income) the result might well have been different. The focus would then have shifted to whether the context otherwise required, a topic which the Court did not need to address.

The Court referred[25] to the 2010 addition to the OECD Commentary on Article 15, which was as follows:

> "8.11 The conclusion that, under domestic law, a formal contractual relationship should be disregarded must, however, be arrived at on the basis of objective criteria. For instance, a State could not argue that services are deemed, under its domestic law, to constitute employment services where, under the relevant facts and circumstances, it clearly appears that these services are rendered under a contract for the provision of services concluded between two separate enterprises.…Conversely, where services rendered by an individual may properly be regarded by a State as rendered in an employment relationship rather than as under a contract for services concluded between two enterprises, that State should

[18] OECD Model, above fn.11, Art.3(2).
[19] See, for example, the discussion in Nikolakakis, above fn.2.
[20] OECD Model, above fn.11, Art.6(2).
[21] OECD Model, above fn.11, Art.10(3).
[22] F. Bennion, *Bennion on Statutory Interpretation*, 5th edn (LexisNexis, 2008), 146; Lord Walker of Gestingthorpe, "'As If…'—The Wonderland of Statutory Hypotheses" (2016) 37(3) *Statute Law Review* 183.
[23] ITTOIA s.9.
[24] TMA 1970 s.118. The Court said in *Fowler*, above fn.1, [2020] UKSC 22; [2020] STC 1476 at [31] that deeming provisions do not in general change the meaning of terms. The latter may be an example where it does.
[25] *Fowler*, above fn.1, [2020] UKSC 22; [2020] STC 1476 at [30].

> logically also consider that the individual is not carrying on the business of the enterprise that constitutes that individual's formal employer…."[26]

The Court states[27] that this paragraph confirms that a "real world" approach to the interpretation and application of tax treaties is required. It adds that to do otherwise would be contrary to the requirement to treat the Treaty as a bilateral international agreement as required by the dicta in *Anson v HMRC* (*Anson*).[28] This refers to the ordinary meaning in Article 31 of the Vienna Convention,[29] under which "a treaty should be construed in a manner which is 'international, not exclusively English'".[30]

However, it seems difficult to conclude that paragraph 8.11 confirms anything more than that sometimes deeming rules that purport to modify the legal qualification of facts may be acceptable, and sometimes they may not be, which is not confirming very much. On the other hand, the references in the paragraph to "objective criteria" and to "relevant facts and circumstances" would seem to suggest that the qualification exercise (and the acceptability or not of a particular deeming rule) should be approached from the perspective of determining the "substance" of the parties' relationships, as if the meaning of the term "employment" is a separate matter (although one that presumably would inform the determination of which facts and circumstances may be relevant). More importantly, the Court implies that[31] this part of the Commentary, which is designed to stop states from artificially enlarging the scope of employment, so as to give the state a taxing right under Article 15, is of general application, and is therefore relevant to the UK situation where exactly the opposite is being done. The Commentary to Article 7, which is the article that the divers deeming rule would enlarge without the application of objective criteria, does not suggest that doing so would be inappropriate. Indeed it says:

> "The question whether an activity is…deemed to constitute in itself an enterprise has always been interpreted according to the provisions of domestic laws of the Contracting States."[32]

Finally, there is a logical fallacy in using paragraph 8.11 to rein in the extent of a deeming rule. If domestic law applies up to a limit one must already have decided that it did apply; and the cause of its applying may be a deeming provision.[33] In any event, the focus here is rather different and precedes the issue addressed in paragraph 8.11: what is the meaning of the undefined treaty term in domestic tax law? Accordingly, this part of the Commentary is of no assistance in deciding the prior question of whether the deeming provision applies to the Treaty.[34]

[26] OECD Model, above fn.11, Commentary on Article 15.
[27] *Fowler*, above fn.1, [2020] UKSC 22; [2020] STC 1476 at [30].
[28] *Anson v HMRC* [2015] UKSC 44; [2015] STC 1777.
[29] Vienna Convention on the Law of Treaties, concluded at Vienna on 23 May 1969.
[30] *Fowler*, above fn.1, [2020] UKSC 22; [2020] STC 1476 at [18]; *Anson*, above fn.28, [2015] UKSC 44 at [110]–[111].
[31] *Fowler*, above fn.1, [2020] UKSC 22; [2020] STC 1476 at [30].
[32] OECD Model, above fn.11, Commentary on Article 3 para.4.
[33] A situation envisaged by OECD Model, above fn.11, Commentary on Article 15 para.8.4 referring to "various legislative or jurisprudential rules".
[34] Many of these rules are intended to deem non-employment relationships to be employment, in an effort to address tax avoidance situations. But the motive of a deeming rule (that is, to address tax avoidance versus a desire to expand taxing jurisdiction) goes to the question of good faith, not the question of whether deeming in principle can have tax treaty implications.

The Court also noted[35] that Article 2(1) of the Treaty provided that it

> "shall apply to taxes on income and on capital gains imposed on behalf of a Contracting State or of its political subdivisions, *irrespective of the manner in which they are levied*" (emphasis added).

This type of provision lends a degree of support to the proposition that a third category of domestic deeming rule should be recognised in the context of the interpretation and application of tax treaties, consisting of rules that presume the normal meaning of a term, and the normal qualification of facts, but direct a tax treatment whereby something is to be taxed "as if" it is something that it is not, without thereby necessarily affecting the application of a tax treaty. But this may be reading too much into the "the manner", particularly considering that, as has been seen, treaties tend to avoid deeming provisions and instead directly define a term (for example, the Treaty definition of "immovable property" includes livestock, and so while farming might be taxed as a trade under domestic law,[36] the Treaty category, which determines a state's right to tax, remains Article 6). The Commentary on Article 2 explains that the purpose of Article 2 overall is to widen the field of application of a tax treaty "as much as possible" and to ensure longevity. One may question the Court's reliance on Article 2 to support its decision, which does not concern whether a tax is covered by the Treaty.

It remains somewhat unclear whether the Court has held that such deeming rules are generally ineffective in relation to the application of a tax treaty, unless their purpose specifically contemplates such an effect, as discussed below in greater detail.

It is required to determine for what purposes and between whom is a fiction created, and whether it is for the purpose of rendering a person immune from tax in the UK, or adjudicating between the Contracting States as the potential recipient of tax

Should finding a purpose of treaty-application be required in relation to a deeming rule that purports to modify the meaning of a term? Consider Article 3(2) of the Treaty which provides:

> "As regards the application of the provisions of this Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which this Convention applies, *any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State*." (Emphasis added.)

Clearly, this provision draws from both the tax laws and the non-tax laws of the Contracting States. While deeming rules introduced into the tax laws may or may not in fact have or include the application of a tax treaty as their purpose, that would be less likely to be found in deeming provisions in non-tax law. Thus, since Article 3(2) contemplates non-tax law which is less likely to be driven by a treaty application purpose, it seems to be inappropriate for there to be any

[35] *Fowler*, above fn.1, [2020] UKSC 22; [2020] STC 1476 at [6] and [34].
[36] As it is in the UK as a result of a deeming in ITTOIA s.9 because originally farming was taxed as income from land on the basis of the land's annual value.

requirement to find a purpose of treaty application in relation to a tax law deeming rule that purports to modify the meaning or interpretation of a term that is within the scope of a provision such as Article 3(2) of the Treaty. If the deeming rule has the effect of modifying the meaning of a term, it seems to be too much to require a purpose that specifically contemplates the interpretation of tax treaty terms (or even to require that a purpose contemplates the taxation of non-residents). On the other hand, such a purposive analysis should, arguably, inform an inquiry into whether or not any such deeming rule could breach the requirement of good faith.

With respect to a deeming rule that purports to modify the facts as opposed to the meaning of a term (that is, "a parrot is deemed to have four legs…"), if the rule does not come within the scope of provisions such as Article 3(2) of the Treaty, then an analysis of the purposes and intended effects of the rule seems more appropriate in determining its technical implications in the tax treaty context. If it could be shown that it was intended to affect the application of tax treaties, then it seems difficult to see how a court in a legal system such as that prevailing in the UK, where Parliament is supreme, or in any event where the legislature is at least empowered to legislate in the treaty context, could decline to apply such a rule. Whether or not such a deeming rule would constitute a treaty override should not determine its effectiveness, even if there may be concerns with regard to the requirement of good faith, although of course it seems appropriate for a court to not presume or lightly accept that such an intended effect was present or achieved. The purposes of certain rules are clear in this regard,[37] while others may be more difficult to discern.

Ultimately, with reference to the facts of this case, the Court relied on a finding that the purposes and effect of section 15 ITTOIA were limited to modifying the manner in which tax is to be calculated and imposed in respect of the relevant income, rather than modifying the meaning or interpretation of any term or the legal qualification of the facts. Interestingly, the Court made the following statements:

> "25. The reason for this particular tax treatment of this class of divers was a matter of some debate in submissions before this court. But the FtT found that it was because, at least at the time of the enactment of the precursor to section 15 ITTOIA, section 29 of the Finance Act 1978, this class of divers commonly incurred their own costs, and therefore deserved the more generous expenses regime afforded to the self-employed, by comparison with employees. The FtT relied on an opinion to that effect published by the Office of Tax Simplification in March 2011, in preference to broader but less persuasive observations by the Financial Secretary to the Treasury in February 1978 when announcing the intention to introduce section 29: Hansard (HC Debates), 3 February 1978, written answers, col 359. There is no good reason to doubt that essentially factual finding by the FtT. It is clear that it was not a purpose of the deeming provision in section 15 ITTOIA(2)

[37] For example, Canada has an Income Tax Conventions Interpretation Act, R.S.C. (1985), c. I-4, as amended, which includes both deeming rules that purport to modify the meaning and interpretation of treaty terms as well as deeming rules that purport to modify the qualification of a state of affairs or other matters that arguably go beyond the meaning or interpretation of a term. Some of these include the following type of language, which provides very clear evidence of intent: "Notwithstanding the provisions of a convention or the Act giving the convention the force of law in Canada, it is hereby declared that the law of Canada is that…."

> to resolve some legal or factual uncertainty about whether such divers were genuinely employed or self-employed. On the contrary, section 15 ITTOIA applies only to employed divers."[38]

What is strange about this approach is that the Court was reluctant to make its own finding on "purpose", although it was "a matter of some debate in submissions", but instead treated it as a finding of fact by the First-tier Tribunal (FTT).[39] There the Judge made his own finding that the real purpose was the more relaxed rules for the deductibility of expenses and possibly the timing advantage of tax payments, adding a footnote that this was the view of the Office of Tax Simplification in a 2011 Report.[40] It was therefore an overstatement for the Court to say that the Judge relied on the Report. The last two sentences quoted above are also doubtful. As the case note on the FTT decision states[41] the whole process started when the Revenue changed their ruling that divers were employed, thus demonstrating that there was uncertainty about their categorisation; this had the result that the deductibility of expenses, particularly of travel to work, was made worse. In fact, the underlying cause of the legislation was a political decision to prevent a strike ultimately caused by the re-categorisation of the divers that would have disrupted North Sea oil production. That was the motive.[42]

To apply such a deeming provision so as to alter the meaning of terms in the Treaty with the result of rendering a qualifying diver immune from UK taxation would produce an anomalous result, and would be contrary to the purposes of the Treaty

The Court noted[43] that there is no general provision in the Treaty to deal with "double non-taxation", and that the question whether South Africa did tax the earnings of its residents employed abroad was not investigated, "so it would be inappropriate to place any weight on this consideration in construing the Treaty".[44] Curiously, however, the Court may have placed some weight on this consideration, in referring to an "anomalous result"[45] and to the "purposes of the Treaty".[46]

[38] *Fowler*, above fn.1, [2020] UKSC 22; [2020] STC 1476 at [25].
[39] *Fowler v HMRC* (*Fowler (FTT)*) [2016] UKFTT 234 (TC); 18 ITL Rep 644.
[40] *Fowler*, above fn.1, [2020] UKSC 22; [2020] STC 1476 at [25]; *Fowler (FTT)*, above fn.39, [2016] UKFTT 234 (TC) at [94] fn.1; Office of Tax Simplification, *Review of tax reliefs: final report* (March 2011).
[41] Avery Jones and Hattingh (2016), above fn.2, 417. It was also stated to the Standing Committee that the standard rules for categorisation did not meet the rules of the industry, because safety requirements meant that the diver had limited scope for determining how to do the job in the way a self-employed person normally has (Standing Committee A, 6 June 1978, Pt II, col 662).
[42] "North Sea divers' threat to strike over PAYE", *The Times*, 8 July 1977.
[43] *Fowler*, above fn.1, [2020] UKSC 22; [2020] STC 1476 at [4].
[44] The conditions for the exemption in South Africa (Income Tax Act, 58 of 1962, s.10(1)(o)) have always been that the services must be performed outside South Africa for more than 183 days in a 12 month period, and for 60 continuous days in that period, about which there was no evidence in the case so it is impossible to say whether the taxpayer in fact enjoyed the unilateral exemption. Since the case was brought on behalf of a number of South African divers some may, and some may not, have benefited from the exemption. It should also be noted that a monetary limit to the exemption applies from 1 January 2020.
[45] *Fowler*, above fn.1, [2020] UKSC 22; [2020] STC 1476 at [33].
[46] *Fowler*, above fn.1, [2020] UKSC 22; [2020] STC 1476 at [34].

Would it be an anomalous result for the UK to effectively surrender taxing rights in respect of employment income to a foreign country where the UK has clearly waived its most effective collections measures under PAYE in a context where the taxpayer does not necessarily have any assets in the UK (and it is assumed the taxpayer does not have a permanent establishment to which the income is attributable)? One might reasonably think otherwise, especially if the anticipated costs of instituting alternative collections measures could reasonably be expected to exceed the tax at stake.[47] Would it be contrary to the purposes of the Treaty for "double non-taxation" to arise? That is debatable and somewhat controversial, in that tax treaties do in certain cases contemplate this, whether positively or by default.[48] Moreover, this may vary as a function of the particular country of which the taxpayer is a resident, which may or may not be a country which taxes the income, or may or may not be a country with which the UK has a tax treaty. It seems inappropriate, or at least remarkable, to condition the conclusion on the effect of section 15 ITTOIA on the tax treatment that may be applicable under the laws of a foreign country. If the UK intends to continue to tax the income in question, that should not be dependent upon whether or not some other country may also seek to tax the income. If the UK has effectively surrendered its taxing rights to a tax treaty country, it should not recover its taxing rights if the other country does not exercise its rights, unless the tax treaty contains a subject to tax provision or otherwise displaces the other country's exclusive taxing rights. Given that the Treaty does not contain any such provisions, it seems natural that the question whether South Africa did tax the earnings of its residents employed abroad was not investigated.

The Court may have been indirectly influenced by trying to avoid conflicts of qualification. This is unnecessary. Even if the UK qualified income as something which it could tax South Africa would still be obliged to give credit under its domestic rules, in accordance with Article 23 (see paragraph 32.1 onwards of the Commentary). Article 23(1) of the Treaty makes South Africa's obligation to provide relief for UK tax imposed in accordance with the Treaty "subject to" South Africa's unilateral foreign tax credit rules (the same reference applies to the UK under Article 23(2)). This link between treaty relief and domestic law is important because unlike the UK, South Africa does not have a schedular approach to income taxation. Rather, for income tax liability a global notion of income applies such that it is not necessary to characterise income of residents as either employment or trading income (the charging section simply refers to "amounts" "received" or "accrued"[49]). Under the unilateral foreign tax credit rules, relief is given if the income, as defined in the broad sense (that is, income of any kind), is not received from a

[47] Any tax would have to be collected from Mr Fowler either by using the assistance in collection provision in the Treaty Art.25A or under a secondary-liability notice from the licence holder under TMA 1970 Pt 7A. Although there are provisions for collecting tax from non-resident self-employed taxpayers in ITA 2007 s.835C onwards they are inapplicable as there is no UK representative.

[48] See, for example, the discussion in A. Nikolakakis, "The Unthinkable Anathema of Double Non-Taxation: The Relevance and Implications of Foreign Tax Considerations in the Context of Applying GAAR" (2010) 58 (special supp.) *Canadian Tax Journal* 243; M. Lang, "General Report on Subject I: Double non-taxation" in IFA, *Cahiers de droit fiscal international* (2004), Vol.89a, 77–119. The position has changed for treaties where the preamble is modified by the Multilateral Instrument: OECD, *Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion And Profit Shifting* (24 November 2016).

[49] Income Tax Act, 58 of 1962 s.1 definition of "gross income": "means…in case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident".

source within South Africa.[50] As a consequence, treaty relief in South Africa would not be affected by the head under which the UK taxes, as long as the income is sourced there.

An interesting development on whether deeming is contrary to the purpose of a treaty is that, only days after the Court's decision not to apply a deeming to a treaty, the revenue authority of the Netherlands sent a Tax Treaty Policy Memorandum to their Parliament proposing that:

> "The Netherlands intends to stipulate in the relevant treaty relations that certain fictions or fiction-like regulations included in the domestic legislation affect the tax treaty."[51]

The background to this memorandum is a series of decisions since 2003 by the Supreme Court of the Netherlands about the application or not of deeming to tax treaties of the Netherlands.[52] That should make an interesting negotiation when they next discuss their treaty with the UK.

Conclusions

The decision of the Court reinforces the view that domestic law deeming rules may in certain cases neither affect the meaning or interpretation of a term, nor the legal qualification of facts, and may fall into a third category of rules that presume the ordinary meaning of a term, and the normal legal qualification of facts, but direct the manner in which taxes are levied, by providing something to be treated for tax that it is not, without thereby necessarily affecting the application of a tax treaty. This may depend on the type of income in question, given that certain tax treaty rules may be conditioned on income being subjected to a particular tax treatment which is the same as the tax treatment to which other types of income may be subjected.

The Court's decision also to some extent suggests that there may be an important distinction between domestic law deeming rules that affect the meaning or interpretation of a term and those that affect the legal qualification of facts, although the reasons are not clear in this regard. This may be important mainly with regard to the application of provisions such as Article 3(2) of the Treaty, and the ambulatory approach that it reflects (which was not an issue here as the deeming existed before the Treaty). Moreover, if a domestic law definition applied *only* for treaty purposes, one might even question whether it is truly "the meaning" that the term has under the tax law of the Contracting State, in that this would be a special meaning not a general meaning. What is clear is that section 15 ITTOIA has been held to be neither of these, and, in that sense, is neither fish nor fowl.

While uncertainty is never welcomed, the Court's decision should be taken in a different context, where taxing rights are appropriated rather than surrendered, as a caution against interpretations that could be inconsistent with the principle of *pacta sunt servanda* and the requirement of good faith and may fall into the third category.

[50] Income Tax Act, 58 of 1962, s.6*quat*(1)(a), (1A)(a)(i).

[51] *Notitie Fiscaal Verdragsbeleid 2020* (29 May 2020). Unofficial translation kindly supplied by Frank Pötgens.

[52] Dutch law has some deeming provisions in the direction of employment including agents, such as insurance agents, acting for one principal (Wage Withholding Tax Act art.3(1)(d)), contract work (production of an item at a fixed price) (art.3(1)(a)), and the possibility for a person engaging in miscellaneous activities falling short of an enterprise to opt to be treated as an employee (art.4(f)). It is thought that the first two might affect treaties and the third would not: see F. Pötgens, *Income from International Private Employment* (IBFD, 2007), Ch.V para.4.2.9, subpara.F.

What implication does the decision have for other deeming provisions? Some are irrelevant to treaties (such as farming and the commercial occupation of land being treated as the carrying on of a trade, and profits of mining concerns being calculated as if the concern were a trade[53] as the treaty defines immovable property to include these).[54] Others (such as IR35 and the off-payroll working regime for public sector clients[55]) deem payments to be employment income without creating a deemed employment so the issue of whether the definition of employment for domestic tax law has been expanded does not arise. Others (such as loans as disguised remuneration[56]) deem payments to a person who is undoubtedly an employee to be employment income which they would not otherwise be; these seem to be within the phrase "salaries, wages and other similar remuneration"[57] for treaty purposes. And finally, others (such as agency workers[58]) deem there to be an employment by the agency where in the real world the person is self-employed (the reverse of the scenario presented by the divers deeming). It now seems to be doubtful whether they are covered by the domestic tax law meaning of employment; there is no employment within section 4 ITEPA, merely a charge to tax under section 6 ITEPA, and on the approach of paragraph 8.11 of the OECD Commentary on Article 15 the deemed employment by the agency is hardly arrived at on the basis of objective criteria. If so, it would follow that the relevant treaty article applicable to the non-resident working in the UK is the business profits or dependent services article which means there is no UK taxation in the absence of a permanent establishment or fixed base, so PAYE cannot be applied by the agency. HMRC may regret having won the case.

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[53] ITTOIA ss.9, 10, and 12.
[54] Incidentally these provide examples of domestic law taxation being different from the Treaty categorisation of the income.
[55] ITEPA s.48 onwards; s.61K onwards.
[56] ITEPA s.554A onwards.
[57] OECD Model Art.15.
[58] ITEPA s.44.

Deeming provisions; Divers; Double taxation treaties; Employment income; Income tax; Legal fictions; South Africa; Trading income

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HMRC v University of Cambridge and *HMRC v Frank A Smart & Son Ltd*: deduction of input tax incurred on non-economic activities linked to downstream taxable supplies

The issue defined

In July 2019 two related decisions were promulgated: *HMRC v University of Cambridge* (*Cambridge*),[1] a decision of the European Court of Justice; and *HMRC v Frank A Smart & Son Ltd* (*Smart*),[2] a decision from Scotland of the UK Supreme Court. Both these cases involved a claim by a taxable person for input tax credit incurred in the course of non-economic activities on the basis that there was an immediate and direct link to future taxable activities for the purposes of Article 168 of Directive 2006/112/EC (the Principal VAT Directive or PVD).[3] The *Cambridge* case followed a reference to the Court of Justice of the European Union (CJEU) by the Court of Appeal[4] who regarded the issue as not being *acte clair*. In the event, dispensing with an Advocate General's Opinion, the CJEU refused the claim. In *Smart*, however, the Supreme Court declined to make a reference to the CJEU and in a single judgment allowed the claim.[5] Interestingly it had the CJEU decision in *Cambridge* before it before handing down its decision.

Article 168 provides:

> "In so far as the goods and services are used for the purposes of the taxed transactions of a taxable person, the taxable person shall be entitled…to deduct the following from the VAT which he is liable to pay: (a) the VAT due or paid…in respect of supplies to him of goods or services, carried out or to be carried out by another taxable person."

That is a fundamental right in the operation of VAT.[6]

In both cases the issue was whether input tax paid on the provision of services connected to the raising of funds (which is not of itself an economic activity) could be claimed under Article 168, where those funds were intended to be "used for the purposes of the taxed transactions of a taxable person"[7] which were downstream at the time of the fund-raising. The facts of the two cases, however, although apparently raising that same issue, were different in ways which proved in the end to be of great significance.

[1] *HMRC v University of Cambridge* (C-316/18) EU:C:2019:559; [2019] STC 1523.
[2] *HMRC v Frank A Smart & Son Ltd* [2019] UKSC 39; [2019] STC 1549.
[3] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax [2006] OJ L347/1. The UK implementation of this right of deduction is in VATA 1994 s.26 and The Value Added Tax Regulations 1995 (SI 1995/2518). Nothing in the cases turned on those.
[4] *HMRC v University of Cambridge* [2018] EWCA Civ 568; [2018] STC 848 at [58]. Both the First-tier Tribunal (FTT) (*University of Cambridge v HMRC* [2013] UKFTT 444 (TC)) and Upper Tribunal (UT) (*University of Cambridge v HMRC* [2015] UKUT 305 (TCC); [2015] STC 2353) had allowed the claim.
[5] The claim had also been allowed by the FTT (*Frank A Smart & Son Ltd v HMRC* (*Smart (FTT)*) [2014] UKFTT 1090 (TC)), the UT (*Frank A Smart & Son Ltd v HMRC* (*Smart (UT)*) [2016] UKUT 121 (TCC); [2016] STC 1956) and the Court of Session (IH) (*HMRC v Frank A Smart & Son Ltd* (*Smart (CSIH)*) [2017] CSIH 77; [2018] STC 806).
[6] To avoid double taxation: see *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549 at [65(i)] per Lord Hodge SCJ.
[7] This is the first requirement of PVD, above fn.3, Art.168 which proved to be of great significance for these two cases.

The factual analysis in Cambridge: the issue refined (1)

The University is a charity making predominantly exempt supplies of education, but which also makes taxable supplies such as commercial research, catering, accommodation, bar sales and the hiring of facilities and equipment. In line with standard practice for such partially exempt suppliers any input tax which is wholly attributable to taxable outputs is fully deductible and that which is wholly attributable to exempt outputs is not. More importantly where goods and services are used for both taxable and exempt supplies, the "residual input tax" on those is apportioned under an agreement with HMRC known as a partial exemption special method (PESM).[8] This is an application of the well-known "overheads" basis for deduction of input tax.[9]

The University receives donations and endowments which are then invested in a fund which in turn invests the money in a variety of securities and investments. The income generated by the fund is then used by the University to support all its activities. In the specimen year used in the case, the income generated by the fund was over £40 million which met approximately 6 per cent of the University's operational expenditure. The fund is managed by a professional fund manager which charges fees some of which are subject to VAT. The University now sought to claim the input tax paid on such fees as residual input tax under the PESM agreement. HMRC refused the claim on the basis that the management fees had a direct link only to the investment activity, which has long been held not to be an economic activity.[10] Accordingly they were outside the ambit of VAT and thus no input tax relief was available. The CJEU agreed that this applied equally to the costs associated with such investments.[11] The University, however, argued that those costs could instead be linked to its downstream taxable activities.

That issue, whether the fund-raising activities upstream could be linked for input tax relief to the University's downstream taxable activities, when the funds produced were used to reduce the price of all its activities, is the specific nub of the case.

The factual analysis in Smart: the issue refined (2)

The taxable person in *Smart*[12] was a one-man Scottish farming company (FASL) making only taxable supplies. The company, like other farmers, received government subsidies in the form of a number of single farm payment entitlements or SFPEs. The SFPEs were allocated according to the amount of eligible land held in "Good Agricultural and Environmental Condition".[13] These SFPEs were tradeable and a market developed over time. FASL bought on this market and purchased some 34,477 SFPE units.[14] In order to acquire these units, the company leased additional farmland up to the area of eligible land required to justify holding the additional units. These

[8] The residual input tax is the phrase used to denote the input tax which is not wholly attributable to either taxable or exempt supplies. The particular PESM was negotiated between HMRC and the Committee of Vice Chancellors and Principals.
[9] See, e.g. *CC&E v Midland Bank plc* (*Midland Bank*) (C-98/98) EU:C:2000:300; [2000] STC 501; [2000] ECR I-4177, and subsequent cases.
[10] There are several cases which establish this, and the point was not disputed by the University. See, e.g. *Kretztechnik AG v Finanzamt Linz* (*Kretztechnik*) (C-465/03) EU:C:2005:320; [2005] STC 1118; [2005] ECR I-4357.
[11] This was confirmed by the CJEU in *Cambridge* (C-316/18), above fn.1, [2019] STC 1523 at [30].
[12] *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549.
[13] *Smart*, above fn.2, [2019] UKSC 39 at [3].
[14] The farm's original allocation was 194.48 units.

were seasonal leases which allowed the landlords to continue to graze on the land but which required them to keep the land in the requisite good condition.[15] As a result the company built up a considerable income from subsidies in the years 2010 to 2013.[16] The company incurred input tax on its acquisition of the units. But, just as in *Cambridge*,[17] that investment activity was not an economic activity and so that input tax could not be reclaimed on the basis of a link to that activity.[18]

But significantly, as the First-tier Tribunal (FTT) found as a fact,[19] the company acquired the units with the intention of applying the income received from them in paying off its overdraft and developing its business operations. These developments were to establish a windfarm,[20] the construction of further farm buildings,[21] and the purchase of neighbouring farms which were expected to come on the market. There was no challenge to those findings. As a result, the FTT concluded that:

> "The financing opportunity afforded by purchasing the SFPE units did not form a distinct business activity in our view. Given the intended application of the profits *ab initio* it was a wholly integrated feature of the farming enterprise. It was not a separate enterprise."[22]

It followed that, in the FTT's view, the input tax incurred on the upstream activities could be deducted from the company's downstream taxable farming supplies as being part of the overheads of that business. That was also the view of the Upper Tribunal[23] and the Court of Session Inner House (CSIH).[24] No reference was made to the CJEU.

The case then reached the Supreme Court,[25] which upheld the decision of the CSIH. The issue before the Court was whether input tax incurred as part of a non-economic activity which raised funds commercially designed to be used in downstream business developments could be deducted as being sufficiently linked to that business so as to form part of its overheads. Factually that is different from *Cambridge* in that: 1. the investment activity was specifically found to be part of the business enterprise as opposed to general charitable fund-raising so that the trader was thus acting as a taxable person at that point; 2. all the company's outputs were taxable; and 3. the income was to be used to fund the development of its taxable business activities rather than to reduce the costs of its output activities both taxable and exempt.

The question arises as to whether in applying the law as to the overheads basis of downstream input tax deduction and as to what constitutes acting as a taxable person, all or any of these differences resulted in the different outcomes of the two cases.

[15] There was no obligation on the holders of the SFPEs to actually cultivate or stock the land themselves.
[16] In 2013 alone that income amounted to £3,285,650, as against some £275,389 from cattle sales. It is no wonder that Lord Hodge in the Supreme Court in *Smart* described this as an "interesting business model": *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549 at [2].
[17] *Cambridge* (C-316/18), above fn.1, EU:C:2019:559; [2019] STC 1523.
[18] The claim for input tax deduction was for £1,054,852.
[19] *Smart (FTT)*, above fn.5, [2014] UKFTT 1090 (TC) at [38].
[20] It had spent money on preliminary investigations into the project.
[21] Site preparation works and planning applications had been made.
[22] *Smart (FTT)*, above fn.5, [2014] UKFTT 1090 (TC) at [42].
[23] *Smart (UT)*, above fn.5, [2016] UKUT 121 (TCC); [2016] STC 1956.
[24] *Smart (CSIH)*, above fn.5, [2017] CSIH 77; [2018] STC 806.
[25] *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549.

There is an additional issue in relation to the decision in *Smart*, apart from the evidential point that the future development intentions must be shown to be genuine. If the input tax deduction is allowable against potential downstream activities, at what point can it be claimed? Is it at the time the input tax is incurred?[26] And, if so, what happens if in fact those developments are not carried out?

The right to deduct input tax

The initial requirement of Article 168 PVD: taxable person

Article 168 PVD requires that the claimant must be incurring the input tax for the purposes of a taxable transaction of a "taxable person". Unless the claimant is thus a taxable person, no question of "for the purposes of" can arise. A taxable person is defined in Article 9(1) PVD[27] as

> "any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity".

In cases such as the present where the relevant activity (for example, acquiring or selling shares, dealing in investments) is not regarded as an economic activity per se, the initial question is therefore whether there is something connected with that activity which nevertheless allows the court to find that the person was in fact acting as a taxable person at that time. Such a finding then allows the court to consider the subsequent question of the necessary link to allow a deduction under Article 168.

A classic example is the decision of the CJEU in *Ryanair Ltd v HMRC* (*Ryanair*).[28] Ryanair intended to make a takeover bid for another company and acquired a holding of its shares. That was not of itself an economic activity, but because the holding was intended to result in Ryanair becoming involved in the management of the target company (an economic activity), the position was different. The Court ruled accordingly:

> "Any person with the intention, as confirmed by objective elements of independently starting an economic activity, and who incurs the initial investment expenditure for those purposes must be regarded as a taxable person."[29]

Thus, the question as to whether a person is acting as a taxable person in incurring the input tax depends upon the purpose of the otherwise non-economic activity. If the purpose is to fund an economic activity, then those inputs may be deducted if the immediate and direct link criteria are also satisfied (see below).

The Supreme Court in *Smart* followed this classic approach. Lord Hodge was clear:

> "I am satisfied that there is no need for a reference in the present appeal. This is because, as I will seek to show, there are findings of fact that entitled the FTT to conclude that [the company] was acting as a taxable person because of its aim of accumulating sums to develop

[26] This is the general rule: see PVD, above fn.3, Art.167.
[27] PVD, above fn.3, 11.
[28] *Ryanair Ltd v HMRC* (C-249/17) EU:C:2018:834.
[29] *Ryanair* (C-249/17), above fn.28, EU:C:2018:834 at [18]. The issue in that case was whether being so regarded still applied when the proposed takeover failed. The answer was yes.

> its taxable business through capital expenditure on assets which it would use to generate taxable output transactions."[30]

In *Cambridge*, however, the CJEU found that in raising and collecting the donations and endowments (and incurring the associated costs) the University was not then acting as a taxable person and so must be regarded as the final consumer liable to bear the input VAT cost. Since the donations, etc. were made for subjective reasons and on a random basis they could not be regarded as consideration[31] for any economic activity regardless of the reasons why those donations were made.[32] As such they were outside the scope of VAT.

The distinction made by the CJEU therefore was between input tax incurred on non-economic activities which involve consideration and those which do not, irrespective of the purpose for which those activities were undertaken. This meant that the CJEU was on that basis, separating the fund-raising activities from the University's taxable activities irrespective of whether they were otherwise linked to the latter as a cost component. The conclusion must be that even if the fund-raising activities could not in any event be those of a taxable person (because of a lack of consideration for the acquisition of the funds) then even if they were for the purposes of a downstream economic activity, as in *Ryanair* or *Smart*, the person involved cannot be acting as a taxable person *ab initio* so as to satisfy Article 168.

It follows that if the sole reason for the costs of the fund-raising activities, etc. being regarded as non-economic activities initially is the nature of those activities, then that can be "cured" by following through to the intended use of those funds (*Smart*). But if there is another reason why the original fund-raising activities are not regarded as being within the scope of VAT such as the lack of any consideration,[33] then the acquisition and management costs cannot be transformed into the activities of a taxable person by reference to the purposed use of the funds raised. The CJEU regarded the nature of the acquisition of the funds as a game changer irrespective of their purposed use. The contrary position would be that if the management costs, etc. of the funds, however raised, are incurred for the purposes of funding a downstream economic activity, then the *Ryanair* test should be applied. The commerciality or otherwise of the acquisition of the funds would not be the significant factor, it would be the purposed use of acquiring those funds, so as to satisfy the necessary linkage, which matters.[34]

Interestingly, despite that decision on the taxable person issue in *Cambridge*, the CJEU nevertheless went on to consider whether the input tax would otherwise have actually been deductible from the downstream activities under Article 168. For the Supreme Court in *Smart* that was the main issue.

[30] *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549 at [59].
[31] Applying the CJEU decision in *Tolsma v Inspecteur der Omzetbelasting Leeuwarden* (C-16/93) [1994] STC 509; [1994] ECR I-743 (money paid to a street musician by passers-by).
[32] *Cambridge* (C-316/18), above fn.1, [2019] STC 1523 at [30].
[33] VAT only applies to persons making taxable supplies and such supplies must be for a consideration. See, e.g. *Apple and Pear Development Council v CC&E* (C-102/86) EU:C:1988:120; [1988] STC 221 (ECJ).
[34] If X is a shrewd investor and uses the acquired funds to takeover and manage a company, whereas Y borrows the money for the same purpose, should there on that basis be a difference as regards the input tax paid on the management, etc. of those funds?

The second requirement of Article 168 PVD: immediate and direct link

There was no dispute between the two cases as to the legal requirements for linking input and output transactions made by taxable persons so as to allow deductibility under Article 168 PVD. As developed by a series of cases before the CJEU,[35] both Courts agreed that there are two ways under which such an input tax deduction will be allowed. The first is that there is an immediate and direct link between a particular input transaction and a particular output transaction(s). This is often expressed as requiring that the input transaction be a cost component of the specific goods or services provided.[36] The second way is known as the overheads' exception. Both Courts expressed this exception in similar terms. According to the CJEU in *Cambridge*, this is where although there is no such link with a specific output transaction the input transaction(s) form part of the trader's general costs, which are reflected in the outputs.[37] According to the Supreme Court in *Smart*, they must have the necessary link to (and form cost components of) the trader's economic activities as a whole and so form part of its overheads.[38] Naturally, if they do not form part of these general overheads then only the first route is available.[39]

Downstream element

It was common ground in both cases that the input tax incurred on the investment activities could not be deducted as being directly linked to any specific output.[40] The cases therefore focussed on whether the overheads route could apply on the facts. Both Courts accepted that the downstream element (using the funds acquired at a later date) was not of itself a bar to such overheads' deductions. This had been made clear by the CJEU in *Kretztechnik AG v Finanzamt Linz* (*Kretztechnik*).[41] The company in that case had issued shares (a non-economic activity) in the course of which it had incurred input tax. The Court held that nevertheless the company could deduct that input tax as the money raised was to benefit its subsequent general trading activities. The input supplies were part of its business overheads. Lord Hodge in *Smart*, in citing this case, used the word "develop" rather than "benefit" which of course related to the facts of

[35] See, e.g. *Midland Bank* (C-98/98), above fn.9, [2000] STC 501; *Abbey National plc v CC&E* (C-408/98) EU:C:2001:110; [2001] STC 297; [2001] ECR I-1361; *Kretztechnik* (C-465/03), above fn.10, [2005] STC 1118; *Securenta Göttinger Immobilienanlagen und Vermögensmanagement AG v Finanzamt Göttingen* (*Securenta Göttinger*) (C-437/06) EU:C:2008:166; [2008] STC 3473; [2008] ECR I-1597 cited by the Supreme Court in *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549. The CJEU in *Cambridge* (C-316/18), above fn.1, EU:C:2019:559; [2019] STC 1523 cited *Staatssecretaris van Financien v X BV* (C-651/11) EU:C:2013:346; [2013] STC 1893 and *Direktor na Direktsia 'Obzhalvane i danachno-osiguritelna praktika' - Sofia v 'Iberdrola Inmobiliaria Real Estate Investments' EOOD* (*EOOD*) (C-132/16) EU:C:2017:683; [2017] STI 2102; [2017] BVC 39.

[36] *Cambridge* (C-316/18), above fn.1, [2019] STC 1523 at [25]; *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549 at [65(ii)].

[37] *Cambridge* (C-316/18), above fn.1, [2019] STC 1523 at [26]–[27]. The cases in fn.35 were also cited for this proposition.

[38] *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549 at [65(iii)]. The cases in fn.35 were also cited for this proposition.

[39] For a recent example see *HMRC v Royal Opera House Covent Garden Foundation* [2020] UKUT 132 (TCC); [2020] STC 1170.

[40] *Cambridge* (C-316/18), above fn.1, [2019] STC 1523 at [30]; *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549 at [65(iv)].

[41] *Kretztechnik* (C-465/03), above fn.10, [2005] STC 1118. See also *Securenta Göttinger* (C-437/06), above fn.35, EU:C:2008:166; [2008] STC 3473.

the case before him.[42] The CJEU in *Cambridge*, with a view to the facts of that case, emphasised that this applied only if the right to deduct arose in the context of the taxable person's economic activity, that is, those costs were incorporated into the price of goods and services provided by the taxable person in the context of that economic activity.[43]

Applying Article 168 PVD to the facts

As noted above, despite its decision on the taxable person point, the CJEU in *Cambridge* went on to consider whether the *Kretztechnik*[44] line of authority would have otherwise[45] allowed the input tax to be linked to the University's downstream taxable supplies.[46] Its answer was negative based on the University's use of the funds generated by the non-economic activity:

> "[A]s…the costs at issue are incurred in order to generate resources that are used to finance all of that university's output transactions, thus allowing the price of the goods and services provided by the latter to be reduced, those costs cannot be considered to be components of those prices and, consequently, do not form part of that university's overheads."[47]

No cases were cited in support of this part of the decision and no further explanation or analysis was given.[48] If it is correct, then using funds to simply reduce the final price of supplies does not amount to a cost component of them even as residual input tax, whereas funding part of the process of making those supplies, for example subsidising buying raw materials, does. The economic effect is however the same: the final cost of the supplies to the consumer is reduced.

That distinction is, however, made clearer by the decision in *Smart* that a deduction would be allowed. The funds raised by the dealings in SFPE units intended to be used to fund the developments of the farming business downstream could be deducted under the *Kretztechnik* principle:

> "Where the taxable person acquires professional services for an initial fundraising transaction which is outside the scope of VAT, that use of the services does not prevent it from deducting the VAT payable on those services as input tax and retaining that deduction if its purpose in fundraising, objectively ascertained, was to fund its economic activity and it later uses the funds raised to develop its business of providing taxable supplies."[49]

[42] *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549 at [65(iv)].
[43] *Cambridge* (C-316/18), above fn.1, [2019] STC 1523 at [31].
[44] *Kretztechnik* (C-465/03), above fn.10, [2005] STC 1118. See fn.41 above.
[45] This was not stated expressly as such, but the two issues were identified separately in the judgment: *Cambridge* (C-316/18), above fn.1, [2019] STC 1523 at [29] and [32].
[46] The CJEU considered this issue without ostensibly referring back to its decision on the taxable person point, although the connection may in fact have been relevant: see below.
[47] *Cambridge* (C-316/18), above fn.1, [2019] STC 1523 at [32].
[48] Did it matter, for example, that many of the supplies so subsidised were exempt?
[49] *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549 at [65(iv)].

It followed that, since the FTT had found as a fact that the purchase of the units and receipt of the subsidies was a single transaction which was part of the raising of funds for the company's economic activities, that principle applied.[50]

In *Smart*, Lord Hodge referred to the decision of the CJEU in *Cambridge*,[51] and its reasoning, set out above,[52] of denying a deduction on the basis of price reduction by subsidising all the University's activities rather than funding the cost of making a supply.[53] He considered that such a distinction was sound and in line with the established case law,[54] although he gave no explanation or analysis for that endorsement. It is true that many of the University's activities funded by the endowments, etc. were exempt but since there can be apportionment of input tax in such circumstances that should not be a relevant factor. Therefore, what is left is the distinction between a reduction effected by applying the funds to the costs of the downstream supply (*Smart*) and one effected by subsidising the final price of the downstream supply to the consumer (*Cambridge*). Whether that is a valid distinction or not, perhaps in the light of the principle of neutrality, which may be open to doubt, it is one clear difference between the two decisions.

But there would seem to be a better way of distinguishing between the two cases, relating not to the cost component issue, but, instead, to the need to be acting as a taxable person in relation to the fund-raising. In *Smart*, in relation to both the funding activities and the intended use of the funds, the company was regarded as acting as a taxable person pursuing economic activities. Trading in the units was thus subsumed into a downstream commercial activity. In *Cambridge*, however, there was found to be a clear disjunct between the non-consideration funding activities (and therefore not acting as a taxable person) and the intended use of those funds downstream. If the University in *Cambridge* had raised the funds by a commercial process such as in *Smart*, but then used those funds to subsidise all its activities, should the results of the two cases not have been the same?

Effect of planned downstream activities not taking place

A further issue which arises from the linking of input tax to intended downstream activities as in *Smart*[55] is a possible consequence of the time lapse between the two activities. What is to happen if the intended downstream taxable activities do not actually take place? Apart from the obvious evidential point as to intention, the question is: when does the right to deduct input tax arise and, if that is when the input tax was incurred, can that right to deduct be subsequently rescinded? This issue was not canvassed in *Cambridge*, but it was in *Smart*. For Lord Hodge the answer was clear:

[50] *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549 at [67]. Lord Hodge continued that this was simply an application of the principle of neutrality to inputs incurred in the course of taxable activities. That of course begs the question as to whether the input was so incurred.
[51] *Cambridge* (C-316/18), above fn.1, EU:C:2019:559; [2019] STC 1523.
[52] See fn.47 above.
[53] *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549 at [63].
[54] *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549 at [64].
[55] *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549.

> "The right to deduct VAT as input tax arises immediately when the deductible tax becomes chargeable[56]…if the taxable person acquired the goods and services for its economic activity but, as a result of circumstances beyond its control, it is unable to use them in the context of taxable transactions, the taxable person retains its entitlement to deduct."[57]

For that second, very relevant, proposition Lord Hodge cited part of the CJEU judgment in *CC&E v Midland Bank plc*.[58] This is to the effect that once the entitlement to deduct has arisen it is retained even though the economic activity envisaged does not give rise to taxed transactions

> "or the taxable person has been unable to use the goods or services which give rise to a deduction in the context of taxable transactions by reason of circumstances beyond his control".[59]

In fact, the Court in that case used this to in effect "set up" the overheads' exception.[60] It clearly did not have the downstream issue in mind. Nevertheless, it is a very clear statement and, as a general principle, it has recently been confirmed, albeit with a significant twist, by Kokott AG in her Opinion in the case of *Sonaecom SGPS SA v Autoridade Tributária e Aduaneira*.[61] In a familiar scenario, the company wished to acquire shares in another company and then to supply taxable management services to it. By way of preparation it used consultancy services and services relating to the issue of corporate bonds. Established case law would allow a downstream link between the consultancy services and the management services, but in fact the company was unable to acquire the shares and instead made the funds raised available as an exempt loan to the parent company of the target company. With regard to the consultancy services inputs the AG had no doubt that that had no effect on the established right to a deduction on the overheads' exception.[62]

But, by way of an interesting twist, Kokott AG considered that the same did not apply to the inputs incurred in putting together the bond issues where the capital raised was then transferred to the parent company as an exempt loan, rather than to fund the acquisition of shares for future management purposes. She considered that there was in that situation an immediate and direct link to the exempt loan transaction which took precedence over the overheads' exception.[63] Thus, in those circumstances, the effect was that the actual use of the sums raised took precedence

[56] PVD, above fn.3, Art.167 provides: "A right to deduct shall arise at the time the deductible tax becomes chargeable."
[57] *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549 at [65(vi)].
[58] See *Smart*, above fn.2, [2019] UKSC 39; [2019] STC 1549 at [29]; *Midland Bank* (C-98/98), above fn.9, [2000] STC 501.
[59] *Midland Bank* (C-98/98), above fn.9, [2000] STC 501 at [22]. The Court referred at [20] and [21] inter alia to *Intercommunale voor zeewaterontzilting (INZO) v Belgian State* (C-110/94) EU:C:1996:67; [1996] ECR I-857.
[60] *Midland Bank* (C-98/98), above fn.9, [2000] STC 501 at [23].
[61] Opinion of Advocate General Kokott in *Sonaecom SGPS SA v Autoridade Tributária e Aduaneira* (Opinion of Advocate General Kokott in *Sonaecom*) (C-42/19) EU:C:2020:378. The judgment in that case is awaited.
[62] Opinion of Advocate General Kokott in *Sonaecom* (C-42/19), above fn.61, EU:C:2020:378 at [48].
[63] Opinion of Advocate General Kokott in *Sonaecom* (C-42/19), above fn.61, EU:C:2020:378 at [59]–[60], citing *'Sveda' UAB v Valstybine mokesciu inspekcija prie Lietuvos Respublikos finansu ministerijos* (C-126/14) EU:C:2015:712; [2016] STC 447, and *EOOD* (C-132/16), above fn.35, EU:C:2017:683; [2017] STI 2102. This would seem to be clearly established.

over the planned use.[64] If the combined effect of those two propositions[65] is confirmed by the Court then it follows that if the funds raised, for example in *Smart*, were in fact subsequently used to effect an exempt transfer rather than the planned expansion of the farm business, the accrued right to deduct the input tax downstream on the overheads' basis would be revoked by the change of use to a specific exempt supply. The jury is out on that one. ☞

Geoffrey Morse*

Arron Banks v HMRC: establishing discrimination

Introduction

The Upper Tribunal (UT) considered the application of the human rights regime to inheritance tax provisions in *Arron Banks v HMRC* (*Banks*).[1] In *Banks*, the UT has shown that identification of a proscribed ground status within the context of the European Convention on Human Rights continues to prove difficult for taxpayers. Further, reliance upon historical materials to determine legislative intent and legitimate aim continues to pose difficulties.

The facts

Mr Banks (and a company controlled by Mr Banks) made donations to the UK Independence Party (UKIP) and an affiliated organisation totalling £976,781.38 between 7 October 2014 and 31 March 2015 (the Relevant Period).[2]

At the UK General Election (in May 2010) immediately preceding the Relevant Period, UKIP failed to achieve the election of any of its candidates to the House of Commons, despite securing 3.1 per cent of total votes cast.[3]UKIP did succeed in obtaining 24 European Parliamentary seats (more than any other single party) at the 2014 European Parliamentary Elections.[4] In March 2014, Ofcom (the UK broadcast, telecommunications and postal regulatory authority) recognised UKIP as having "major party status" for the purposes of the UK General Election in May 2015.[5] UKIP subsequently succeeded in returning two Members of Parliament in by-elections which took place in October and November 2014. At the UK General Election on 7 May 2015, UKIP secured 12.6 per cent of total votes cast, and had one of its candidates elected as an MP.[6]

[64] Opinion of Advocate General Kokott in *Sonaecom* (C-42/19), above fn.61, EU:C:2020:378 at [65].
[65] That the overheads' exception will not apply if there is an immediate and direct link to a specific transaction (established) and that this can then revoke an accrued right to input tax deduction (novel).

☞ EU law; Farming; Fundraising; Input tax; Scotland; Subsidies; Taxable persons; Universities; VAT

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[1] *Arron Banks v HMRC* [2020] UKUT 101 (TCC).
[2] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [14].
[3] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [14].
[4] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [14].
[5] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [14].
[6] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [14].

HMRC assessed Mr Banks to inheritance tax in the amount of £162,945.34 as a consequence of his donations.[7] Mr Banks unsuccessfully appealed the notice of determination which raised this assessment at the First-tier Tribunal (FTT)[8] and sought to argue at the UT that his donations (and the donations made by a company controlled by him)[9] qualified for the exemption from inheritance tax available under section 24 of the Inheritance Tax Act 1984 (IHTA) (gifts to political parties).

The inheritance tax legislation in issue

Inheritance tax is the successor to capital transfer tax (1974–1986) and estate duty (1894–1974).[10] Inheritance tax is a misnomer in the sense that the charge to tax is not only contingent upon death or the act of inheriting money/property, but also anticipates death by also applying to certain transfers made that reduce the value of the disponor's estate while the disponor is alive (as was the case in *Banks*). Inheritance tax retains certain concepts and features from its predecessors including the concept of a "transfer of value", now found in section 3 IHTA. A "transfer of value" is, subject to exceptions provided by section 3 IHTA, a disposition made by a disponor as a result of which the value of their estate immediately after the disposition is less than what it would be but for the disposition; and the amount by which it is less is the value transferred by the transfer. A transfer of value becomes a chargeable transfer[11] subject to the charge to inheritance tax, unless it is an exempt transfer.[12]

The central issue at stake in *Banks* was whether section 24 IHTA rendered the transfer(s) of value, exempt transfer(s).[13]

So far as relevant, section 24 IHTA reads as follows:

> **"24.— Gifts to political parties.**
>
> (1) Transfers of value are exempt to the extent that the values transferred by them—
>
> (a) are attributable to property which becomes the property of a political party qualifying for exemption under this section;
>
> (2) A political party qualifies for exemption under this section if, at the last general election preceding the transfer of value,—
>
> (a) two members of that party were elected to the House of Commons, or
>
> (b) one member of that party was elected to the House of Commons and not less than 150,000 votes were given to candidates who were members of that party."

[7] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [1].
[8] *Arron Banks v HMRC* (*Banks FTT*) [2018] UKFTT 617 (TC).
[9] By virtue of IHTA s.94 the "transfers of value" comprising the donations made by a company controlled by an individual can be treated as having been made by such individual.
[10] On the history of inheritance tax see J. Tiley, "Death and Taxes" [2007] BTR 300.
[11] IHTA s.2.
[12] IHTA s.3.
[13] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [3].

The parties agreed that the donations made by, or treated as having been made by Mr Banks were transfers of value.[14] Mr Banks also accepted that a strict application of section 24 IHTA would preclude these transfers of value from falling within that exemption.[15]

The human rights and EU law dimension

Mr Banks put the following arguments before the UT, arguing that a strict application of section 24 IHTA involved[16]:

> "1. discrimination contrary to Article 14 of the European Convention on Human Rights ('ECHR') together with Article 1 of the First Protocol to the ECHR ('A1P1') (protection of property);
> 2. discrimination contrary to Article 14 ECHR together with either Article 10 ECHR (freedom of expression) or Article 11 ECHR (freedom of assembly);
> 3. a breach of Mr Banks's rights under Article 10 ECHR or under Article 11 ECHR; and
> 4. a breach of UKIP's rights under the ECHR."

Mr Banks argued that, to the extent which the application of section 24 IHTA constitutes a breach of the ECHR, the UT must, so far as it is possible to do so, read and give effect to section 24 IHTA in a way which is compatible with his ECHR rights in accordance with section 3 of the Human Rights Act 1998 (HRA).[17] Mr Banks contended that such construction was possible and would extend the exemption offered by section 24 IHTA to the donations in question. In the alternative, it was argued that section 24 IHTA contravened EU law.[18]

The approach of the UT considered

Article 14 ECHR taken with A1P1

The UT considered each of the above arguments in turn, beginning with the argument that the difference in treatment between Mr Banks and a hypothetical individual who did receive an exemption under section 24 IHTA in 2014 amounted to discrimination proscribed by Article 14 ECHR taken together with A1P1.

The structure of the UT decision mirrored that of the FTT in adopting the approach set out by Lord Steyn in *R. (on the application of S) v Chief Constable of South Yorkshire Police*.[19] The criteria are as follows:

> "(1) Do the facts fall within the ambit of one or more of the Convention rights?

[14] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [2].
[15] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [6].
[16] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [7].
[17] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [8].
[18] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [9].
[19] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [23]: *R. (on the application of S) v Chief Constable of South Yorkshire Police* [2004] UKHL 39; [2004] 1 WLR 2196 at [42]. See also *R. (on the application of Stott) v Secretary of State for Justice* [2018] UKSC 59; [2018] 3 WLR 1831 at [207]. The Steyn criteria can be collapsed into four questions rather than the five, but decisions should not turn on the exact formulation used.

(2) Was there a difference in treatment in respect of that right between the complainant and others put forward for comparison?
(3) If so, was the difference in treatment on one or more of the proscribed grounds under article 14?
(4) Were those others in an analogous situation?
(5) Was the difference in treatment objectively justifiable in the sense that it had a legitimate aim and bore a reasonable relationship of proportionality to that aim?"

A1P1 states:

> "Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.
>
> The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties."

Article 14 ECHR states:

> "The enjoyment of the rights and freedoms set forth in this Convention shall be secured without discrimination on any ground such as sex, race, colour, language, religion, political or other opinion, national or social origin, association with a national minority, property, birth or other status."

The Tribunal necessarily began by considering whether the difference in treatment was on one or more of the proscribed grounds under Article 14.[20] The UT drew on a range of case law to consider whether either direct or indirect discrimination had occurred based on Mr Banks' status as the holder of a political opinion or as a supporter or UKIP, in violation of his A1P1 rights. It was accepted that A1P1 rights were engaged because the tax provisions in question deprived Mr Banks of the sum of money in the payment of inheritance tax, and it was agreed that there was a difference in treatment in respect of A1P1 rights between Mr Banks and, for example, Labour Party supporters (an analogous grouping).[21] Further, the UT accepted HMRC's argument that status as a supporter of UKIP was indistinguishable from holding a particular political opinion within the meaning of Article 14 ECHR, and therefore it was not necessary to consider "supporter of UKIP" as an "other status".[22]

Direct discrimination

The UT defined direct discrimination by reference to *Preddy v Bull* (*Preddy*),[23] concluding that direct discrimination may only be proved if it can be said that[24]:

[20] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [57].
[21] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [30] and [56].
[22] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [65].
[23] *Preddy v Bull* [2013] UKSC 73; [2013] 1 WLR 3741.
[24] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [67] and [68]; *Preddy*, above fn.23, [2013] 1 WLR 3741: *James v Eastleigh Borough Council* (*James*) [1990] 2 AC 751 (HL).

1. the face of section 24 IHTA discriminates against persons sharing the status of holder of a particular political opinion or as a supporter of UKIP; or
2. there is an "indissociable link"[25] between the conditions set out in section 24 IHTA and the relevant statuses on terms set out in *James v Eastleigh Borough Council*.[26]

The core principle that the Tribunal's reasoning rested upon was that direct discrimination must be considered by reference to status rather than in the abstract.[27] It is not enough to show that there are instances of individuals receiving more favourable treatment (for example, donors to the Labour Party), but that reference must be given to Mr Banks' particular status of UKIP supporter vis-à-vis political parties more generally.[28] Focussing on the question of whether the face of section 24 IHTA discriminates against persons sharing the status of holder of a particular political opinion or as a supporter of UKIP, it is difficult to see how the UT could have reached a different conclusion. The Tribunal used the example of the Green Party to show that the legislation does not distinguish between political parties (even though certain donors to certain political parties did receive more favourable treatment).[29] The principle enumerated above seems to produce the result that in order to be successful on this point, Mr Banks would have been required to show that discrimination was suffered by donors of other political parties sharing a common characteristic, by for example showing that all Brexit-oriented political parties did not benefit from the exemption as a result of the plain wording of the legislation. This would seem impossible in so far as the criteria were measured on the basis of electoral success.

Flowing from the above, an "indissociable link" would seem impossible to prove on the basis that UKIP could meet the criteria of section 24 IHTA at any time, and indeed did meet the criteria after the 2015 UK General Election.[30] Therefore, the situation of a UKIP donor was not indissociable from failing to meet the criteria. This is notwithstanding the fact that discrimination is judged by reference to the time discrimination is alleged to have taken place (that is, beginning in 2014). The criteria set out in section 24 applied by reference to UKIP's measure of electoral success, rather than by reference to the statuses claimed by Mr Banks. Therefore, it is difficult to accept that the criteria coincide with Mr Banks' status(es) to form an indissociable link, and are discriminatory, as required by the authorities brought to the attention of the Tribunal.

Indirect discrimination

It seems clear that the principle outlined above (that discrimination must be by reference to status) was also determinative in the question of whether indirect discrimination had occurred. The Tribunal determined:

> "Although it might be argued that it is obvious that the conditions in s 24(2) IHTA had a disproportionately prejudicial effect on UKIP supporters in that donors to UKIP did not obtain tax relief, whereas donors to other parties such as the Labour Party or Conservative

[25] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [70].
[26] *James*, above fn.24, [1990] 2 AC 751.
[27] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [70].
[28] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [70] and [71].
[29] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [74].
[30] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [85].

> Party did, the conditions equally disadvantaged other parties not represented in the Westminster Parliament in the manner required by the conditions, *whatever their political persuasion*." (Emphasis added.)[31]

The key focus of the Tribunal again is whether the criteria applied are indirectly discriminatory by reference to status, rather than by reference to the relative electoral success of the political parties which serve as the vehicle of expression of such political persuasion. It is unhelpful that the Tribunal frames its determination in the terms of "other parties" being "equally disadvantaged" rather than focussing on the lack of coincidence between status and the criteria's basis of electoral success. That lack of coincidence also appears to form the basis of the determination that the only relevant prejudicial effect was on all of those supporters of parties that did not meet the conditions at the relevant time.

Other status

The status of a supporter of UKIP and status as holder of a particular political opinion were deemed to be equivalent for the purposes of Article 14 ECHR.[32] However, Mr Banks also requested that the Tribunal considered his status as supporter of a "new party" or as a "supporter of a party without an MP", as "other statuses" within the meaning of Article 14.[33] When considering the principle above (that discrimination must be by reference to status), prima facie, one might feel sympathetic to Mr Banks' technical arguments. These purported other statuses seem to put supporters of UKIP squarely within the same status as all other political parties which would fail to meet the section 24(2) criteria and demonstrate discrimination *by reference to status* on the face of the legislation. However, as the UT found, a thorough analysis of these purported "other statuses" must fail to demonstrate discrimination.

The status as "supporter of a party without an MP" was given short shrift. It is clear from the authorities that an "other status" within the meaning of Article 14 cannot be reverse engineered from the criteria, as criteria necessarily divide persons into those who meet the conditions and those who do not. The status as "supporter of a party without an MP" directly references, and coincides with, the criteria and thus cannot be regarded as another status upon which discrimination is premised because it does not have "independent existence" of the discrimination complained of. No consideration was given to whether "supporter of a party disadvantaged by plurality voting" (or similar) could be a relevant status. Such status would be thought to have "independent existence" of the discrimination complained of, as it is a product of the "first past the post" plurality voting system used to generate the purportedly discriminatory criteria.

The status as "supporter of a new party" was given more pragmatic treatment by the Tribunal. The temptation here would have been to treat the status of "supporter of a new party" as an extension to the status of "supporter of a party without an MP", albeit one step removed. However, through consideration of the authority, the Tribunal distilled the concept that the more debatable a proposed other status was, the less likely it was to constitute other status, and astutely dealt

[31] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [85].
[32] See fn.22.
[33] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [61].

with the evidentiary problems that consideration presented to determine that "supporter of a new party" could not be an "other status".[34]

Legitimate aim and proportionality

The Tribunal was not required to determine: 1. whether or not the differential treatment had a legitimate aim; and 2. whether or not the differential treatment was reasonably proportionate to that aim in accordance with Lord Steyn's formulation.[35] The FTT determined that the difference in treatment was in pursuit of a legitimate aim, being that to prevent abuse the exemption should be restricted to political parties that play a meaningful role within the national debate.[36] However, the FTT[37] went on to state that section 24(2) IHTA was not a proportionate means for achieving that legitimate aim because the concentration on MPs elected at the previous election under a first past the post system did not strike a fair balance in the context of the provision of tax relief for the funding of political parties.[38] The UT chose to demonstrate that the conclusions of the FTT were incorrect by reference to an exercise in legislative history.[39]

Here, the UT determined the purpose of the legislation by reference to a thorough analysis of legislative history. Ultimately, by consideration of the "Short Money Rules" and the predecessors to inheritance tax noted above, the Tribunal determined that the purpose of the exemption in section 24 is

> "to provide tax relief on donations to political parties that are participating in Parliamentary democracy by being represented in the House of Commons, and not in respect of individual independent MPs".[40]

The supposed error of the FTT was adding anti-abuse colour to the legislation, and this led the FTT to conclude that the legislation was disproportionate by reference to the incorrect legitimate aim.[41]

The Short Money Rules comprise two resolutions of the House of Commons, which have been consolidated and updated by the House of Commons Members Estimate Committee.[42] The Short Money Rules allocate opposition parties three components of expenditure, being: general funding for opposition parties; travel expenses for opposition parties; and funding for the Leader of the Opposition's Office. The Short Money Rules allocate funding to opposition parties in the House of Commons that secured either two seats, or one seat and more than 150,000 votes at the previous General Election.

The UT traced the genesis of section 24 IHTA to a rejected amendment tabled by the then opposition MP, Nigel Lawson, to the capital transfer tax regime.[43] The amendment proposed by

[34] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [190].
[35] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [10].
[36] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [10].
[37] *Banks FTT*, above fn.8, [2018] UKFTT 617 (TC).
[38] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [10].
[39] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [140] onwards.
[40] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [150].
[41] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [150].
[42] House of Commons, R. Kelly, *Short Money* (2020), Commons Research Briefing SN01663.
[43] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [145].

Mr Lawson (as he then was) was in substantively the same form as section 24 IHTA, paralleling the criteria of the Short Money Rules. Mr Lawson's amendment was subsequently adopted by a Government amendment to the capital transfer tax. That Government amendment was introduced at the report stage of the Finance Bill which became the Finance Act 1975, as part of the replacement of estate duty by capital transfer tax (subsequently renamed inheritance tax).[44]

It is interesting that the UT chose to rely upon this history to determine the purpose of section 24 IHTA. Statements made by Mr Lawson inferring that "consistency" as between the (now) "inheritance tax" regime and Short Money Rules were relied upon by the UT in concluding that the purpose of section 24 IHTA is to provide tax relief on donations to political parties that are participating in Parliamentary democracy by being represented in the House of Commons.[45] The UT acknowledges that compliance with the criteria for the use of Parliamentary material laid out in *Wilson v First County Trust Ltd (No 2)* (*Wilson*)[46] is required in determining purpose.[47] Further, the Tribunal acknowledges that compliance with Convention rights must be tested by reference to current circumstances.[48] Therefore, one may question whether determinative weight should be given to the statements of Lawson and no consideration given to the introduction of "Representative Money".

In *Wilson*, Lord Nicholls provided guidance on the approach to using Parliamentary materials in identifying the legislative intent underpinning a statute and assessing proportionality in the ECHR context. Distinct from the rule in *Pepper v Hart*,[49] courts may examine Parliamentary debate to better understand the rationale underlying legislation but must not give determinative weight, nor should a ministerial or other statement be treated as indicative of the objective intention of Parliament. From the face of section 24 IHTA, it is only clear that donations must be made to a political party and that a broad level of support going beyond a single constituency is required. In working out what the purpose was of section 24 IHTA, the UT would appear to have given considerable weight to the statements of what was then an opposition MP.

Further, the UT did not consider the introduction of Representative Money, which grants funding allocation to political parties which do not participate in Parliamentary democracy, such as Sinn Féin.[50] Representative Money was introduced in a motion providing funding for

> "expenses wholly, exclusively and necessarily incurred for the employment of staff and related support to Members designated as that party's spokesman in relation to the party's representative business".[51]

There is no mention of participation in Parliamentary democracy, and the common thread appears to be that funding is allocated to political parties with broad support.

[44] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [145].
[45] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [149].
[46] *Wilson v First County Trust Ltd (No 2)* [2003] UKHL 40; [2004] 1 AC 816.
[47] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [138] and [144].
[48] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [144].
[49] *Pepper v Hart* [1993] AC 593; [1992] STC 898 (HL).
[50] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [151], and fn.6 of *Banks*.
[51] See House of Commons, Kelly, *Short Money*, above fn.42; The Journals of the House of Commons, Vol.262 (11 May 2005–8 November 2006) [No.105; WH, No.65].

Therefore, one might question whether the UT is correct in its view that, "the fact that [the Short Money Rules] remain unchanged in relevant respects, is noteworthy".[52] The overall regime has changed significantly. The conjuncture of funding for abstentionist parties (which do not participate in Parliamentary democracy), and a political party receiving in excess of 900,000 votes but not returning a single MP could have been considered in deciphering the purpose of section 24 IHTA, at least in the context of Convention rights.

The UT's consideration of whether there has been a breach of Article 10 and/or Article 11 ECHR alone

The UT determined that it was not apparent that the conditions in section 24(2) IHTA placed any restriction on Mr Banks' freedom of expression within Article 10(1) ECHR or his freedom of association under Article 11(1) ECHR.[53] The argument that freedom of association may have been breached seems weak. The existence of a tax charge did not restrict Mr Banks' ability to associate with UKIP (or anybody for that matter). Pragmatism prevailed in determining that Article 11(1) was not breached.[54]

However, it is that same pragmatism that meant that there was no further discussion of the issues in relation to Article 10 ECHR. The Tribunal concluded that as there was no evidence to support the argument that Mr Banks was deterred from expressing his opinions or supporting UKIP (whether by making donations or otherwise) it was not clear his freedom of expression was restricted.[55] HMRC had accepted that Mr Banks' decision to donate to UKIP was a manifestation of his political opinion.[56] It does not seem much of a stretch to conclude that the Tribunal ought to have considered whether Mr Banks' decision to donate to UKIP was a manifestation of his right to freedom of expression. If it had considered his decision to donate to UKIP was a manifestation of his right to freedom of expression, a more nuanced discussion of the (dis)incentive structure created by section 24 IHTA could have been drawn out. The extent to which the lack of exemption had an impact upon Mr Banks' expression (and the extent to which it reduced or deterred donations) could have fed into a clearer consideration of whether the legislation was proportionate in the context of the legitimate aim identified above. It is therefore regrettable that Counsel for Mr Banks argued that the (dis)incentive structure created a self-evident proposition that it interfered with Mr Banks' expression.[57] Introducing evidence to this effect could have forced a more detailed discussion.

The UT's consideration of UKIP's rights

The Tribunal dispatched the argument that UKIP's rights had been breached in two concise paragraphs of judgment, not least because the arguments were identical albeit from the perspective of the donee rather than the donor.[58] One wonders whether there was more to discuss here. The

[52] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [148].
[53] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [204].
[54] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [202] and [204].
[55] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [204].
[56] See fn.22.
[57] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [205].
[58] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [211]–[213].

inheritance tax charge not alleviated by section 24 IHTA could have warranted discussion in relation to UKIP's freedom to associate as a political party, or Article 14 ECHR discrimination as a "political party aspiring to the status of a Parliamentary political party" but prevented from doing so because of a bar to raising the funds necessary.[59] However, it is clear that these arguments are necessarily precluded by the circularity correctly identified by the UT, in that any impact on UKIP was an "indirect consequence of an imposition of a tax charge on the donor".[60]

A breach of EU law?

The jurisprudence of the Court of Justice of the European Union demonstrates that domestic taxation can substantively breach EU law where tax provisions effect detriment contrary to the duty of genuine co-operation and assistance owed by Member States of the EU in accordance with Article 4(3) of the Treaty on European Union (TEU), which states:

> "Pursuant to the principle of sincere cooperation, the Union and the Member States shall, in full mutual respect, assist each other in carrying out tasks which flow from the Treaties.
> The Member States shall take any appropriate measure, general or particular, to ensure fulfilment of the obligations arising out of the Treaties or resulting from the acts of the institutions of the Union.
> The Member States shall facilitate the achievement of the Union's tasks and refrain from any measure which could jeopardise the attainment of the Union's objectives."[61]

The thrust of Mr Banks' argument was that the case law demonstrated substantive breach could be found where there had been interference with the proper functioning of an EU institution.[62] The argument ran that section 24 IHTA made donations to parties principally operating within the framework of the European Parliament less attractive than donations to parties operating within the House of Commons.[63] This, it was argued, interfered with the proper functioning of the European Parliament and jeopardised the aims of equality and democracy.[64] The UT rejected assertions that such interference was self-evident and appeared to agree with the conclusion of the FTT (without explicitly stating so) that

> "the availability of tax relief on donations to UK political parties is too remote and any potential effect too indirect to be regarded as a breach of the UK's obligations under Article 4(3) [TEU]".[65]

Again, as Counsel for Mr Banks did not put forward evidence to demonstrate interference, the discussion was limited as to whether the provisions had the effects alleged by Mr Banks.[66]

[59] However, see *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [207]–[209].
[60] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [212].
[61] Consolidated version of the Treaty on European Union [2012] OJ C326/13; see *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [262]–[263], in conjunction with *Hurd v Jones (Inspector of Taxes)* (C-44/84) EU:C:1986:2; [1986] STC 127.
[62] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [268]–[269].
[63] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [268]–[269].
[64] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [269].
[65] *Banks FTT*, above fn.8, [2018] UKFTT 617 (TC) at [151]; *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [271].
[66] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [272].

Mr Banks' arguments relating to Article 4(3) TEU failed on the basis that substantive breach was not proven to the UT's satisfaction.

Turning entirely on lack of substantive breach, and the finding that the FTT had made no error of law on the question of direct effect, the UT did not need to consider whether Article 4(3) TEU gave rise to any directly enforceable right.[67] However, the UT helpfully clarified the position by stating that Article 4(3) TEU alone does not create obligations of an appropriate nature to be directly enforceable. The UT stated that the obligations in Article 4(3) TEU are in the nature of general objectives/aspirations.[68] The laws surrounding the funding of political parties across Member States were likely to contain legitimate differences, which taken with the nature of Article 4(3) TEU does not suggest obligations sufficiently precise to be directly enforceable.[69]

How are discrimination or legitimate aim established?

The hurdles faced in establishing an Article 14 ECHR case have been laid bare. Clearly: 1. it is difficult to establish a proscribed ground which is discriminated against by a tax provision that has independent existence of that provision; and 2. it is unclear which materials are relevant in determining the legislative purpose of provisions, to ascertain legitimate aim and proportionality. Banks demonstrates that where the criteria for an exemption is objective and turns on numbers, the woolly concept of "status" will be hard to pin down in the context of discrimination. Further, there is no clear guidance on which historical materials are relevant to testing compliance with Convention rights today. It would seem there is a clear black hole as between determining purpose at the time of enactment, and finding legitimate aim today. Banks provides a clear example of the pitfalls in failing to resolve this difficulty: statements made by opposition MPs at the time of enactment appear to be given determinative weight; and subsequent developments, given limited consideration. Clarity would be helpful on whether a selective exercise in legislative history is appropriate in determining "legitimate aim", and where legitimate aim sits in relation to legislative intent given the timing discrepancy between the two analyses required.

Aiden Hepworth*

Beadle v HMRC: legality, interpretation and access to justice

Introduction

The principle of legality lies at the heart of the relationship between Parliament and the citizen,[1] one strand of which provides for the protection of the individual against the power of the state

[67] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [261].
[68] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [283].
[69] *Banks*, above fn.1, [2020] UKUT 101 (TCC) at [283].

Discrimination; EU law; Exemptions; Inheritance tax; Political donations; UK Independence Party

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[1] *HM Treasury v Ahmed* [2010] UKSC 2 at [75]; [2010] 2 WLR 378 (Lord Hope).

through the restrictive interpretation of statutes.[2] To this end, history is replete with examples of British judges scrupulously examining the precise intention of Parliament when it gives powers to public officials which purport to override an individual's fundamental rights.[3] Where ambiguity arises in the wording of such statutes, the judiciary has interpreted the ambiguity in such a way as to restrict the scope for public authorities to undermine individuals' rights.[4] One such recognised right is access to justice.[5]

Putting these points together, one might be tempted to think that they have a strong case against a public authority where it has used a statute in a manner which impairs the individual's access to justice. The recent unanimous decision of the Court of Appeal in the case of *Beadle v HMRC* (*Beadle*)[6] however highlights why this belief is misconceived, as the answer to the question of what amounts to an unacceptable restriction on access to justice will be dictated by the context in which the relevant statute operates. The principle of legality does not preclude the frustration of individual liberties; it just makes the task more difficult for Parliament. It simply asks that the legislature "squarely confront what it is doing and accept the political cost".[7]

Background

In the ordinary course of events, taxpayers can challenge a tax assessment from HMRC in respect of direct taxes, though not indirect taxes,[8] without having to pay the disputed tax immediately. By operation of section 55(3) of the Taxes Management Act 1970 the taxpayer can apply for the payment to be postponed until there has been a legal determination, and it will be agreed provided there are reasonable grounds for believing that the taxpayer has been overcharged.[9] This norm is departed from in situations where a "notice", either in the form of an accelerated payment notice (APN) or partner payment notice (PPN), requiring the upfront payment of disputed

[2] M. Elliott, "Beyond the European Convention: Human Rights and the Common Law" (2015) 68(1) CLP 85, 97.
[3] See for instance *R. v Secretary of State for the Home Department Ex p. Doody* [1994] 1 AC 531 (HL); *Anisminic Ltd v Foreign Compensation Commission* [1969] 2 AC 147 (HL); *Dr. Bonham's Case* 77 ER 638; (1608) 8 Co. Rep. 107 (KB). For a critical account, see K. Ewing and C. Gearty, *The Struggle for Civil Liberties: Political Freedom and the Rule of Law in Britain, 1914-1945* (Oxford: Clarendon Press, 2000), Ch.1 in particular.
[4] *R. v Lord Chancellor Ex p. Witham* [1998] QB 575 (QB) at 581E–F (Laws LJ); *R. v Secretary of State for the Home Department Ex p. Pierson* [1998] AC 539 (HL) at 575 (Lord Browne-Wilkinson); *R. v Ministry of Defence Ex p. Smith* [1996] QB 517 (CA) at 554E–G (Bingham LJ).
[5] *R. (on the application of Unison) v Lord Chancellor* (*Unison*) [2017] UKSC 51 at [65]; [2017] 4 All ER 903 (Lord Reed). On the relationship between the rule of law and access to justice, see W. Lucy, "Access to Justice and the Rule of Law" (2020) 40(2) OJLS 377.
[6] *Beadle v HMRC* [2020] EWCA Civ 562; [2020] STC 1058; *Beadle v HMRC* (*Beadle (UT)*) [2019] UKUT 101 (TCC); [2019] STC 1042; *Beadle v HMRC* (*Beadle (FTT 2)*) [2017] UKFTT 829 (TC); [2017] 11 WLUK 437; *Beadle v HMRC* (*Beadle (FTT 1)*) [2017] UKFTT 544 (TC); [2017] 7 WLUK 80.
[7] *R. v Secretary of State for the Home Department Ex p Simms* [2000] 2 AC 115 (HL) at 131E–F (Lord Hoffmann).
[8] On which, see VATA 1994 s.84 in particular subss.(3A) and (3B).
[9] TMA 1970 ss.55(6). For an elaboration of the meaning of this provision, see: *Gui Hui Dong & Hong Fang v National Crime Agency* [2014] UKFTT 128 (TC) at [40]–[60]; [2016] 1 WLUK 599 (Judge Barbara Mosedale).

tax is issued.[10] APNs and PPNs are identical but for the fact that PPNs are issued to partners in a partnership. An APN or PPN can be issued where the following conditions are satisfied[11]:

1. either an enquiry or appeal are in progress;
2. a tax advantage accrues from the particular arrangements (which is very broadly defined and includes obtaining relief from tax due where it is reasonable to conclude that obtaining such relief was one of the main purposes of the arrangement)[12]; and
3. a follower notice has been issued[13]; the arrangements are disclosure of tax avoidance schemes (DOTAS) notifiable[14]; or a General Anti-Abuse Rule counteraction notice has been issued.[15]

Once an APN or PPN has been issued to the taxpayer, the money becomes payable within 90 days.[16] There is no right of appeal against the APN or PPN specified expressly in the legislation, but merely the right to make representations to HMRC, as a means only of objecting to either the satisfaction of the conditions or to the amount submitted to be due.[17] If representations have been made, this can delay the period within which the monies must be paid.[18] After taking into account the representations, HMRC may refuse to withdraw the APN or PPN.[19] Failure to pay the disputed tax can result in a penalty of 5 per cent of the amount of disputed tax when the 90 day payment period ends (plus any time added on by virtue of the representations).[20] If still unpaid five months from the date of the first penalty, a further 5 per cent penalty can apply[21] and another 5 per cent penalty six months after that.[22] Though there is no right of appeal against the issuance of the APN or PPN, there is a right of appeal against the penalty[23] on grounds such as that the taxpayer had a "reasonable excuse" for failing to pay[24] or that "special circumstances" exist such that the penalty ought not to be paid.[25]

Given the combination of the different elements of the regime—the fact that disputed tax must be paid upfront, that there is no right of appeal against the notice and that penalties can

[10] The relevant taxes for which an APN or PPN can be issued are set out in FA 2014 s.200. These are income tax, capital gains tax, corporation tax, apprenticeship levy, inheritance tax, stamp duty land tax and annual tax on enveloped dwellings.
[11] See principally FA 2014 s.219. See FA 2014 s.228 and Sch.32, para.3 also, which apply these conditions in respect of partners.
[12] FA 2014 s.201.
[13] See FA 2014 s.204.
[14] See FA 2004 s.306 and Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2006 (SI 2006/1543), regs 6–8 and 10–19.
[15] See FA 2013 s.209 and Sch.43, para.12.
[16] FA 2014 s.223(5); FA 2014 Sch.32, para.6(5).
[17] FA 2014 s.222(2); FA 2014 Sch.32, para.5(2).
[18] By up to 30 days from the date HMRC make a determination about the representations: FA 2014 s.223(5)(b)(ii); FA 2014 Sch.32, para.6(5)(b)(ii).
[19] FA 2014 s.222(4); FA 2014 Sch.32, para.5(4).
[20] FA 2014 s.226(2); FA 2014 Sch.32, para.7.
[21] FA 2014 s.226(3); FA 2014 Sch.32, para.7.
[22] FA 2014 s.226(4); FA 2014 Sch.32, para.7.
[23] FA 2014 s.226(7); FA 2014 Sch.32, para.7.
[24] FA 2009 Sch.56, para.16.
[25] FA 2009 Sch.56, para.9.

accumulate—it is unsurprising that it has been described as "draconian".[26] Rather than paying the disputed tax, many taxpayers (some of whom may have had little other choice)[27] have resorted to judicially reviewing HMRC's decision to issue the APN or PPN.[28] The taxpayer in *Beadle* took a slightly different route. Though the case concerned a PPN, the judgment and the comments in this note should be taken as being equally applicable to APNs.

The taxpayer was a partner in the now well-known Ingenious Film Partners LLP, which engaged in tax arrangements which were DOTAS notifiable.[29] This means that the third condition above was satisfied. The LLP invested in films and in doing so sought to produce trading losses that the partners could offset against their other taxable income.[30] As such, the second condition was satisfied. HMRC issued a closure notice against the LLP in 2012 reducing its trading loss to nil and an appeal against the closure notice is ongoing.[31] Thus, the first condition was satisfied. In 2014 accordingly, HMRC issued a PPN to the taxpayer requiring the payment of £100,054.80.[32] Mr Beadle failed to pay this amount on time and was then issued with a 5 per cent penalty, at which point he paid the disputed tax and appealed the penalty.[33] It is the appeal against this penalty which the case of *Beadle* concerns.

Before arriving at the Court of Appeal, the case came twice before the First-tier Tribunal (FTT) and thereafter before the Upper Tribunal (UT). In the first FTT decision,[34] where the taxpayer sought disclosure of information from HMRC, Judge Jonathan Richards held that the Tribunal did not have jurisdiction to entertain arguments as to the validity of the PPN. In the second FTT decision,[35] where the lawfulness of the PPN was also challenged albeit with the invalidity of the underlying PPN formulated as a "reasonable excuse" or a "special circumstance" for late payment,[36] Judge Rupert Jones upheld the penalty. The UT dismissed the appeals of the FTT decisions.[37]

Judgment

The challenge before the Court of Appeal revolved around the core issue of whether the FTT has jurisdiction to consider the lawfulness of the underlying PPN when determining appeals in

[26] Per the taxpayers in *R. (on the application of Dickinson) v HMRC* [2017] EWHC 1705 (Admin) at [181]; [2017] STC 2129 (Charles J) and *Walapu v HMRC* [2016] EWHC 658 (Admin) at [3]; [2016] STC 1682 (Green J). See also the comments in *R. (on the application of Haworth) v HMRC* [2019] EWCA Civ 747 at [66]; [2019] STC 1063 (Gross LJ) and *R. (on the application of Locke) v HMRC* [2019] EWCA Civ 1909 at [51]; [2019] STC 2543 (Rose LJ), albeit that both judges were discussing the combination of the follower notice and APN.

[27] See: S. Daly, "Public Law in the Tax Tribunals and the Case for Reform" [2018] BTR 94, 105.

[28] *R. (on the application of VVB Engineering Services Ltd) v HMRC* [2017] EWHC 506 (Admin) at [10]; [2017] 3 WLUK 420 (Supperstone J) where it was noted that at the time there were 4,116 applicants or potential applicants seeking interim relief from APNs/PPNs which HMRC's records show amounted to a total sum in excess of £756 million.

[29] *Beadle*, above fn.6, [2020] STC 1058 at [1].

[30] *Beadle*, above fn.6, [2020] STC 1058 at [1].

[31] *Beadle*, above fn.6, [2020] STC 1058 at [1].

[32] *Beadle (FTT 1)*, above fn.6, [2017] UKFTT 544 (TC) at [5].

[33] *Beadle*, above fn.6, [2020] STC 1058 at [28].

[34] *Beadle (FTT 1)*, above fn.6, [2017] UKFTT 544 (TC).

[35] *Beadle (FTT 2)*, above fn.6, [2017] UKFTT 829 (TC).

[36] *Beadle (FTT 2)*, above fn.6, [2017] UKFTT 829 (TC) at [182] and [196]–[198].

[37] *Beadle (UT)*, above fn.6, [2019] UKUT 101 (TCC).

relation to penalties issued for failure to pay the PPN. The taxpayer's argument was advanced in two ways. First, the FTT may consider a public law defence to an enforcement action unless Parliament expressly excludes the possibility. With respect to the present legislation, Parliament has not done so. The FTT accordingly ought to have jurisdiction. The taxpayer sought to draw upon a line of cases to support this proposition; cases which circumvent[38] the exclusivity principle established in *O'Reilly v Mackman*[39] that it can be an abuse of process for public law arguments to be raised otherwise than by way of judicial review.[40] In *Wandsworth LBC v Winder* (*Winder*),[41] the House of Lords permitted the use of the public law defence where enforcement proceedings were taken against a tenant over unpaid rent. Lord Fraser found that it was not an abuse of power for the defendant to argue that the enforcement was unlawful: the defendant was

> "seeking only to exercise the ordinary right of any individual to defend an action against him on the ground that he is not liable for the whole sum claimed by the plaintiff".[42]

In *Boddington v British Transport Police* (*Boddington*),[43] the House of Lords permitted the use of a public law defence against an enforcement action for breach of a by-law prohibiting smoking on trains. The Court found that there is a "strong presumption that Parliament will not legislate to prevent individuals from" challenging legal measures which affect them and "to vindicate their rights in court proceedings".[44] In *Pawlowski (Collector of Taxes) v Dunnington* (*Pawlowski*),[45] where the Inland Revenue pursued a former employee—a director—for the failure of the employer to deduct PAYE from source, the Court of Appeal permitted the use of a public law defence. In the case of *Dill v Secretary of State for Housing, Communities and Local Government* (*Dill*)[46]—which was decided after the judgment was handed down by the Court of Appeal in *Beadle* and was not cited in the proceedings—the Supreme Court found that it was permissible to raise a public law challenge to an enforcement notice for failure to obtain listed buildings consent.[47] The Supreme Court found that there had not been a rebuttal to

> "the presumption that the accused should be able to raise any grounds relating to the lawfulness of the proceedings on which the prosecution is based".[48]

But what underpins these cases is the paramount importance of the relevant statutory context in determining whether restrictions on access to justice are permissible, as noted by the House of Lords in *Boddington*:

[38] Sometimes these cases are referred to as being "exceptions" to the *O'Reilly v Mackman* ([1983] 2 AC 237 (HL)) case (for instance *Beadle (UT)*, above fn.6, [2019] UKUT 101 (TCC) at [44]), but that is to mischaracterise them. The question is ultimately whether the relevant statute allows for public law matters to be determined otherwise than by way of judicial review. If not, then to allow such proceedings would be an abuse of process. If so, then it is not an exception to the exclusivity principle; it is simply allowed by the statute.
[39] *O'Reilly v Mackman*, above fn.38, [1983] 2 AC 237.
[40] *O'Reilly v Mackman*, above fn.38, [1983] 2 AC 237 at 285D–F (Lord Diplock)
[41] *Wandsworth LBC v Winder* [1985] AC 461 (HL).
[42] *Winder*, above fn.41, [1985] AC 461 at 509E–F.
[43] *Boddington v British Transport Police* [1999] 2 AC 143 (HL).
[44] *Boddington*, above fn.43, [1999] 2 AC 143 at 161D–E (Lord Irvine).
[45] *Pawlowski (Collector of Taxes) v Dunnington* [1999] EWCA Civ 3020; [1999] STC 550.
[46] *Dill v Secretary of State for Housing, Communities and Local Government* [2020] UKSC 20; [2020] 1 WLR 2206.
[47] *Dill*, above fn.46, [2020] UKSC 20 at [20]–[26] (Lord Carnwath).
[48] *Dill*, above fn.46, [2020] UKSC 20 at [23] (Lord Carnwath).

> "[I]n every case it will be necessary to examine the particular statutory context to determine whether a court hearing a criminal or civil case has jurisdiction to rule on a defence based upon arguments of invalidity of subordinate legislation or an administrative act under it."[49]

Thus, in *Boddington*, it was central to the Lords' reasoning that the enforcement action against the smoker was the first reasonable opportunity that he had to challenge the lawfulness of the public authority's approach to the regulation of smoking on trains. As such, it was important to distinguish the situation faced in *Boddington* with those situations where there

> "had been clear and ample opportunity provided by the scheme of the relevant legislation…to challenge the legality of those acts, before being charged with an offence".[50]

So too the tenant in *Winder*, who was raising a public law defence as to the lawfulness of the increase in rent which underpinned the demand at the first reasonable opportunity to do so. Meanwhile, the taxpayer in *Pawlowski* found himself in a situation brought about by the relevant statutory provisions such that he could not challenge the underlying tax assessment, which was made against the company of which he was formerly a director. In *Dill*, the defendant found himself otherwise unable to challenge the validity of the initial assessment of a planning officer that "urns" should be "listed buildings". On the other hand, in the case of *R. v Wicks* (*Wicks*)[51] the House of Lords held that the defendant was not entitled to raise a public law defence to an enforcement notice for a breach of planning control. This narrow construction was justified on the basis that the

> "statutory grounds of appeal are so wide that they include every aspect of the merits of the decision to serve an enforcement notice".[52]

That the statutory context must be given regard is a manifestation of the principle of legality. It is not that Parliament cannot override fundamental rights such as access to justice. It is that the courts will restrictively interpret statutes which purport to do so. The best the taxpayer in *Beadle* accordingly could hope for was that the Court of Appeal would restrictively interpret the provisions of FA 2014. Unfortunately for the taxpayer, the Court's interpretation was that the legislation did indeed remove the right to raise a public law defence before the FTT.[53]

Simler LJ, who gave the Court's judgment, found that the right could be removed either by express wording in legislation or by "necessary implication" of the operation of its provisions.[54] In the case of *Wicks* for instance, the legislation did not restrict the right by way of a specific exclusivity provision, but rather it was the necessary implication of the particular statutory scheme.[55] Simler LJ found that the provisions of FA 2014 concerning PPNs gave rise to the necessary implication that a public law defence could not be raised in penalty enforcement proceedings for three key reasons. First, the PPN regime has as its express purpose deterring

[49] *Boddington*, above fn.43, [1999] 2 AC 143 at 161F–H (Lord Irvine).
[50] *Boddington*, above fn.43, [1999] 2 AC 143 at 160B–D (Lord Irvine).
[51] *R. v Wicks* [1998] AC 92 (HL).
[52] *Wicks*, above fn.51, [1998] AC 92 at 122D–E (Lord Hoffmann).
[53] *Beadle*, above fn.6, [2020] STC 1058 at [48].
[54] *Beadle*, above fn.6, [2020] STC 1058 at [45].
[55] *Beadle*, above fn.6, [2020] STC 1058 at [45].

marketed tax avoidance schemes by removing the cash flow benefit that would otherwise accrue to taxpayers whilst challenging HMRC's assessment.[56] To allow a taxpayer to appeal against the PPN through this "back door" route and therefore continue to hold the disputed tax whilst litigation proceeds would frustrate this very purpose.[57] Simler LJ in this sense here is echoing her earlier analysis of the statutory purpose in the High Court decision in *R. (on the application of Rowe) v HMRC* (*Rowe*),[58] a judgment which the Court of Appeal subsequently quoted as "impeccable"[59] and which arrived at the similar conclusion that the purpose was to change the economics of marketed tax avoidance schemes.[60]

Secondly, the PPN regime does not determine the underlying tax liability but merely decides who should hold the disputed tax.[61] That liability can be determined by way of ordinary appeal for which Parliament has enacted a detailed scheme. That Parliament would not offer an appeal route to the PPN accordingly is a deliberate omission. Though this reasoning is similar to that which prevailed in *Wicks*, it is interesting to note the subtle distinction between the cases. In *Wicks* the defendant could challenge the public authority's decision by way of statutory appeal, whereas in the case of a PPN, the taxpayer has no such appeal right at all. What the taxpayer can appeal is the underlying tax assessment, but even if successful (and that necessarily will not be determined until long after the obligation to pay the sum demanded by the PPN arises), that has no impact upon the PPN itself which still requires the upfront payment of the disputed tax.

Thirdly, Parliament has provided alternate means of challenging the PPN, either through making representations to HMRC or by way of judicial review challenge.[62] As a result, and with a clear nod to the *Boddington* judgment, the statutory scheme provides clear and ample opportunity for the taxpayer who is visited with a PPN to challenge it.[63]

The Court of Appeal also rejected the taxpayer's second ground of appeal: that the FTT has jurisdiction because invalidity of the underlying PPN can be considered either a "reasonable excuse" for failure to pay the penalty or as amounting to "special circumstances" justifying non-compliance.[64] Adopting the reasoning of the UT, a reasonable taxpayer would not have failed to pay the penalty on the basis of a belief as to the invalidity of the PPN.[65] A reasonable taxpayer instead would have paid the PPN on time and separately challenged the underlying liability.[66] Further, a different interpretation would circumvent Parliament's "evident intention" as to who should hold the disputed tax pending the final determination of the tax liability by allowing taxpayers to institute multiple proceedings in different fora.[67]

[56] *Beadle*, above fn.6, [2020] STC 1058 at [49].
[57] *Beadle*, above fn.6, [2020] STC 1058 at [49].
[58] *R. (on the application of Rowe) v HMRC* [2015] EWHC 2293 (Admin); [2015] BTC 27 at [66], [70], [96], [106], [143], [146].
[59] *R. (on the application of Rowe) v HMRC* (*Rowe (CA)*) [2017] EWCA Civ 2105; [2018] STC 462 at [82] (Arden LJ).
[60] *Rowe (CA)*, above fn.59, [2018] STC 462 at [53] (Arden LJ).
[61] *Beadle*, above fn.6, [2020] STC 1058 at [50]–[51].
[62] *Beadle*, above fn.6, [2020] STC 1058 at [52]–[54].
[63] *Beadle*, above fn.6, [2020] STC 1058 at [54].
[64] *Beadle*, above fn.6, [2020] STC 1058 at [57].
[65] *Beadle*, above fn.6, [2020] STC 1058 at [58].
[66] *Beadle (UT)*, above fn.6, [2019] UKUT 101 (TCC) at [203].
[67] *Beadle (UT)*, above fn.6, [2019] UKUT 101 (TCC) at [209].

Comments

In a sense, the outcome in the case is not surprising. As predicted by Loutzenhiser, judges will no doubt keep use of the public law defence "under very tight control to prevent it from becoming another avenue of appeal".[68] To this end, judicial scepticism to innovative arguments from counsel is entirely merited in order to protect both Parliamentary intent and the administration of justice. Nevertheless, some comments on the Court's approach to the construction of the statutory scheme, with particular reference to its purported statutory purpose, are merited.

Running through the judgment is the considerable weight that the Court placed upon (what it and other courts had interpreted as) the statutory purpose of the legislation, a consequence of which it concluded was the deliberate closing off of the possibility that the lawfulness of a PPN could be challenged by way of appeal in enforcement proceedings. The easiest way that Parliament could have signalled this intent, and thereby pre-empted this case, would have been to have added an exclusivity provision along the lines of "there is no appeal right in relation to the lawfulness of a PPN". Given the pedigree of the public law defence, it would be odd if the drafters had not at least contemplated such an addition.

What can certainly be discerned from the legislative text along with the surrounding policy documents (helpfully annotated by Simler LJ in the High Court decision in *Rowe*[69] is that the statutory purpose is to remove the cash flow benefit that might otherwise accrue to taxpayers in direct tax disputes. The PPN regime represents a "novel, bold and concerted move to incentivise taxpayers to resolve disputes with HMRC more quickly and efficiently".[70] But this purpose only takes effect in circumstances where the specific statutory conditions and the public law considerations which inform the exercise of discretionary power have been satisfied. The statutory purpose accordingly *must* be construed more narrowly: it is that disputed tax should reside with HMRC rather than the taxpayer in circumstances where HMRC have acted *lawfully* in issuing a PPN. That proposition in turn only raises, rather than resolves, the question as to appropriate forum (or even fora) for determining the lawfulness of HMRC's action. Indeed, as the writer has pointed out elsewhere in this *Review*,[71] the FTT already has the jurisdiction to consider arguments which fall under all of the public law heads of judicial review in the context of challenges under particular statutory provisions: to consider legality, rationality, procedural propriety, proportionality and the lawfulness of frustrating a legitimate expectation.[72] Whilst Parliament may have deliberately decided that the FTT should not have jurisdiction to hear judicial review cases, there is no natural reason to assume in any given situation that Parliament does not intend for the FTT to have jurisdiction to determine public law issues. That can only be determined by reference to the specific legislative text and its context.

Though the principle of legality was not cited in the judgment (or indeed in the judgments of the FTT and UT), it should also be considered in terms of the context for the statutory scheme. In *R. (on the application of Unison) v Lord Chancellor*, the Supreme Court declared employment tribunal fees unlawful on the basis that there was a "real risk" that they could hinder access to

[68] G. Loutzenhiser, *Tiley's Revenue Law*, 9th edn (Bloomsbury, 2019), 79.
[69] *Rowe*, above fn.58, [2015] EWHC 2293 (Admin) at [11]–[52].
[70] F. Fitzpatrick, "R. (on the application of Rowe and Others) v HMRC" [2018] BTR 25, 25.
[71] Daly, above fn.27.
[72] Daly, above fn.27, 99–103.

the courts.[73] It cannot be questioned that the PPN legislation does have a "real risk" of jeopardising an individual taxpayer's access to justice: it allows HMRC to demand upfront payment of disputed taxes for schemes that may have been entered into a decade prior, thereby providing considerable power to HMRC to force the hands of (albeit sometimes recalcitrant) taxpayers to settle rather than continue with an appeal to a tribunal or court. The principle of legality requires that a restrictive interpretation to Parliament's intention to limit a taxpayer's options should accordingly be taken. Such a restrictive interpretation could very conceivably result in a different outcome for the taxpayer if the case were to be appealed.[74] That could have chaotic consequences, with taxpayers purposefully incurring and then appealing penalties for failing to pay PPNs on time, but that chaos would be attributed to Parliament's failure to legislate more precisely. If the protection of individuals is a serious concern of the courts, there is no room for giving Parliament the benefit of the doubt; it should have squarely confronted what it was doing. Would it be such a bad thing to request that Parliament pay greater attention when enacting tax legislation? Perhaps the fallout from the loan charge for instance[75]—whereby the Government ended up belatedly introducing amending measures after the full impact of the charge was realised[76]—could have been avoided if there had been greater scrutiny initially.

Indeed, the courts have already responded in other cases to the severity of the PPN legislation by interpreting the wording of the legislation in order to limit the scope of HMRC's powers to issue PPNs. Even where the express conditions have been satisfied, it is necessary additionally, as the Court of Appeal in *Rowe* held,[77] that HMRC must be of the view that the tax scheme is ineffective before issuing a PPN. As found by the Court of Appeal in *Dickinson v HMRC* (*Dickinson*)[78] meanwhile, the discretion to issue a PPN "has to be exercised in accordance with public law principles",[79] such as ensuring that its exercise is consistent with the underlying statutory purpose.[80]

Perhaps, however, the taxpayer in *Beadle* does not represent the right figure for the successful application of this access to justice argument. Unlike some who would not have the means to pursue judicial review proceedings[81] and for whom arguments predicated on inability to challenge executive power might better rest, Mr Beadle did have open to him the possibility to advance judicial review proceedings. When prompted by the penalty, the taxpayer paid the sum due under the PPN of £100,000. He elected, rather than being unable due to the lack of available resources, not to seek judicial review.[82] The outcome in the case itself then supports Peacock's thesis that

[73] *Unison*, above fn.5, [2017] UKSC 51 at [87] (Lord Reed).
[74] It would not be the first time that the Supreme Court applied the principle of legality to overturn a Court of Appeal decision and find in favour of the taxpayer. On this see: *R. (on the application of Ingenious Media Holdings plc and another) v HMRC* [2016] UKSC 54 at [19]; [2016] STC 2306 (Lord Toulson) and S. Daly, "R. (Ingenious Media) v HMRC: public disclosures and HMRC's duty of confidentiality" [2017] BTR 10.
[75] On which, see: M. Blackwell, "The April 2019 loan charge" [2019] BTR 240.
[76] HMRC, *Disguised remuneration: guidance following the outcome of the independent loan charge review* (6 March 2020; updated 13 August 2020), available at: *https://www.gov.uk/government/publications/disguised-remuneration-independent-loan-charge-review/guidance* [Accessed 18 August 2020].
[77] *Rowe (CA)*, above fn.59, [2018] STC 462 at [75] (Arden LJ).
[78] *Dickinson v HMRC* [2018] EWCA Civ 2798 at [50]; [2019] STC 319.
[79] *Dickinson*, above fn.78, [2018] EWCA Civ 2798 at [50] (McCombe LJ).
[80] *Dickinson*, above fn.78, [2018] EWCA Civ 2798 at [51] (McCombe LJ).
[81] See S. Daly, *Tax Authority Advice and the Public* (Oxford: Hart Publishing, 2020), 136–138 and 195–199.
[82] *Beadle*, above fn.6, [2020] STC 1058 at [27].

in order to succeed in challenging the exercise of discretionary power, the taxpayer "needs to point to some other cardinal principle offended by the actions of HMRC".[83] Whilst access to justice is such a cardinal principle, it was not offended here as the taxpayer's ability to access the courts does not appear to have been restricted by HMRC's actions.

The perennial problem with tax rules is "that people seek to find a way round them".[84] The conferral of discretionary powers to the executive provides one means of managing this phenomenon. Given the danger that certain discretionary powers inherently pose, it is right that the courts should jealously guard their limits, as expressed through the principle of legality. The PPN legislation, of course, reflects a deliberate political decision, but it does not follow that the courts will be shy to scrutinise the effectuation of this decision through legislation. What the judgment of the Court of Appeal in *Beadle* demonstrates is ultimately that such scrutiny does not always provide relief for individuals against the power of the state.

Stephen Daly[*]

Dong Yang Electronics: whether a subsidiary of a parent company is a fixed establishment by the mere fact of it existing

Introduction

Dong Yang Electronics Sp. z o.o. v Dyrektor Izby Administracji Skarbowej we Wrocławiu (*Dong Yang*)[1] concerned a request for a preliminary ruling on the interpretation of Article 44 of Council Directive 2006/112/EC of 28 November 2006[2] centring on the meaning of fixed establishment. The request arose from a dispute between Dong Yang and the Director of the Tax Administration Chamber in Poland concerning a decision to impose an additional assessment to value added tax (VAT) on Dong Yang on 28 February 2017.

The European Court of Justice (the Court) was asked whether the mere fact that a company (which is established outside the EU) has a subsidiary in Poland means that it has a fixed establishment in Poland under Article 44 of Directive 2006/112/EC and Article 11(1) of Implementing Regulation No 282/2011.[3] If not, it was asked whether a third party is required to examine contractual relationships between a company outside the EU and its subsidiary to establish if there is a fixed establishment. It was held that not only did the mere fact of a non-EU

[83] J. Peacock, "The 'Margin of Appreciation' Afforded in the Tax Tribunals: is there any Limit to Judicial Deference?" [2017] BTR 404, 417.
[84] D. Southern, "R. (on the application of Dickinson) v HMRC and R. (on the application of Vacation Rentals (UK) Ltd) v HMRC: delegitimising legitimate expectations—the macro-political field" [2019] BTR 126, 137.

Accelerated payment notices; Access to justice; Administrative law; Appeals; Defences; Non-payment; Partner payment notices; Penalties; Purposive interpretation

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[1] *Dong Yang Electronics Sp. z o.o. v Dyrektor Izby Administracji Skarbowej we Wrocławiu* (C-547/18) EU:C:2020:350.
[2] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax [2006] OJ L347/1.
[3] Council Implementing Regulation (EU) No 282/2011 of 15 March 2011 laying down implementing measures for Directive 2006/112/EC on the common system of value added tax [2011] OJ L77/1.

company having a subsidiary in Poland not mean that there was a fixed establishment, but also, there was no requirement on a third party to examine the contractual relationship between the parent company and its subsidiary to determine if this was so.

This decision is of general importance because the concept of "fixed establishment" is fundamental to VAT in that it is central to the place of supply rules, the right to VAT refunds and where tax is incurred other than where the business is established. This is an area of frequent dispute, of unclear definition and scope, which has been recently intensified by the impact of globalisation and modern economic realities.[4] The Court's decision is consequently a welcome development in this area, as it does in the writer's view provide *some* helpful clarification on the concept of fixed establishment and the responsibilities on suppliers to ascertain whether their customers have created one.

The decision is also of particular importance because, as expressed in Advocate General Kokott's Opinion:

> "[I]t is not possible to find a clear statement on the assessment of a subsidiary as a fixed establishment of a parent company…The Court must now provide a clear answer to this question."[5]

The issue was first considered in *CC&E v DFDS A/S* (*DFDS*),[6] where it was held that a subsidiary could be a fixed establishment of a parent company if it were a mere auxiliary organ of that parent.[7] The Court distanced itself from this view in *Daimler AG and another v Skatteverket*[8] and then avoided the question in *Welmory sp. z o.o. v Dyrektor Izby Skarbowej w Gdansku* (*Welmory*).[9] The *Dong Yang* case is therefore the first time this particular issue has been considered directly.

However, there are significant differences between the Court's approach and the approach of AG Kokott (the AG) in her Opinion. In particular, rather than adopting the approach of the AG (where the answer to the first issue was no, unless there is abuse under the *Halifax*[10] doctrine), the Court held simply that the mere fact of a subsidiary did not mean that a fixed establishment had been created, although it is possible for it to be so and that the economic and commercial reality needs to be considered. From a legal certainty perspective the Court's approach is less helpful than the AG's.

Background facts

On 27 October 2010, Dong Yang, incorporated under Polish law, concluded a contract with a Korean incorporated company called LG Display Co Ltd (LG Korea). The contract was for the supply of services consisting of assembling printed circuit boards (PCB) from materials and

[4] For more information on this, please see R. de la Feria, "Permanent Establishments in Indirect Taxation" (2016) in A. Cracea and I.J.J. Burgers (eds), *Permanent Establishments* (IBFD, 2006).
[5] Opinion of Advocate General Kokott in *Dong Yang* (C-547/18), above fn.1, EU:C:2019:976 at [5].
[6] *CC&E v DFDS A/S* (C-260/95) EU:C:1997:77; [1997] STC 384.
[7] *DFDS* (C-260/95), above fn.6, EU:C:1997:77 at [26].
[8] *Daimler AG and another v Skatteverket* (Joined Cases C-318/11 and C-319/11) EU:C:2012:666; [2013] STC 670 at [47].
[9] *Welmory sp. z o.o. v Dyrektor Izby Skarbowej w Gdansku* (C-605/12) EU:C:2014:2298; [2015] STC 515.
[10] *Halifax plc and others v CC&E* (*Halifax*) (C-255/02) EU:C:2006:121; [2006] STC 919.

components owned by LG Korea.[11] The materials were cleared through customs and supplied to Dong Yang by a subsidiary of LG Korea, LG Display Poland (LG Poland), a company incorporated under Polish law.[12] Dong Yang supplied the PCB to LG Poland, which on the basis of a contract with LG Korea, used those PCB to produce TFT-LCD modules.[13] These modules, which were owned by LG Korea, were supplied to another company, LG Display Germany GmbH.[14] These facts were not known by Dong Yang.[15] Dong Yang invoiced the PCB assembly services to LG Korea, treating those services as not subject to VAT within Poland.[16] LG Korea assured Dong Yang that it had no fixed establishment in Poland and did not employ staff, own immoveable property or have technical resources there.[17]

The Polish authorities assessed that Dong Yang had supplied PCB assembly services in Poland (as in its view LG Poland constituted a fixed establishment of LG Korea) on 28 February 2017,[18] on the basis that LG Korea used LG Poland as its own establishment.[19] The Polish authorities also held that the onus was on Dong Yang to examine in accordance with Article 22 of Implementing Regulation No 282/2011 who the actual beneficiary of the services it provided was, and that on such an examination,[20] Dong Yang would have concluded that the beneficiary was LG Poland. Dong Yang appealed seeking an annulment of the decision by the Polish authorities, arguing that the decision breached Article 44 of Directive 2006/112/EC and Articles 21 and 22 of Implementing Regulation No 282/2011.[21]

Relevant law

Article 44 of Directive 2006/112/EC provides:

> "The place of supply of services to a taxable person acting as such shall be the place where that person has established his business. However, if those services are provided to a fixed establishment of the taxable person located in a place other than the place where he has established his business, the place of supply of those services shall be the place where that fixed establishment is located. In the absence of such place of establishment or fixed establishment, the place of supply of services shall be the place where the taxable person who receives such services has his permanent address or usually resides."

Article 11 of Implementing Regulation No 282/2011 provides:

> "1. For the application of Article 44 of Directive 2006/112/EC, a 'fixed establishment' shall be any establishment, other than the place of establishment of a business referred to in Article 10 of this Regulation, characterised by a sufficient degree of

[11] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [8].
[12] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [9].
[13] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [10].
[14] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [11].
[15] Opinion of Advocate General Kokott in *Dong Yang* (C-547/18), above fn.5, EU:C:2019:976 at [16]–[17].
[16] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [12].
[17] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [13].
[18] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [14].
[19] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [15].
[20] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [16].
[21] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [17].

permanence and a suitable structure in terms of human and technical resources to enable it to receive and use the services supplied to it for its own needs.

…

3. The fact of having a VAT identification number shall not in itself be sufficient to consider that a taxable person has a fixed establishment."

Article 22 of Implementing Regulation No 282/2011 provides:

"1. In order to identify the customer's fixed establishment to which the service is provided, the supplier shall examine the nature and use of the service provided.
Where the nature and use of the service provided do not enable him to identify the fixed establishment to which the service is provided, the supplier, in identifying that fixed establishment, shall pay particular attention to whether the contract, the order form and the VAT identification number attributed by the Member State of the customer and communicated to him by the customer identify the fixed establishment as the customer of the service and whether the fixed establishment is the entity paying for the service.
Where the customer's fixed establishment to which the service is provided cannot be determined in accordance with the first and second subparagraphs of this paragraph or where services covered by Article 44 of Directive 2006/112/EC are supplied to a taxable person under a contract covering one or more services used in an unidentifiable and non-quantifiable manner, the supplier may legitimately consider that the services have been supplied at the place where the customer has established his business.

2. The application of this Article shall be without prejudice to the customer's obligations."

The reference

The referring court took the view that previous cases on the meaning of fixed establishment under Article 44 of Directive 2006/112/EC were unhelpful as they are factually very different, as LG Korea is established in a non-Member State and is not entitled to the freedoms under the Treaty on the Functioning of the European Union and may not freely conduct activity in Poland.[22] As conducting such activity is possible only by owning a subsidiary that is a company, the referring court took the view that the company established in a non-Member State always has the possibility of influencing activities of its subsidiary and having access to the resources.[23] The question was therefore when a company established in a non-Member State in this context must be regarded by the supplier of services as a fixed establishment for the place of supply of services rules.[24]

The two questions referred for a preliminary ruling were consequently:

[22] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [18].
[23] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [19].
[24] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [20].

"(1) Can it be inferred, from the mere fact that a company established outside the European Union has a subsidiary in the territory of Poland, that a fixed establishment exists in Poland within the meaning of Article 44 of Directive 2006/112 … and Article 11(1) of Implementing Regulation No 282/2011 … ?

(2) If the first question is answered in the negative, is a third party required to examine contractual relationships between a company established outside the European Union and its subsidiary in order to determine whether the former company has a fixed establishment in Poland?"[25]

Analysis by the Court

The Court began by considering the first sentence of Article 44 of Directive 2006/112/EC, which states that the place of supply of services to a taxable person acting as such is to be the place where that person has established his business,[26] however, the second sentence states that if those services are provided to a fixed establishment of the taxable person located in a place other than the place where he has established his business, the place of supply of those services is to be the place where that fixed establishment is located.

Regarding the issue of whether there is a fixed establishment, the Court held that the issue must be examined by reference to the taxable person constituting the customer to whom the services are supplied. Article 11 of Implementing Regulation No 282/2011 goes on to state that a fixed establishment is to be any establishment, other than the place of establishment of a business referred to in Article 10 of Implementing Regulation No 282/2011, characterised by a sufficient degree of permanence and a suitable structure in terms of human and technical resources to enable it to receive and use the services supplied to it for its own needs.[27]

The Court commented that the Free Trade Agreement between Poland and Korea[28] allows Korean investors to undertake and conduct economic activity in Poland only in the form of an LLP, limited joint stock partnership, LLC and joint stock company.[29] However, the Court held that it cannot be ruled out that the subsidiary held for the purposes of conducting economic activity by the parent company established in South Korea may constitute a fixed establishment of that parent company in a Member State of the EU, within the meaning of Article 44 of Directive 2006/112/EC and Article 11(1) of Implementing Regulation No 282/2011, and so the reservation was irrelevant in interpreting the "fixed establishment" concept.[30]

The Court stated that consideration of economic and commercial realities forms a fundamental criterion for the application of the common system of VAT (citing *Budimex S.A. v Minister Finansów* (*Budimex*)[31]) and that the treatment of an establishment as a fixed establishment cannot

[25] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [22].
[26] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [24].
[27] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [28].
[28] Free Trade Agreement between the European Union and its Member States, of the one part, and the Republic of Korea, of the other part, approved on behalf of the European Union by Council Decision 2011/265/EU of 16 September 2010 [2011] OJ L127/1.
[29] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [29].
[30] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [30].
[31] *Budimex S.A. v Minister Finansów* (C-224/18) EU:C:2019:347.

depend solely on the legal status of the entity concerned.[32] While it is possible that a subsidiary constitutes the fixed establishment of its parent (citing *DFDS*),[33] such treatment depends on the substantive conditions set out in Implementing Regulation No 282/2011 (in particular Article 11), which must be assessed in the light of economic and commercial realities.[34] It consequently follows from this that the existence, in the territory of a Member State, of a fixed establishment of a company established in a non-Member State may not be inferred by a supplier of services from the mere fact that the company has a subsidiary there.[35]

On the second issue, the Court considered that Article 22 of Implementing Regulation No 282/2011 did not show that the supplier of the services concerned is required to examine contractual relationships between a company established in a non-Member State and its subsidiary established in a Member State to determine whether the former has a fixed establishment. In particular, it held that the second subparagraph of Article 22(1) concerns the contract for the supply of services between the supplier and the taxable person constituting the customer of the services and not the contractual relationships between that customer and an entity which may (depending on the particular facts of the case) be identified as a fixed establishment.[36] The judgment also cited with approval the AG's Opinion that the tax authorities' responsibilities may not be imposed on suppliers of services in this way.[37]

Comment

Conclusion on the first issue

The Court's judgment is welcome in several respects; in particular (and most importantly) in giving a clear negative answer to the first question on whether a subsidiary in these circumstances necessarily gives rise to a fixed establishment. This not only increases certainty following the history of *DFDS*,[38] *Welmory*[39] and *Budimex*[40] but is also helpful for taxpayers in that it sets out that a subsidiary in these circumstances is not automatically a fixed establishment, giving scope for different circumstances to be appropriately taken into account.

However, in the writer's view, the AG's Opinion was clearer and more useful on this point. The AG's Opinion sets out[41] that the answer to the first question (whether a company from a third country which has a subsidiary in a Member State is a fixed establishment within the second sentence of Article 44 of Directive 2006/112/EC) is no. This is because Article 44 refers to a single taxable person who has established his business in one place and has a fixed establishment in another, and a parent company and its subsidiary are two people, not one. The VAT group

[32] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [31].
[33] *DFDS* (C-260/95), above fn.6, EU:C:1997:77.
[34] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [32].
[35] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [33].
[36] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [36].
[37] *Dong Yang* (C-547/18), above fn.1, EU:C:2020:350 at [37]: Opinion of Advocate General Kokott in *Dong Yang* (C-547/18), above fn.5, EU:C:2019:976 at [73] and [74].
[38] *DFDS* (C-260/95), above fn.6, EU:C:1997:77.
[39] *Welmory* (C-605/12), above fn.9, [2015] STC 515.
[40] *Budimex* (C-224/18), above fn.31, EU:C:2019:347.
[41] Opinion of Advocate General Kokott in *Dong Yang* (C-547/18), above fn.5, EU:C:2019:976 at [29]–[34].

provisions in Article 11 of Implementing Regulation No 282/2011 are limited to the territory of the Member State (and as LG Korea is established in South Korea, this is ruled out).

Although the focus on the form of an entity could (in isolation) be criticised as too rigid and potentially vulnerable to abuse, in the AG's Opinion[42] it was outlined that there are criteria where in exceptional circumstances a subsidiary is included in a group structure in such a way that it is to be regarded as an independent person and a permanent establishment of the parent company within Article 44. This gives rise to a fundamental reservation where an alternative assessment is possible only if abusive practices are found to exist, applying the *Halifax*[43] abuse doctrine.

In essence, whilst the AG's Opinion set out that a subsidiary could not be a fixed establishment of a parent company unless there was abuse, the Court answered the question in much weaker terms, stating that the mere fact of a subsidiary does not equate to a fixed establishment. The approach of the Court is therefore vastly different from that taken by the AG, in that the Court preferred to focus on substance over form without regard to the legal personality of a subsidiary and required a consideration of the economic and commercial reality in determining if there is a fixed establishment. This is a significantly less clear answer than the one given in the AG's Opinion and is, in the writer's view, consequently significantly less helpful (particularly as "economic and commercial reality" is an inherently flexible, and arguably opaque, term).

Consideration of the findings in DFDS

The AG's Opinion also sought to deal with *DFDS*[44] head on, which held that a subsidiary might be a fixed establishment if it is a mere "auxiliary organ".[45] The AG's Opinion outlined that in her view,[46] *DFDS* was limited to its facts and was not automatically transferable to the situation being considered in *Dong Yang*. It is unfortunate that the Court did not consider *DFDS* in more detail (rather than in passing comment), in order to clarify the circumstances in which a subsidiary can be a fixed establishment of a parent (that is, whether this is limited to, or distinct from, where a subsidiary is a mere auxiliary organ of a parent).

Conclusion on the second issue

Towards the end of the AG's Opinion, it was outlined that the

> "tax authorities may not oblige a taxable person to undertake complex and far-reaching checks, de facto transferring their own investigative tasks to him".[47]

It was further stated that

> "unless there are indications to the contrary, a contracting partner can certainly rely on a written assurance from another contracting partner stating that it does not have a fixed establishment in the country concerned".[48]

[42] Opinion of Advocate General Kokott in *Dong Yang* (C-547/18), above fn.5, EU:C:2019:976 at [35].
[43] *Halifax* (C-255/02), above fn.10, [2006] STC 919.
[44] *DFDS* (C-260/95), above fn.6, EU:C:1997:77.
[45] *DFDS* (C-260/95), above fn.6, EU:C:1997:77 at [29].
[46] Opinion of Advocate General Kokott in *Dong Yang* (C-547/18), above fn.5, EU:C:2019:976 at [59]–[66].
[47] Opinion of Advocate General Kokott in *Dong Yang* (C-547/18), above fn.5, EU:C:2019:976 at [73].
[48] Opinion of Advocate General Kokott in *Dong Yang* (C-547/18), above fn.5, EU:C:2019:976 at [73].

The taxable person may only be required to exercise a reasonable degree of care.[49]

From a legal certainty perspective, it would have been helpful for the Court to comment on whether a taxpayer can rely on the written assurances of a contracting partner when considering the issue of identifying the customer's fixed establishment. However, the judgment certainly provides welcome clarification in principle, in that it outlines very clearly that the time and expense of investigating the existence of a fixed establishment in this context is an obligation of the tax authority, rather than the contracting partner.

Rebecca Sheldon*

[49] Opinion of Advocate General Kokott in *Dong Yang* (C-547/18), above fn.5, EU:C:2019:976 at [77].

EU law; Fixed establishment; Multinational companies; Parent companies; Subsidiary companies; VAT

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The Equalisation Levy: Dodging Existing Treaty Obligation Through a "Moral Tax"

Sachit Jolly[*]

Abstract

Taxation of the digital economy has occupied the minds of nations and tax experts for decades. The introduction of a digital services tax or equalisation levy as a consumption tax to side-step the tax treaty threshold of physical presence raises important issues of customary international law and constitutional law. This article seeks to examine the nature and scope of the equalisation levy introduced in India on foreign e-commerce operators and concludes that the levy has all the attributes of an "income tax" or at least a tax which is identical or substantially similar to income tax in addition to, or in place of, the existing income tax. As a result, the equalisation levy should be subject to the applicable Double Taxation Avoidance Agreement. In addition, this article explains how unilateral attempts to dodge existing tax treaty obligations are not only contrary to customary international law but also the Constitution of India.

A. Introduction

"The only constant in life is change."[1]

Innovation in digital technology and the rapid expansion of digital transactions are perhaps best summed up by this insight of the Ionian Greek philosopher, Heraclitus. The need for and growth of digital platforms can hardly be overemphasised, particularly in these uncertain times of physical distancing. The growth of the digital economy presents both exciting opportunities as well as immense challenges. One such challenge, which has occupied the minds of lawmakers, scholars, lawyers, accountants as well as national and international experts alike, is how best to tax the digital economy. For the past two decades, the Organisation for Economic Co-operation and Development (OECD), the United Nations (UN) and the G20 have been at the forefront of addressing concerns about the taxation of enterprises engaged in some form of digital economy, with no permanent establishment (PE) within the territory of the source nation.

The introduction of the Equalisation Levy (EL) on e-commerce operators by the Parliament of India in April 2020 (EL-2020), in the midst of the coronavirus pandemic, is an example of a unilateral effort to address the challenge.[2]

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[1] Attributed to Heraclitus of Ephesus (c. 535 BC-475 BC).

[2] The Equalisation Levy (EL) introduced by the Finance Act, 2016, No.28 of 2016 (IND) (FA 2016 (IND)) and further extended by the Finance Act, 2020, No.12 of 2020 (IND) (FA 2020 (IND)) inserting s.165A from 1 April 2020 in FA 2016 (IND) Pt IV. FA 2020 (IND) s.153(iv)–(xii) inserting FA 2016 (IND) s.165A, s.166A, s.167(A)–(C), s.168(A)–(D), s.169, ss.170–180.

This article traces the origins of the EL and reveals the scope and ambit of the levy in India. In the latter part of this article, an attempt has been made to examine the interplay between the EL and existing tax treaties, and the impact of this interplay on the touchstones of customary international law and the Constitution of India.[3]

B. Genesis of the EL

The Task Force on the Digital Economy (TFDE)[4] was established by the OECD in September 2013 to identify both the issues raised by the digital economy and possible options for addressing them. The TFDE identified four tax challenges posed by the digital economy: nexus; data collection; characterisation of business for direct tax purposes; and collection of value added tax (VAT). Based on work done by the TFDE, the OECD published a Final Report in October 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1—2015 Final Report* (OECD 2015 Final Report).[5]

The OECD 2015 Final Report dealt specifically with the issue of taxation of the digital economy and, inter alia, suggested three options for taxation of enterprises with no PE in the source nation: 1. insertion of a new definition of "nexus", based on significant economic presence; 2. enacting withholding tax on digital transactions; and 3. enforcing the EL. But, it said:

> "None of the other options analysed by the TFDE, namely (i) a new nexus in the form of a significant economic presence, (ii) a withholding tax on certain types of digital transactions, and (iii) an equalisation levy, were recommended at this stage."[6]

This was

> "…because, among other reasons, it is expected that the measures developed in the BEPS Project will have a substantial impact on BEPS issues previously identified in the digital economy, that certain BEPS measures will mitigate some aspects of the broader tax challenges, and that consumption taxes will be levied effectively in the market country".[7]

The OECD advised countries adopting such options in their domestic laws to respect existing international legal commitments.[8]

Pursuant to the OECD 2015 Final Report, a "Committee on Taxation of E-Commerce" was formed in India by the Central Board of Direct Taxes (CBDT) and its Report, *Proposal for Equalization Levy on Specified Transactions (Report of the Committee on Taxation of*

[3] Constitution of India [As on 1st April, 2019], available at: *http://legislative.gov.in/sites/default/files/COI-updated.pdf* [Accessed 24 August 2020].
[4] OECD/G20 Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges of the Digital Economy* (Paris: OECD Publishing, 2014), as referred to in the Executive Summary and following.
[5] OECD/G20 Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges of the Digital Economy, Action 1—2015 Final Report* (Paris: OECD Publishing, 2015), available at: *https://dx.doi.org/10.1787/9789264241046-en* [Accessed 24 August 2020].
[6] OECD 2015 Final Report, above fn.5, 13.
[7] OECD 2015 Final Report, above fn.5, paras 357 and 383.
[8] OECD 2015 Final Report, above fn.5, 13 and paras 357 and 383.

E-Commerce) (CBDT Report)[9] recommended that the EL be introduced in India. The CBDT Report noted that the EL could be introduced as a tax, other than income tax, in accordance with Entries 92C[10] and 97[11] of List 1 of the Seventh Schedule to the Constitution of India.[12] The Finance Act, 2016 (IND) (FA 2016 (IND)),[13] introduced a new Chapter VIII, outside the Income-Tax Act, 1961 (IND) (ITA 1961 (IND))[14] proposing an Equalisation Levy (EL-2016) at the rate of 6 per cent of the amount of consideration received or receivable by a non-resident in the form of advertisement revenue from a person resident in India or a non-resident having a PE in India.[15] The levy was to be deducted by the Indian tax payer or the PE while remitting the consideration of the non-resident.

Simultaneously with the introduction of Chapter VIII of FA 2016 (IND), section 10(50)[16] was inserted in ITA 1961 (IND) to exempt receipts of such non-residents, which had suffered an EL, from any further income tax. Similarly, section 40 ITA 1961 (IND) was amended to introduce a new clause (ib)[17] to provide that a person responsible for paying amounts which are subject to an EL shall be disallowed a deduction of such amounts, if the EL is not deducted from the consideration. This is analogous to the other provisions of ITA 1961 (IND) which prohibit deduction of expenses which are the subject matter of withholding tax when such withholding tax is not affected.

The EL-2020 has now been introduced to provide a 2 per cent levy on the consideration (in excess of INR 20,000,000) received or receivable by a non-resident e-commerce operator on

[9] Committee on Taxation of E-Commerce, *Proposal for Equalization Levy on Specified Transactions (Report of the Committee on Taxation of E-Commerce)* (February 2016), available at: *https://incometaxindia.gov.in/News/Report-of-Committee-on-Taxation-of-e-Commerce-Feb-2016.pdf* [Accessed 24 August 2020].

[10] Constitution of India, above fn.3, Seventh Schedule, List 1, Entry 92C: "Taxes on Services." (Although this Entry was inserted by the Constitution 88th Amendment Act, 2003 (IND), it was never notified and brought into effect. This Entry 92C was omitted by the Constitution (101st Amendment) Act, 2016 (IND) as VAT and service tax were replaced by GST.)

[11] Constitution of India, above fn.3, Seventh Schedule, List 1, Entry 97: "Any other matter not enumerated in List II or List III including any tax not mentioned in either of those Lists."

[12] Constitution of India, above fn.3.

[13] FA 2016 (IND), above fn.2.

[14] Income-Tax Act, 1961, No.43 of 1961 (IND).

[15] FA 2016 (IND), above fn.2, s.165 inserted vide FA 2016 (IND), above fn.2.

[16] ITA 1961 (IND), above fn.14, Ch.111, s.10:

" **Incomes not included in total income.**

10. In computing the total income of a previous year of any person, any income falling within any of the following clauses shall not be included—…

(50) any income arising from any specified service provided on or after the date on which the provisions of Chapter VIII of the Finance Act, 2016 comes into force *or arising from any e-commerce supply or services made or provided or facilitated on or after the 1st day of April, 2021* and chargeable to equalisation levy under that Chapter." (Italicised portion inserted vide FA 2020 (IND), above fn.2.)

[17] ITA 1961 (IND), above fn.14, Ch.111, s.40:

" **Amounts not deductible.**

40. Notwithstanding anything to the contrary in sections 30 to 38, the following amounts shall not be deducted in computing the income chargeable under the head 'Profits and gains of business or profession',—…

(ib) any consideration paid or payable to a non-resident for a specified service on which equalisation levy is deductible under the provisions of Chapter VIII of the Finance Act, 2016, and such levy has not been deducted or after deduction, has not been paid on or before the due date specified in sub-section (1) of section 139…."

account of the sale of goods or services by the e-commerce operator itself or facilitated by such an e-commerce operator, if such goods, services or facilities are extended to:

1. any Indian resident; or
2. any person who buys goods or services from the e-commerce operator using an IP address located in India; or
3. any non-resident
   (a) for sale of advertisement, which either targets a customer in India, or is made using an IP address located in India; or
   (b) for sale of data, which is either collected from an Indian resident, or from a person who uses an IP address located in India.

The EL-2020 will have a significant impact on non-resident providers of digital supply or services, considering the expansive definition of the terms "e-commerce operator" and "e-commerce supply or services". Apart from non-resident online platforms, even travel aggregators, subscription-based platforms, paid search engines, streaming and online gaming, e-music, e-movies and e-books appear to be within the scope of the EL-2020.

A purchase made by a non-resident on an e-commerce platform, owned or operated by another non-resident is brought into account for tax purposes solely because the purchaser used an IP address located in India. Imagine a situation where a US resident, stuck in India due to COVID-19, placing an order with a non-resident e-commerce operator for delivery of food or medicine to his/her spouse in the US being subject to a levy because he/she used an IP address in India. The extension of the EL to sale of advertisement or data between two non-residents and making it contingent on nebulous phraseology like "targets a customer in India" raises questions of arbitrariness. Perhaps that is why leading industry organisations like Japan Electronics and Information Technology Industries Association (JEITA), and the US-India Business Council (USIBC) have sought deferral of the levy in its present form.

It is not that India is alone in levying some form of digital tax:

> "As of June 22 [2020], Austria, France, Hungary, Italy, Poland, Turkey, and the United Kingdom have implemented a [digital services tax] DST. Belgium, the Czech Republic, Slovakia, and Spain have published proposals to enact a DST, and Latvia, Norway, and Slovenia have either officially announced or shown intentions to implement such a tax."[18]

Even Indonesia has proposed to levy "a 10 per cent VAT on digital products sold by non-resident internet companies with a significant presence in the Indonesian market".[19]

The EL enacted in India is, however, significantly different from what was proposed by the OECD and what other countries have enacted. One of the major distinctions and concerns is that the EL discriminates directly against foreign corporations and exports while explicitly exempting Indian companies. This was never intended in the OECD 2015 Final Report. Even the scope of

[18] E. Asen, "What European OECD Countries Are Doing about Digital Services Taxes", *Tax Foundation*, 22 June 2020, available at: *https://taxfoundation.org/digital-tax-europe-2020/* [Accessed 24 August 2020].

[19] T. Diela and F. Potkin, "Indonesia to impose VAT on internet giants from July", *Technology News* (Reuters), 15 May 2020, available at: *https://www.reuters.com/article/us-indonesia-tax-digital/indonesia-to-impose-vat-on-internet-giants-from-july-idUSKBN22R23V* [Accessed 24 August 2020].

the levy is significantly wide. For example, while Austria and Hungary have introduced a DST only on tax revenues from online advertising, France's tax base is much broader, including revenues from the provision of a digital interface, targeted advertising, and the transmission of data collected about users for advertising purposes. The combined scope of the EL-2016 and the EL-2020 is, as indicated earlier in this article, much wider. Further, the levy is applicable to all companies with a turnover of INR 2 crore (INR 20 million), which is a very low exemption threshold when compared to the thresholds applied in Europe; the lowest being in Turkey,[20] that is, €3.1 million of domestic turnover and a global turnover of €750 million.

On 2 June 2020, the United States Trade Representative (USTR) announced that investigations into DST policies in nine countries and the EU were to be conducted under section 301 of the Trade Act 1974 (US).[21]

Similar investigations in 2019 into the French DST and the threat of tariffs being imposed by the US on French wine led to an offer of a concession from France to limit the scope of the levy to automated digital services companies only. Reports suggest that the UK, Italy and Spain have also offered to limit the scope of the DST.[22] Belgium, too, reintroduced an adjusted DST proposal: a 3 per cent tax on revenue from activities such as the selling of user data on companies with global revenues exceeding €750 million (US $840 million) and domestic revenues exceeding €5 million (US $5.6 million). The Czech Republic has also lowered its proposed DST rate from 7 per cent to 5 per cent and postponed the date on which this is to become effective to January 2021. No such concession or deferral had been announced by either Indonesia or India until June 2020.

Unlike the EL-2016, which was to be recovered by way of a deduction[23] from the Indian payer, the EL-2020 is to be discharged by the non-resident e-commerce operator itself.[24] Consequently, the compliance burden of reporting[25] the transactions, which was to be borne only by the payer in respect of specified services, is now, under the new regime, to be borne by the e-commerce operator. As a result, failure to provide details of the transaction and to pay the tax/levy will result in a penalty[26] being imposed on the e-commerce operator and not the payer.

It is also noteworthy that there is no right to appeal against the levy of either the EL-2016 or EL-2020; however, an order levying a penalty for failure to pay the tax/levy is appealable. The absence of an explicit statutory right to appeal against a levy can at best be described as giving rise to ambiguity and without any clarification from the Income Tax Department this ambiguity could lead to a scurry of writ petitions being filed by taxpayers before the respective High Courts.

Having noted the general characteristics of the EL and its scope in general, the nature of the EL will now be examined, that is, whether it is an "income tax" or a separate "transaction tax".

[20] Asen, above fn.18.

[21] Office of the United States Trade Representative, press release, *USTR Initiates Section 301 Investigations of Digital Services Taxes* (6 February 2020), available at: *https://ustr.gov/about-us/policy-offices/press-office/press-releases/2020/june/ustr-initiates-section-301-investigations-digital-services-taxes* [Accessed 24 August 2020].

[22] A. Brambilla, *France, U.K. Offer to Limit Digital Tax After U.S. Threat* (Bloomberg, 25 June 2020), available at: *https://www.bloomberg.com/news/articles/2020-06-25/france-u-k-offer-to-limit-digital-tax-scope-after-u-s-threat* [Accessed 28 August 2020].

[23] FA 2016 (IND), above fn.2, s.166 inserted by FA 2016 (IND), above fn.2.

[24] FA 2016 (IND), above fn.2, s.166A inserted in FA 2016 (IND), above fn.2, vide FA 2020 (IND), above fn.2.

[25] FA 2016 (IND), above fn.2, s.167 as amended by FA 2020 (IND), above fn.2.

[26] FA 2016 (IND), above fn.2, s.172 as amended by FA 2020 (IND), above fn.2.

C. Nature of the EL: is it an income tax in disguise?

The EL-2016 and the EL-2020 owe their existence to the OECD 2015 Final Report. This is admitted even in the CBDT Report.[27] It is, therefore, imperative to undertake a thorough appraisal of the OECD 2015 Final Report to appreciate the need for and purpose of the levy, both of which are factors to be considered when determining the nature of the EL.

C.1 Need and purpose of the EL

The EL, both as a concept and as perceived in the OECD 2015 Final Report is intended to address issues of tax neutrality. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation, in order to avoid the introduction of distortions to the market.[28] In other words, the same principles of taxation should apply to all forms of business, while keeping in mind those specific features that might otherwise undermine an equal and neutral application of those principles. This objective is also specifically recognised in the CBDT Report in the following words:

> "The word 'equalization' represents the objective of ensuring tax neutrality between different businesses conducted through differing business models or residing within or outside the taxing jurisdiction."[29]

It is further noted in the CBDT Report that

> "asymmetry in tax burden faced by purely domestic and multi-national enterprises can have distortionary impact on the market competition and can adversely affect the development of purely domestic enterprises".[30]

Tax, in this context, refers to "income tax".

It is also interesting to note that, while discussing the concept of tax neutrality, both the OECD 2015 Final Report and the CBDT Report refer to "income tax" and not to any "transaction tax" like the VAT or goods and services tax (GST). In fact, Chapters 1 to 7 of the OECD 2015 Final Report deal with direct tax challenges faced by nations whereas a separate Chapter 8 deals with issues with respect to "collection" of VAT/GST and not the levy of such transaction taxes. Any doubt as to what is sought to be addressed through tax neutrality and the EL is put to rest in the OECD 2015 Final Report itself wherein the EL is proposed to "avoid some of the difficulties arising from creating new profit attribution rules for purposes of a nexus based on significant economic presence",[31] and "as an alternative way to address the broader direct tax challenges of the digital economy".[32] The OECD 2015 Final Report further provides that the "equalisation levy could be considered as an alternative to overcome the difficulties raised by the attribution of income to the new nexus"[33] and "would be intended to serve as a way to tax a non-resident

[27] CBDT Report, above fn.9, paras 109–118.
[28] OECD 2015 Final Report, above fn.5, para.351.
[29] CBDT Report, above fn.9, para.109.
[30] CBDT Report, above fn.9, para.169.
[31] OECD 2015 Final Report, above fn.5, para.302.
[32] OECD 2015 Final Report, above fn.5, para.302.
[33] OECD 2015 Final Report, above fn.5, para.276.

enterprise's significant economic presence in a country".[34] Even the Committee on taxation of E-commerce in its CBDT Report[35] acknowledges that the need and purpose of the EL, or the other alternatives suggested in the OECD 2015 Final Report, are to overcome the hurdles confronting the levy of "income tax" on digital companies and that the EL should seek to neutralise or equalise the tax equations between domestic and foreign taxpayers.

On a bare perusal of the exposition in the OECD 2015 Final Report and the CBDT Report referred to above, it is not difficult to conclude that the purpose of the EL is to achieve neutrality between domestic and foreign taxpayers *qua* their income tax and that the EL needs to be introduced in order to overcome the hurdles posed by the existing Double Taxation Avoidance Agreements (DTAA) to achieve these objectives.

However, interestingly, after quoting extensively from the OECD 2015 Final Report, the CBDT Report comes to the conclusion that:

> "As the Equalization Levy on a transaction is, in any case, inherently different from a tax on income, it need not be included within the laws governing tax on income."[36]

The above findings and the understanding of the Committee on taxation of E-commerce in the CBDT Report is not only contrary to the analysis in this article but also to the Revenue Secretary's own admission that "[a]lthough people are viewing it as indirect tax, this is a direct tax".[37] In fact, it would be interesting to know from the CBDT, which is the nodal authority for "income tax" or "direct tax", whether the collections from the EL would go towards meeting the targets of the Income Tax Department or those of the GST Department (which comes under the Central Board of Indirect Taxes and Customs), knowing that the achieving of targets is one of the bases for promotion in both of these Departments.

One can understand the frustration[38] of the tax authorities in India (or for that matter in other jurisdictions) and their consequent endeavour to camouflage the EL as a "transaction tax" in a separate chapter of FA 2016 (IND) because any income tax levied under ITA 1961 (IND) is subject to applicable DTAAs and the non-resident operator would escape the EL by virtue of the applicable DTAA if such a levy was introduced under ITA 1961 (IND). However, merely because the levy is introduced by way of a separate chapter in FA 2016 (IND), does not alter the basic character of the EL. There is enough jurisprudence[39] to suggest that the nomenclature given to a levy cannot be the decisive criteria to be used to determine the nature of the levy.

[34] OECD 2015 Final Report, above fn.5, para.302.
[35] CBDT Report, above fn.9, paras 69–76.
[36] CBDT Report, above fn.9, para.129.
[37] D. Mondal, "There will not be in future any retrospective taxation: Business Today's Dipak Mondal caught up with Revenue Secretary Hasmukh Adhia", *Business Today*, 5 June 2016, available at: *https://www.businesstoday.in/magazine/features/revenue-secy-hasmukh-adhia-on-countrys-tax-issues/story/232552.html* [Accessed 24 August 2020].
[38] M. Schellekens, *Report on Seminar H: Recent developments in international taxation in IFA's 70th Congress in Madrid* (IBFD Online, 26 September 2016); A. Baez Moreno and Y. Brauner, "Taxing the Digital Economy Post BEPS…Seriously" (2019) 58(1) *Columbia Journal of Transnational Law* 121, 166: "Discussions with Indian officials reveal that the levy was enacted out of frustration with the inability of India to expand the PE rules within BEPS to include digital presence: India will allow MNEs to avoid the levy by declaring PE in India, applying the normal attribution rules, and India even seems to prefer a negotiated (hopefully treaty-based) solution that will allow it to impose sufficient source based taxation."
[39] *R. M. D. Chamarbaugwalla v Union of India AIR* 1957 SC 628, 1957 SCR 930; *Union of India & Others v M/S Martin Lottery Agencies Ltd* (2009) 12 SCC 209.

Moreover, the inability to amend existing DTAAs (which may not be correct in view of the fact that most countries have signed the MLI[40]), cannot be a ground for a unilateral override. Administrative inconvenience can never be a ground for imposing and collecting a tax which is otherwise not payable.[41] The construct and structure of the EL, discussed below, leaves no room for any intendment or speculation as to the nature of the levy.

C.2 Construct and structure of the EL

The EL-2020 charge attaches to the person providing the e-commerce facility. Secondly, the levy relates to receipts (consideration received) of the e-commerce operator and not to the value of the transaction, that is, it does not extend to the entire value of the transaction but only to the consideration received for rendering a particular service, or to the consideration received for the supply of a particular item, or to the consideration for facilitation of the sale or service. Thirdly, unlike GST, there is no mechanism to recover such tax under a "reverse charge" from the payer in India.

It is also surprising to note that, although the CBDT Report refers to the EL as a "transaction tax", amendments are still made to ITA 1961 (IND) to exempt[42] the e-commerce operator from any further "income tax" and to disallow deduction[43] of expenses for payers who do not withhold the EL-2016 from payments made to non-residents. Such disallowance is peculiar to non-deduction or non-payment of income tax. The disallowance of payment of a "transaction tax" like VAT/GST is housed in a different provision[44] of ITA 1961 (IND). The levy of the EL is inapplicable if the non-resident recipient of EL consideration has a PE in India and such consideration is effectively connected with such a PE. The definition of PE is borrowed from ITA 1961 (IND). It is unfathomable how a levy of a "transaction tax" can lead to exemption from charge of "income tax" or that the presence of a PE exempts the levy of a "transaction tax". This is completely contrary to any principle of tax jurisprudence. These contemporaneous expositions further strengthen the argument that the EL has all the attributes of "income tax". Moreover, the fact that the EL-2020 and the Online Information Database Access and Retrieval services (OIDAR)[45] under the GST regime operate simultaneously on similar or the same transactions and that the EL-2020 provides exemption from income tax and not OIDAR, also indicates that the EL is an "income tax" and not an "indirect tax"/"transaction tax". Not only that, there is a charge on the provision of e-commerce services under the GST[46] anyway. The field of "transaction tax" is, therefore, completely occupied by the OIDAR/GST and a reasonable presumption can be drawn that the Parliament of India does not intend to doubly tax the same transaction. Therefore, to

[40] OECD, *Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion And Profit Shifting* (24 November 2016).
[41] *GE India Technology Centre Private Ltd v Commissioner of Income-tax* (2010) 327 ITR 456 (SC); *Bharti Airtel Ltd v Union of India and Others* (2017) 291 CTR (Del) 254.
[42] ITA 1961 (IND), above fn.14, s.10(50).
[43] ITA 1961 (IND), above fn.14, s.40(iib).
[44] ITA 1961 (IND), above fn.14, s.43B.
[45] Central Board of Indirect Taxes and Customs, Department of Revenue, Ministry of Finance, Government of India, Online Information Database Access and Retrieval Services, available at: *http://cbic.gov.in/resources//htdocs-cbec/gst/OIDAR.pdf;jsessionid=298F141258A2D6D807AE6B8E688E5455* [Accessed 6 November 2020].
[46] See Integrated Goods and Services Tax Act, 2017 (IND) s.14 read with s.2(17).

provide a "transaction tax" outside the GST seems not only illogical but arbitrary. Moreover, the author cannot understand the logic of imposing two transaction taxes on the same transaction but providing "income tax" exemption on account of the second "transaction tax", that is, the EL. This demonstrates that the EL-2020 has all the attributes of an "income tax".

The aforesaid analysis reveals that not only is the purpose of the EL to overcome hurdles in enforcement of income tax but also that the nature and mechanics of the levy in the Indian context suggest that it is, in pith and substance, an "income tax" and not a "transaction tax".

Having examined the purpose, need and construct of the EL and concluding that the EL is an "income tax", the author now embarks upon an examination of its interplay with existing DTAAs.

D. Interplay with DTAAs and the constitutional scheme

The power to enter into a treaty is an inherent part of the sovereign power of India. In terms of Article 73[47] when read with Articles 246[48] and 253 of the Constitution of India, subject to the provisions of other Articles of the Constitution, the power of the Government of India extends to the matters with respect to which the Parliament of India has power to make laws, which include "income tax" and the power to enter into treaties concerning subject matter on which Parliament of India can legislate. But the obligations arising under the agreement or treaties are not automatically binding upon Indian nationals and must be enforced by way of domestic law. Theoretically, in order to enforce a DTAA, it has to be translated into an Act of Parliament, which is a time consuming and cumbersome procedure. Accordingly, section 90[49] ITA 1961 (IND) provides for a special procedure, which allows the Government of India to enforce a DTAA through a notification issued in the Official Gazette.

Once a DTAA is notified in this way, it is a settled principle of law that if a non-resident taxpayer is resident in a country with which India has a DTAA, the taxpayer has the option of

[47] Constitution of India, above fn.3, Art.73 states:

"(1) Subject to the provisions of this Constitution, the executive power of the Union shall extend—
(a) to the matters with respect to which Parliament has power to make laws; and
(b) *to the exercise of such rights, authority and jurisdiction as are exercisable by the Government of India by virtue of any treaty or agreement*:…." (Emphasis added.)

[48] Constitution of India, above fn.3, Art.246(1) states:

"(1) Notwithstanding anything in clauses (2) and (3), *Parliament has exclusive power to make laws with respect to any of the matters enumerated in List I* in the Seventh Schedule (in this Constitution referred to as the 'Union List')" (Emphasis added.)

(Entry 14 of List I reads as: "*Entering into treaties and agreements* with foreign countries and implementing of treaties, agreements and conventions with foreign Countries.") (Emphasis added.)

[49] ITA 1961 (IND), above fn.14, s.90:

"90. (1) The Central Government may enter into an agreement with the Government of any country outside India or specified territory outside India,—
(a) …
(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country or specified territory, as the case may be, or
(c) …
(d) …,
and may, *by notification in the Official Gazette*, make such provisions as may be necessary for implementing the agreement." (Emphasis added.)

being taxed either under the provisions of the tax treaty or under ITA 1961 (IND) whichever is more beneficial to the taxpayer.[50]

As the EL is in the nature of income tax, the next question is whether or not the levy is within the ambit of "Taxes Covered" under the applicable DTAA and, consequently, whether the non-resident taxpayer can take the benefit of the applicable DTAA by either seeking exemption from payment of the EL or taking credit for the EL paid in the source country.

India has DTAAs with over 90 countries. The DTAAs apply to and provide benefit in respect of "Taxes Covered" by the relevant DTAA. Broadly, for the purposes of this discussion, the DTAAs can be divided into two categories: 1. where "Taxes Covered" are defined to include both income tax levied under ITA 1961 (IND) and also any identical or substantially similar taxes which are imposed after the date of signature of the DTAA in addition to, or in place of, the existing taxes[51]; and 2. where "Taxes Covered" is defined to include both income tax without any reference to ITA 1961 (IND) and also any identical or substantially similar taxes which are imposed after the date of signature of the DTAA in addition to, or in place of, the existing taxes.[52]

In the second category there cannot be any quarrel that the EL is in the nature of an "income tax" and has been introduced as a substitute for "regular" income tax. Even if the EL is a *sui generis* income tax, protection under the relevant DTAA should be available to the non-resident taxpayer because the DTAAs do not create any distinction between "ordinary taxes" and "extraordinary taxes". In the first category referred to above, an argument could be made that, since the main provision refers to income tax under ITA 1961 (IND) only, the reference to identical or substantially similar taxes in the latter part of ITA 1961 (IND) could only be a reference to taxes imposed under ITA 1961 (IND). One needs to remember that DTAAs are not to be read as statutes but as contractual agreements and words used in DTAAs have to be read in *good faith*, having regard to the objects of the DTAA and the Vienna Convention on the Law of Treaties (VCLT).[53] Secondly, the purpose of a DTAA is to relieve double-taxation. This objective cannot be defeated on the basis of technicalities. If these principles are kept in mind and the scope and ambit of the EL, in its current form, is analysed by reference to the touchstones referred to above, it follows that the EL is substantially similar to the income tax levied under ITA 1961 (IND) and that it has been introduced to overcome and be a substitute for the "regular" income tax in order to maintain tax neutrality.

Therefore, there is a strong argument to be made that the EL is akin to "income tax" and, hence, is subject to the provisions of the applicable DTAA. The natural corollary of this is that, in the absence of a PE of a non-resident e-commerce operator, the consideration received from

[50] ITA 1961 (IND), above fn.14, s.90(2). See also the decision of the Supreme Court of India in *Union of India v Azadi Bachao Andolan* (2003) 263 ITR 706 (SC).
[51] For example, DTAAs with Austria, Canada, the Czech Republic, and the US.
[52] For example, DTAAs with the Netherlands, Singapore, and the UK.
[53] Vienna Convention on the Law of Treaties (with annex), concluded at Vienna on 23 May 1969, No.18232, Authentic texts: English, French, Chinese, Russian and Spanish, Registered ex officio on 27 January 1980. Art.26 incorporates the principle of "Pacta sunt servanda", stating: "Every treaty in force is binding upon the parties to it and must be performed by them in good faith." Although India is not a signatory to the Vienna Convention, the Supreme Court of India has, in the case of *Ram Jethmalani v Union of India* (2011) 8 SCC 1, recognised that the Vienna Convention codifies many principles of customary international law, which are useful aids in the interpretation of treaties.

India will not be subject to any tax, including the EL, unless it is held to be in the nature of a "royalty"[54] or "fees for technical/included services".[55]

The final section of this article will review the consequences of the introduction of the EL, as a unilateral measure, under public international law.

E. The EL: consequences under public international law

As discussed earlier in this article, the introduction of the EL by way of the EL-2016 and the expansion of its scope by way of the EL-2020 may have very laudable objectives, that is, the maintenance of tax neutrality and the provision of uniformity of taxation, etc. The morality of multinationals in structuring their transactions in such a way as to reduce taxation in the source nation has also been called out by many countries. However, can those objectives and concerns justify India overriding its existing tax treaty obligations? Does the structuring of transactions to reduce taxation in the source jurisdiction allow such jurisdictions to dodge existing DTAAs?

The OECD *BEPS Project Explanatory Statement: 2015 Final Reports* categorically notes that the measures discussed in that Report, including the EL, were not recommended at this stage. The caveats being that

> "[c]ountries could, however, introduce any of these options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties"[56]

and that such measures are interim or temporary in nature, until other Action points are resolved. This is in line with the OECD's earlier approach[57] wherein the *Recommendation of the Council concerning Tax Treaty Override* was adopted by the OECD Council on 2 October 1989. The Instrument recommends that the Member countries undertake "bilateral or multilateral consultations to address problems connected with tax treaty provisions" and avoid enacting legislation that contradicts international treaty obligations.[58] Secondly, the EL portrays an unrealistic picture of temporariness. The classification of these measures as "interim measures" is illusory. Once interim measures are in place, there will be less political will to push for implementation of the permanent, consensus based measures; more importantly, it is unclear how long it will take to reach such consensus, if such were to be possible at all.[59] Therefore, the introduction of the EL cannot and should not be a measure which is used to reduce or deny the benefits of an existing DTAA or to completely dodge such DTAAs.

India may not be a signatory to the VCLT but Article 26 of that Treaty, which incorporates the principle of "*Pacta sunt servanda*", and Article 27, which dissuades states from citing domestic

[54] ITA 1961 (IND), above fn.14, s.9(1)(vi).
[55] ITA 1961 (IND), above fn.14, s.9(1)(vii).
[56] OECD/G20 Base Erosion and Profit Shifting Project, *BEPS Project Explanatory Statement: 2015 Final Reports* (Paris: OECD Publishing, 2016), available at: *http://dx.doi.org/10.1787/9789264263437-en* [Accessed 2 September 2020], para.19.
[57] OECD, OECD Legal Instruments, *Recommendation of the Council concerning Tax Treaty Override*, OECD/LEGAL/0253, OECD adopted on 2 October 1989 (OECD, 2020), available at: *https://legalinstruments.oecd.org/en/instruments/OECD-LEGAL-0253* [Accessed 25 August 2020].
[58] OECD, *Recommendation of the Council concerning Tax Treaty Override*, above fn.57, I, 1 and 2.
[59] Baez Moreno and Brauner, above fn.38.

law to override treaties, are both rules of customary international law, and as such are useful aids to interpretation and form the basic norms of civility. Similar provisions are reflected in other public international documents such as the International Law Commission articles on State Responsibility.[60] In addition, Article 51 of the Constitution of India requires that:

> "The State shall endeavour to-…(c) foster respect for international law and treaty obligations in the dealings of organised peoples with one another…."[61]

If the EL were to be examined using the principles referred to above as a touchstone, it is submitted that it would be found that the levy falls foul of all of these principles. Source jurisdictions cannot use domestic law (the EL) to disregard solemnly signed DTAAs. In other words, in the absence of a PE, the source jurisdiction cannot bring to tax business income of foreign taxpayers by imposing the EL. Additionally, the introduction of the EL strikes at the very root of the bilateral nature of tax treaties by creating friction between partner countries, which is exactly what the founders of the Constitution of India wanted to avoid.[62] Interestingly, the EL-2020 did not form part of the original Finance Bill, 2020 which was introduced in Parliament on 1 February 2020. It found its place only in the amendments to the Finance Bill, 2020 moved by the Finance Minister on 23 March 2020 and the amended Bill was passed by Parliament on the same day without any discussion. In effect, the EL-2020 was never discussed or debated in the Parliament of India and became effective on 1 April 2020.

Thus, the consequences of such unilateral measures not only impinge upon the existing DTAAs and violate the VCLT but are also in conflict with constitutional principles and the rule of law. Unlike what took place in the *Jadhav Case*,[63] treaty partners may not be able to drag India or other source jurisdictions to the International Court of Justice (ICJ) or to the Permanent Court of Arbitration for such unilateral measures as the ICJ may not have jurisdiction in the absence of specific incorporation of the protocol in the relevant DTAA. But alleged treaty misuse provides no excuse for indulging in dodging existing treaty obligations.

F. Conclusion

Overwhelming evidence suggests that the EL has all the attributes of an "income tax". The Income tax authorities in India are, however, not likely to accept this proposition, particularly when the stand taken by the Committee in the CBDT Report is considered.[64] Given the foregoing discussion, taxpayers will now have the option of challenging the constitutional validity of the EL, particularly the EL-2020, on the grounds of extra-territoriality or remoteness of nexus and

[60] International Law Commission, *Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries 2001*, text adopted by the International Law Commission at its fifty-third session, in 2001, and submitted to the General Assembly as a part of the Commission's report covering the work of that session (A/56/10). The report, which also contains commentaries on the draft articles, appears in the *Yearbook of the International Law Commission, 2001*, Vol.II, Part Two, as corrected.
[61] Constitution of India, above fn.3, Art.51(c).
[62] Constitution of India, above fn.3, Art.51. See also *Commissioner of Customs, Bangalore v G.M. Exports* [2015] 324 ELT 209 (SC).
[63] *Jadhav Case (The Republic of India v Islamic Republic of Pakistan)*, 17 July 2019, General List No.168, available at: *https://www.icj-cij.org/files/case-related/168/168-20190717-JUD-01-00-EN.pdf* [Accessed 25 August 2020].
[64] CBDT Report, above fn.9.

arbitrariness. Alternatively, taxpayers could dispute the liability itself on the grounds of the levy being within the scope of "Taxes Covered". In either case, it will be interesting to see how the courts in India react to the EL imposed by Parliament as a transaction tax by "dodging"[65] the existing tax treaty obligations.

[65] A. Mehta, "'Equalization Levy' Proposal in Indian Finance Bill 2016: Is it Legitimate Tax Policy or an Attempt of Treaty Dodging?" (2016) 22(2) *Asia-Pacific Tax Bulletin Online*.

Constitutionality; Double taxation; E-commerce; Equalisation tax; India; Tax administration

Book Reviews

Current Tax Treaty Issues — 50th Anniversary of the International Tax Group, by G. Maisto (ed.), (IBFD, 2020), 728pp., €130, ISBN: 978-90-8722-596-4.

This book[1] celebrates the 50th anniversary of the International Tax Group, a group of experts who have made a lasting contribution to research on international tax law through their publications. Many of these publications have been published in this *Review*. This book contains individual contributions by all of the Group's current members.[2] Just as differences in tone become audible when members of an orchestra play solo works instead of symphonies, the contributions in this book vary in style and approach too. Some of them depart from the Group's distinct integrated approach—whereby there are no separate sections for different countries, but rather an integrated text. None of this is distracting as the individual class of the contributions makes for fascinating—and, in spite of the 696 pages—admittedly pleasant reading. The topics discussed in the 16 contributions, which are subdivided into four Parts—"Treaty Policy and General Considerations", "Treaty Definitions", "Taxing Rules" and "Non-Discrimination and Beneficial Ownership"—do not have a logical common denominator other than that they all address "current tax treaty issues". In spite of the range of topics being somewhat eclectic, it is apparent from the quality of the contributions and the research done that the authors have a strong affiliation with their topics.

The first chapter, "A History of the International Tax Group" by John Avery Jones and Toshio Miyatake (Japan)[3] is a trip down memory lane. The four founding fathers of the Group held a meeting after the 1970 IFA Congress and agreed to publish co-authored articles on international concepts by analysing the international precedents of all countries and the analogies of the internal precedents of each country as constituting a single body of international law, starting with "permanent establishment". This was in a time when "virtually nobody had written about tax treaties",[4] information about the tax systems of other countries was not merely a mouse click away and way before oh-so-valuable *www.taxtreatieshistory.org/*.

In that era, without fax and email, the group set the now almost unimaginable (but still largely observed) tradition of meeting twice a year for three days, with an excursion on the Sunday afternoon and a separate programme for accompanying spouses. It is hard to miss the authors' reminiscence of that period with its "slower pace of life", where draft versions were shared a month ahead of the meetings, carefully read by all attending and every change was meticulously thought through before a draft would be updated. Now we have become accustomed to submissions just before (or typically, after) the due date and last-minute reading on the plane.

[1] G. Maisto (ed.), *Current Tax Treaty Issues — 50th Anniversary of the International Tax Group* (Amsterdam: IBFD, 2020).
[2] Sadly, ITG member Professor Jürgen Lüdicke (Germany) was unable to write due to illness and passed away earlier this year. A beautiful tribute to Professor Lüdicke by Professor Wolfgang Schön (Germany) may be found here: *https://www.jura.uni-hamburg.de/forschung/institute-forschungsstellen-und-zentren/iifs/ueber-das-institut/aktuelle-meldungen/2020-01-29--todesanzeige-luedicke/f--luedicke--sod-schoen.pdf* [Accessed 17 August 2020].
[3] J. Avery Jones and T. Miyatake, "A History of the International Tax Group" in Maisto (ed.), above fn.1.
[4] Avery Jones and Miyatake, above fn.3, 2.

The authors' musing should not be anachronistic: Avery Jones and Miyatake rightly suggest that what sets the Group and its publications apart is the uncompromising process of discussing draft versions twice a year "for as long as it took to satisfy us that the draft was ready to publish".[5] This should be a clarion call for younger tax experts to at least sometimes resist the "publish or perish" pressure or the instant gratification of blog post likes and dedicate their efforts to the relentless crafting of articles that do not pass into nothingness.

The book's contributions will appeal to a wide audience and include two eminent historical contributions by Richard Vann (Australia)[6] and a comparison of tax litigation between the Netherlands and the UK (Frank Pötgens (Netherlands), and John Avery Jones)[7] that exemplifies how true comparative research goes beyond identifying possible similarities and differences between two legal systems, and also seeks to explain those differences and even debates whether the differences are really what they appear to be. Koichi Inoue and Toshio Miyatake's (Japan) rigorous contribution on the "Preservation Principle"[8] addresses the important topic of interaction between domestic law and international tax law. Bertil Wiman's (Sweden) plea for the reinforcement of parliament's role in the tax treaty ratification process[9] will not fall on deaf ears: international tax has become a highly politicised topic in recent years. Guglielmo Maisto (Italy) is the editor of the series in which this book was published and also hosted the Group's 50th anniversary meeting. The cool, analytical style of his treatise on the "Taxation of States under Tax Treaties"[10] is classic European-style research at its finest. As is more common in the US, Peter Blessing's contribution[11] is more theoretically oriented. He concludes that the principal purpose test (PPT), which is now included in many tax treaties, is not adequate in addressing the different forms of inappropriate treaty access behaviour and proposes a cocktail of a limitation on benefits (LOB) test, an anti-conduit rule and a general anti-avoidance principle, whether in the form of a domestic general anti-avoidance rule (GAAR) or a PPT. In a high-brow contribution, Angelo Nikolakakis (Canada) bridges common law and civil law,[12] inimitably finds common themes in two seemingly very different cases (*Fowler v HMRC*[13] and the *McDonald's*[14] case) and displays eloquence and wit. Johan Hattingh (South Africa) raises legitimate concerns about the use of Memoranda of Understandings[15] that attempt to legislate post a treaty's conclusion date. In characteristically articulate, almost conversationalist prose, Philip Baker[16] makes a convincing case for the development of a common understanding as to what constitutes an adequate nexus

[5] Avery Jones and Miyatake, above fn.3, 7.
[6] R. Vann, "Writing Tax Treaty History" and "International Tax Policy and International Tax Institutions: Never the Twain?" in Maisto (ed.), above fn.1.
[7] J. Avery Jones and F. Pötgens, "Four Comparisons of Tax Litigation between the Netherlands and the UK" in Maisto (ed.), above fn.1.
[8] K. Inoue and T. Miyatake, "Preservation Principle" in Maisto (ed.), above fn.1.
[9] B. Wiman, "Constitutional Issues in Developing International Tax Norms: A Swedish Perspective" in Maisto (ed.), above fn.1.
[10] G. Maisto, "Taxation of States under Tax Treaties" in Maisto (ed.), above fn.1.
[11] P. Blessing, "Limitations on Treaty Access by or through Commercial Entities" in Maisto (ed.), above fn.1.
[12] A. Nikolakakis, "Interpretation vs Qualification" in Maisto (ed.), above fn.1.
[13] *Fowler v HMRC* [2018] EWCA Civ 2544.
[14] *McDonald's Europe* (C(2018) 6076), 19.9.2018.
[15] J. Hattingh, "Legal Considerations Arising from the Use of Memoranda of Understanding in Bilateral Tax Treaty Relations" in Maisto (ed.), above fn.1.
[16] P. Baker, "Some Thoughts on Jurisdiction and Nexus" in Maisto (ed.), above fn.1.

for tax jurisdiction. It is laudable that Stjepan Gadžo's "excellent and thought-provoking" work[17] in this area (Baker's words) receives wide acknowledgment in Baker's contribution[18]: a full recognition of the work of younger scholars by those who have already arrived can give such a boost.

Stéphane Austry's (France)[19] contribution will be read with some relief by multinational corporations and their tax advisors who may have feared that after the change of wording of Article 5(5) of the OECD Model Tax Convention on Income and on Capital (OECD Model)[20] suddenly every commissionaire-like arrangement will give rise to a permanent establishment: its practical impact will at least in the near future be limited. Shefali Goradia (India)[21] discusses the currently inadequate framework in both the OECD Model and the UN Model[22] for the taxation of services and makes a strong case for "place of performance" of services as a logical approach, which could be applied to digital services too as their utilisation in a market state could be seen as the place where they are performed. Kees van Raad's (The Netherlands)[23] razor-sharp analysis of the ambiguous tax treaty practice regarding Article 21 OECD Model/UN Model is a note-to-self to every tax practitioner applying that Article, to carefully understand its intended meaning in the tax treaty-specific context.

Fully observant of Betteridge's law, Robert Danon's (Switzerland)[24] answer to the question he raises in his contribution's title is: no, we no longer need the beneficial ownership (BO) limitation, "since the PPT is now intended and capable of addressing the conduit company problem in a holistic fashion".[25] Finally, Luc De Broe (Belgium)[26] concludes that there are strong arguments for a national court of a Member State that is called on to interpret the BO term in an OECD-conforming tax treaty to consider the definition of BO in the EU Interest-Royalty Directive[27] as clarified in the CJEU's explosive "Danish" cases of 26 February 2019,[28] even if that treaty was concluded before the Directive's adoption in 2003 and even if that tax treaty is concluded with a third (non-EU) country. This should send some shivers down the spines of

[17] S. Gadžo, *Nexus requirements for taxation of non-residents' business income: a normative evaluation in the context of the global economy* (Amsterdam, IBFD: 2018).
[18] See for instance Baker, above fn.16, 441 fn.2.
[19] S. Austry, "PE and Dependent Agent: Where Do We Stand?" in Maisto (ed.), above fn.1.
[20] OECD, *Model Tax Convention on Income and on Capital 2017 (Full Version)* (OECD Publishing, 2019), available at: *http://www.oecd.org/ctp/model-tax-convention-on-income-and-on-capital-full-version-9a5b369e-en.htm* [Accessed 15 October 2020].
[21] S. Goradia, "Taxation of Services" in Maisto (ed.), above fn.1.
[22] United Nations Model Double Taxation Convention between Developed and Developing Countries 2017, available at: *https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf* [Accessed 15 October 2020].
[23] K. van Raad, "Tax Treaty Practice Regarding Article 21 and Related OECD and UN Model Issues" in Maisto (ed.), above fn.1.
[24] R. Danon, "The Beneficial Ownership Limitation in Articles 10, 11 and 12 OECD Model and Conduit Companies in Pre- and Post-BEPS Tax Treaty Policy: Do We (Still) Need It?" in Maisto (ed.), above fn.1.
[25] Danon, above fn.24, 662.
[26] L. De Broe, "Should Courts in EU Member States Take Account of the ECJ's Judgment in the Danish Beneficial Ownership Cases When Interpreting the Beneficial Ownership Requirement in Tax Treaties?" in Maisto (ed.), above fn.1.
[27] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States [2003] OJ L157/49.
[28] *N Luxembourg 1 and Others v Skatteministeriet* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16) EU:C:2019:134 (26 February 2019).

taxpayers and their advisors in Member States where courts have so far taken a formalistic approach to interpretation of the BO requirement and have been reluctant in allowing domestic GAARs to be used against treaty shopping.

In short, this book is an excellent example of craftmanship and "slow" writing. Let us hope that the Group continues to produce their timeless articles and that, with the passing of time, its composition will grow to more proportionately reflect today's large group of female tax experts.

Dr Frederik Boulogne[*]

Tax Law, State Building and the Constitution, by D. de Cogan, (Hart Publishing, 2020), 208pp., £43.20, ISBN: 9781509923564.

At the end of this book Dr de Cogan poses the rhetorical question of whether tax law is

> "a type of public law with special features reflecting the centrality of finance to state building or instead a *sui generis* field that operates outside the mainstream of both public and private law".[1]

The book is a sustained and convincing justification of the first view, a view which should not be surprising to a student of the UK's constitutional history but which is rarely acknowledged now either in tax law or in public law scholarship. The book is hugely important in reminding us that tax law is, above all, public law.

To summarise the argument of the book, the author emphasises two dimensions of tax law and constitutions: constitutional change is relevant to the proper understanding of our tax system; and, conversely, decisions in the tax field may influence wider constitutional developments.[2] Both can be drawn from the essential role of tax capacity in state-building. This is well documented in the case of the creation of new states, but it applies also to developed states such as the UK. Examples of the interaction of public law and tax law include the application of administrative law doctrines and basic public law principles to tax problems, the building and maintenance of the institutions of government concerned with tax, the significance of tax for social roles addressed by public law such as gender, race and class, and the emergence of trans-national tax law.[3] Paradoxically, however, tax does not appear to be of everyday constitutional importance and operates as "normal law within the usual constitutional constraints",[4] though the issues are now being addressed in part by the new discipline of fiscal sociology,[5] drawing on Schumpeter's pioneering work a century ago.[6] The interaction between tax law and

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[1] D. de Cogan, *Tax Law, State Building and the Constitution* (Oxford: Hart Publishing, 2020), 175.
[2] de Cogan, above fn.1, 2.
[3] de Cogan, above fn.1, 4.
[4] de Cogan, above fn.1, 6.
[5] See for instance A. Mumford, *Fiscal Sociology at the Centenary: UK Perspectives on Budgeting, Taxation and Austerity* (Basingstoke: Palgrave MacMillan, 2019).
[6] J. Schumpeter, "The Crisis of the Tax State" in R. Swedburg (ed.), *The Economics and Sociology of Capitalism* (Princeton: Princeton University Press, 1991).

constitutional law has emerged at key constitutional moments, such as the seventeenth century conflicts between Parliament and the Crown and the "People's Budget" crisis of 1909 culminating in the Parliament Act 1911. The weakness of the existing literature is in its fragmentation:

> "What is missing is some broader sense of whether tax matters to the constitution, whether the centrality of tax revenues and rules to the creation and survival of a state makes any difference to the contemporary evolution either of tax or of constitutional law."[7]

These questions are then addressed through a series of case studies. The first is perhaps the most obvious in recent constitutional politics: that of tax devolution to the constituent nations of the UK and, in embryonic form, to English regions through the role of combined authorities. In line with the nature of devolution as a process, not an event, this has been complex and changing, but does seem to involve a move towards something closer to a more recognisably federal form of constitution, though it remains vulnerable to the underlying principle of Parliamentary sovereignty. Secondly, the author examines processes of tax reform and the pre-legislative scrutiny of policy. Key themes are the uncertainties of ministerial responsibility when revenue is carried out through the non-ministerial department of HMRC ("[t]he question of ministerial responsibility, as may be imagined, becomes quite involved when there is no minister to be held responsible…")[8] and limitations on the capacity of Parliament. There is no specialist tax select committee, though an important role has been played by other committees, notably the Committee of Public Accounts under the chairing of Dame Margaret Hodge MP. Despite the charade of budget secrecy, there have been improvements in consultation, although the mechanisms involved are all "soft" in that government can ignore their recommendations, perhaps inevitably given that "to lose control of the finances is to lose control of the state".[9] There is strong resistance to any form of radical reform, especially when it comes from outsiders, as in the case of the *Mirrlees Review*.[10] Though the constitution has been important in shaping these processes, there is no substantial evidence that tax decisions will have a wider constitutional significance here.

The next case study is that of taxpayer protection. Tax law is unusual in that so much of it is contained in highly detailed primary legislation, thereby limiting the opportunities for judicial review. At the other extreme, there has been an increased reliance on "soft law" standards, for example in the context of anti-avoidance measures.[11] The courts have adopted a more purposive approach to statutory interpretation, and procedural protections are weak given the decision by the European Court of Human Rights in *Ferrazzini v Italy*[12] that tax matters are generally outside the scope of Article 6 of the European Convention on Human Rights. Instead, an increasing range of extra-legal complaints mechanisms have been established. As a result

[7] de Cogan, above fn.1, 27.
[8] de Cogan, above fn.1, 67.
[9] de Cogan, above fn.1, 95.
[10] J. Mirrlees, et al. (eds), *Tax by Design: The Mirrlees Review* (Oxford: OUP, 2011).
[11] HMRC, Policy paper, *Code of Practice on Taxation for Banks* (December 2013), available at: *https://www.gov.uk/government/publications/code-practice-taxation-banks/code-of-practice-on-taxation-for-banks* [Accessed 11 September 2020].
[12] *Ferrazzini v Italy* (44759/98) [2001] STC 1314 (ECtHR).

> "[p]erhaps the prevalent mode of taxpayer protection, rooted in statutory detail, anti-avoidance principles and purposive interpretation, is no longer capable of conciliating public-private tensions in the face of rapidly accumulating revenue powers".[13]

Not only does this raise questions of the status of individual rights, it also raises fundamental questions of the philosophical basis of taxation.

The final case study is entitled "Europe and Beyond" and looks at international law, including sceptical questioning of the view that the state has been "hollowed out" by supranational governance mechanisms thereby limiting the capacities of individual nation states. There is also discussion of the OECD and its Base Erosion and Profit Shifting Project,[14] though it has still to realise its potential. The final section is on Brexit. Although any such discussion rapidly becomes dated, it emphasises strongly the role of customs duties and the special arrangements for Northern Ireland, still likely to be a major problem in the future. Although

> "constitutional law is generally well-equipped to process the challenges of international and European taxation, [it] arguably does not have the apparatus to de-escalate the Irish border crisis".[15]

A brief concluding chapter revisits some key themes. Dr de Cogan emphasises the developing nature of the state-building through tax systems: "[e]ach of chapters two to five deals with aspects of the tax system that could conceivably be unrecognisable within 10 years".[16] Though there have been major developments in institution building, notably in Scotland and Wales, it is also noticeable that central government institutions have been relatively static; trends underlying the devolution, localisation or globalisation of tax have been accommodated through existing structures and are subject to underlying continuities in the competence of central government.[17] This shows an inherent flexibility in the UK constitution, and one which is open to protecting government revenues given their importance for maintenance of the state. Despite the wide range of developments covered in the book, there has been no recent exposure of the limits of constitutional law as occurred, for example, in the crisis over the People's Budget of 1909. This is desirable according to the author: "there are very good reasons indeed for not making the basic finance function of the state too exciting".[18]

This book is of enormous importance in making clear that tax law is public law, and in providing detailed coverage of major issues which illustrate this point. It would not go too far to say that it is ground-breaking in suggesting new paths for research and new ways of understanding both legal disciplines. It is extremely well written and easy to understand, and it should be accessible to both tax and public law audiences. Inevitably it has some limitations, and this reviewer shall now identify some of these without wishing to qualify their strong appreciation of the book as a whole.

[13] de Cogan, above fn.1, 128.
[14] For background, see OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013), available at: *https://www.oecd.org/ctp/BEPSActionPlan.pdf* [Accessed 11 September 2020].
[15] de Cogan, above fn.1, 163.
[16] de Cogan, above fn.1, 165.
[17] de Cogan, above fn.1, 168.
[18] de Cogan, above fn.1, 173.

At this time, more than ever, authors are at the mercy of rapidly changing events. The most recent development identified in a footnote is that of the result of the December 2019 Election though it was not possible to discuss its implications in the book. Neither the COVID-19 crisis nor the radical change of style of the new Government could be covered. Both have major implications for the themes of this book. The pandemic has resulted in an enormous increase in public spending. It is as yet unclear how this will be paid for; despite rumours of future tax increases, it seems likely that borrowing will be the most likely source for meeting these huge costs. This means that it is all the more important to see government fundraising in the round rather than concentrating on taxation alone. Dr de Cogan is clearly aware of this, and there is good justification for his concentration on tax as providing a clear focus for his study. It may well be that this will be unsustainable in the future, however, and that any future study of government revenue will need to examine it alongside borrowing and quantitative easing as economic instruments for state-building. The contribution of "modern monetary theory" in the work of writers such as Stephanie Kelton could be particularly helpful here.[19]

The second change is on the constitutional side. Since the 2019 Election a very different style of governing has been seen, with greatly increased centralisation around the Prime Minister and his advisers accompanied by a clear marginalisation of both Parliament and the courts as vehicles for accountability. Instead, legitimacy is secured by the "will of the people" expressed by referendum or general election. It will be fascinating to see how the apparent flexibility of the UK constitution which is celebrated in the conclusion to this book will cope with such radical change. The new governing style may of course merely be a passing phenomenon and things will soon return to constitutional normality, but this is by no means certain. At the very least, however, it is already leading to increased conflict with the devolved nations; at most, it may introduce a new constitutional paradigm highly relevant to the themes set out here. If the existing constitution can cope, is this to be applauded or regretted?

Dr de Cogan suggests two pathways for future research. They are detailed empirical examination of the themes he covers, and future comparative work. Both will be enormously valuable, and it will be particularly important to see how the nations of Continental Europe with their radically different constitutional traditions cope with the issues raised in the study. Let the reviewer finish by suggesting another future direction. Can tax law be taught not as a technical subject analogous to commercial law and similar areas of professional interest, but as a form of public law governed by, and illustrative of constitutional and administrative law principles? That would be a fitting legacy of this highly important book.

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[19] See for instance S. Kelton, *The Deficit Myth: Modern Monetary Theory and the Birth of the People's Economy* (New York: Public Affairs, 2020).

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