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Table of Contents

Case Notes

Article

Book Reviews

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Current Notes

The Draft Non-Contentious Probate (Fees) Order 2018

For a second time in recent years the prospect of greatly increased fees payable by personal representatives in England and Wales in order to administer the estate of a deceased person is looming. The Government's aim in moving from a costs recovery basis fee to an enhanced fee is to generate additional income to be used to fund the court service generally. However, there has been much discussion about whether the level of the proposed increased fee is such that it effectively amounts to taxation, although the Government considers that the increase in fees is necessary to provide funds to modernise and update the justice system generally.

When do these fees apply?

The personal representatives[1] of a deceased individual have to administer that individual's estate and will, in many cases,[2] have to apply for a grant of representation[3] in order to be able to prove that they are legally authorised to do so.[4] The grant is issued by the Probate Service which is part of HM Courts and Tribunal Service and a fee is payable when the application for a grant is made. Before making the application an inheritance tax account has to be submitted to HMRC (unless it is an excepted estate) and HMRC must issue a receipt.

Between 1981 and 1999 the application fee for a grant was based on the net value of the estate. For an estate worth £100,000 the fee for a general grant was £250 but the fee increased (with no upper limit) by £50 for every £100,000 (or part thereof) for estates worth more than £100,000.

Since 1999, however, the application fee has been set at a flat rate (currently £215 if made by an individual or £155 if made by a solicitor). The fee currently only applies where the estate is worth more than £5,000. In 2017–2018 the Probate Service issued 260,000 grants of probate.[5]

2016–2017 proposed fee increase

As a result of concerns about the cost to the taxpayer of running the court system,[6] the Ministry of Justice issued a consultation document in 2016[7] inviting views on the proposed introduction of a seven band fee structure to be based on the value of the estate, and an increase in the threshold

[1] Executors or administrators depending on whether they are appointed under a will or not.
[2] e.g. unless the deceased's assets were jointly owned as joint tenants and so pass by survivorship or the deceased only had certain types of savings or premium bonds.
[3] That is, a grant of probate where there is a will with an effective appointment of executors, or a grant of letter of administration if there is no will or a grant of letters of administration with the will annexed if there is a will but, for example, there is no effective appointment of executors.
[4] The Government indicated that around 50% of deaths in England and Wales require a grant of representation, see: Ministry of Justice, *Court Fees—Consultation on proposals to reform fees for grants of probate* (February 2016), Cm.9195.
[5] Draft explanatory memorandum to the Draft Non-Contentious Probate (Fees) Order 2018, para.7.1.
[6] The net cost was stated to be £1.1 billion in 2014–2015.
[7] Ministry of Justice, above fn.4.

below which no application fee would be payable to £50,000. The maximum proposed fee was £20,000 payable where the estate had a value of over £2 million.

It was envisaged that the proposed fee structure would generate around £250 million of additional income which would be used to subsidise other court services. In addition to the fee increase, the general fee remission scheme "Help with Fees"[8] would no longer apply (although the Lord Chancellor would still have power to waive the fee in exceptional circumstances). The consultation document also linked the proposed increased application fee with the introduction of the inheritance tax residence nil rate band indicating that the benefit of the latter would outweigh the cost of the increased application fee.

The Government's response to the consultation, published in February 2017,[9] stated that a large number of the 853 responses to the consultation had disagreed with the proposal to charge fees on the basis of the value of the estate rather than the cost of fulfilling the service. However, the Government decided to go ahead and a draft order[10] based on the proposals set out in the consultation document was laid before Parliament in February 2017.

It was considered by the House of Lords Secondary Legislation Scrutiny Committee[11] and the Joint Committee on Statutory Instruments[12] and both committees expressed concerns that the Government was exceeding its power to levy enhanced fees[13] and that the proposed fee structure had the hallmarks of a tax rather than a fee structure.[14] The difference between applying for a grant, which is an administrative process personal representatives must carry out in order to administer an estate, and the position of other litigants who can decide whether or not to litigate was highlighted by the Joint Committee. Outside Parliament there was also a lot of media coverage about the proposed increase in fees. However, as a result of the calling of a General Election in June 2017, the draft order had to be withdrawn.

2018 proposed fee increase

On 5 November 2018, the Justice Minister announced a revised proposal and a new draft statutory instrument was laid.[15] Although the new proposed fee structure still operates according to the value of the estate, the level of the fees has been reduced and the aim now is to raise more than £145 million of additional fee income in 2019–2020 rising each year after that in line with increases in estate values.

[8] Gov.UK, *Get help paying court and tribunal fees*, available at: *https://www.gov.uk/get-help-with-court-fees* [Accessed 12 June 2019].
[9] Ministry of Justice, *Court Fees—The Government Response to consultation on proposals to reform fees for grants of probate* (February 2017), Cm.9426.
[10] The Draft Non-Contentious Probate (Fees) Order 2017.
[11] House of Lords. Secondary Legislation Scrutiny Committee, *28th Report of Session 2016–17* (16 March 2017), HL Paper No.131.
[12] Joint Committee on Statutory Instruments, *26th Report of Session 2016–17* (31 March 2017), HL 152, HC 93.
[13] Under the Anti-Social Behaviour, Crime and Policing Act 2014 s.180(1) which allows the Lord Chancellor with the consent of the Treasury to set a fee of an amount intended to exceed the cost of anything in respect of which the fee is charged.
[14] For a more detailed discussion of the Parliamentary proceedings, see C. Fairbairn, *Probate fees* (8 April 2019), House of Commons Briefing Paper No.07929.
[15] The Draft Non-Contentious Probate (Fees) Order 2018.

Value of estate	Fee under 2017 proposal	Fee under 2018 proposal
£50,000 or less	nil	nil
More than £50,000 but not more than £300,000	£300	£250
More than £300,000 but not more than £500,000	£1,000	£750
More than £500,000 but not more than £1,000,000	£4,000	£2,500
More than £1,000,000 but not more than £1,600,000	£8,000	£4,000
More than £1,600,000 but not more than £2,000,000	£12,000	£5,000
More than £2,000,000	£20,000	£6,000

The Minister indicated that the increase in the fee threshold will mean that around 25,000 estates per annum will not need to pay a fee for making the application and that 80 per cent of estates will need to pay £750 or less.[16] As before, the "Help with Fees" scheme will no longer apply but the Lord Chancellor will have power to waive fees in exceptional cases.

The draft order requires the formal approval of both Houses of Parliament and it has been considered by the House of Lords Secondary Legislation Scrutiny Committee,[17] the Joint Committee on Statutory Instruments[18] and the House of Lords.[19] During these proceedings,[20] concerns were again raised about whether the power to levy enhanced fees is being misused in order to impose a stealth tax. However, the Junior Justice Minister made it clear that the Government considers this is an application fee for a specific purpose and is not general taxation.[21]

As it had been thought that the new fees would come into effect on 1 April 2019, personal representatives were concerned to avoid any delay in making an application as this would substantially increase the costs involved. This led many of those potentially affected by the new higher fees to expedite the making of the application for a grant which increased the work load of HMRC and the Probate Registry. HMRC announced on 27 March 2019[22] that during the period before the introduction of the new fees, the Probate Registry will accept applications for grants after the inheritance tax account has been submitted to HMRC but before the issue of the IHT 421 receipt.

However, due to the Brexit process, a date has not yet been set for the formal approval of the order by the House of Commons and the new fees can only come into operation 21 days after such approval has been given.

[16] L. Frazer, *Justice Update: Written statement - HCWS1066* (5 November 2018).
[17] House of Lords. Secondary Legislation Scrutiny Committee (Sub-Committee A), *6th Report of Session 2017–19* (21 November 2018), HL Paper No.235.
[18] Joint Committee on Statutory Instruments, *40th Report of Session 2017–19* (7 December 2018), HL 247, HC 542.
[19] *Hansard*, HL, Vol 794, col 1722 (18 December 2018).
[20] For a more detailed discussion of the Parliamentary proceedings, see Fairbairn, above fn.14.
[21] *Hansard*, HC, 14th Delegated Legislation Committee (7 February 2019)—The Parliamentary Under-Secretary of State for Justice Lucy Frazer.
[22] HMRC, *Proposed change to probate fees* (27 March 2019), available at: *http://www.gov.uk/government/news/proposed-change-to-probate-fees* [Accessed 12 June 2019].

Comment

Whilst the increase in the threshold for payment of the fee to £50,000 is to be welcomed, the proposed new fees will still give rise to a substantial increase in the cost of applying for probate for estates worth more than £50,000. The higher level of the fee is likely to become an important factor for many people when considering estate planning and how to hold assets in future. It is to be hoped that this does not lead to an increase in the potential for fraud, with elderly individuals worried about the cost being persuaded to make inappropriate lifetime gifts or transfers of assets into joint names to avoid the need for probate.

It is also unfortunate that the fee increase is set to go ahead at a time when practitioners are experiencing significant delays in obtaining a grant. There appear to be a number of factors contributing to these delays, not just the increase in the workload of HMRC and the Probate Registry caused by applications being made before April. However, once the new fees are in operation, personal representatives are likely to be more critical of any delay or reduction in the level of service provided.

Laura Kermally[*]

The April 2019 Loan Charge

Introduction

The Loan Charge was enacted in the Finance (No.2) Act 2017 (F(No.2)A 2017)[1] to deal with legacy cases of disguised remuneration (DR) loans. The clauses appeared uncontentious when before the Public Bill Committee. The debate lasted 15 minutes, with contributions from only the Paymaster General and Financial Secretary to the Treasury (Mel Stride) and the Shadow Treasury Minister (Anneliese Dodds). There was no division.[2] The yield from the Loan Charge was expected to be £3.2 billion over five years.[3]

Two-and-a-half years on, the Loan Charge has become politically contentious. The Loan Charge Action Group (LCAG) has been formed to raise awareness of the Loan Charge.[4] The LCAG has established the Loan Charge Litigation Trust to pursue a judicial review of the Loan Charge.[5]

Administration of estates; Fees; Personal representatives; Probate

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[1] F(No.2)A 2017 s.34 and Sch.11.

[2] *Hansard*, Public Bill Committee (2017), Finance Bill (Fourth Sitting), Vol 629, cols 99–102 (19 October 2017).

[3] HM Treasury, *Section 95 of the Finance Act 2019: report on time limits and the charge on disguised remuneration loans* (March 2019), available at: *https://www.gov.uk/government/publications/report-on-time-limits-and-the-disguised-remuneration-loan-charge* [Accessed 19 June 2019], para.3.72. This would appear to include, from the tax information and impact note, settlements in anticipation of the Loan Charge and the extension of disguised remuneration to the self-employed and the removal of the company deduction.

[4] Loan Charge Action Group, available at: *https://www.hmrcloancharge.info/* [Accessed 19 June 2019].

[5] Loan Charge Action Group, above fn.4, *The Loan Charge Action Group to launch crowd-funded Judicial Review*, available at: *https://www.hmrcloancharge.info/judicial-review/* [Accessed 19 June 2019].

The House of Lords Economic Affairs Committee's report on *The Powers of HMRC* has criticised the Loan Charge and recommended "that the loan charge legislation is amended to exclude from the charge loans made in years where taxpayers disclosed their participation in these schemes to HMRC or which would otherwise have been 'closed'".[6]

The Loan Charge All-Party Parliamentary Group (the APPG) was formed and has held an inquiry into the Loan Charge. The APPG's report, *Loan Charge Inquiry: April 2019: Final Report* (Final Report), made recommendations including that there be: 1. an Independent Review into the Loan Charge led by an experienced tax judge; 2. an immediate policy change ahead of the Review to remove closed years from the scope of the Loan Charge; and 3. a return of taxpayers' statutory rights to defend against HMRC's enquiries into any open years (which would presumably mean repeal of the Loan Charge, with any enforcement being under pre-existing law).[7]

The APPG's Final Report notes that they had been informed of "as many as six possible suicides of people facing the Loan Charge, and that the APPG had been sent confirmation of three of these".[8] The report criticises Mel Stride for failing to acknowledge these suicides when the issue had been raised in the House of Commons.[9] However HMRC have subsequently referred themselves to the police and the Independent Office for Police Conduct (which investigates serious complaints involving HMRC), following the suicide of an individual facing the Loan Charge.[10]

The Finance (No.3) Bill 2017–19 was amended at report stage,[11] to include a new clause (now section 95 of the Finance Act 2019 (FA 2019)) which required the Chancellor of the Exchequer to review the effects of the changes made by sections 80 (Offshore matters or transfers: income tax and capital gains tax) and 81 (Offshore matters or transfers: inheritance tax) FA 2019, and compare them with the time limits for the Loan Charge. The Treasury's subsequent report[12] has provided a broader review, and justification, of the Loan Charge by the Treasury. Subsequently (following a debate which was suspended due to a leak in the roof of the chamber[13] and resumed some days later[14]) the House of Commons has passed a motion, broadly reflecting the recommendations of the APPG's Final Report, resolving that

> "this House expresses its serious concern at the 2019 Loan Charge which applies from 5 April 2019; expresses deep concern and regret about the effect of the mental and emotional impact on people facing the Loan Charge; is further concerned about suicides of people facing the Loan Charge and the identified suicide risk, which was reported to HMRC;

[6] Economic Affairs Committee, *The Powers of HMRC: Treating Taxpayers Fairly* (4 December 2018), HL Paper 242 (4th Report of Session 2017–19), para.78.
[7] APPG, *Loan Charge Inquiry: April 2019: Final Report* (2019), available at: *https://hmrcexposed.co.uk/wp-content/uploads/2019/04/Loan-Charge-Inquiry-Report-April-2019-FINAL.pdf* [Accessed 19 June 2019], "Summary and key recommendations".
[8] APPG, above fn.7, para.255.
[9] APPG, above fn.7, para.261.
[10] E. Agyemang, "HMRC reports itself to police watchdog over taxpayer's suicide", *Financial Times*, 31 March, 2019, available at: *https://www.ft.com/content/b5c2b6e2-513e-11e9-b401-8d9ef1626294* [Accessed 19 June 2019].
[11] *Hansard*, HC, Finance (No.3) Bill, Vol 652, col 317 (8 January 2019).
[12] HM Treasury, above fn.3.
[13] *Hansard*, HC, Vol 657, col 1287 (4 April 2019).
[14] *Hansard*, HC, Vol 658, col 553 (11 April 2019).

> believes that the Loan Charge is fundamentally unfair and undermines the principle of the rule of law by overriding statutory taxpayer protections; expresses disappointment at the lack of notice served by HMRC and the delays in communication with those now facing the Loan Charge, which has further increased anxiety of individuals and families; is concerned about the nature and accuracy of the information circulated by HMRC with regard to the Loan Charge; further regrets the inadequate impact assessment originally conducted; understands that many individuals have received miscalculated settlement information; calls for an immediate suspension of the Loan Charge for a period of six months and for all related settlements to be put on hold; and further calls for an independent inquiry into the Loan Charge to be conducted by a party that is not connected with either the Government or HMRC".[15]

However, despite the Commons resolution, the Government indicated that it will not change its policy, except by expanding its one-to-one support for vulnerable customers.[16]

This note first reviews the DR schemes that the Loan Charge targets. It then discusses the nature of the Loan Charge and whether it can be said to be a retrospective tax. The note then assesses the impact of the Loan Charge, considering whether the Loan Charge might create a liability where none existed before: either because the DR schemes were successful at avoiding tax or because HMRC are out-of-time to raise an assessment. The note concludes by considering what may be learnt from a similar experience in Australia in the late 1990s, where the Australian Taxation Office (ATO) sought to raise assessments against taxpayers who had been mis-sold a tax avoidance scheme.

Background: the schemes

DR schemes came in many varieties, but generally involved an employer making payments into an employee benefit trust, with the employee then receiving loans from the employee benefit trust.[17] The Finance Act 2011 (FA 2011) introduced Part 7A into the Income Tax (Earnings and Pensions) Act 2003 (ITEPA) to target such arrangements going forward.[18] Some taxpayers sought to circumvent this charge with schemes which were "more contrived and aggressive than those that existed before 2011 but often also take the form of a loan or debt".[19] In the Public Bill Committee debate of the Loan Charge clauses Mel Stride stated that "since 2011 the tax avoidance industry has created and sold more than 70 new and different schemes aimed at sidestepping the 2011 legislation".[20] Apparently more than half of the DR loans now outstanding were taken out after the changes introduced in FA 2011.[21] HM Treasury have stated that the Loan Charge will

[15] *Hansard*, HC, Vol 657, col 1287 (4 April 2019).
[16] *Hansard*, HC, Vol 658, col 568 (11 April 2019).
[17] HMRC, *Tackling disguised remuneration avoidance schemes overview of changes and technical note* (2016), available at: *https://www.gov.uk/government/publications/tackling-disguised-remuneration-avoidance-schemes-overview-of-changes-and-technical-note/technical-note* [Accessed 19 June 2019], Ch.3 "background".
[18] See D. Cohen, "Finance Act 2011 notes: section 26 and Schedule 2: employment income provided through third parties (the "disguised remuneration" legislation)" [2011] BTR 381.
[19] HMRC, *Tackling disguised remuneration avoidance schemes overview of changes and technical note*, above fn.17, Ch.3, para.9.
[20] *Hansard*, Public Bill Committee (2017), Finance Bill (Fourth Sitting), Vol 629, col 100 (19 October 2017).
[21] HM Treasury, above fn.3, para.3.57.

apply in total to more than 250 different types of scheme.[22] HMRC data shows that "around 50,000 individuals have made use of DR schemes. This represents around 0.1% of the taxpayer population and less than 2.5% of an estimated population of 2 million freelancers in the UK."[23] In contrast, the LCAG estimates that closer to 100,000 individuals will be affected by the Loan Charge.[24]

Reported case law gives us some indication of further details of the schemes. The leading case on DR is *RFC 2012 plc (in liquidation) (formerly the Rangers Football Club plc) v Advocate General for Scotland (Scotland)* (*Rangers*),[25] which deals with schemes operating from 2001–02. However, case law gives us earlier examples with *Sempra Metals Ltd v HMRC* (*Sempra*)[26] and *Dextra Accessories Ltd and others v MacDonald (HM Inspector of Taxes)* (*Dextra*),[27] which show DR schemes involving loans operating since, respectively, 1995 and 1998. It may be supposed that by 1997 such tax planning technology was fairly well known, as a book was published on the subject,[28] co-authored by a Queen's Council and a solicitor (the latter was subsequently struck-off and became an actor and entrepreneur in the adult entertainment industry).[29]

Examples of newer variants can be found in two recent decisions of the First-tier Tribunal (Tax Chamber), that also show how promoters of these schemes have failed to comply with their disclosure of tax avoidance schemes (DOTAS) obligations. The *Hyrax* scheme, which was operating at least as recently as 2015, involved minimum-wage payments to employees who also received a loan that was never expected to be repaid (and the benefit of which was assigned to an offshore employer-financed retirement benefits scheme).[30] *HMRC v Curzon Capital Ltd* (*Curzon Capital*) provides an example of a self-employed version of a loan scheme. This involves an employee ceasing employment and becoming a member of a British Virgin Isles (BVI) LLP, through which their services are provided to their former employer. The former employer is invoiced by a trading trust, which on-loans the monies to a benefit trust, which in turn loans the money to the former employee.[31] Apparently some DR schemes continue to be marketed.[32]

[22] HM Treasury, above fn.3, para.3.56.
[23] HM Treasury, above fn.3, para.3.13.
[24] APPG, above fn.7, para.39.
[25] *RFC 2012 plc (in liquidation) (formerly the Rangers Football Club plc) v Advocate General for Scotland (Scotland)* [2017] UKSC 45; [2017] STC 1556. See discussion in D. Small and R. Macleod, "Murray Group Holdings Ltd and Others v HMRC: HMRC's new tactics win the day in the Court of Session" [2016] BTR 27 and M. 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. Following the decision in *Rangers* there have been two First-tier Tribunal (Tax Chamber) decisions on broadly similar facts: *OCO Ltd and another v HMRC* (*OCO Ltd*) [2018] SFTD 123 (First-tier Tribunal (Tax Chamber)); *Landid Property Ltd (and others) v HMRC* (*Landid*) [2017] UKFTT 692 (TC).
[26] *Sempra Metals Ltd v HMRC* [2008] STC (SCD) 1062 (Special Commissioners).
[27] *Dextra Accessories Ltd and others v Macdonald (HM Inspector of Taxes)* [2002] STC (SCD) 413 (Special Commissioners).
[28] A. Thornhill QC and P. Baxendale-Walker, *The law and taxation of remuneration trusts* (Oxford: Key Haven, 1997).
[29] V. Weldon, "Rangers EBT scheme mastermind Paul Baxendale-Walker faces bankruptcy", *The Herald*, 18 April 2018, available at: *https://www.heraldscotland.com/news/16165652.rangers-ebt-scheme-mastermind-paul-baxendale-walker-faces-bankruptcy/* [Accessed 19 June 2019].
[30] *HMRC v Hyrax Resourcing Ltd, Bosley Park Ltd, Peak Performance Head Office Services Ltd* [2019] UKFTT 175 (TC) at [3].
[31] *HMRC v Curzon Capital Ltd* [2019] UKFTT 63 (TC) at [11]–[16].
[32] HMRC, Guidance, *Disguised remuneration: schemes claiming to avoid the loan charge (Spotlight 49)* (2019).

These schemes all involved little or no income tax and National Insurance contributions (NICs) being paid. However, it was not just the employee (or former employee) who benefited. Some benefit will have accrued to the employer, due to lower employer's NICs. Also the scheme may have enabled the employer to pay a lower amount whilst the employee received the same or greater amount (net of taxes) than before the implementation of the scheme. These benefits to the employer seem to have caused some employers to make staff redundant and then offer to re-engage them under DR schemes: the House of Lords' report gives an example of this being done by one local authority in respect of the employment of a social worker.[33] HMRC claim not to have "seen cases that support the claim of individuals being forced to use a DR scheme".[34] However what HM Treasury perceive as forced may seem to exclude acting under economic duress, as in the relevant passage they go on to state that "employers cannot dictate what someone puts on their tax return".[35]

It has been suggested that many contractors entered into DR schemes in order to avoid complexities caused by the introduction of the off-payroll working rules (IR35).[36] However, as HM Treasury observe, the use of umbrella companies does not necessitate the use of "DR arrangements, rather than receiving employment income in the usual way".[37]

The scheme promoter clearly will have made a significant turn on these arrangements: the case law shows them retaining amounts of around 18 per cent in *Curzon Capital*[38] and 12 per cent in *Rangers*-style schemes.[39] This cut clearly provides an incentive to them to encourage participation in such schemes, which may have incentivised unscrupulous promoters to down-play the risks.

The Loan Charge

Following a consultation in 2016,[40] the Loan Charge was introduced in F(No.2)A 2017[41] to tackle the historic use of DR loans. Broadly speaking the Loan Charge applies, by treating it as a "relevant step" for the purposes of Part 7A of 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.[42]

[33] Economic Affairs Committee, above fn.6, 24.
[34] HM Treasury, above fn.3, para.3.19.
[35] HM Treasury, above fn.3, para.3.19.
[36] APPG, above fn.7, at paras 10–14.
[37] HM Treasury, above fn.3, paras 3.11–3.12.
[38] *Curzon Capital*, above fn.31, [2019] UKFTT 63 (TC) at [11].
[39] *OCO Ltd*, above fn.25, [2018] SFTD 123 (First-tier Tribunal (Tax Chamber)) at [19]; *Landid*, above fn.25, [2017] UKFTT 692 (TC) at [61].
[40] HMRC, *Tackling disguised remuneration avoidance schemes overview of changes and technical note*, above fn.17, Chs 5, 4 and 6.
[41] F(No.2)A 2017 Sch.11; see 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.
[42] F(No.2)A 2017 para.1, Sch.11.

F(No.2)A 2017 also introduced a provision[43] which mirrors the Loan Charge dealing with the similar DR loans, but for self-employed earnings.

HMRC have consistently been of the opinion that DR schemes, in all their guises, were not effective in reducing liability to tax.[44] However, there are significant disparities between the amount charged under the Loan Charge and any credible assessment of historic liability. The Loan Charge is a one-off payment in the 2019–20 tax year, 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 lent before the introduction of the additional rate in 2011 may be subject to tax at that rate. However, in some respects the charge favours the taxpayer. As the amount is payable in the current tax year there are no penalties or interest due. Further, unlike the *Rangers* decision which taxed the entire amount paid by the employer,[45] the Loan Charge is only on the amount received by the taxpayer, thereby excluding the sizeable cut (often around 16–18 per cent[46]) retained by the scheme provider.

Thus the Loan Charge is not motivated by ensuring that the taxpayer pays the correct amount of tax. Rather it seems to be motivated by the exasperation of the Government with taxpayers' involvement in DR schemes, resulting in the Government seeking a "quick-fix", which roughly approximates to the correct tax and collecting that tax without administrative exertion, "drawing a line under this avoidance once and for all"[47]; thereby eliminating the challenges HMRC have faced in identifying and investigating use of DR schemes.[48] HM Treasury's exasperation with DR schemes is evident from the March 2019 report, which notes:

> "HMRC has opened tens of thousands of enquiries into these schemes over the last 20 years. As individual schemes have been litigated through the courts, new schemes have been devised with slightly different arrangements requiring fresh litigation."[49]

The wish for a "quick-fix" to the problem is also evident from the report, which notes:

> "The decision to introduce the loan charge reflected the fact that individually litigating the hundreds of different and evolving scheme types was not an effective approach to ending this form of avoidance."[50]

and:

> "Some have asked that the charge is restricted only to DR loans entered into after 2011 or 2017. The government believes this would be unfair to ordinary taxpayers as it would mean enquiries for earlier years would continue to have to be pursued through the courts or would allow some people to continue to benefit from highly contrived tax avoidance."[51]

[43] F(No.2)A 2017 Sch.12; Noble, above fn.41.
[44] HMRC, *Tackling disguised remuneration avoidance schemes overview of changes and technical note*, above fn.17, Ch.3.
[45] *Rangers*, above fn.25, [2017] UKSC 45; [2017] STC 1556 at 1570h.
[46] APPG, above fn.7, para.28.
[47] HM Treasury, above fn.3, para.3.2.
[48] HM Treasury, above fn.3, paras 3.27–3.37.
[49] HM Treasury, above fn.3, 3.
[50] HM Treasury, above fn.3, 6.
[51] HM Treasury, above fn.3, para.3.85.

It is unclear why complying with rule of law requirements, by pursuing litigation through the courts, is "unfair to ordinary taxpayers". Rather, as discussed below, conforming to expectations of procedural justice would benefit taxpayers at large by upholding tax morale and fostering a culture of compliance. The policy motivation underpinning this appears similar to that which underpinned the introduction of follower notices[52]: an awareness of a huge backlog of cases and a belief that they cannot be resolved simply by ordinary litigation.

HMRC's stated policy is, where possible, to pursue the employers rather than the employees for legacy liabilities from DR schemes. Hence the insolvency of Rangers, rather than HMRC action against the players and other employees of the club. HMRC anticipate that:

> "Around 75% of the overall yield from the charge on DR loans is expected to come from employers and so far [correct as at 31 December 2018], about 85% of the yield from settlements in advance of the charge have come from employers."[53]

Even if HMRC seek recovery from the employer, it may be possible for the employer to seek recovery from the employee. Whether this will be possible will be highly fact specific, depending on whether: 1. the employer took reasonable care to comply with the PAYE regulations and the failure to deduct was due to an error made in good faith; or 2. the employee received relevant payments knowing that the employer wilfully failed to deduct PAYE.[54] Further, in some circumstances, it is not possible to collect the tax from the employer, since:

> "The arrangements used by many contractors mean the employer entity was only created for the purposes of the avoidance scheme. The 'employer' was created offshore and/or has since been dissolved, which means the liability cannot be reasonably collected from the employer. In these cases, HMRC can only collect the tax liability from the individual who benefited from the scheme and received the income without deduction of tax."[55]

HMRC offered taxpayers the opportunity to settle with them prior to the introduction of the Loan Charge, including arrangements giving the taxpayers time to pay.[56] They have also made clear that no taxpayer will be forced to sell their main home.[57] Under general principles, taxpayers will have until 31 January 2020 to pay amounts they self-assess for under the Loan Charge.[58]

Retrospective legislation?

There has been significant criticism of the retrospective effect of the Loan Charge.[59] HMRC's response is that the Loan Charge is not retrospective. This section shows that the Loan Charge

[52] See HMRC, *Tackling marketed tax avoidance: Consultation document* (2014), available at: *https://www.gov.uk/government/consultations/tackling-marketed-tax-avoidance* [Accessed 19 June 2019], 1.1.
[53] HM Treasury, above fn.3, 7.
[54] Income Tax (Pay As You Earn) Regulations 2003 (SI 2003/2682) reg.72. See discussion of relevant case law in Simon's Taxes E4.11136 (Recovery of PAYE tax from an employee). For discussion in relation to the Loan Charge, see E. Agyemang, "Employees could be on the hook for employers' loan charge debt", *Financial Times*, 24 April 2019, available at: *https://www.ft.com/content/43fe5658-61ef-11e9-a27a-fdd51850994c* [Accessed 19 June 2019].
[55] HM Treasury, above fn.3, para.3.23.
[56] HM Treasury, above fn.3, 6.
[57] HM Treasury, above fn.3, 6.
[58] HM Treasury, above fn.3, para.3.78.
[59] Economic Affairs Committee, above fn.6, para.77; APPG, above fn.7, para.84.

is best considered as retrospective legislation and discusses how parliamentary conventions with regard to retrospective legislation were not complied with, although this does not render the legislation unlawful. The section then considers the prospects of a challenge to the legislation as retrospective on the grounds that it infringes Article 1 Protocol 1 (A1P1) of the European Convention on Human Rights. The following two sections then discuss issues related to retrospectivity: 1. if the DR schemes might be effective, so the Loan Charge has created a tax liability where none existed before; and 2. whether the Loan Charge circumvents time-bars on HMRC raising assessments, thereby disturbing finality, which is a crucial rule of law value.

In the UK the words retrospective and retroactive are often used interchangeably. However, in Canada there is a clearer distinction.[60] It has been suggested in this *Review* that it would be better to follow the Canadian approach and

> "restrict retroactive to statutes that alter or do something to the past (Latin: *retroagere* meaning to lead back, to reverse); and use retrospective for statutes that recognise past transactions but alter the consequences of them in the future without changing the past (Latin: *retrospicere* meaning to look back)".[61]

The Loan Charge is clearly not retroactive in the Canadian sense, in that it does not alter something in the past: it received Royal Assent on 16 November 2017 and alters liability in the present (2019–20) tax year. Whether it is retrospective, in the Canadian sense, depends on what we regard as the relevant (past) transaction.

The Government's position is that the relevant transaction is the fact that the loans are outstanding on 5 April 2019 (so after the enactment).[62] It also argues it is not retrospective because it does not alter the time limit for assessment, or the tax treatment of any historic transaction or the tax position of any previous year.[63] It has further been argued by the Government that the Loan Charge is not retrospective because there was a liability already, as the DR schemes were not effective.[64]

However, that is a very artificial interpretation of the Charge, since it applies to any loan or quasi-loan that was made on or after 6 April 1999. Accordingly, the making of the loan should be seen as either the relevant transaction, or (at the very least) part of the relevant transaction. Indeed, it seems somewhat unnatural to regard a loan being outstanding as a transaction, rather than simply a state of affairs.[65] Viewing the Loan Charge in its context, as a charge to income tax, reinforces the view that the relevant transaction is the making of the loan: especially when seen from HMRC's perspective that repayment was to be in the never-never,[66] since from an economic perspective income comes from the receipt of the loan. Hence, following the Canadian definition, the Loan Charge would indeed be retrospective.

[60] C.S.B., "Retroactive or retrospective? A note on terminology" [2006] BTR 15; G.T. Loomer, "Taxing out of time: parliamentary supremacy and retroactive tax legislation" [2006] BTR 64.
[61] C.S.B., above fn.60.
[62] HM Treasury, above fn.3, p.4, paras 2.15, 3.82–3.95.
[63] HM Treasury, above fn.3, p.4, paras 2.15, 3.82–3.95.
[64] *Hansard*, HC, Vol 658, col 566 (11 April 2019).
[65] If there is something extra, such as the continual compounding of interest to the principal, perhaps this can lead to an outstanding loan being regarded as a transaction.
[66] HM Treasury, above fn.3, p.3, paras 3.20, 3.70.

However retrospective legislation is not uncommon, in a fiscal context, in the UK. Although there is a presumption against retrospectivity, that can be displaced by the clear words of Parliament.[67] Historically the surtax and parts of the income tax (which used a three years' average) were structurally retrospective.[68] There is a long history of retrospective legislation in the UK, especially in the context of tax avoidance, since 1937.[69] In 1950 there was even retrospective legislation introduced to specifically target high-profile tax avoidance by two prominent businessmen, although the legislation was expressed in general terms.[70]

In more recent times, when legislating retrospectively, governments have tended to follow the "Rees Rules".[71] These follow the principles enunciated by the then backbench MP, Peter Rees, in the Standing Committee debate on Finance Bill 1978. He suggested that it was acceptable

> "to give a warning in the House of Commons by some recognised method—either by an answer to a Parliamentary Question or by some statement—and to legislate in the subsequent Finance Bill back to the date of that warning"[72]

where the following conditions were met:

> "[F]irst, the warning must be precise in form. A mere general suggestion that there are vague schemes of tax avoidance that must be counted should not suffice. Secondly, the problem at which the warning has been directed should immediately be referred to a committee which I understand exists…to devise the precise legislative measures which should then be introduced. Thirdly, if the committee can hit on an appropriate legislative provision, the draft clause…should immediately be published in advance of the Finance Bill so that those who are likely to be in the field of fire will have a second clear intimation of what to expect. Fourthly, such a clause must, without fail, be introduced in the following Finance Bill."[73]

It seems in the case of the Loan Charge,[74] the Government regard the relevant warning[75] to be the written statement issued by Dawn Primarolo, then Paymaster General, in December 2004 in which she stated

> "experience has taught us that we are not always able to anticipate the ingenuity and inventiveness of the avoidance industry. Nor should we have to. Our objective is clear and the time has come to close this activity down permanently.
>
> I am therefore giving notice of our intention to deal with any arrangements that emerge in future designed to frustrate our intention that employers and employees should pay the

[67] *R. (on the application of Rowe and others) v HMRC* [2017] EWCA Civ 2105; [2018] STC 462 (*Rowe*) at 486j.
[68] E. Fletcher, "Retrospective Fiscal Legislation" [1959] BTR 412, 416.
[69] Fletcher, above fn.68, 417–426.
[70] Fletcher, above fn.68, 421.
[71] For a full discussion see A. Seely, *Retrospective taxation* (Commons Briefing papers SN04369, 2012) and *Retrospective taxation* (Commons Briefing papers SN6361, 2013).
[72] *Hansard*, SC Deb (A), col 719 (6 June 1978).
[73] *Hansard*, SC Deb (A), col 719 (6 June 1978).
[74] Although HM Treasury do not specifically address the Rees Rules as they do not consider the Loan Charge to be retrospective legislation.
[75] HM Treasury, above fn.3, para.3.38.

proper amount of tax and NICs on the rewards of employment. Where we become aware of arrangements which attempt to frustrate this intention we will introduce legislation to close them down, where necessary from today."[76]

Clearly this is a somewhat general warning, so perhaps not in conformity with the first principle of the Rees Rules. Although a similarly general warning was given, and subsequently acted upon, by Neville Chamberlain in 1936 in relation to transactions whereby income was transferred to persons abroad.[77] Most significantly, in the case of the Loan Charge, the Government has not acted with the haste implied by the final three principles: we can infer that it has known of DR schemes for well over a decade before seeking to implement the Loan Charge. Also the Loan Charge is not retrospective to the date of the Primarolo statement (2 December 2004) but to 6 April 1999. However the Rees Rules are only a convention, so failure to comply with them does not render the Loan Charge illegal.

Retrospective tax legislation has been challenged on the basis that it infringes A1P1, which provides:

"(1) 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.

(2) 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."[78]

Perhaps the best arguments for the taxpayer could be made on the basis that the Loan Charge is not "deemed necessary" by the UK Government, as it has been consistently clear that it regards the taxpayers as liable under existing law.[79] However Strasbourg jurisprudence suggests A1P1 is very unlikely to protect taxpayers who are affected by retrospective legislation targeted at artificial tax avoidance.[80]

Any domestic challenge under the Human Rights Act 1998, such as potentially may be contemplated by the LCAG, is likely to face some difficulties. It is possible following the Court of Appeal decision in *Rowe* that A1P1 is engaged.[81] But even if it is engaged it is most likely that the interference is suitably provided by law and is a proportionate one in all the circumstances. In *R. (on the application of Huitson) v HMRC* (*Huitson*)[82] the Court of Appeal considered whether retrospective legislation in the Finance Act 2008 infringed A1P1. Mummery LJ considered that Kenneth Parker J had been correct[83] in identifying and applying

[76] *Hansard*, HC, Vol 428, col WS46 (2 December 2004).
[77] Fletcher, above fn.68, 417–418.
[78] Protocol to the Convention for the Protection of Human Rights and Fundamental Freedoms, Art.1 (Paris, 1952).
[79] For example, see the comments of Mel Stride at *Hansard*, HC, Vol 658, col 566 (11 April 2019) or see HM Treasury, above fn.3, 3.
[80] P. Baker, "Retrospective tax legislation and the European Convention on Human Rights" [2005] BTR 1.
[81] *Rowe*, above fn.67, [2017] EWCA Civ 2105; [2018] STC 462 at 501–507.
[82] *R. (on the application of Huitson) v HMRC* [2011] EWCA Civ 893; [2011] STC 1860.
[83] *Huitson*, above fn.82, [2011] EWCA Civ 893; [2011] STC 1860 at 1871g.

> "the 'fair balance' principle: in securing the payment of taxes a national authority must strike a fair balance between the general interests of the community and the protection of the individual's fundamental rights, including the right to possessions in art 1. In that balancing exercise the national authority has a margin of appreciation under the Convention and a discretionary area of judgment under domestic law. The area of appreciation and judgment is wide in matters of social and economic policy."[84]

In reaching this view Kenneth Parker J had placed reliance on the general scheme of the legislation, including in *Huitson* that residence is the connecting factor entitling a state to impose tax, leading to the corollary that an individual who enjoys benefits provided to residents has a reasonable expectation of being taxed.[85] In the case of the Loan Charge, the fact that individuals received, as a consequence of their employment or trade, money they never expected to pay back, might be thought to give rise to a similar expectation that they would be liable to income tax. In *Huitson*, assessing the "fair balance", Kenneth Parker J placed reliance on the fact that:

> "HMRC never accepted the interpretation of the legislation relied on by those who asserted the efficacy of the scheme. HMRC challenged those assertions. Further, HMRC had never undertaken not to bring proceedings. They had never suggested that no legislation would be enacted, or that any such legislation would only have prospective effect."[86]

Similarly, in the case of the Loan Charge, HMRC claim to never have accepted that the DR schemes were effective.[87] In this context it should be noted, however, that the Primarolo statement suggests that any legislation would have retrospective effect only from the date of that statement, December 2004, not April 1999.

In *Huitson* whether the schemes were effective (discussed in respect of the Loan Charge in the next section), was also a factor taken into account in assessing whether the taxpayer had a legitimate expectation and so whether a fair balance was struck.[88] However it was held that any legitimate expectation also necessitated taking account of the overall scheme of the legislation, so in *Huitson*, even if the scheme was effective, a fair balance had been struck by the retrospective legislation.[89] It may be thought the same reasoning may apply with regard to the Loan Charge.

HMRC having failed to conduct prior test litigation, their delay in taking action and the lack of pre-legislation impact assessment on taxpayers[90] were also rejected as grounds of appeal by the taxpayer in *Huitson*. Thus whilst similar criticisms have been made in respect of the Loan Charge,[91] they are unlikely to provide the basis for a successful challenge under A1P1.

[84] *Huitson*, above fn.82, [2011] EWCA Civ 893; [2011] STC 1860 at 1867–1868.
[85] *Huitson*, above fn.82, [2011] EWCA Civ 893; [2011] STC 1860 at 1868e.
[86] *Huitson*, above fn.82, [2011] EWCA Civ 893; [2011] STC 1860 at 1868g.
[87] For example, see the comments of Mel Stride at *Hansard*, HC, Vol 658, col 566 (11 April 2019) or see HM Treasury, above fn.3, 3.
[88] *Huitson*, above fn.82, [2011] EWCA Civ 893; [2011] STC 1860 at 1871–1873.
[89] *Huitson*, above fn.82, [2011] EWCA Civ 893; [2011] STC 1860 at 1872c, 1873j.
[90] *Huitson*, above fn.82, [2011] EWCA Civ 893; [2011] STC 1860 at 1874–1877.
[91] APPG, above fn.7.

Did the DR schemes work?

The APPG's Final Report suggests that HMRC and the Treasury have "misrepresented" the reality of the legal position of the Loan Charge and that:

> "the outcomes of court cases have been misrepresented, deliberately, to give the false impression that they are the legal justification for the Loan Charge, when they manifestly are not".[92]

In one sense it is true that the *Rangers* decision does not mean that DR loans are themselves taxable. The decision states that it is not the payment to the employee, but the payment by the employer as remuneration, which is the taxable event.[93] But in *Rangers*-style schemes for the loan to be made, the trustee will need to have been put in funds, hence there is likely to be a payment by the employer that attracts liability. In taxing the loan, the Loan Charge is something of a makeshift solution to effecting this charge.

The APPG Final Report seems to suggest that there are good arguments that there is potentially no tax charge associated with DR schemes, in support of which it cites the Special Commissioners' decisions in *Sempra*[94] and in *Dextra*.[95] However both these decisions were specifically stated to be wrongly decided by the Supreme Court in *Rangers*.[96]

For schemes where HMRC consider that the principles laid down, or the reasoning given, in the ruling in *Rangers* would, if applied to the relevant DR scheme, deny the asserted tax advantage, then HMRC could potentially issue a follower notice.[97] Indeed it is understood that in many cases where the *Rangers* decision is relevant HMRC have issued follower notices.[98] There appear to be some cases where HMRC consider *Rangers* to be relevant, but this is disputed by the taxpayer:

> "Many scheme promoters – those who put together DR schemes and sell them to individuals for a fee – claim that their arrangements are unique and that, as a result, the *Rangers* decision does not apply to their scheme. This forces HMRC into protracted litigation with each individual scheme. HMRC has found that promoters often seek to delay progress at every opportunity, through a variety of methods, adding many years to an already lengthy process. HMRC has also faced challenges in obtaining information about schemes where they involve offshore arrangements."[99]

However, as already noted at the outset, there are over 250 different types of DR scheme to which the Loan Charge applies. HMRC have conceded that the ruling in *Rangers* is not relevant to many DR schemes in their justification of the Loan Charge, stating:

[92] APPG, above fn.7, 31.
[93] *Rangers*, above fn.25, [2017] UKSC 45; [2017] STC 1556 at 1570h.
[94] *Sempra*, above fn.26, [2008] STC (SCD) 1062 (Special Commissioners).
[95] *Dextra*, above fn.27, [2002] STC (SCD) 413 (Special Commissioners).
[96] *Rangers*, above fn.25, [2017] UKSC 45; [2017] STC 1556 at 1576b.
[97] FA 2014 s.204–205; see discussion in H. Gething, "Finance Act 2014 notes: sections 199–218 and Schedules 30–31: follower notices; Sections 219–229 and Schedule 32: accelerated payment notices" [2014] BTR 445. Recently the Court of Appeal has clarified the standard in *R. (on the application of Haworth) v HMRC* [2019] EWCA Civ 747.
[98] HM Treasury, above fn.3, para.3.50.
[99] HM Treasury, above fn.3, para.3.54.

> "There are also some schemes which were designed to deliberately circumvent the anti-avoidance legislation enacted in 2011 and where the *Rangers* decision is not directly applicable. These schemes are newer and often even more contrived than previous arrangements. HMRC has always maintained that these schemes were ineffective, but they would have to be litigated separately."[100]

To justify these schemes as being ineffective, HM Treasury refer to how the "GAAR Panel has considered eight different DR schemes, and found each of them to be abusive and therefore liable to counteraction under GAAR".[101] However, the GAAR applies only to arrangements entered into on or after 17 July 2013.[102] Hence these GAAR Panel decisions do not justify the Loan Charge being applied to loans made as far back as 6 April 1999. Also, the courts only need to "take into account"[103] the views of the GAAR Panel: the opinions of the Panel are not law. Further, it needs to be remembered that HMRC can cherry pick the cases to which they apply the GAAR and so which cases go before the GAAR Panel: hence these eight cases are not a random selection of the 250 or so DR schemes. It is possible that some DR schemes are effective despite the GAAR.

Although many DR schemes are unlikely to have worked, that is not to say the taxpayers did not believe they were effective, or have a legitimate reason to believe this. For example, in *Curzon Capital* we are told that there was a note of consultation with a well-known QC dated 17 May 2011 which included the phrase "overall the structure is a very neat and cleverly worked variant on what I have seen previously, in my opinion it would, if operated as set out in this note, provide the anticipated results".[104] The enquiries into DR schemes have found evidence of mis-selling, in that "[p]rofessional advisers reassured users that arrangements were HMRC compliant and QC approved",[105] and that:

> "Many witnesses said they had joined these schemes without being aware of HMRC's attitude towards them. They were assured by their employers or promoters of the schemes that they were effective (sometimes with legal opinions) and that HMRC knew about the schemes and approved them. HMRC did not do enough to counter this misinformation. It used its 'Spotlight' online guidance publications to make known its views, but this is little read."[106]

It is perhaps noteworthy that a well-known advisor, involved in the promotion of DR schemes, was found by the Court of Appeal to have been negligent in not advising a client of the "significant risk"[107] that a "very aggressive tax avoidance scheme"[108] would not work (although the scheme in that case was an employee benefit trust scheme which is not a loan scheme).

[100] HM Treasury, above fn.3, paras 3.54–3.55.
[101] HM Treasury, above fn.3, para.3.59.
[102] FA 2013 s.215.
[103] FA 2013 s.211(2)(b).
[104] *Curzon Capital*, above fn.31, [2019] UKFTT 63 (TC) at [10].
[105] APPG, above fn.7, para.24.
[106] Economic Affairs Committee, above fn.6, para.60.
[107] *Barker v Baxendale Walker Solicitors (a firm)* (*Baxendale Walker Solicitors*) [2017] EWCA Civ 2056; [2018] STC 310 at 333f.
[108] *Baxendale Walker Solicitors*, above fn.107, [2017] EWCA Civ 2056; [2018] STC 310 at 332d.

As shown by the Australian experience,[109] which is discussed in the final section of this note, it is probably unreasonable to expect many taxpayers to know something is dubious when it has the ostensible blessing of one of Her Majesty's counsel learned in the law.

Were HMRC out of time?

To some, perhaps, time limits may seem purely procedural and unimportant technicalities that should be disregarded or dispensed with in order to obtain a substantively fair result. However, by guaranteeing finality, even in respect of an otherwise substantively incorrect outcome, time limits represent an important part of the rule of law value of certainty.[110] Speaking extra-judicially Lord Dyson has noted:

> "I doubt whether it is controversial that, although the fundamental aim of any system of justice in a modern democracy is that parties should have their disputes determined fairly and so far as possible correctly, there must be finality at some point. Of course, it hardly needs any longer to be stated that access to justice is a fundamental right both at common law and under the European Convention on Human Rights. But the question arises: when is enough enough? How much time should be allowed to a claimant from the date when his cause of action arises before it becomes too late for him to start proceedings?…
>
> Any answer to these questions should attempt to strike a fair balance between the interests of claimant and defendant. It is now realised that the State also has an interest in ensuring that litigation is conducted in a responsible and proportionate manner."[111]

Under the self-assessment regime for income tax, subject to certain exceptions, a "taxpayer's self-assessment is the final determination of his taxable income and chargeable gains for a particular year of assessment."[112] One exception is where HMRC open an enquiry[113] and then amend the assessment.[114] Any such enquiry must be opened within 12 months of the filing date, assuming the return was submitted in time.[115] Once an enquiry is opened there is no fixed maximum period for it to last, although a taxpayer may apply to the tribunal for a direction requiring HMRC to issue a closure notice.[116] Also HMRC may potentially issue a discovery

[109] For the use of QC's opinions to market tax schemes in Australia, see: Senate Economics References Committee, *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection: Interim Report* (Parliament of the Commonwealth of Australia, March 2001), paras 4.54–4.55.

[110] Regarding the importance of finality in achieving certainty, see: Lord Neuberger, speech, *The Role of the Judge: Umpire in a Contest, Seeker of the Truth or Something in Between?* (Singapore Panel on Judicial Ethics and Dilemmas on the Bench, 19 August 2016), available at: *https://www.supremecourt.uk/docs/speech-160819-04.pdf* [Accessed 8 July 2019], para.7; and Lord Dyson, lecture, *Time to call it a day: Reflections on Finality and the Law* (Edinburgh University, 14 October 2011), available at: *https://www.supremecourt.uk/docs/speech_111014.pdf* [Accessed 8 July 2019].

[111] Lord Dyson, above fn.110, 3–4.

[112] *Tower MCashback LLP 1 and another v HMRC* [2010] EWCA Civ 32; [2010] STC 809 at 812.

[113] TMA 1970 s.9A.

[114] TMA 1970 ss.9C, 28A.

[115] TMA 1970 s.9A(2)(a).

[116] TMA 1970 s.28A(4). There does seem to be some confusion on the part of taxpayers as to the mechanism for obtaining a closure notice. The APPG Final Report suggests some wrote to HMRC rather than to the tribunal: APPG, above fn.7, para.255. Taxpayers' failure to understand the process of self-assessment may explain some of their frustration.

assessment,[117] subject to the relevant conditions being satisfied.[118] The ordinary time limit for making a discovery assessment is four years after the end of the year of assessment to which it relates.[119] This is extended to six years in the case of carelessness[120] and 20 years in the case of a loss of income tax brought about deliberately.[121] In this context "deliberately" has been held to mean "tantamount to fraud".[122] FA 2019 introduced an extended time limit of 12 years for loss of tax involving an offshore matter or offshore transfer,[123] but that amendment is not retrospective as it does not re-open any closed years.[124] These time limits apply, with necessary modifications, where HMRC seek recovery against an employer in respect of PAYE.[125]

By looking back into tax years up to 20 years ago, in striking the balance between the "venerable principle of tax law to the general effect that there is a public interest in taxpayers paying the correct amount of tax"[126] and the taxpayer's interest in finality, the Loan Charge effectively treats all taxpayers involved in DR schemes as being on a par with those having engaged in conduct "tantamount to fraud". As a matter of law, Parliament can do this. But as a matter of policy this seems disproportionate, especially in the case of those taxpayers who are more victims than fraudsters. Its disproportionate nature is emphasised by how relatively little revenue yield appears to be gained by looking so far back, to April 1999. Apparently more than half of the DR loans now outstanding were taken out after the changes introduced in FA 2011[127] and only 1 per cent of loans were taken out before 2003.[128]

For the reasons discussed in the next section, it would be better policy if HMRC fostered procedural legitimacy in the tax system by applying existing law within normal time limits to collect historic tax liabilities and repealed the Loan Charge. That would indeed seem to strike a better balance between the public interest in taxpayers paying the correct amount of tax and the desirability of finality for individual taxpayers.

Whether any taxpayer falls within the conditions for a disclosure assessment will be highly fact specific, as will be the issue of whether the ordinary time limit applies, or that for careless or deliberate conduct. HMRC's claim that in over half of DR cases a DOTAS disclosure has not been made,[129] suggests that some disclosure assessments may be possible. In many other cases HMRC will still have enquiries open.

[117] TMA 1970 s.29.
[118] TMA 1970 s.29. See *Langham (Inspector of Taxes) v Veltema* [2004] EWCA Civ 193; [2004] STC 544; *Sanderson v HMRC* [2016] EWCA Civ 19; [2016] STC 638; *HMRC v Tooth* (*Tooth*) [2018] UKUT 38 (TCC); [2018] STC 824.
[119] TMA 1970 s.34.
[120] TMA 1970 s.36(1).
[121] TMA 1970 s.36(1A).
[122] *Tooth*, above fn.118, [2018] UKUT 38 (TCC); [2018] STC 824 at 841c, 842b. On the recent appeal of this case, the Court of Appeal suggested that blameworthiness is not necessary: *HMRC v Tooth* [2019] EWCA Civ 826 at [84]–[97]. However, this part of the Court of Appeal's judgment is strictly obiter: *HMRC v Tooth* [2019] EWCA Civ 826 at [74].
[123] TMA 1970 s.36A.
[124] TMA 1970 s.36A; see HM Treasury, above fn.3, para.2.12.
[125] Income Tax (Pay As You Earn) Regulations 2003 (SI 2003/2682) reg.80(5).
[126] Lord Walker in *Tower MCashback LLP 1 and another v HMRC* [2011] UKSC 19; [2011] STC 1143, approvingly citing Henderson J in *Tower MCashback LLP 1 and another v HMRC* [2008] EWHC 2387 (Ch); [2008] STC 3366.
[127] HM Treasury, above fn.3, para.3.57.
[128] HM Treasury, above fn.3, para.3.73.
[129] HM Treasury, above fn.3, 3 ("History of tackling DR and rationale for the loan charge").

Conclusion: learning from the Australian experience

There are strong parallels between the Loan Charge and mass-marketed tax avoidance in Australia in the 1990s. There was an enquiry by the Senate Economics References Committee[130] before which the ATO reported

> "that it had taken action on 231 schemes involving 57,667 participants and claimed deductions totalling $4.3 billion. An additional 45 schemes involving 8,425 participants and totalling $555 million were also under examination. The potential risk to the revenue is about 40 per cent of the overall claimed deductions of approximately $4.8 billion."[131]

Before a crackdown by the ATO in 1998, it was found that the ATO had engaged in limited action with regard to the avoidance and had sent mixed signals to taxpayers.[132] Many participants believed they had acted with due diligence, relying on the opinions of an eminent barrister, Robert O'Connor QC.[133] There were concerns that the ATO was acting retrospectively.[134] There were threats of suicide, including anecdotal evidence of some suicide.[135] A "great deal of political, professional and taxpayer resources were directed at resisting"[136] the ATO action, with "fighting funds and lobbying groups set up to represent scheme investor's interests".[137] However, in Australia the ATO acted more promptly than HMRC seem to have done in that within 12 to 18 months they denied deductions in up to 90 per cent of cases and the maximum delay before denying deductions seems to have been six years.[138]

The matter was largely resolved when, in February 2002, the ATO

> "put forward a final settlement offer in which culpability penalties and interest on scheme related tax debts would be abolished for those investors who had been the victims of aggressive marketing and bad advice. As part of the deal, investors were given a two year interest free period in which to repay their debts".[139]

[130] Senate Economics References Committee, *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection: Interim Report*, above fn.109; Senate Economics References Committee, *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection: Second Report* (Parliament of the Commonwealth of Australia, August 2001); Senate Economics References Committee, *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection: Final Report* (Parliament of the Commonwealth of Australia, February 2002).
[131] Senate Economics References Committee, *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection: Interim Report*, above fn.109, para.2.1.
[132] Senate Economics References Committee, *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection: Interim Report*, above fn.109, para.4.19.
[133] Senate Economics References Committee, *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection: Interim Report*, above fn.109, paras 4.54–4.55.
[134] Senate Economics References Committee, *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection: Interim Report*, above fn.109, para.4.64.
[135] Senate Economics References Committee, *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection: Interim Report*, above fn.109, para.2.11.
[136] L. Fullarton, *Heat, Dust, and Taxes* (Ibidem-Verlag, Jessica Haunschild U Christian Scho, 2015), 78.
[137] K. Murphy, "Procedural justice and tax compliance" (2003) 38(3) *Australian Journal of Social Issues (Australian Council of Social Service)* 379, 395.
[138] Senate Economics References Committee, *Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection: Interim Report*, above fn.109, para.2.15.
[139] Murphy, "Procedural justice and tax compliance", above fn.137, 394; see also V. Braithwaite, *Defiance in Taxation and Governance* (Edward Elgar Publishing, 2009), 193–194.

This offer was "highly successful for the ATO, with 87 per cent of investors agreeing to take up the offer".[140] Before this, many investors were resisting the ATO's demands, believing that they had done nothing wrong,[141] yet the ATO was implying they were "tax cheats"[142] and treating them in a "callous and unsympathetic"[143] manner. As at January 2002, so just before the change in policy, less than half of scheme investors had agreed to settle.[144]

Kristina Murphy's research into this instance of mass-marketed tax avoidance in Australia shows how procedural legitimacy increases trust in the tax authority, which in turn reduces resistance and makes taxpayers more likely to follow the tax authority's directions and decisions.[145] The research, based on both in-depth interviews[146] and a survey of 2,292 taxpayers accused of tax avoidance, the results of which are analysed using structural equation modelling,[147] discusses how a policy based on threats and coercion by the ATO led to resistance, as it generated a perception of unfair treatment and lack of procedural justice, undermining trust in the ATO.[148] Because most Australians take a pride in being "honest taxpayers", when the ATO was responsive to them and gave them the benefit of the doubt, treating them as victims rather than "tax cheats", this fostered trust and thereby increased compliance.[149]

Similarly Valerie Braithwaite has identified two types of defiance in the tax context. Dismissive defiance is a call for freedom, with the message to authority being "[y]ou have no right to expect subservience from me"[150] and a "call for the state to look the other way and accept the individual's right to use ingenuity to circumvent the tax law".[151] Conversely, resistant defiance signals "dissatisfaction with the form the constraints are taking"[152] the message to authority being "if you were reasonable and fair in the way you exercised your authority I would not resist you",[153] such as "when taxpayers organise a protest against a tax that they regard as unfairly high or unfairly levied, with the expectation that the government will heed their concerns and be responsive to their discontent".[154] It is this latter form of defiance, resistant defiance, that seems generally present in the opposition to the Loan Charge and to have been present with regard to mass-marketed tax avoidance in Australia. Braithwaite shows that, by the ATO demonstrating integrity, including most importantly through procedural justice, it can change the taxpayer's

[140] Murphy, "Procedural justice and tax compliance", above fn.137, 394.
[141] K. Murphy, "The role of trust in nurturing compliance: A study of accused tax avoiders" (2004) 28(2) *Law and human behaviour* 187, 192.
[142] Murphy, "Procedural justice and tax compliance", above fn.137, 391.
[143] Murphy, "Procedural justice and tax compliance", above fn.137, 390.
[144] Murphy, "The role of trust in nurturing compliance: A study of accused tax avoiders", above fn.141, 192.
[145] Murphy, "Procedural justice and tax compliance", above fn.137; Murphy, "The role of trust in nurturing compliance: A study of accused tax avoiders", above fn.141.
[146] Murphy, "Procedural justice and tax compliance", above fn.137.
[147] Murphy, "The role of trust in nurturing compliance: A study of accused tax avoiders", above fn.141.
[148] Murphy, "Procedural justice and tax compliance", above fn.137, 397.
[149] Murphy, "Procedural justice and tax compliance", above fn.137, 394.
[150] Braithwaite, above fn.139, 1.
[151] Braithwaite, above fn.139, 7.
[152] Braithwaite, above fn.139, 1.
[153] Braithwaite, above fn.139, 2.
[154] Braithwaite, above fn.139, 7.

frame of engagement with the tax authority and foster compliance where there is resistant defiance.[155]

In the case of the Loan Charge, the greatest perception of procedural unfairness comes from its retrospective effect.[156] To improve taxpayer compliance and settlement, following the findings of Murphy and Braithwaite, it would be much better for the Loan Charge to be repealed and historic liabilities collected under pre-existing law, with recourse to the courts if necessary. In many cases the suggested approach would mean that time limits would likely bar the collection of tax otherwise due. However, considerations of procedural justice and the rule of law value of finality should be balanced against the public interest in taxpayers paying the correct amount of tax, with the appropriate balance being struck by the presently existing structure of time limits. Jurisprudential considerations might be seen to lead to a similar result. Loomer has observed, in this *Review*, how:

> "Raz and Fuller, have argued that a fundamental tenet of the rule of law is that law should be prospective, open and clear, such that subjects of the law can comply with and rely upon the law.[157] Clearly, it is impossible for subjects to comply with or rely upon laws which are unannounced and retroactive. This impossibility of reliance is of particular concern in revenue law, where honest self-assessment and reporting are critical. The unfettered use of retroactive tax measures may undermine the integrity of a tax system because taxpayers who have no confidence in the system's stability may be less inclined to comply with existing rules."[158]

Thus as a matter of law the Loan Charge is within the competence of Parliament and is legal. But as a matter of policy it seems disproportionate, especially in the case of those taxpayers who are more victims than fraudsters. ☙

Michael Blackwell

UK accelerated depreciation policy in an international context

After three years of stability the Finance Act 2019 (FA 2019) brings another temporary increase in the level of the annual investment allowance (AIA) for the two calendar years 2019 and 2020. It is worth just reminding readers that this is the sixth change in the maximum allowance since its inception at £50,000 11 years ago in 2008.[1] The last adjustment, in Finance Act 2015, set the top line at £200,000 for the duration of the then Parliament, although the *Red Book* at the time

[155] Braithwaite, above fn.139, Ch.6.
[156] APPG, above fn.7, at paras 116–117; Economic Affairs Committee, fn.6, paras 75–78.
[157] J. Raz, "The Rule of Law and its Virtue" in *The Authority of Law* (OUP, New York, 1979) at 210–29; L.F. Fuller, *The Morality of Law* (revised ed., Yale University Press, New Haven, 1969) at 33–39, 53… [footnote from quoted text].
[158] Loomer, above fn.60, 89–90.

☙ Australia; Disguised remuneration; Loan charge; Retrospective legislation; Tax administration; Tax avoidance
[1] FA 2008 s.74 and Sch.24 (£50,000), FA 2010 s.5 (£100,000), FA 2011 s.11 (£25,000), FA 2013 s.7 and Sch.1 (£250,000), FA 2014 s.10 and Sch.2 (£500,000), and F(No.2)A 2015 s.8 (£200,000).

might be thought to have implied more, using the somewhat paradoxical phrase "highest ever permanent level".[2] The Office of Tax Simplification (OTS) has commented in detail on the issues raised by both instability in the maximum allowance and the unpredictability of alterations to it.[3] Be that as it may, by section 32 FA 2019 the AIA maximum allowance is lifted to £1 million (its highest ever temporary level) with effect for expenditure incurred between 1 January 2019 and 31 December 2020. As with former changes, the end of the period is pegged to a calendar year, but in addition, this time, so is the commencement.[4] However, 31 March year ends are commonly encountered, as well, of course, as other dates, and so there is frequently a misalignment of a taxpayer's chargeable period and the calendar year. Once again there are the now familiar transitional provisions, found in Schedule 13 FA 2019, for businesses with chargeable periods which straddle either the beginning of the temporary increase, termed the "first straddling period", or the end of it, denoted as the "second straddling period".[5]

The provisions

Whilst the Explanatory Note to the Bill stated that section 51A(5) of the Capital Allowances Act 2001 is amended, no such language is used either in the Bill or the Act. The increase is achieved, one might say, almost metaphorically, by directing taxpayers to proceed "as if" the amount specified were £1 million.[6] The mechanisms of similar transitional provisions, prescribed in respect of earlier temporary extensions, have previously been examined in the pages of this *Review*, and many of the implications arising historically remain valid.[7] As in the past, the main technical difficulty in FA 2019 continues to be the second straddling period. The potential timing trap remains for any business that has a chargeable period which starts in 2020 and straddles the expiry of the uplift on 31 December that year. This is because paragraph 3 of Schedule 13 FA 2019 replicates *mutatis mutandis* the terms of paragraph 4 of Schedule 2 to the Finance Act 2014. The stipulation limits the AIA available for expenditure which is "incurred" on or after 1 January 2021 to a time apportioned part, calculated *at the post 1 January rate of the allowance*, that is to say the £200,000 ceiling to which the allowance then reverts. Thus a business that has a chargeable period ending on 31 March 2021 can only receive AIA on merely £50,000 of investment where the expenditure is "incurred" on or after 1 January. The Association of Taxation Technicians (ATT) in their written evidence to the Public Bill Committee suggested modifications to paragraph 2 of Schedule 12 to the Bill (as it then was) designed to guarantee that a business could off-set expenditure of at least £200,000 in the second straddling period, even if that expenditure was all incurred after 1 January 2021.[8] The simplest of the ATT's proposals was to give firms an opt-out from the temporary increase. Their alternative sought to establish a "floor"

[2] F(No.2)A 2015 s.8; HM Treasury, *Summer Budget 2015* (London: TSO, 8 July 2015), HC 264, 55, para.1.242.
[3] Office of Tax Simplification, *Simplification of the corporation tax computation* (London: TSO, 3 July 2017), 43, para.4.14 and following.
[4] Compare FA 2014 s.10(3).
[5] FA 2019 s.32(1).
[6] FA 2019 s.32(1); HM Treasury: *Finance (No.3) Bill Explanatory Notes* (7 November 2018), 112, para.2.
[7] See particularly A. Harper, "Section 10 and Schedule 2: temporary increase in annual investment allowance" [2014] BTR 354, 355–356.
[8] ATT, Written evidence submitted by the Association of Taxation Technicians (ATT) (FB01): Finance (No.3) Bill 2017–19: Clause 31 and Schedule 12: Temporary increase in Annual Investment Allowance (2018), s.C and Appendix.

availability of £200,000 across the entire straddling period, regardless of the date within that period on which expenditure was incurred. The Labour Party was openly sympathetic to the opt-out idea, but claimed to be unable to table an amendment owing to what it said was the Government's "undemocratic approach", a reference to the Government's failure to move the "amendment of the law resolution" or allow the Committee to receive oral evidence.[9] Instead Labour pressed to supplement section 32 with a requirement that a review be commissioned to determine the impact of the allowance on investment. This failed to carry when put to a vote. Nevertheless, Jonathan Reynolds MP, Labour's shadow Economic Secretary to the Treasury, devoted his speech to the points which the ATT had made to no avail.[10] The Government expects businesses to anticipate and plan their expenditure mindful of the second straddling period and its operation, if it affects them.[11] Research carried out jointly by the writers published in this *Review* in 2013, suggests that fewer than 3 per cent of businesses gain from any increase in the allowance above £100,000, and that these will be the largest firms, or groups of companies that share a single allowance.[12] In 2018 the OTS considered the AIA as part of its report *Accounting depreciation or capital allowances? Simplifying tax relief for tangible fixed assets*. Employing CT 600 returns data the OTS established that only about 8,000 companies consistently spend in excess of £200,000 on capital expenditure year on year whilst some 18,000 do so occasionally.[13] The cost of augmenting the AIA to £1 million, it should be noted, will be £600 million in 2019–20 and a further £425 million in 2020–21.[14]

UK theory/policy

Previous commentaries in the guise of Finance Act Notes in this *Review*, have discussed the consequences of accelerated depreciation in relation to equity between tax payers carrying on different lines of business, the departure that it represents from true economic depreciation, the shift that it causes in the tax base from income to expenditure (especially when available up to £1 million) and the simplicity and utility of the AIA's particular design, but these matters will not be re-visited here.[15] Rather, it is now time to look at the allowance in the context of the UK

[9] Jonathan Reynolds MP (Lab.: Stalybridge and Hyde), *Hansard*, Public Bill Committee (2017–19), Fourth Sitting, col 150 (29 November 2018). Without passing the amendment of the law resolution the amendments that the Public Bill Committee can entertain must be of a technical nature only and not seek to challenge policy, see e.g. Peter Dowd MP (Lab.: Bootle), *Hansard*, Public Bill Committee (2017–19), First Sitting, cols 5–6 (27 November 2018) and Jonathan Reynolds MP (Lab.: Stalybridge and Hyde), *Hansard*, Public Bill Committee (2017–19), First Sitting, col 10 (27 November 2018), M. Hutton, et al., *Erskine May's Parliamentary Practice*, 25th edn (London: LexisNexis, 2019), para.36.37.

[10] Jonathan Reynolds MP (Lab.: Stalybridge and Hyde), *Hansard*, Public Bill Committee (2017–19), Fourth Sitting, cols 150–151 (29 November 2018).

[11] Rt Hon Mel Stride MP, Financial Secretary to the Treasury, *Hansard*, Public Bill Committee (2017–19), Fourth Sitting, col 152 (29 November 2018).

[12] A. Harper and L. Liu, "Section 7 and Schedule 1: temporary increase in annual investment allowance" [2013] BTR 385, 390–391.

[13] Office of Tax Simplification, *Accounting depreciation or capital allowances? Simplifying tax relief for tangible fixed assets* (London: TSO, 15 June 2018),60–61, para.5.7.

[14] HM Treasury, *Budget 2018* (London: TSO, 29 October 2018), HC 1629, 36, Table 2.1, item 20; HMRC, *TIIN Temporary increase in the Annual Investment Allowance* (29 October 2018).

[15] In particular see A. Harper, "Annual investment allowance, etc. sections 74–76 and Schedule 24" [2008] BTR 480, 484; Harper and Liu, above fn.12, 388–389.

Government's current aspirations. Announcing the AIA increase at the despatch box, the Chancellor of the Exchequer made a vocal and unvarnished appeal for foreign direct investment into the UK post-Brexit, sending a "…message loud and clear to the rest of the world: Britain is open for business".[16] No doubt amidst the Brexit brouhaha which beset UK politics during the passage of the Bill, he was aiming as much at his domestic audience as anyone. Perhaps better expositions of the policy are those advanced in the technical literature accompanying the Budget, for example paragraph 3.3 of the *Red Book* which offers the following:

> "The Budget introduces measures to reaffirm the UK's international competitiveness and support local growth. The Budget announces…a temporary increase in the Annual Investment Allowance to £1 million, to support business investment."[17]

This is supplemented by paragraph 14 of the Explanatory Notes to the Bill (the Background Note) which elaborates:

> "The temporary increase is designed to stimulate growth in the economy by providing an additional, time-limited incentive for businesses (particularly medium-sized businesses) to increase, or bring forward, their capital expenditure on plant or machinery."[18]

There are, therefore, clearly two elements. First, the desire to maintain global competitiveness in the face of the (still) anticipated Brexit and, secondly, to stimulate growth in the UK economy. In this Note we shall discuss only the first of these, the cost of capital with the benefit of a 100 per cent allowance in the international context. In a future publication we will evaluate the effectiveness of the AIA as a spur to investment, including how it interacts with the traditional main pool writing down allowance (WDA).[19]

Cost of capital with immediate expensing in the international context

1. Immediate expensing in G7 and beyond

Recent expansion of AIA in the UK reflects an increasing trend toward full and immediate expensing of capital investment in several other major economies. Among other G7 countries, the US has introduced immediate expensing of investments in various forms of tangible assets that have a recovery period of less than 20 years, as part of the Tax Cuts and Jobs Act (TCJA) that was passed in December 2017. The 100 per cent write-off is, however, temporary and applies until the end of 2022. From 2023 to 2027 the write-off rate is reduced by 20 percentage points per year.[20] Introduction of this generous write-off of capital investment expenses is on top of immediate expensing that was already available for smaller firms in the US under section 179

[16] Rt Hon Philip Hammond (Chancellor of the Exchequer), *Hansard*, HC, Vol 648, col 660 (29 October 2018).
[17] HM Treasury, *Budget 2018* (29 October 2018), HC 1629, 41, para.3.3.
[18] HM Treasury, above fn.6, 113, para.14.
[19] At the time of writing (5 June 2019) the writers are awaiting CT 600 statistical data from HMRC in order to facilitate this aspect of the study.
[20] Immediate expensing is not available to companies in construction and real estate, and certain public utilities. For a more detailed description of the immediate expensing provision in the TCJA, see, for example, N. Chalk, M. Keen and V. Perry, "The Tax Cuts and Jobs Act: An Appraisal" (2018) *IMF Working Papers 18/185*, International Monetary Fund.

of the Internal Revenue Code.[21] Similar to the experience of AIA in the UK, there is a maximum deduction limit and a threshold over which section 179 expensing is phased out dollar for dollar. The threshold and phase-out regions have increased incrementally since 1993. In particular, the deduction limit for section 179 was US$25,000 until 2003, when it increased to US$100,000. In 2008, it increased to US$250,000 and then to US$500,000 in 2010 and to US$1 million in 2018.[22]

Canada has also moved toward immediate expensing in the 2018 *Fall Economic Statement*,[23] which introduced immediate expensing for manufacturing and processing investments and clean energy investments.[24] In addition, accelerated investment incentives were introduced for other assets, including 1.5 times the normal capital cost allowance rate for other depreciable assets, and for goodwill and other intangible assets. These measures are meant to be temporary: they will be phased out gradually in 2024 and return to the pre-2018 capital cost allowance system by 2028.

Several countries in the G20, including Australia, Mexico, Japan and South Korea, have also experimented with using immediate expensing to stimulate investment by small and medium-sized enterprises (SMEs) in recent years. In Australia, SMEs with a turnover of less than AU$10 million could immediately write off business assets purchased between 12 May 2015 and 30 June 2018 for less than AU$20,000. The write-off threshold has been increased to AU$30,000 since 2 April 2019 and has been extended to 30 June 2020. A more generous scheme was also available in Mexico, which allows SMEs to calculate taxes on a cash basis, allowing investment to be expensed immediately between 2016 and 2017.

2. Effect of immediate expensing on cost of capital

In general, immediate expensing pushes the corporate income tax (CIT) towards a cash-flow taxation, for equity-financed investment as well as debt-financed investment when combined with restriction on interest deduction. In this case, the cost of capital (CoC)—defined here as the required financial rate of return for investment to break even—is the same as the normal rate of return on capital so that the CIT is neutral to firms' investment decisions. In the financial year 2018–19, at a statutory CIT rate of 19 per cent (with a real interest rate of 5 per cent), the cost of capital with AIA is 5 per cent, while the cost of capital with regular WDA is slightly higher at 6.3 per cent. The extent of reduction in CoC is essentially due to timing: compared to

[21] 26 U.S. Code §179. Election to expense certain depreciable business assets.

[22] Using corporate tax returns, E. Zwick and J. Mahon, "Tax Policy and Heterogeneous Investment Behaviour" (2017) 107(1) *American Economic Review* 217, 233–235, show that there is sharp bunching of s.179 eligible investment around the phase-out threshold from 1993 through 2009.

[23] Canada, Department of Finance, *Investing in Middle Class Jobs: Fall Economic Statement 2018* (Ottawa: Department of Finance, 2018), 54–61, Budget Implementation Act 2019 No.1 s.52(6) amending Canadian Income Tax Regulations subs.1100(2).

[24] P. Harris, M. Keen and L. Liu, "Policy Forum: International Effects of the 2017 US Tax Reform—A View from the Front Line" (2019) 67(1) CTJ 27, 31 and fig.2 estimate that the immediate expensing and accelerated deprecation in combination reduces the average marginal effective tax rate in Canada by 5 percentage points (from 17 to 12 per cent).

depreciation, immediate expensing implies a narrower tax base when the investment is undertaken, but—since in either case the asset is fully written off over time—a broader tax base later.[25]

Conceptually, in today's world where companies can shift profit across borders, the effect of immediate expensing on the cost of capital can be even more muted. Intuitively, if a multinational company (MNC) can shift the profit generated by its incremental investment out of the UK, then the effective CIT rate on its investment becomes zero and the investment decision at the margin is no longer affected by the statutory CIT rate or the capital allowance scheme in the UK.

But profit shifting is also costly, so that there is a trade off between the amount of tax savings and the cost incurred, which may in turn affect the extent of profit shifting and the associated cost of capital. To illustrate, the following simple model shows the impact of immediate expensing on the cost of capital:

Consider a profit-maximising multinational affiliate invests K in the UK. Output is produced through the technology $F(\cdot)$, which has the standard properties that $F'(\cdot) > 0$ and $F''(\cdot) < 0$. Let τ denote the statutory corporate tax rate that applies to pre-tax profits, α the fraction of capital investment that can be immediately written off, and s the fraction of pre-tax profits that are shifted to a foreign country with a zero corporate tax rate. The cost of shifting profit is $c(s, \lambda)$, where $\lambda > 0$ is a cost parameter and where $c(\cdot)$ is strictly concave, strictly increasing, continuous, and continuously differentiable. To simplify, let $c(s, \lambda) = \lambda c(s)$. The after-tax profits of the MNC affiliate is:

$$\pi = F(K) - rK - \lambda c(s) - \tau(1 - s)\{F(K) - \alpha rK\}, \tag{1}$$

where r is the normal return to capital. The optimal level of capital is given by differentiating Equation (1) with respect to K:

$$F'_K = \frac{r(1 - \alpha\tau(1 - s))}{1 - \tau(1 - s)}, \tag{2}$$

where the right hand side of this equation is the CoC, and at the profit-maximising position is equal to marginal revenue (the left hand side).

In the special case with no expensing ($\alpha = 0$) and no profit shifting ($s = 0$), Equation (2) becomes

$$F'_K = \frac{r}{(1 - \tau)}, \tag{2.a}$$

[Continued on next page]

[25] As discussed in Harper and Liu, above fn.12, immediate expensing can provide additional funds for investment by firms that are financially constrained due to a lower tax bill. The extent of additional cash from tax savings is however quite limited, ranging between £1,000 and £3,000 for firms that become newly eligible to AIA (per the calculation in Harper and Liu, above fn.12) and is likely to be even smaller (relative to the amount of investment) nowadays at a lower statutory CIT rate of 19 per cent.

where the cost of capital has the standard expression as the nominal after-tax rate of return r grossed up to offset the corporate income tax. Moreover, with full expensing and no profit shifting, $F'_K = r$, so that the corporate income tax no longer distorts the investment decision. In general, more generous expensing as captured by a larger α lowers the cost of capital at any given level of s,

$$\frac{\partial CoC}{\partial \alpha} = -\frac{r\tau(1-s)}{1-\tau(1-s)} < 0,$$

which is the rationale for stimulating investment by offering more generous capital allowance. The optimal amount of profit shifted is given by differentiating Equation (1) with respect to s:

$$\lambda c'(s) = \tau\{F(K) - \alpha r K\}. \tag{3}$$

which shows that profits will be shifted up to the point where the marginal cost of shifting (on the left side of Equation (3)) is equal to the tax savings from shifting (on the right side).

It is also easy to see that profit shifting attenuates the effect of immediate expensing on lowering the cost of capital, since:

$$\frac{\partial CoC}{\partial s \partial \alpha} = \frac{r\tau}{(1-\tau(1-s))^2} > 0.$$

The intuition is straightforward. With profit shifting, there is no UK tax on the underlying investment at the margin, for which the cost of capital is simply r. Neither a change in the statutory corporate tax rate nor in the generosity of capital allowance would affect the cost of capital with profit shifting. Thus more profit shifting attenuates the effect of immediate expensing on lowering the cost of capital.

Figure 1 illustrates the idea with a 5 per cent rate of return and a 19 per cent statutory CIT rate. The solid line shows that more generous expensing lowers the cost of capital, assuming no profits are shifted out of the UK. The two lines below illustrate the effect of expensing at 50 per cent shifting (dotted line) and 100 per cent shifting (dashed line), where the cost of capital reduces at a lower rate than in the case with no shifting. As noted before, in the case of full shifting, the cost of capital is the normal rate of return and no longer varies with α.

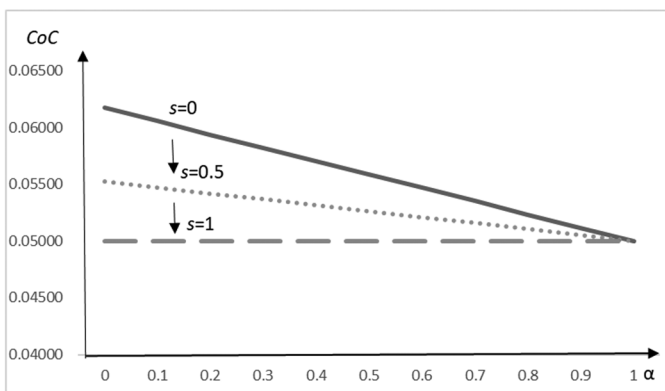

Figure 1: effect of immediate expensing with profit shifting

Note: this figure illustrates the value of the cost of capital as a function of capital allowance (α), at three levels of profit shifting intensity (s).

3. Policy implication

Though highly stylised and simplified, the model offers some insights that are relevant to policy concerning the effectiveness of immediate expensing (and statutory CIT rate) in relation to the cost of capital for domestic investment, in the presence of profit shifting. In general, opportunities for profit shifting would imply a lower cost of capital than would the cost of capital without such opportunities. At the same time, profit shifting attenuates the effectiveness of lowering the cost of capital through immediate expensing or a lower statutory CIT rate, which is the common objective of policy makers when introducing immediate expensing in the first place.

The implications for the UK are three-fold. On the one hand, still expecting to leave the EU at some point in 2019, HM Treasury have been claiming that the increased AIA will "reaffirm the UK's international competitiveness". As shown in the writers' analysis, it would bring down the cost of capital for UK firms that have no opportunities for profit shifting, to a level similar to that for firms that do shift profit abroad. Firms in the former group are typically small domestic-owned, with no or only a limited number of affiliates in the UK. In contrast, firms which have ample opportunities for profit shifting are typically part of a large company group with affiliates both in the UK and abroad. As illustrated in Figure 1, not only is the cost of capital already lower for firms in the latter group, but also AIA is likely to be less effective in reducing their cost of capital. This in turn suggests that the AIA will be less effective in stimulating investment by firms that engage in profit shifting. At the same time, the more generous allowance is associated with a narrow tax base for all taxpayers, which would reduce revenue to the Exchequer without the intended investment stimulus for many UK firms.

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Annual investment allowances; Brexit; Capital allowances; Depreciation; Tax administration

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Finance Act 2019 Notes

Editorial: Finance Act 2019—just a side show?

The Finance Act 2019 (given Royal Assent on 12 February 2019) (FA 2019) is in some ways symptomatic of other developments in 2019, namely, the fact that some of the most important issues affecting UK tax are not encompassed within this year's legislation. Another theme appears to be legislate in haste and repent in subsequent years at leisure.

A particularly good example of the latter is the reinstatement of relief for expenditure on certain types of intangible fixed assets,[1] keeping up the good work of reversing some of the changes made in the 2015 Finance Act in the following year. Similarly section 19 FA 2019[2] and section 24 FA 2019[3] are retrospective to correct deficiencies in earlier legislation.[4] In addition, not something in this year's (but instead last year's) Finance Act, about which HMRC may be having regrets, is the introduction of the "loan charge" which attempts to reverse, in effect, 20 years of arrangements by employers, engagers and their workforce to find ways of reducing income tax using loans. While it reflects badly on our legislators that the original legislation was introduced without much scrutiny of, or scepticism concerning, HMRC's claims and past behaviour, it is not clear whether HMRC thought enough about the balance between seeking tax from facilitators as much as end users.

Another example of tax policy which may well be addressed in a subsequent Finance Act, not least because a partial fix to the problem could easily be made, is the introduction in 2015 of the pensions tapered annual allowance, given that a lifetime allowance is only £1 million (subject to indexation)[5] and before the introduction of the taper the annual allowance was limited to £40,000 which means that 25 years of contribution/accruals, whether from employer or employee, without any investment growth reach the lifetime allowance. It must simply have been the attraction of raising relatively modest amounts of income tax[6] "stealthily" while the former Chancellor was seeking to reduce the deficit that led to a policy error; but what value do you place on cancelled operations? The writer refers, of course, to the impact, in particular, on medical professionals within the NHS who, because they are not readily able to reduce earnings related contributions to their pension scheme, are finding that marginal tax rates in the thousands of percentages are being engendered as a result of their taking on modest amounts of extra work to clear waiting list backlogs at a time when the NHS is said to be short of several thousand

[1] A. Fairpo, "Section 25 and Schedule 9: intangible fixed assets: restrictions on goodwill and certain other assets" [2019] BTR 324.
[2] FA 2019 s.19: "hybrid and other mismatches: scope of Chapter 8 and 'financial instrument'".
[3] FA 2019 s.24: "group relief etc: meaning of 'UK related' company".
[4] B. Onuonga, "Section 19: hybrid and other mismatches: scope of Chapter 8 and 'financial instrument'" [2019] BTR 304; G. Richards "Section 24: group relief etc: meaning of 'UK related' company" [2019] BTR 323.
[5] FA 2004 s.218(2A)–(2D).
[6] HMRC Policy Paper, *Pensions tapered annual allowance* (8 July 2015) identifies under "Summary of Impacts" £260 million (2016/17), £425 million (2017/18), £900 million (2018/19) and £1,180 million (2019/20).

medical professionals.[7] It is not clear whether the culprit is an insufficiently influential Department of Health or "tin eared" Treasury officials, but it is certainly no way to make tax policy.

Returning to FA 2019, perhaps the most important change, although it could have been said to have been trailed ever since the Finance Act 2013 (when the principle of not taxing non-residents on UK property, albeit then only on residential property, was breached) is the extension of levying chargeable gains on non-residents making direct or indirect disposals of UK real estate.[8] Another real estate related change, again reflecting a policy change of heart following the removal of industrial buildings allowances from 2008 onwards, is the introduction of relief for construction on buildings and structures permitted by section 30 FA 2019 but largely dealt with in an ongoing consultation on secondary legislation.[9]

Moving on to tax relief, it was perhaps unsurprising that changes were made to tighten up the conditions for entrepreneurs' relief, a relief that the Office of Tax Simplification (OTS) had said in its *Business Lifecycle Report* seemed ill targeted.[10]

FA 2019 is no exception in terms of it containing anti-avoidance measures—whether it be the tax charge on off-shore recipients (and persons connected with them) in respect of intangible property,[11] avoidance involving profit fragmentation arrangements[12] or substitution of market value as regards stamp duty and stamp duty reserve tax on certain listed securities.[13]

Another feature of FA 2019 and 2020's Bill is the impact of decisions made outside the UK domestic sphere. Section 21 FA 2019 picks up BEPS-related tightening up of permanent establishments, section 22 FA 2019 reflects a CJEU decision[14] as does the extension in section 53 FA 2019 and Schedule 18 FA 2019 to non-residents within VAT groups to give effect to the

[7] R. Harwood, *My working life. A 'perfect storm' for doctors*, BMA (9 May 2019), available at: *https://www.bma.org.uk/connecting-doctors/my_working_life/b/weblog/posts/a-39-perfect-storm-39-for-doctors* [Accessed 24 June 2019]; BMA, *The pensions paradox: would you pay to work?* (last updated 17 June 2019), available at: *https://www.bma.org.uk/news/2019/june/pensions-paradox-would-you-pay-to-work* [Accessed 8 July 2019].

[8] S. Squires, "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 and G. Clarke, "Section 13: disposals by non-UK residents etc; and Schedule 1: chargeable gains accruing to non-residents etc" [2019] BTR 268.

[9] G. Loutzenhiser, "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; HMRC, *Capital allowances for structures and buildings: Introductory note to draft secondary legislation* (13 March 2019), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/785034/Capital_allowances_for_structures_and_buildings_-_Introductory_note_to_draft_secondary_legislation_and_draft_secondary_legislation.pdf* [Accessed 24 June 2019].

[10] OTS, *Business Lifecycle Report: Simplifying the taxation of key events in the life of a business* (April 2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/699972/OTS_Business_Lifecycle_report_final.pdf* [Accessed 24 June 2019]. For instance the OTS states that it "has seen no evidence that Entrepreneurs' Relief encourages further investment in new business ventures", at para.5.10.

[11] FA 2019 s.15 and A. Fairpo, "Section 15 and Schedule 3: offshore receipts in respect of intangible property" [2019] BTR 298.

[12] P. Baker, "Section 16 and Schedule 4: avoidance involving profit fragmentation arrangements" [2019] BTR 300.

[13] N. Popplewell, "Section 47: stamp duty: transfers of listed securities and connected persons; Section 48: SDRT: listed securities and connected persons" [2019] BTR 350.

[14] *Trustees of the P Panayi Accumulation & Maintenance Settlements v HMRC* (C-646/15) EU:C:2017:682 (request for a preliminary ruling under Article 267 TFEU from the First-tier Tribunal (Tax Chamber), made by decision of 30 November 2015, received at the Court on 3 December 2015, in the proceedings *Trustees of the P Panayi Accumulation & Maintenance Settlements v HMRC*).

Larentia and *Minerva* decision.[15] Apart from decisions of the CJEU there is also the recent decision on the part of the Commission that the controlled foreign company rules are too generous and state aid needs to be recovered. Clearly, an extra-territorial scrutiny was, in effect, substituted for the scrutiny that MPs should have given to the measures at the time they were introduced in 2013. Finally, the most important topic, namely the taxation of the digital economy, is subject to further international discussion.

A novel feature of FA 2019 was the requirement in sections 92 to 95 to prepare impact analyses of certain anti-avoidance provisions,[16] reviews of the effectiveness of these anti-avoidance provisions,[17] a review of public health effects of gaming provisions,[18] and a review on time limits and the disguised remuneration loan charge.[19] While well intentioned, because the requirement to produce reports provided for a six month time limit, in many cases HMRC were able to report, in effect, that it was too early to tell. In relation to section 95 FA 2019 and the review of the loan charge,[20] HM Treasury also treated this as an opportunity to re-state their reasons for introducing the legislation without really addressing the underlying issues such as: the focus on users not facilitators, HMRC's performance over the past years and the possible impact of receiving sizeable tax demands on the physical or mental well-being of individuals (whatever the period of time over which arrangements might be made to spread payment).

Although 29 March 2019 passed (rather like the alleged "Y2K" bug) without immediate ill effects,[21] clearly once the direction of travel of the UK economy has become apparent some management of the UK tax code can be expected from the Chancellor. Fortunately the current Chancellor has not shown that he is attracted to legislative hyper-activity. Even so, FA 2019 was 328 pages which, although short for a Finance Act not influenced by a forthcoming election,[22] is still a sizeable amount to digest.

Gary Richards

[15] *Beteiligungsgesellschaft Larentia + Minerva mbH & Co KG v Finanzamt Nordenham, Finanzamt Hamburg-Mitte v Marenave Schiffahrts AG* (Joined Cases C-108/14 and C-109/14) EU:C:2015:496 (Judgment of the Court (Second Chamber) of 16 July 2015 (request for a preliminary ruling from the Bundesfinanzhof—Germany)).

[16] FA 2019 s.92. HM Treasury and HMRC, *Tackling tax avoidance, evasion and other forms of non-compliance: Presented to Parliament pursuant to sections 92 and 93 of the Finance Act 2019* (13 March 2019), available at: *https://www.gov.uk/government/publications/tackling-tax-avoidance-evasion-and-other-forms-of-non-compliance* [Accessed 24 June 2019].

[17] FA 2019 s.93. HM Treasury and HMRC, above fn.16.

[18] FA 2019 s.94.

[19] FA 2019 s.95.

[20] HM Treasury, *Section 95 of the Finance Act 2019: report on time limits and the charge on disguised remuneration loans* (March 2019), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/789160/DR_loan_charge_review_web.pdf* [Accessed 24 June 2019].

[21] Depending on your perspective, could be *Much Ado About Nothing* (W. Shakespeare) or *Paradise Postponed* (J. Mortimer).

[22] Which "Brenda from Bristol" must be hoping will not be the case.

Annual allowances; Capital gains tax; Disposition of property; Intangible fixed assets; Non-residents; Pensions; Reliefs; Tax avoidance

Section 13: disposals by non-UK residents etc; and Schedule 1: chargeable gains accruing to non-residents etc

Introduction

Until 2013 capital gains tax (CGT) was subject to strict territorial limits, in that non-residents were not in general subject to the tax. The one exception was the non-resident carrying on business in the UK through a branch, agency or permanent establishment.[1] Also gains accruing to non-resident trusts or companies could (and still can) in certain circumstances be attributed to UK residents.[2]

Starting in 2013 the strict territorial limits began to be eroded with the annual tax on enveloped dwellings (ATED) related CGT, which applied to certain high value residential disposals by close and open companies and by collective investment schemes.[3] In 2015, a more far reaching erosion took place, with the introduction of non-resident CGT or NR CGT.[4] This applied to all UK residential property and to non-residents individuals, trusts and close companies, but not to disposals by open companies and collective investment schemes.

With effect from 6 April 2019, more fundamental surgery has been effected in that all forms of UK property held by all kinds of non-residents are in scope to CGT or corporation tax on chargeable gains. More radically certain shareholdings and other interests in companies are also in scope.

The changes are effected by Schedule 1 to the Finance Act 2019 (FA 2019), which rewrites the whole of Part 1 of the Taxation of Chargeable Gains Act 1992 (TCGA). As a result the pre-existing sections 1 to 14H TCGA (and associated schedules) are now repealed and replaced by 31 new sections and four new schedules, divided into three chapters. Chapter 1, comprising sections 1 to 1O TCGA, deals with individuals and trusts, including such matters as territorial scope, rates and annual exemption. Chapter 2, comprising sections 2 to 2G TCGA, makes equivalent provision as respects corporation tax on chargeable gains. Chapter 3, comprising sections 3 to 3G TCGA, re-enacts the section 13 TCGA charge on non-resident participators in close companies.

The new legislation applies to individuals and trusts for 2019–20 and subsequent tax years.[5] It applies to companies for accounting periods starting after 6 April 2019, and also to disposals made after that date in straddling accounting periods.[6]

The legislation contains transitional provisions for assets brought within charge for the first time. These take the form of amendments to the computational rules in Part 2, Chapter 3 TCGA, including a new section 36A and Schedule 4AA. At the same time a number of complex

[1] TCGA ss.10 and 10B.
[2] TCGA ss.13, 86 and 87.
[3] TCGA s.2B.
[4] TCGA ss.14B-14H.
[5] FA 2019 Sch.1, para.120(1)(a).
[6] FA 2019 Sch.1, para.120(1)(a) and (2).

computational provisions relating to ATED related CGT and NR CGT have been repealed, notably sections 57A and 57B TCGA and Schedules 4ZZA, 4ZZB and 4ZZC TCGA.

A new Schedule 5AAA TCGA enacts special rules for property rich collective investment vehicles. These are not discussed in this note.[7]

Direct disposals

The term "direct disposal" is a convenient shorthand for referring to disposals by non-residents where the asset disposed of is an interest in UK land. The charge on non-resident individuals and trusts is imposed by section 1A(3)(b) TCGA and in the case of companies the charge is under section 2B(4)(a) TCGA. The respective charging sections are embedded in the general CGT legislation and as a result two consequences follow. The first is that the tax applicable to non-resident companies is corporation tax, not CGT. The second is that all the general CGT rules apply, most notably as respects computation, rates of tax and annual exemption.

The term "interest in land" is defined in section 1C TCGA. The basic meaning is any estate or interest in land, but the term also includes rights or powers over land and the benefit of obligations, restrictions or conditions affecting the land. But security interests (mortgages), licences and tenancies at will are excluded. The definition is expressed in terms of land in the UK, so it is clear that land outside the UK remains outside scope. The grant of a call option over UK land is expressly deemed to be the disposal of an interest in land.[8]

One consequence of the rate of CGT being the same as for CGT generally is that non-resident individuals and trusts have to contend with alternate rates of tax, the applicable rate depending on whether or not the gain is attributable to residential property.[9] If it is so attributable the rate is 28 per cent (or 18 per cent in so far as the basic rate band is available). Otherwise for non-residential property the rate is 20 per cent (or 10 per cent in so far as the basic rate band is available). In all cases the annual exemption applies, currently (2019–20) £12,000 for individuals and up to £6,000 for trusts.[10] The rules determining whether and to what extent a gain is attributable to residential property are rewritten as Schedule 1B TCGA.

In contrast to the old NR CGT regime that existed prior to April 2019, non-close companies are fully in scope subject to the special rules where the company is a collective investment vehicle (as to which see new Schedule 5AAA TCGA). Also in contrast to NR CGT all kinds of UK real property are in scope, including both commercial and agricultural, as well as residential.

Indirect disposals

The term "indirect disposal" is a convenient shorthand for disposals by a non-resident where the asset disposed of is not an interest in land but shares or a participation in a company. The charging provisions are section 1A(3)(c) TCGA, or for companies section 2B(4) TCGA. These provisions

[7] For a discussion of these rules see note by S. Squires, "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.
[8] TCGA s.1C(4).
[9] TCGA ss.1H and 1I.
[10] TCGA s.1K and Sch.1C.

inter alia make it clear that shares or a participation are caught whether the company is a UK company or a non UK company.

The provisions impose the charge on assets deriving at least 75 per cent of their value from UK land, but subsequent provisions make it clear that by "asset" is meant a right or interest in a company. These subsequent provisions are contained in Schedule 1A TCGA.

The rate of tax for individuals and trusts is 20 per cent (or 10 per cent in so far as the basic-rate band is available). The higher 28 per cent rate does not apply even if the underlying assets of the company consist of residential property. This result follows because the higher rate applies only where what is disposed of is residential property, a term defined as an interest in land which consists of or includes a dwelling.[11]

The rate of tax payable by a corporate disponor is the normal rate of corporation tax. Currently the rate is 19 per cent, but under present legislation the rate is set to fall to 17 per cent in April 2020.[12]

The 75 per cent test

Under paragraph 3(1) of Schedule 1A TCGA a disponor's right or interest in the company derives at least 75 per cent of its value from UK land if at least 75 per cent of the total market value of the company's qualifying assets derives from interests in UK land. The derivation can be direct or indirect. Paragraph 3(2) of Schedule 1A TCGA allows market value to be traced through any number of companies, trusts, partnerships or other entities or arrangements. Paragraph 3(4) of Schedule 1A TCGA requires that at each stage the attribution must be in whatever way is appropriate in the circumstances.

The general rule is that all the company's assets are qualifying assets[13] but to this there is one exception. The relevant provision[14] is obscurely worded but in broad terms it applies where the asset is a liability of a related company. In such a case, the asset is not a qualifying asset unless it is UK land.

Normal commercial loans are qualifying assets but under paragraph 3(2) of Schedule 1A TCGA market value cannot be traced through them. What this means is that where the company's asset is a normal commercial loan, its value does not count as derived from UK land even if the loan is secured on, or otherwise valued by reference to, UK land. The same applies if the loan is in a subsidiary. The provision thus protects non-resident shareholders in banks and other financial institutions from CGT.

The term "normal commercial loan" bears the same meaning as it has for the purposes of corporation tax group relief.[15] In broad terms, the term connotes any commercial loan provided it is not convertible and the return is not linked to the borrower's results or assets.

In general interests in UK land are taken into account in applying the 75 per cent test regardless of whether the land is investment or trading stock or otherwise used for a trading business. A measure of relaxation is introduced by paragraph 5 of Schedule 1A TCGA, in that the 75 per

[11] TCGA Sch.1B paras 1(1) and 3.
[12] F(No.2)A 2015 s.7.
[13] TCGA Sch.1A, para.4(1).
[14] TCGA Sch.1A, para.4.
[15] TCGA Sch.1A, para.3(5); CTA 2010 s.162.

cent test is not satisfied if all the land is used in a trade or for trading purposes. Such trading must be on a commercial basis with a view to the realisation of profits and must both have been carried on prior to the disposal and anticipated as carrying on after the disposal.[16] The trade can be carried on either by the company owning the land or by a connected person.[17] The relief requires land to be taken into account both where the company holds the land directly and where it is held indirectly, that is, where the value of qualifying assets which are not land is attributable to the land.

In general this relief only applies if all the land satisfies the trading test. But a de minimis relief allows non-trading land to be ignored if its value is less than 10 per cent of the value of all the land used in or for the purposes of the trade.[18]

The 75 per cent test is a snapshot test applied at the time of the disposal.[19] The normal CGT rule as to time of disposal applies, so the critical date is the date of contract.[20] But if the contract is conditional, the date of disposal is when the condition is satisfied.

Provided the 75 per cent test is satisfied on the date of the disposal, it is immaterial that the test was not satisfied for some or all of the disponor's prior period of ownership. Equally if the test is not satisfied at the date of disposal, it is immaterial it was satisfied for some of the period previously.

The 25 per cent test

Even where a company satisfies the 75 per cent test, it is not all shareholders or other participators who are subject to CGT or corporation tax. Instead a disponor is only caught if he has a 25 per cent investment in the company.[21] In contrast to the 75 per cent test, this test is satisfied both where it is satisfied at the date of the disposal and where it is satisfied at any time in the prior two years.

The disponor has a 25 per cent investment in the company if he owns or is entitled to acquire at least 25 per cent of the voting power in the company. He also has a 25 per cent investment if he is or would be entitled to 25 per cent or more of any dividend, liquidation distribution or sale proceeds of the company that are available for distribution among the equity holders in the company.[22] In carrying out this exercise the rights or interests of connected persons are aggregated.

The term "connected" bears its normal CGT meaning save that two important modifications are made.[23] One is that partners are not treated as connected, and the other is that one individual is not connected with another unless they are spouses or one is the lineal descendant or ancestor of the other.

A point to stress is that the charge is engaged whether the holder of the 25 per cent interest is a non-resident individual, or a non-resident company. In the latter event, and as indicated above, the charge is to corporation tax.

[16] TCGA Sch.1A, para.5(3).
[17] TCGA Sch.1A, para.5(3)(a).
[18] TCGA Sch.1A, para.5(1)(b).
[19] TCGA Sch.1A, para.3(1)(b).
[20] TCGA s.28.
[21] TCGA ss.1A(3)(c) and 1D and Sch.1A, para.8(1).
[22] TCGA Sch.1A, para.9.
[23] TCGA Sch.1A, para.10(3), applying TCGA s.286.

The term equity holder excludes holders of restricted preference shares and normal commercial loans.[24] This has two consequences. The first is that the holders of such instruments or debt are not subject to CGT or corporation tax as they ipso facto fail the 25 per cent test. The second is that other participators satisfy the 25 per cent test if they have 25 per cent or more of what is left after what is due to those holders is deducted.

In applying the 25 per cent test, indirect participations are taken into account. Thus if the disponor owns 20 per cent of Company A he potentially escapes CGT. But this is not so if, for example, the disponor also owns Company B and Company B owns the remaining shares in Company A.[25] Where Company B owns less than 100 per cent of Company A, the corporation tax rules in sections 1155 to 1157 of the Corporation Tax Act 2010 (CTA 2010) apply in determining what percentage of Company A is attributed to the disponor.

As indicated above, the general rule is that the 25 per cent test is satisfied if it is satisfied at any time in the final two years of ownership. But periods during which the test is not satisfied may be ignored if they constitute an insignificant part of the whole.[26]

Losses

The general rule that losses are computed in the same way as gains applies on both direct and indirect disposals.[27] The targeted anti-avoidance rule (TAAR) restricting the deduction of losses in avoidance cases is applicable[28] and so too is the rule requiring the loss to be claimed when realised.[29] More importantly a loss realised by a non-resident is not allowed unless, had the disposal generated a gain, such gain would have been chargeable.[30] So too emigrants can only bring forward losses from periods of residence if they would have been allowable had they been incurred when the emigrant was non-resident.[31]

The TAAR

There is a TAAR, but it applies only to indirect disposals covered by paragraph 11 of Schedule 1A TCGA. The TAAR is engaged if the following conditions are met:

1. A person has entered into arrangements.
2. The purpose, or one of the main purposes, of doing so is to obtain a tax advantage.
3. That tax advantage is the result of a provision in Schedule 1A TCGA applying or not applying.
4. The person obtaining the tax advantage is the person entering into the arrangements.[32]

[24] TCGA Sch.1A, para.9(2) and (4).
[25] TCGA Sch.1A, para.9(7) and (8).
[26] TCGA Sch.1A, para.8(2).
[27] TCGA s.16.
[28] TCGA s.16A.
[29] TCGA s.16(3).
[30] TCGA s.1E.
[31] TCGA s.1E(3).
[32] TCGA Sch.1A, para.11(1).

The term "tax advantage" includes the avoidance or deferral of tax. But significantly the term "tax" means only CGT or corporation tax. It follows, therefore, that arrangements to avoid inheritance tax (IHT) or income tax are outside the scope of the TAAR, unless one of their main purposes is also the avoidance of CGT or corporation tax.

The TAAR is also engaged if, instead of the tax advantage being the application or non-application of Schedule 1A TCGA, the advantage is the securing of treaty relief precluding a charge under Schedule 1A TCGA. But this override applies only if securing the treaty benefit is contrary to the object and purpose of the treaty. Arrangements so caught are caught if entered into at any time after 22 November 2017. Otherwise the TAAR cannot apply unless the arrangements were entered into after 6 July 2018.[33]

Rebasing and related elections

The charges on both direct and indirect disposal are not retroactive. The general rule is that rebasing as at 5 April 2019 applies to all assets acquired before then that are within scope.[34] But the taxpayer can elect for actual cost to be used subject to the caveat, in the case of indirect disposals only, that any resultant loss is not allowable.[35]

Rebasing, where no election is made, is to market value as at 5 April 2019. In the present climate of Brexit induced uncertainty such a value may be difficult to arrive at. Protective valuations now would be prudent if there is concern that valuations with hindsight will be less favourable.

For direct disposals of residential property, rebasing as at 5 April 2019 does not apply. Instead, the base cost is actual cost or, if the property was acquired before 6 April 2015, rebasing as at 5 April 2015.[36] In the case of pre 2015 acquisitions there is the option to elect for either actual costs or straight line apportionment.[37]

These provisions as to residential property apply whether or not under previous law any gain would have been ATED related. All provisions as to ATED related CGT have been repealed, and, in a further simplification, the base date for all direct disposal of residential property is 5 April 2015, rather than the 2013 date which used to apply to ATED properties whose value was in excess of £2 million.

There is one category of direct disposal of residential property for which the base date is 5 April 2019 rather than 5 April 2015. This is residential property owned by entities not within the former NR CGT, that is, principally non close companies.[38] This is so even if in the unlikely event the non close company was previously within the charge to ATED.[39]

The legislation recognises that certain properties will have been partly residential in the period 6 April 2015 to 5 April 2019. Such partial status may have been by space or by time. In such cases, the legislation postulates disposal and reacquisition on both 5 April 2015 and 5 April 2019

[33] TCGA Sch.1A, para.11(5).
[34] TCGA Sch.4AA, para.3.
[35] TCGA Sch.4AA, para.4.
[36] TCGA Sch.4AA, para.7.
[37] TCGA Sch.4AA, paras 8 and 9.
[38] TCGA Sch.4AA, para.6(4) and 2(1)(c).
[39] TCGA Sch.4AA, para.2(4)(a).

and requires the gain accruing on the latter occasion to be added to the post 2019 gain accruing on the actual disposal.[40] The legislation does not in terms state that the part of the gain so added is confined to the residential part and to the gain (if any) since 5 April 2015. But the inference must be that it is and that the applicable rules for determining what part was residential are those in the prior law in force as at 5 April 2019.

Indirect disposals: issues of difficulty

With such a far reaching change as that represented by the charge on indirect disposals, there will inevitably be issues of difficulty. Most will only become apparent over time but five may be referred to now.

Qualifying assets

The 75 per cent test is easy enough to apply where the investee company owns only real estate. If half by value is in the UK and half is not, a non-resident's shares in the investee are not in scope. But if 75 per cent or more of the value is in the UK the non-resident's shares are in scope provided he or she satisfies the 25 per cent test.

But what if the investee company also owns shares in other companies? Such a shareholding could amount to a control holding or even a wholly owned subsidiary. But equally the holding could be a minority stake or even a portfolio investment.

Here the natural reading of paragraph 3 of Schedule 1A TCGA is that the assets which must be examined in applying the 75 per cent test are the assets of the investee company, that is, its controlling or minority holdings or its portfolio investments. The 75 per cent test is met if and only if 75 per cent or more of the aggregate value of those items, together with that of the investee's other assets such as directly held land or cash, is directly or indirectly derived from UK land.

The alternate view is that shareholdings held by the investee company are looked through, and a proportion of the assets of each company in which it holds shares are attributed to it. In the case of 100 per cent subsidiaries the proportion would be 100 per cent but in the case of a minority holding it would be whatever fraction the minority represents. Thus if the minority were just 10 per cent, 10 per cent of the assets of the company concerned would be attributed to the investee company.

An example in draft guidance published by HMRC indicates they appear to subscribe to this latter view (CG73940).[41] Superficially some support for this view may be given by the discretionary language in sub-paragraphs (2) and (4) of paragraph 3. But in reality it cannot be right because:

1. paragraph 3(1)(b) of Schedule 1A TCGA applies the 75 per cent test to the investee company's "qualifying assets";

[40] TCGA Sch.4AA, para.13.
[41] HMRC, draft guidance, *CG73920P, The charge to NRCGT and NRCG and the exemptions: Disposals from 6 April 2019* (Draft Guidance), CG73940, "Examples of establishing the level of investment".

2. paragraph 4(1) of Schedule 1A TCGA provides that "all of the assets of the company are qualifying assets";
3. although the corporation tax rules for pro rata tracing[42] are applied to the 25 per cent test, they are not applied to the 75 per cent test.

In the light of this it is clear the discretionary language in sub-paragraphs (2) and (4) of paragraph 3 of Schedule 1A TCGA goes merely to the issue of how it is determined whether and to what extent the value of the investee company's interest in other companies or entities is directly or indirectly derived from UK land.

The significance of the point is demonstrated by an example in the draft guidance.[43] This postulates an investee company, B Ltd, owning a 100 per cent subsidiary, C Ltd, and a 10 per cent holding in D Ltd. D Ltd's sole asset is UK land worth £1 million whereas C Ltd has £700,000 of UK land and £200,000 in bonds unrelated to UK real estate. HMRC take the view that the 75 per cent test is satisfied in relation to B Ltd, because 10 per cent of D Ltd's land holding can be attributed to B Ltd, along with 100 per cent of C Ltd's land and bonds. On this basis the land is 80 per cent and the non-land is 20 per cent with the result that the 75 per cent test is satisfied.

But for the reasons given above it may be suggested the example is wrong. B Ltd's shares in C Ltd and D Ltd have to be valued and then the property component is 100 per cent of the value of the 10 per cent in D Ltd plus seven-ninths of the value of 100 per cent of C Ltd. Only if that property component is 75 per cent or more of the combined value of 10 per cent in D Ltd and 100 per cent of C Ltd is the 75 per cent test met. On the figures in the example it will not be met if, as one would expect, the value of the 10 per cent in D Ltd is heavily discounted for the fact it is a small minority.

Liabilities

It is clear from paragraph 3 of Schedule 1A TCGA that the 75 per cent test looks at the gross assets of the investee company rather than at those assets net of any liabilities secured on them. However if the conclusion reached above is right, the tracing exercise otherwise takes account of liabilities. This is because the 75 per cent test has to be applied to the value of the company's qualifying assets. Necessarily where those assets are shares in other companies, the value of those shares is reduced by debt and other liabilities in the company or companies concerned. Thus the investee company might have two subsidiaries: one worth 20 with no real estate and no borrowing and the other owning only UK real estate worth 80. If that latter company had no debt or other liabilities, the investee company is over the 75 per cent threshold. But the result would be different if the property company had, say, 50 per cent gearing. Equally the result would be different again were there no second subsidiary and the property and the gearing all in the top company. Here the 80 represented by the property would not be reduced by the gearing and so the 75 per cent threshold would be crossed.

It should be kept in mind that this point about gearing in investee companies would not arise if HMRC's apparent view as represented in the draft guidance is right. But even if anomalous, it is difficult to see how this gearing point can prevail over the clear wording in the legislation.

[42] CTA 2010 ss.1154–1156.
[43] Draft Guidance, above fn.41, CG73940, "Examples of establishing the level of investment".

Land used in a trade

As indicated above the 75 per cent test is not satisfied if all the land in question or all bar 10 per cent is used for trading purposes. Paragraph 5 of Schedule 1A TCGA defines trading use as use in or for the purposes of the trade or acquired for such use.[44]

This plainly covers cases where the investee company owns premises from which it or connected persons trade and means that non-resident shareholders in such a company are not subject to CGT if neither it nor any company it is invested in own other UK land. In general the trading use has to be by the owning company, but the relief also applies if the use is by a person connected with the company. However the relief is not available where the user is unconnected, so it does not apply where the property is pure investment.

An issue with the relief is whether it applies only where the UK property is a fixed asset of the trade or where the UK property is itself the trading stock of a dealing or development business. This turns on whether dealing or developing land amounts to using the land in or for the purposes of the dealing or developing trade. It is at least arguable it does.

The draft guidance implies to the contrary, albeit failing to address the point specifically (CG73946).[45] At a purposive level, there is an argument that dealing and development trades should be within the exemption as on a direct disposal of such land any gain is a trading receipt rather than in scope to CGT. Even if the point is good, the requirement that at least 90 per cent of the land be used for trade would have to be met. As noted above, this test is applied to all interests in land taken into account in applying the 75 per cent test, and not on a company by company basis.

Connected persons

As indicated above, in applying the 25 per cent test, the definition of connected persons is modified in two important respects. One, the exclusion of partners is useful in practice, as partnership is often the legal framework for co-investment by otherwise independent parties.

Unfortunately one category of connection that has been retained is the rule that persons acting together to secure or exercise control of a company are treated in relation to the company as connected with each other.[46] This could potentially catch co-investors below the 25 per cent threshold. The precise ambit of the rule has never been clear. In the leading case of *John Steele (Her Majesty's Inspector of Taxes) v EVC International NV (formerly European Vinyls Corporation (Holdings) BV)*,[47] the Court of Appeal held the rule was engaged where a shareholders' agreement had been executed and was performed and observed by the parties. It was accepted that a mere coincidence of voting the same way did not engage the rule. But where the boundary lies between those two extremities is not clear, albeit a reasonable inference is that some kind of advance agreement is an essential prerequisite.

[44] TCGA Sch.1A, para.5(2).
[45] Draft Guidance, above fn.41, CG73946, "The trading exemption".
[46] TCGA s.286(7).
[47] *John Steele (Her Majesty's Inspector of Taxes) v EVC International NV (formerly European Vinyls Corporation (Holdings) BV)* [1996] STC 785 (CA).

The TAAR

On the face of it, careful planning can ensure the 75 per cent test is never met. All that is necessary is to ensure that a given company's direct and indirect assets are either as to more than 25 per cent outside the UK or as to more than 25 per cent unrelated to UK land. But doing so raises the issue of whether and in what circumstances the TAAR might be engaged.

It may be suggested it is not engaged where the company always has a mixed portfolio of investments and the UK land never reaches 75 per cent. It may be suggested the same result follows if the company's UK land interests are initially over 75 per cent but it sells and invests elsewhere, thereby taking it below 75per cent. In both cases the result in the absence of the TAAR would be that shareholders would not be exposed to CGT. But on the language of the TAAR such activity would only engage the TAAR if it was avoidance. By analogy with cases such as *IRC v Willoughby*[48] it is difficult to regard such activity as avoidance as in economic terms the investee company's exposure to UK land falls below the 75 per cent threshold.

Where the TAAR could be engaged is if the investee were closely held and the sale taking it below the 75 per cent threshold were to its shareholders or other companies they control. Here it could be said that there was little substantive alteration in their economic position. But even if in principle the TAAR could be in point, it may be suggested that it would not be unless the land sale could be seen as part of the same arrangement as a subsequent disposal of shares in the investee company.

Comment

The recasting of Part 1 TCGA is welcome and the drafting is clear. A criticism is that the prevailing modern habit of using a combination of numbers and letters to designate sections has been used.

The extension of CGT to all direct disposals of UK real property is logical and in line with international norms. Save for taxpayers based in low or nil tax jurisdictions the result will be to shift tax from foreign tax authorities to the UK. As this is in line with international norms it is to be welcomed.

What is not so welcome is both the concept behind indirect disposals and the detail in the drafting. A point to stress is that the charge on indirect disposals can be wholly extra territorial. This will be the position in all cases where the investee company is neither resident nor incorporated in the UK. In such a case, there is a tax charge on a person who is non UK resident as respects an asset which is non UK situs.

Its unsatisfactory nature is emphasised by a further point, namely the fact that the 75 per cent test is a snapshot applied at the moment of disposal. The result is the charge on an indirect disposal can be on a gain whose underlying economic derivation is entirely unrelated to UK land. This may be illustrated by postulating a non UK company acquired by a non-resident in 2019 for 100 which invests in foreign land worth 100. In 2025 the company sells the foreign land for 200 and invests in UK land. In 2026, when the UK land is still worth 200, the owner

[48] *IRC v Willoughby* [1997] STC 995 (HL).

sells his shares. In such a case the non-resident is subject to CGT on 100, even though no part of that gain is attributable to UK real estate.

A related issue concerns corporate chains. Postulate A owning X Ltd, X Ltd owning Y Ltd, and Y Ltd owning UK land. Assuming the UK land satisfies the 75 per cent test at the level of Y Ltd, each of the following disposals will trigger CGT: namely, a disposal by Mr A of X Ltd; a disposal by X Ltd of Y Ltd; and a disposal by Y Ltd of the land. Such a result will indubitably follow where the disposals are in that order. But it is avoided if the disposals are in reverse order, for then, once Y Ltd sells the land, neither X Ltd nor Y Ltd satisfies the 75 per cent test.

To these and other points it may be objected the well advised can avoid the adverse consequences by getting the disposals in the right order and by careful planning. But is it reasonable to expect foreigners who may previously have had little connection with the UK to understand these complexities?

Giles Clarke[*]

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

Background

When the consultation document, *Taxing gains made by non-residents on UK immovable property* (the Consultation) was published on 22 November 2017, the UK Government was clear that overseas collective investment schemes would be fully within the scope of the proposed non-resident capital gains tax (CGT) charge. HM Treasury and HMRC said:

> "It follows that once non-residents' disposals are brought within scope of UK tax, then disposals by these funds will be chargeable in accordance with the normal rules.
>
> In general this is the outcome that the government wants, since it would be inconsistent with the rationale for introducing the measure to exclude non-resident funds that are major investors in non-residential UK property; in addition, any exclusion for non-resident funds would be a fault line that could be easily exploited."[1]

Capital gains tax; Connected persons; Disposition of property; Non-residents; Real property; Rebasing; Targeted anti-avoidance rule; Tax avoidance

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[1] HM Treasury and HMRC, *Taxing gains made by non-residents on UK immovable property: Consultation document* (22 November 2017), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/661467/Taxing_gains_made_by_non-residents_on_UK_immovable_property_-_consultation.pdf* [Accessed 28 June 2019], paras 6.15 and 6.16.

By July 2018 there had been a significant policy change. Responses to the Consultation[2] had highlighted certain attributes of collective investment in UK real estate that had shown that a different approach was justified.[3]

The first of these was the extent to which tax-exempt investors, such as pension funds and sovereign wealth funds, invested in UK real estate through participating in collective vehicles.

Investing in this way gave the tax-exempt investor access both to specialist investment management experience and the opportunities available as a result of pooling funds with those of other investors. At the same time, provided the vehicle's investments were held by non-UK companies, tax exemption could be effectively maintained in respect of any gains given the territorial limits of CGT.

The changes to non-resident CGT announced at HM Treasury's Autumn Budget 2017 meant that direct and indirect disposals of UK land within a property fund would be liable to CGT from April 2019. Exempt investors could as a consequence be subjected to a UK tax charge that would not apply if they invested directly.

The second attribute follows on from how property funds tend to structure their investments. Individual properties would be held by single purpose vehicles (SPVs). Often, there could be several tiers of SPV between the fund and an underlying property investment. This ring-fencing of investments could be due to the requirements of a particular financing or simply to confer flexibility on a future exit from the investment. The CGT proposals created a risk that the same economic gain could be subject to multiple charges to CGT within the property fund before it could be distributed to investors: again subjecting investors to tax charges that would not apply if they invested directly.

As a result, once the Consultation period had closed, HMRC began to explore ways of addressing the concerns raised by stakeholders. This involved working closely with both industry bodies and advisers with, as HMRC described, "ideas evolving over time with engagement and input".[4]

But with the timetable for introduction of the new CGT charge on non-resident owners of UK land already set, HMRC had a limited period in which to identify, and develop, a specific policy solution to issues raised, whilst avoiding any potential "fault-lines" and Exchequer risk.

[2] For example, see Chartered Institute of Taxation, *Consultation: Taxing gains made by non-residents on UK immovable property: Response by the Chartered Institute of Taxation* (16 February 2018), available at: *https://www.tax.org.uk/sites/default/files/180216%20Taxing%20gains%20made%20by%20non-residents%20on%20UK%20immovable%20property%20-%20CIOT%20comments.pdf* [Accessed 28 June 2019] and the Law Society of England and Wales, *Taxing gains made by non-residents on UK immovable property: consultation document: The Law Society's response* (February 2018), available at: *https://www.lawsociety.org.uk/policy-campaigns/consultation-responses/society-responds-to-taxing-gains-made-by-non-residents-on-uk-immovable-property/* [Accessed 28 June 2019].

[3] HM Treasury and HMRC, *Taxing gains made by non-residents on UK immovable property: Summary of Responses* (6 July 2018) (Summary of Responses), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/722418/Taxing_gains_made_by_non-residents_on_UK_immovable_property_summary_of_responses.pdf* [Accessed 28 June 2019], paras 2.11 and 3.89–3.91.

[4] Summary of Responses, above fn.3, para.3.92.

Policy

Given the policy approach generally taken by HMRC in taxing UK collective investment schemes, it seemed likely that HMRC would favour a form of exemption at fund level, with investors remaining taxable on UK land related gains. Such an approach had the benefit of not only eliminating the risk of multiple charges to CGT within the fund itself, but also ensured that exempt investors could apply their exemption to such gains, thereby addressing the concerns of stakeholders. The alternative—taxing the fund and exempting investors—would raise significant technical challenges, not least how to give the fund credit for the exempt status of some of its investors.[5]

However, a fund-level exemption was not necessarily straightforward.

Exemption at fund level meant that non-resident investors in the fund would need to be within the scope of the charge to CGT. The core provisions on indirect disposals, as then proposed, risked this not being the case:

1. Only non-resident investors with a 25 per cent investment in a UK property rich entity would be within the charge to CGT.[6] On this basis, there would be a clear risk that, for many funds, no CGT would ever be payable in connection with disposals of UK land.
2. The provisions relating to indirect disposals required the underlying company to be UK property rich at the time of the disposal.[7] If an investor was able to defer any disposal of its interest in a fund until a time after which the fund had sold all its UK land (and was no longer UK property rich), a charge to CGT under the indirect disposal rules could potentially be avoided.

In addition, HMRC had to ensure that any proposed solution was flexible enough to cope with the practical realities of the fund sector. Overseas collective investment vehicles were in many ways an unknown quantity (unlike their UK equivalents, they were not regulated as such), and some were not even strictly "overseas" (for example, English limited partnerships (LPs) are often used as a fund vehicle). The lack of homogeneity between fund structures meant there was no "one-size fits all".[8] An approach that made sense for a partnership vehicle may not be optimum for an open-ended investment company (OEIC) and vice versa; likewise for open-ended and closed-ended vehicles.

Plus, it was important that the solution did not advantage non-UK residents as compared to their UK equivalents: after all, the changes to non-resident CGT had been justified as being necessary to ensure a level playing field.

[5] Although there is now a precedent for a form of "trickle down exemption" within the qualifying institutional investor provisions included in TCGA Sch.7AC (QII SSE), it is still relatively untested.
[6] See TCGA ss.1(A)(3)(c), 1D, 2B(4)(b) and Sch.1A, para.9.
[7] In addition to being a condition of the charge under TCGA s.1A(3) and s.2B(4), "property-richness" is a pre-condition of the standard form of securitised land article adopted in many of the UK's double tax agreements (see OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (OECD Model Convention) (OECD Publishing, 21 November 2017), available at: *http://www.oecd.org/ctp/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm* [Accessed 28 June 2019], Art.13.
[8] Summary of Responses, above fn.3, paras.3.100 and 3.101.

Recognising the complexity, it is to HMRC's credit that they prioritised the development of a complete policy solution before committing to legislation. As a result, when draft Finance Bill clauses were published in July 2018, the CGT provisions made no reference to funds. However, HMRC set out in Annexe A to the Summary of Responses a relatively detailed outline of their core proposals for ameliorating the impact of the non-resident CGT changes on collective investment in UK real estate.[9] Further engagement with the funds industry continued over the summer as HMRC sought to develop what the Summary of Responses described as a "robust set of rules that addresses the issues appropriately".[10]

The proposed new Schedule 5AAA to the Taxation of Chargeable Gains Act 1992 (TCGA) was published on 7 November 2018 (as part of Finance (No.3) Bill 2017–2019).[11] Although various representative bodies may have been disappointed at the lack of any opportunity to scrutinise (and comment on) the legislation before it was introduced to Parliament, it is understandable, why, in the circumstances, HMRC departed from the tax policy framework. Although the parliamentary timetable meant that amendments prior to Royal Assent were unlikely, paragraph 48 of Schedule 5AAA TCGA allows HMRC to amend provisions by regulation, including with retrospective effect. As a result, there appears to be scope for scrutiny and comment post-Royal Assent (even if there was limited opportunity before).

Schedule 5AAA TCGA: overview

The new Schedule 5AAA TCGA is introduced by paragraph 21 of Schedule 1 to the Finance Act 2019 (FA 2019). Headed "UK property rich collective investment vehicles etc", Schedule 5AAA TCGA modifies the application of section 1A, section 2B and Schedule 1A TCGA to certain types of collective investment vehicles and their investors. This means that the provisions have to be read in conjunction with these core charging provisions (and Schedule 1A TCGA now signposts Schedule 5AAA TCGA as a result).[12]

Underlying Schedule 5AAA TCGA is the principle that only investors (and not the fund in which they invest) should be taxed on direct and indirect disposals of UK land. As HMRC say, this is because:

> "HMRC policy with regard to taxation of investors and CIVs generally is to tax investors in a way that provides a similar outcome to direct investment in the underlying assets".[13]

[9] Summary of Responses, above fn.3, 33, "Annexe A: Proposals for treatment of offshore collective investment vehicles."

[10] Summary of Responses, above fn.3, para.3.112.

[11] At the same time, HMRC published a Technical Note, *Taxing gains made by non-residents on UK immovable property in Collective Investment Schemes* (Technical Note) (7 November 2018), available at: *https://www.gov.uk/government/publications/taxing-gains-made-by-non-residents-on-uk-immovable-property-in-collective-investment-schemes/taxing-gains-made-by-non-residents-on-uk-immovable-property-in-collective-investment-schemes* [Accessed 28 June 2019] which provides a helpful overview of the draft legislation.

[12] TCGA Sch.5AAA, para.2.

[13] HMRC, Internal Manual, *Capital Gains Manual* (published 12 March 2016; updated to 13 June 2019), draft CG-APP15, "Non-resident capital gains from 6 April 2019: Collective Investment Vehicles: draft guidance" (Appendix 15), available at: *http://www.hmrc.gov.uk/gds/cg/attachments/CG-APP15__Non-resident_capital_gains_from_6_April_2019_Collective_Investment_Vehicles_draft_guidance.pdf* [Accessed 28 June 2019], CGXXX01.

But the simplicity of this principle can be easily lost when working through the detail of Schedule 5AAA TCGA.

In part this is because the myriad of fund structures available means that Schedule 5AAA TCGA has to accommodate various forms of fund (whether partnerships, unit trusts, companies UK co-ownership authorised contractual schemes (CoACS) or combinations of one or more such entities). As a result, the nature of the exemption differs depending on the form of the collective investment vehicle, with the ability to combine exemptions, from both within and outside Schedule 5AAA TCGA, adding to the complexity.

But it also links to HMRC having to ensure that the UK can exert its taxing rights against non-resident investors in an exempt fund, both under the core provisions and the terms of the UK's double tax agreements.[14]

Schedule 5AAA TCGA therefore serves several distinct purposes.

First, it determines how the core non-resident CGT provisions apply to direct and indirect disposals of UK land associated with a "collective investment vehicle" (CIV).[15]

Secondly, it sets out three alternative ways in which a CIV can be effectively exempted from a charge to CGT on a UK-land related disposal:

1. A non-UK CIV that is tax transparent for income (such as a Jersey property unit trust (JPUT) that is constituted as a *Baker*[16] trust) can elect to be treated as if it were a partnership (and so tax transparent) for chargeable gains purposes: the election for transparency.[17]
2. A non-UK corporate CIV that meets certain conditions can elect to obtain exemption from CGT on all direct and indirect disposals of UK land by both the fund and its subsidiaries: the exemption election for qualifying funds.[18]
3. A CIV that is constituted as a partnership can elect for a wholly owned subsidiary that meets certain conditions (and that subsidiary's subsidiaries) to obtain exemption from CGT on all direct and indirect disposals of UK land: the exemption election for a qualifying company.[19]

Each of these elections is subject to conditions and, in relation to an exemption election, reporting requirements. As a result, not all CIVs will be eligible to make an election (and some may choose not to do so). Absent an election, the default position is that normal rules apply, with the fund and its investors fully within the scope of the proposed non-resident CGT charge.

Thirdly, it addresses what happens once a valid election has been made, including what happens if any of the conditions that had to be met for an election to be made are subsequently failed.

This note comments on each of these aspects of Schedule 5AAA TCGA.

[14] Including OECD Model Convention, above fn.7, Art.13.
[15] TCGA Sch.5AAA, Pt 2 (with "collective investment vehicle" defined in TCGA Sch.5AAA, para.1).
[16] After *Baker v Archer-Shee* [1927] UKHL 1; [1927] AC 844; [1926] 11 TC 749.
[17] TCGA Sch.5AAA, Pt 3.
[18] TCGA Sch.5AAA, Pt 4, paras 12(2) and 16.
[19] TCGA Sch.5AAA, Pt 4, paras 12(3) and 16.

Taxing non-resident investors in a CIV: paragraph 6 of Schedule 5AAA TCGA

Paragraph 6 of Schedule 5AAA TCGA removes the 25 per cent investment condition when there is an indirect disposal of UK land by an investor in a CIV. This is to ensure that all non-resident investors in a CIV are within the charge to CGT when they dispose of an interest in a UK property rich CIV, regardless of the scale of their investment. This is achieved by paragraph 6(2) of Schedule 5AAA TCGA, which simply modifies the definition of "substantial indirect interest in UK land" as it applies for the purposes of sections 1A(3)(c) and 2B(4)(b) TCGA.

Under paragraph 8 of Schedule 1A TCGA, a non-resident has a substantial indirect interest in UK land (and so is within the charge to CGT on an indirect disposal) if it has a 25 per cent investment in a company.[20]

However, paragraph 6 of Schedule 5AAA TCGA removes this 25 per cent investment condition. If a disposal by a non-resident has an "appropriate connection to a collective investment vehicle", the non-resident is treated as having a substantial indirect interest in UK land regardless of the extent of its interest in the CIV.[21] A non-UK investor in a UK property rich entity is therefore broadly in the same position as a UK investor in the same entity.

HMRC's explanation for this change to the original consultation proposals is that

> "…a significant part of the reason for the 25% exemption is to remove from charge investors who have insufficient knowledge of an entity they are invested in to assess whether it is property-rich. Those who invest in UK property funds know that they are investing in UK land, and the government believes that they should be within the rules."[22]

This may be the case, but the assumed knowledge of investors in property funds would have been known when the proposals were announced in November 2017. But the possibility of a new exemption for CIVs meant this change was necessary for HMRC to be able to effectively transfer the liability to CGT on UK land related disposals to investors.

However, paragraph 6 of Schedule 5AAA TCGA does not just apply where a fund has elected for exemption: it also applies where the CIV remains taxable on a disposal of UK land. Here, HMRC say:

> "Removing the 25% exemption only for funds who agreed to report and thereby received special tax treatment, however, was also seen as an issue that could cause significant problems for fund managers and investors.…This would cause irreconcilable conflicts of interests between different groups of investors, potentially making agreement to adopt the treatment inaccessible for those who needed it."[23]

As a result, where a fund is not able to elect for exemption, (non-tax exempt) non-resident investors are in a worse position than if they had invested directly through a non-CIV corporate structure. This may be an issue for funds that invest in property in more than one jurisdiction

[20] The definition of "25% investment" is in TCGA Sch.1, para.9.
[21] Unless the CIV is a company and satisfies the conditions in TCGA Sch.5AAA, para.7(2).
[22] Summary of Responses, above fn.3, para.3.115. Note that TCGA Sch.5AAA, para.6 also applies where a non-resident invests in a UK resident CIV, such as property authorised investment funds (PAIFs) or a UK real estate investment trust (REIT).
[23] Summary of Responses, above fn.3, para.3.109.

(as Schedule 1A TCGA applies at the date of disposal only, such a fund may be unexpectedly UK property rich at the particular time at which an investor redeems its interest). For such funds, there is some mitigation of this risk under paragraph 7 of Schedule 5AAA TCGA—but only where the fund vehicle is a company.[24]

Appropriate connection to a CIV

The loss of the 25 per cent investment condition is dependent on a disposal having "an appropriate connection to a CIV".[25] For investors in a CIV, there are three principal categories of disposal with such a connection, reflecting not only the different types of fund (opaque and transparent) but also the possibility of indirect investment in a fund (through a form of feeder vehicle, which might not itself be a CIV). These are:

1. where the CIV is a company, a disposal of a right or interest in that CIV;
2. where the investor invests in that CIV indirectly through a company, a disposal of a right or interest in that intermediate company[26]; and
3. where the CIV is a partnership, a disposal of a right or interest in a company owned by the partnership.[27]

Although paragraph 6 of Schedule 5AAA TCGA simply refers to a disposal of an asset that consists of a right or interest in a collective investment vehicle, that asset must be a right or interest in a UK property rich company (as paragraph 6 must be read in conjunction with Part 2 of Schedule 1 TCGA). Therefore, if a CIV is not a company, paragraph 3 of Schedule 5AAA TCGA deems it to be one for the purposes of determining if it is UK property rich at any particular time.[28]

For completeness, paragraph 6 of Schedule 5AAA TCGA does not just apply to investors in a CIV: it also applies where: 1. an indirect disposal of UK land is made by a CIV; and 2. in the circumstances set out in paragraph 6(6) of Schedule 5AAA TCGA.

For a non-resident investor in a UK property rich entity, determining whether that entity is a CIV or not is key in identifying whether a non-resident is able to benefit from the 25 per cent investment condition.

[24] See above fn.21. This is subject to the CIV meeting the UK real estate condition (that is, the CIV's investment strategy is that no more than 40% by value of its investments are intended to be UK land related. But note that, if the fund vehicle is a partnership, TCGA Sch.5AAA, para.6(4) still applies.
[25] TCGA Sch.5AAA, para.6(1)(b).
[26] TCGA Sch.5AAA, para.6(3)(b). This ensures that the charge on investors cannot be avoided by investing indirectly, but applies only where at least half the market value of the intermediate company derives from being a participator.
[27] TCGA Sch.5AAA, para.6(4).
[28] Within TCGA Sch.5AAA, whether or not a CIV is UK property rich is also relevant to whether a CIV can make an election (whether for transparency or exemption). Under TCGA Sch.1A, the UK property rich test applies when there is a disposal. Therefore TCGA Sch.5AAA, para.3 assumes a disposal each time that Sch.5AAA requires UK property richness to be tested.

Definition of CIV

The definition of "collective investment vehicle" is contained in paragraph 1 of Schedule 5AAA TCGA. The definition covers both UK and non-UK entities—although only Part 2 of Schedule 5AAA (which includes paragraph 6) is relevant to UK CIVs.

Parts 3 and 4 of Schedule 5AAA TCGA—which govern the making of elections—concern offshore CIVs only.[29]

With both collective investment schemes (within the meaning of section 235 of the Financial Services and Markets Act 2000 (FSMA)) and authorised investment funds (AIFs) defined as CIVs, most classic fund vehicles should be CIVs, although a partnership will only be a CIV if it satisfies the FSMA definition of collective investment scheme.

The definition also includes UK real estate investment trusts (REITs)[30] and what HMRC loosely term "UK REIT equivalents".[31]

"UK REIT equivalent" may be a misnomer: the definition simply refers to a non-UK resident company that meets a "property income condition". The property income condition is drafted broadly and has the potential to bring any non-close non-UK resident property SPV (or its holding company) that benefits from tax exemption in its jurisdiction of residence within the scope of Schedule 5AAA TCGA (regardless of whether that exemption is conferred under a REIT regime).

Although a "UK REIT equivalent", as an offshore CIV, may be able to elect for exemption, this is not the case for a UK REIT (which is not within the scope of Part 4 of Schedule 5AAA TCGA).

However, with HMRC looking to achieve parity in treatment between UK and non-UK residents, paragraph 115 of Schedule 1 FA 2019 introduces the new section 535A of the Corporation Tax Act 2010 (CTA 2010). This is intended to ensure that the exemptions available to a REIT are broadly comparable to those available to a CIV that makes an election for exemption. From 6 April 2019, a company that is, or is a member of, a UK REIT is exempt from CGT on a disposal of an interest in a UK property rich subsidiary,[32] as well as on direct disposals of UK land held for its property business

The transparency election: dealing with JPUTs

Prior to December 2017, the CGT status of JPUTs had been governed by section 99 TCGA. Under section 99 TCGA a unit trust scheme was deemed to be a company (and units deemed shares), with its tax residence determined by reference to the residence of the trustees.

In December 2017, a month after the changes to non-resident CGT were announced, a statutory instrument[33] modified the treatment of JPUTs and similar entities.

[29] "Offshore CIV" is defined in TCGA Sch.5AAA, para.2.

[30] TCGA Sch.5AAA, para.1(1)(c). The reference is to a "company which is a UK REIT". This appears to be intended to include both a company UK REIT and a group UK REIT (each as defined in CTA 2010 Pt 12).

[31] The Technical Note, above fn.11, said this definition applies to "companies that meet a description intended to include the overseas equivalents of UK REITs".

[32] Any gain on such a sale is treated as a gain arising in the tax-exempt property business of the REIT: see CTA 2010 ss.535 and 535A(3). Note that for a REIT, the exemption differs from that available under TCGA Sch.5AAA, Pt 4, as it is limited to the "appropriate proportion" of any gain only.

[33] The Collective Investment Schemes and Offshore Funds (Amendment of the Taxation of Chargeable Gains Act 1992) Regulations 2017 (SI 2017/1204).

From 1 January 2018, if a JPUT was a transparent fund (within the meaning of regulation 11 of the Offshore Funds (Tax) Regulations 2009[34]), section 99 TCGA no longer applied. Instead, section 103D(3) TCGA treated a unit in that JPUT as an asset for CGT purposes (treating the JPUT, as far as the investor was concerned, as opaque—so the investor, on selling a unit, would make a disposal of the unit and not underlying JPUT property) but made no reference to the status of the JPUT. Whether the JPUT itself was transparent or opaque for CGT purposes had to be worked out on a case-by-case basis applying general entity classification principles. As long as non-residents were outside the scope of CGT, this was an interesting, but academic, issue. The proposed extension of CGT to non-residents changed that. Given the prevalence of JPUTs as a holding vehicle for UK land, it was not surprising that respondents to the Consultation "questioned whether this [the statutory instrument] was intended to be relevant" to non-resident CGT.[35]

HMRC's answer to this was rather unexpected. Rather than prescribe how a JPUT should be regarded for CGT purposes, investors in an offshore CIV that is tax transparent for income, but neither a company nor a partnership, have been given the ability to choose how that offshore CIV is to be classified for CGT purposes: in effect, a UK form of check-the-box election.

The default rule is that such an offshore CIV is treated as a company (and units as shares[36]) for the purposes of applying Schedule 5AAA TCGA and the non-resident CGT rules to the vehicle[37] (but not otherwise, with sections 99 and 103D TCGA applying as before to UK resident unit-holders).

But the offshore CIV can elect out of this default position and instead be treated as a partnership for all CGT purposes.[38] All participants in the CIV have to consent to the making of an election given the impact on their tax position.[39]

In the Summary of Responses, HMRC had said that partnership treatment would be limited to non-UK investors. It was clear however that a hybrid classification based on residence of investors would be unworkable. HMRC backtracked almost immediately and so now the only investors not affected by an election for transparency are insurance companies which hold units for the purposes of their long-term business (and remain subject to section 212 TCGA).[40]

Although as a matter of principle the transparency election is available to any offshore CIV that meets the conditions, the need to obtain consent from all investors and the practical implications of the CIV being treated as a partnership for CGT purposes (for example, the impact

[34] Offshore Funds (Tax) Regulations 2009 (SI 2009/3001).
[35] Summary of Responses, above fn.3, para.3.102.
[36] Although units are treated as shares, they do not constitute "ordinary share capital" within CTA 2010 s.1119 and so, as was the position under TCGA s.99, a JPUT cannot be a member of a group for tax purposes.
[37] TCGA Sch.5AAA, Pt 1, para.4(1), (2) and (3).
[38] TCGA Sch.5AAA, paras 4(4), 8 and 9.
[39] Again, note HMRC's willingness to accommodate the practicalities of how funds operate. Appendix 15, above fn.13, CGXXX06 ("How and when the election must be made") says that HMRC will accept consent as having been given if "it is evident that it has been made clear to investors in fund documentation or other relevant material that they are buying an interest in a fund that intends to make a transparency election".
[40] TCGA Sch.5AAA, para.10,

of Statement of Practice D12[41] on a change in unit-holders) means that, in practice, only those CIVs with a small and stable number of investors are likely to make the election. This is certainly HMRC's expectation:

> "HMRC would anticipate the likely users of this election to be smaller, joint-venture arrangements where the investors are predominantly or wholly exempt investors and/or are unlikely to change regularly."[42]

As a result, HMRC's willingness to allow investors the ability to decide their tax treatment for themselves is welcome. Participators can balance out the benefits and costs of deemed partnership treatment before electing.

This is particularly important as, once made, an election is irrevocable. Equally, if an election is not made within the statutory time limit (no later than 12 months after the CIV first acquires an interest in UK land (whether direct or indirect)), it can then never be made.[43] The decision made by the initial participators is therefore binding on all future participators (and, if an election is made, partnership treatment applies even if the CIV ceases to hold UK land). As a result, when deciding whether or not to elect for transparency, participators should consider any future exit strategy: for the type of smaller, joint-venture arrangements for which the election is targeted, exit often involves a sale of the CIV (and not the property), and a prospective buyer may have its own view as to preferred tax status.

For a JPUT set up prior to 6 April 2019, consideration also needs to be given to the effect of an election on the base cost of existing unit-holders. This is because, under paragraph 8(2) of Schedule 5AAA TCGA, where an election is made, the CIV is treated as if, from its constitution, it has always been a partnership.

This means that, notwithstanding that partnership treatment only affects disposals after 5 April 2019 (and the conversion from opacity to partnership is a non-event for CGT purposes),[44] an investor's base cost will need to be recalculated by reference to the alternative reality of a partnership. For non-UK investors, Schedule 4AA TCGA should provide a relatively straightforward method for determining base cost.[45] But taxable UK investors will have to go back to basic principles. As HMRC say:

> "The transition for investors between holding an interest in the CIV as an asset and holding an interest in the underlying assets, including UK resident investors under current rules, will be done by deeming the underlying assets to always have been so held for the purposes of calculating the gain.

[41] See HMRC, Policy paper, *Statement of Practice D12: Partnerships* (updated 14 September 2015), available at: *https://www.gov.uk/government/publications/statement-of-practice-d12/statement-of-practice-d12* [Accessed 12 July 2019].
[42] Appendix 15, above fn.13, CGXXX06 ("The transparency election").
[43] For a JPUT in existence as at 6 April 2019, the transparency election must be made before 6 April 2020: TCGA Sch.5AAA, para.48(2).
[44] TCGA Sch.5AAA, para.49(3) and (4)(b).
[45] For these purposes, where an election for transparency has been made, TCGA Sch.5AAA, para.11 adapts TCGA Sch.4AA in relation to disposals by a participator in a deemed partnership.

Statement of Practice D12, and principles such as those in section 43 TCGA, will assist in calculating any gain or loss when the investor or the CIV makes a disposal."[46]

This may understate the reality of this challenge. For UK taxable investors in particular, opacity of a JPUT (and as a result the JPUT's ability to rely on Schedule 4AA TCGA to rebase any UK land related assets) may therefore be the preferable option—this perhaps illustrates why HMRC anticipate that transparency elections will generally be made only where an offshore CIV's investors are predominately exempt.

Election for exemption: dealing with widely held funds

The transparency election allows investors in one particular type of CIV to eliminate CGT within the fund itself, but where the CIV makes a gain, that gain is taxable on the investors as a result of section 59 TCGA. The election does not affect the timing of a tax point, just the identity of the taxable person.

In contrast, under an exemption election, CGT on any UK land related disposals within a fund is deferred until an investor makes a disposal of its interest in the fund (for example, by sale or redemption) with the amount of gain determined by reference to the disposal by the investor, and not the disposal by the fund. The investor is in the same position that it would have been in had no election been made.

But, where an exemption election is in effect, all direct and indirect disposals of UK land, whether made by the CIV itself or any UK or non-UK resident entity owned by the CIV,[47] are effectively disregarded for CGT purposes.

Therefore, where an exemption election is made, it is possible to avoid multiple charges arising within the fund, and so exempt investors should be in the same position they would have been in had they invested directly.

In some ways the approach taken by HMRC mirrors that which applies to chargeable gains from disposals of property by a REIT. In particular, the tax advantages of this exemption are only available if certain conditions are met (and some of these conditions borrow heavily from the REIT regime).[48] Plus, as is the case under the REIT regime, subsidiaries of a CIV can also benefit from exemption from CGT on direct and indirect disposals of UK land, and this is the case whether those subsidiaries are UK or non-UK resident (with what started off as a policy response to a measure directed at non-residents now conferring an equivalent exemption on certain UK resident companies).

However, whereas the REIT regime exempts the REIT and then relies on withholding as a means of collecting tax from investors (through the property income dividend requirement), for exempt CIVs, HMRC are dependent on investors self-assessing themselves to CGT on disposals: hence the quid-pro-quo for exemption is the obligation imposed on the CIV to provide information to HMRC on an annual basis, including details of investors and their disposals.[49]

[46] Appendix 15, above fn.13, CGXXX06 ("Effect of the election on UK tax resident investors").
[47] Although the election in TCGA Sch.5AAA, para.12(2) can only be made by an offshore vehicle, para.12(3) expressly states that where a particular company is resident is irrelevant. Similarly TCGA Sch.5AAA, para.16 contains no residence condition.
[48] See, for example, TCGA Sch.5AAA, para.46(3).
[49] TCGA Sch.5AAA, para.15.

The election

There are two types of election—and which is applicable depends on whether the CIV in which investors hold their interests is opaque (a company) or transparent (a partnership).

In working out which election is applicable, regard must be had to the effect of the deeming provisions in Parts 2 and 3 of Schedule 5AAA TCGA. This is not straightforward. Although an entity deemed to be a company under paragraph 4 of Schedule 5AAA TCGA is a company for the purposes of the election conditions (Schedule 5AAA being one of the relevant purposes for which the default position applies), it cannot be a qualifying company under paragraph 12(3) of Schedule 5AAA TCGA because it is a CIV.[50] Where such an entity has made an election for transparency under paragraph 8 of Schedule 5AAA TCGA, HMRC's view is that the effect of that election is that the relevant CIV is considered to be a partnership for the purposes of paragraph 12(3).[51] For fund structures which involve JPUTs, exemption may therefore require a number of different elections to be made (under both paragraph 8 and paragraph 12).

If the relevant CIV is a company, an exemption election can only be made if paragraph 12(2) of Schedule 5AAA TCGA applies. An election under paragraph 12(2) can only be made if the CIV is an offshore company, and other than in relation to a CIV within paragraph 1(2)(d) of Schedule 5AAA TCGA (a UK REIT equivalent), the company must be a collective investment scheme for FSMA purposes. A CIV that has elected for exemption under paragraph 12(2) is defined as a qualifying fund.

For a CIV constituted as a partnership or a CoACS, the CIV itself does not itself need an exemption from CGT given its tax transparency. However, such a CIV will generally set up one or more subsidiaries to hold fund investments. Those subsidiaries would not be CIVs and so are not able to elect under paragraph 12(2) of Schedule 5AAA TCGA. Hence the alternative type of election in paragraph 12(3) of Schedule 5AAA TCGA under which the CIV can elect for exemption to apply to a company that meets certain conditions and in which it (that is, the partnership/CoACS) holds a minimum 99 per cent interest[52] (a qualifying company).

Like an election under paragraph 12(2) of Schedule 5AAA TCGA, a paragraph 12(3) election can only be made if the fund vehicle (the partnership or CoACS) is a collective investment scheme for FSMA purposes. But unlike a paragraph 12(2) election, that vehicle does not have to be offshore (and hence an election can be made under this provision by an English LP).

If the partnership (or CoACS) holds more than one company that would qualify for an exemption election under paragraph 12(3) of Schedule 5AAA TCGA, a separate election must be made for each qualifying company. Although this adds complexity to the regime, it was seen as preferable to the alternative (which would have been to deem a partnership to be opaque so that the same election could apply to all funds, regardless of form).

[50] This is even though the "almost wholly owned" condition appears to have been directed at allowing an election to be made in relation to a collective investment scheme (with the 1% allowing for a second participant to enable the company to have the necessary "collective" element).

[51] Even though the CIV was not actually constituted by two or more persons carrying on a business in partnership, TCGA Sch.5AAA, para.12(3)(a) should be met by way of necessary implication given that the entity is deemed to have been a partnership "on its constitution": see *Marshall (Inspector of Taxes) v Kerr* [1995] 1 AC 148; [1994] STC 638 (HL).

[52] This follows from the definition of "wholly (or almost wholly) owned" in TCGA Sch.5AAA, para.49.

In practice, this condition (and the need for a qualifying company to be UK property rich) is likely to have a significant influence on fund structures, particularly those for which UK property represents part only of their investments. Although UK property assets could be ring-fenced within a company held directly by the partnership (so an election could be made), the CIV needs to assess whether an election makes sense overall, particularly given the reporting requirements.[53]

Where an election is made under either provision, paragraph 16 of Schedule 5AAA TCGA extends its scope to companies in which the elected entity (that is, the qualifying fund or qualifying company) has at least a 40 per cent investment (worked out by reference to paragraph 9 of Schedule 1A TCGA). Under paragraph 16, a gain arising on a direct or indirect disposal of UK land by such a company is not a chargeable gain to the extent of the CIV's interest.

There are two other CGT benefits of electing for exemption:

1. Under paragraph 31 of Schedule 5AAA TCGA, where the fund sells a company (C) that is exempt (whether that exemption is conferred by paragraph 12 or 16 of Schedule 5AAA TCGA), there is an effective rebasing by C of its UK land related assets to their then market value (provided, in broad terms, the assets have been held within the fund for at least a year): basically applying the exemption to gains that accrue whilst the election is of effect, as well as to realised gains.[54]
2. Recognising that exempt investors often invest in a CIV indirectly (via an intermediate company (F)), paragraph 33 of Schedule 5AAA TCGA exempts a disposal by F of an interest in an exempt CIV from CGT, provided F is wholly owned by specified types of investors.[55] This is intended to allow an exempt investor to engage its exemption whether it holds its interest in the CIV directly or indirectly.

The entitlement conditions

The ability to elect for exemption is limited to companies that are UK property rich at the time of the election and meet certain other conditions. These entitlement conditions (as they are referred to in paragraph 12 of Schedule 5AAA TCGA) are later described as "applicable exemption conditions"[56]—so that if a company ceases, at any time, to meet any applicable exemption condition, the exemption will generally cease to have effect, with consequences for both the fund and its investors.

Two types of election mean that there are two sets of entitlement conditions: plus, within each set, there are alternative ways of meeting those conditions. This creates multiple combinations

[53] Note non-resident investors in the CIV would be liable to CGT on a disposal of a UK property rich subsidiary owned directly by the partnership (the 25% investment condition does not apply due to TCGA Sch.5AAA, para.6(4)).
[54] The rebasing is effected by a deemed disposal and re-acquisition at market value immediately prior to the sale of C, so that any resultant gain is exempt. This provision again illustrates the influence of the REIT regime on the CIV proposals: see CTA 2010 s.579.
[55] The specified categories of investor include exempt investors that would be qualifying institutional investors for the purposes of TCGA Sch.7AC, para.3A (QII SSE). Note that TCGA Sch.5AAA, paras 34–37 set out an order of priority of exemptions where a disposal by a qualifying fund or qualifying company would also be exempted from CGT under TCGA Sch.7AC or as a result of CTA 2010 Pt 12 (REITs).
[56] TCGA Sch.5AAA, para.38.

of condition that need to be considered by a particular fund to determine if it can make an exemption election.[57] HMRC helpfully set out the conditions in a table in their draft guidance.[58]

Common to both elections is the requirement that the relevant company is UK property rich and that, in broad terms, it is "widely held". The rationale for this latter condition is that HMRC only want the exemption to be available to "true" funds, and not to private arrangements that use a fund-type entity as an investment vehicle.

In the definition of "widely held", the influence of the REIT regime can be clearly discerned.[59] Both sets of entitlement condition include a "non-close condition".[60] This is based on the standard close company definition, but, following the REIT precedent, adapted to exclude participators that are "qualifying investors". The definition of qualifying investor takes the REIT definition of the term as a starting point, but adds an additional condition to investors within specified paragraphs of section 528(4A) CTA 2010 (basically requiring any such investor to itself be "widely held").

Recognising both the need for certainty and the practical challenges for many fund managers in applying the non-close test on a continuing basis, HMRC included an alternative "widely held" test. This is the genuine diversity of ownership (GDO) condition that applies to offshore funds.[61]

For CIVs within paragraph 12(3) of Schedule 5AAA TCGA, however, the drafting of the non-close test means that an election can only be made if the CIV satisfies the GDO test. This is because the voting rights (and so control) of each company owned by the partnership will be held by a single person, the general partner, and so the non-close condition will be failed. As a result, the only circumstance in which an election is available is if the partnership itself meets the GDO test in paragraph 13(2)(b) of Schedule 5AAA TCGA.

This was not intended: HMRC have confirmed this in their draft guidance:

> "Where the general partner of the LP CIS controls the company in question by virtue of its powers as general partner to manage the affairs of the partnership, the company would remain close notwithstanding the disregard for attribution of partner rights at paragraph 46(2)(d). For the purposes of paragraph 46(5) HMRC will nevertheless regard the company in question as not being close provided it is not close for any other reason."[62]

Given HMRC's powers to amend Schedule 5AAA TCGA, including with retrospective effect,[63] it is hoped that the legislation will be amended. In the meantime, the draft guidance provides reassurance on the issue (albeit non-binding).

There are obvious benefits to relying on the GDO test, rather than the non-close test, if the facts allow. The GDO test is to all intents and purposes within the control of the CIV, linked to

[57] The existence of two alternative forms of election has an impact on several provisions within TCGA Sch.5AAA, Pt 4 with the same principle being applied separately to a qualifying fund and a qualifying company.
[58] Appendix 15, above fn.13, CGXXX08.
[59] See Summary of Responses, above fn.3, Annexure A.10.
[60] TCGA Sch.5AAA, Pt 4, paras 13(1)(b) and (c) and 13(2)(a).
[61] TCGA Sch.5AAA, paras 13(3) and 46(4).
[62] Appendix 15, above fn.13, CGXXX08 ("Qualifying investors").
[63] TCGA Sch.5AAA, para.48.

how the CIV chooses (and actually markets) itself. Given that if an exemption condition is failed, exemption is lost,[64] the relative certainty the GDO test offers is clearly advantageous.

Unfortunately though, for some real estate funds (and particularly funds already set up), the GDO test may be impossible to meet. Such funds will have to rely on the non-close test which also requires them to meet what the legislation refers to as the UK tax condition.[65]

The UK tax condition is included so that HMRC can be comfortable that they can recover tax from the majority of investors in an exempt CIV. It is designed to ensure that no more than 25 per cent of the CIV's investors (by value) are able to claim exemption from CGT under the terms of an applicable double tax agreement.[66]

Again, demonstrating a degree of pragmatism, the UK tax condition will be met if the fund manager "reasonably considers" this to be the case. Both the Technical Note and HMRC's draft guidance state that the UK tax condition is not intended to require managers to get specific treaty status confirmations from investors; it is simply about interrogating information they already hold in connection with existing regulatory requirements.[67]

Making an election

There is no statutory requirement to obtain investor consent to make an exemption election. However investors will clearly need to be consulted given the nature of the reporting requirements.

To be in a position to elect for exemption, a fund manager needs to know that they will be able to deliver to HMRC the specified information about investors and disposals. To make such disclosure, investor agreement will be needed—and existing CIVs may find that investor side-letters preclude the provision of such information to any governmental authority unless required by law (and, here, the obligation to report is dependent on an election being made by the CIV).

For HMRC, the receipt of information about investors and disposals is fundamental to the operation of the exemption. The collection of any CGT in relation to exempt funds is dependent on the investors making the relevant self-assessments and returns. Absent information from the fund itself, HMRC may not be able to verify who should be providing those returns.

The legislation provides for two separate reporting requirements, though the information required is broadly the same for both: the first is a "day one" requirement at the time the election is made (under paragraph 14 of Schedule 5AAA TCGA, to be effective, the election must generally be accompanied by information relating to the previous two years); the second, an ongoing annual report (under paragraph 15 of Schedule 5AAA TCGA). The definition of "relevant fund" in paragraph 39 of Schedule 5AAA TCGA ensures that the reporting requirements relate to the CIV whether the election is made in relation to a qualifying fund or any qualifying company.

The paragraph 14 "day one" requirement is a consequence of the flexibility given to a CIV in relation to the timing of an election. The only time limit relevant to an exemption election is

[64] TCGA Sch.5AAA, paras 20, 27 and 28.

[65] For CIVs that are listed companies (which may be the case for CIVs within TCGA Sch.5AAA, para.1(1)(d)), there is an alternative "widely held" test at TCGA Sch.5AAA, para.13(1)(b).

[66] TCGA Sch.5AAA, para.13(7).

[67] Appendix 15, above fn.13, CGXXX08 ("The UK tax condition"). The same pragmatism does not however apply to the non-close test.

that it must be made no later than 12 months after a disposal in respect of which exemption is sought.[68]

HMRC could have applied the same 12 month time limit to an exemption election as applies to a transparency election. However, in most cases, this would have involved CIVs just reporting a list of investor names (and little else) for several years given the likelihood of disposals in the initial investment phase is remote. For some funds, this would be a compliance burden without real purpose. Pragmatism won out, with paragraph 14 of Schedule 5AAA TCGA the compromise.

The current extent of the reporting requirements is set out in the draft guidance (having been trailed in the Technical Note). The decision to address these by guidance rather than legislation (primary or secondary) was deliberate as it allows greater flexibility to adapt the requirements in the light of experience in practice. But it does mean HMRC have discretion to amend these requirements. HMRC say "they will consult relevant stakeholders prior to making material changes to the information to be reported",[69] and although there is no reason to doubt this (particularly given their engagement with the funds sector in developing these provisions), this is just a statement of intent.

The reporting requirements operate as an ongoing exemption condition[70] as a failure to comply potentially leads to an election being revoked.[71]

Here, HMRC have a significant amount of discretion in determining whether a breach of these requirements should lead to revocation. The legislation states that any breach "may" lead to revocation, unless the CIV has a reasonable excuse.[72] The legislation also entitles an HMRC officer to waive breaches that are, in the opinion of that officer, insignificant (taking into account any previous breaches[73]).

For taxpayers, there is some reassurance as to how this discretion will be exercised in practice in the fact that only a designated HMRC officer[74] can revoke an election, and also from the commentary included in the draft guidance on this aspect of the rules.[75] In addition, if an election is revoked, there is a right to appeal under paragraph 19 of Schedule 5AAA TCGA. Given the consequences of revocation (for both CIV and investor), reliance on practice and discretion is perhaps less than ideal, but provided the fund manager has access to the relevant information, issues should hopefully rarely arise in practice. It does however emphasise the importance of clarity as to the detail of requirements: here, the current draft guidance (based on what was in the Technical Note) could be improved.

[68] TCGA Sch.5AAA, para.17.
[69] Appendix 15, above fn.13, CGXXX13 ("Introduction").
[70] See, for example, the Technical Note, above fn.11, para.50: "Eligible CIVs meeting certain qualifying definitions *and which commit to report certain information annually* to HMRC can make an election that provides exemption" (emphasis added).
[71] See TCGA Sch.5AAA, para.15(5)–(7).
[72] TCGA Sch.5AAA, para.15(5)(a).
[73] HMRC can take into account both the seriousness and number of past breaches: this too borrows from the REIT regime as it relates to breaches of conditions (see CTA 2010 Pt 12, Ch.9).
[74] TCGA Sch.5AAA, para.42 defines "designated officer".
[75] Appendix 15, above fn.13, CGXXX13 ("Breaches of requirement to make a report").

Protecting the ability to tax investors: deemed disposals

The CIV exemption is predicated on HMRC being able to recover CGT on gains arising from UK land related disposals from investors when they dispose of their interests in the fund. For this to hold true, all returns of (tax-free) proceeds of disposals of UK land by the CIV need to be effected in a manner that gives rise to a disposal for CGT purposes, and, where the investor is a non-UK resident, that disposal needs to be an indirect disposal within Schedule 1A TCGA.

Certain of the exemption conditions (particularly the UK property rich condition and, if applicable, the UK tax condition) are designed with this in mind. Similarly paragraph 21 of Schedule 5AAA TCGA is intended to discourage a CIV from choosing to distribute UK land related gains by way of an income distribution (which, as a result of the standard dividend article in double tax agreements, the UK may not have a right to tax).

Failure of any exemption condition, like a failure to meet the reporting requirements, may result in an exemption ceasing to be effect.[76] If this happens, HMRC can at least recover CGT from the CIV (and subsidiaries of the CIV) on future direct and indirect disposals of UK land (unless of course the failure is because the CIV no longer owns any UK property).

But, with HMRC also needing to ensure they can collect tax from investors in relation to gains arising within the CIV whilst exempt, Part 4 of Schedule 5AAA TCGA contains provisions designed to crystallise a tax point for investors at the point at which a CIV ceases to be exempt—and, more importantly, where the reason for the CIV losing its exemption is because it ceases to be UK property rich (that is, it has sold its last UK property), at a point at which HMRC still have the right to tax the investor.[77]

The means by which a tax point is triggered is to deem a disposal (and immediate reacquisition) at market value by all participators, whether UK or non-UK resident, of their interests in the CIV (or, where an election has been made under paragraph 12(3) of Schedule 5AAA TCGA, the relevant qualifying company) "immediately before the exemption ceases to be of effect".

The timing of this deemed disposal is important: unless the CIV is UK property rich at the time of the disposal, the UK does not have the ability to tax a non-resident investor (under UK tax law as well as the standard securitised land provision in double tax agreements). By deeming the gain to be realised whilst the CIV is still UK property rich, Part 2 of Schedule 1A TCGA is met at the time of the (deemed) disposal. This means HMRC can tax accrued gains up to the moment just before UK property is sold (including the accrued gain on that property), but not any gains arising after that time.[78]

The relevant provisions—paragraphs 18 to 30 of Schedule 5AAA TCGA—are not the most straightforward. There is an economy (and efficiency) in the drafting that belies the number of different circumstances they are intended to cover.

[76] Not every failure of an exemption condition means that the CIV loses its exemption: see TCGA Sch.5AAA, paras 27 and 28 (temporary period in which exemption conditions not met) and para.30 (steps taken by relevant fund manager to wind up relevant fund).

[77] A failure to meet the UK property rich condition always results in a deemed disposal. If any other exemption condition is failed, but is intended to be, and is, remedied within 30 days, TCGA Sch.5AAA, para.27(3) disapplies the deemed disposal provisions.

[78] In this context, note OECD Model Convention, above fn.7, Commentary on Article 13, paras 7–9.

This is in part due to recognition by HMRC that certain conditions could be failed as a result of events outside the CIV's control. As a result, the provisions allow grace periods in which the CIV has an opportunity to again comply with the condition(s). There are two such provisions which have very different consequences for investors.[79]

But the main reason for the complexity is that HMRC's focus is on triggering a tax point but (other than where an election is revoked) without necessarily accelerating the payment of CGT. Intrinsic to the CIV exemption regime is HMRC's acceptance that, where a CIV disposes of UK land at a gain, the tax point is deferred until such time as value representing that gain is realised by an investor (as a result of an actual disposal by that investor). The deemed disposal provisions, in the most part, respect that principle, responding to the concerns from the fund industry about the risk of imposing dry tax charges on investors.

The provisions that defer the time at which CGT becomes payable on a deemed disposal only apply where an election could cease to be of effect because an exemption condition has been failed (the reference to "could' is important because it is possible for a deemed disposal to occur even if the exemption is not lost[80]).

If, on the other hand, the reason for a deemed disposal is that an election has been revoked (whether by the CIV or by HMRC), any resulting gain is immediately chargeable to CGT.

The relevant provisions are paragraphs 23, 28, 29 and 30 of Schedule 5AAA TCGA. The effect of these, in broad terms, is that a gain that arises on a deemed disposal is not treated as arising until such time as the investor makes an actual disposal (and then only arises to the extent of the consideration received on that actual disposal). This is however subject to a long-stop date of three years (or, if earlier, when the fund is wound up) at which time any remaining part of the deemed gain will arise.[81] The long-stop is there because, although HMRC are willing to defer collecting the tax, they are only willing to defer for so long.

Depending on the facts, this could mean that CGT on the deemed gain is effectively paid in instalments, complicating reporting for any taxable (UK or non-UK) investor, particularly given concurrent reporting requirements in relation to any actual disposal.

It cannot be assumed that, because these provisions only apply if an exemption condition is failed, they are unlikely to be relevant in practice. One of the exemption conditions is that the CIV/qualifying company is UK property rich. For many property funds, there will be a point at which that condition is no longer met as a matter of course. For example, closed-ended funds are generally set up to realise their investments within say, seven to ten years of being set up and, for partnership funds with individual investments in SPVs, it is entirely possible that one or more of those SPVs will make a disposal (and thus cease to be UK property rich) at some point. In this latter case, if an exemption election relates to that SPV (as a qualifying company), the sale of an SPV's only UK property means that SPV then fails an exemption condition, triggering a deemed disposal.

A fund manager therefore has to consider the impact of its investment decisions (including how it structures the holding of its investment portfolio) and the timing of returns or proceeds

[79] TCGA Sch.5AAA, paras 27 and 28.
[80] TCGA Sch.5AAA, para.28(3).
[81] The basic long-stop date is set out in TCGA Sch.5AAA, para.23(8), but this may be modified by TCGA Sch.5AAA, para.29.

on its investors to minimise the risk of a dry tax charge. In any event, the fund manager has to be alert to when a charge under these provisions could apply as it is under an obligation to notify investors when there is a deemed disposal and, separately, when any deemed gain resulting from a deemed disposal becomes chargeable.[82]

Returning capital to investors: paragraph 21 of Schedule 5AAA TCGA

The deemed disposal provisions are also the means by which HMRC look to discourage the return of proceeds of sale to investors in a form that does not result in a disposal for CGT purposes. HMRC note:

> "Without specific provisions, value arising from realisation of UK land assets within an exempt fund could be returned to non-resident investors in a form that would not be subject to UK tax and that would reduce any gain on a subsequent disposal by investors."[83]

The specific provisions are in paragraph 21 of Schedule 5AAA TCGA which applies if value derived from a disposal of UK land is returned to investors as a revenue distribution.

A non-UK resident investor that receives such a distribution is deemed to make a disposal of its interest in the CIV at the time of the distribution (unless the amount of the distribution is brought into account by it as income for UK tax purposes[84]).This is intended to allow HMRC to assert their rights to tax any resultant gain under the capital gains article of a double tax agreement (assuming it contains a securitised land provision).

The difficulty with paragraph 21 of Schedule 5AAA TCGA is that, whilst the intention underlying this provision is clear, the drafting of the key pre-condition in paragraph 21(1)(b) means that it potentially applies more broadly than perhaps was intended. HMRC's draft guidance references this provision as applying where a CIV "makes a return of value…representative of gains on disposals",[85] but this is not what the legislation itself says. "Value derived from a disposal" is not defined; given that, for CGT purposes, "disposal" bears its natural, broad meaning, it seems possible that, as a technical matter, value of a revenue nature could be within its scope, for example, where the disposal consists of the grant of a lease of less than 50 years and the short lease premium rules apply.

But, as the Summary of Responses suggested that there would be a prohibition on distributions, paragraph 21 of Schedule 5AAA TCGA does at least provide CIVs with flexibility,

If such a distribution is made, the gain that arises on the deemed disposal is likely to be greater than the amount of the distribution. The deferral provisions that apply to other deemed disposals will then apply, with the first instalment of CGT on the deemed gain under paragraph 21 of Schedule 5AAA TCGA due at the time the distribution is received (by reference to the amount received) and the long-stop date being the date on which the CIV is wound up (and not earlier).

[82] TCGA Sch.5AAA, paras 25 and 26. A non-resident investor's CGT reporting requirements link to the receipt of such notification (FA 2019 Sch.2, para.12).
[83] Appendix 15, above fn.13, CGXXX11 ("Payments not otherwise taxable").
[84] TCGA Sch.5AAA, para.21(1)(c).
[85] Appendix 15, above fn.13, CGXXX11 ("Payments not otherwise taxable").

Respecting economic reality after a deemed disposal

A deemed disposal risks an investor realising a greater gain than would have been the case had the tax-point been the date of a (subsequent) actual disposal, for example, where subsequent fund expenses reduce the amount available to be returned to investors. Similarly, an investor risks economic double—or even multiple—taxation if accrued gains within the fund at the time of the deemed disposal subsequently fall within the charge to tax when they are eventually realised.

Schedule 5AAA TCGA addresses these risks, although the possibility of paying tax on a gain not reflected by the economic reality is not completely eliminated.

In working out the amount of a deemed gain, paragraph 24 of Schedule 5AAA TCGA allows an investor to take account of what the legislation calls "notional costs" as allowable expenditure. The intention appears to be that an investor should take account of anticipated future costs that would be allowable at the point of a later actual disposal.[86] However, the drafting of paragraph 24 does not quite achieve this. "Notional costs" are defined as those that would have been allowable had the deemed sale been an actual sale. There is no suggestion that the timing of that actual sale is other than that of the deemed sale. As a result, it does not seem to allow the crystal ball gazing necessary to take into account the types of cost suggested in HMRC's draft guidance.

In terms of economic double taxation, the deemed disposal is accompanied by a market value reacquisition: in effect clearing the slate for the investor.[87]

If the CIV is able to maintain exemption (and here paragraph 30 of Schedule 5AAA TCGA, which applies where a fund is in the process of being wound up, is particularly pertinent), the risk of any (pre-deemed disposal) accrued gains coming into the charge to CGT should be limited.

It is where a CIV loses its exemption that a potential issue arises. But here, again borrowing from the REIT regime, provided that election was in place for a continuous period of five years, and the CIV is not seen as at fault in relation to its loss of exempt status, the slate is also cleared at the level of the CIV. This is because, at the point the election ceases to be of effect, UK land related assets are rebased to then market value (subject, in relation to subsidiaries of the CIV, to those assets having been held for at least 12 months).[88] However where the election has been revoked by HMRC in order to safeguard public revenue or because they consider that there have been at least three serious breaches of the reporting requirements, no such rebasing applies. ☞

Sarah Squires[*]

[86] Appendix 15, above fn.13, CGXXX11 ("Calculation of the gain or loss on a deemed disposal").
[87] TCGA Sch.5AAA, paras 21(2)(b), 21(2)(c), 22(2)(b) and 22(3)(b).
[88] TCGA Sch.5AAA, para.32: in comparison, see CTA 2010 s.581 in relation to REITs (which requires the REIT regime to have applied for a continuous period of 10 years).

☞ Capital gains tax; Collective investment schemes; Deemed disposals; Disposition of property; Exemptions; Non-residents; Real property; Unit trusts

[*] Barrister, Old Square Tax Chambers.

Section 15 and Schedule 3: offshore receipts in respect of intangible property

Background

HM Treasury appear to be becoming increasingly exasperated with the prospect of non-UK businesses earning profits within the UK which are outside the scope of UK tax: it might be noted that similar exasperation has been evident in other governments of countries which feel themselves to be the source of, but not the taxable jurisdiction of, profits. What is perhaps new is that now the UK (and a number of other Western countries) feel themselves to be source jurisdictions in this context whereas, historically, they would have been regarded as the taxable jurisdiction for profits earned in source jurisdictions.

What has changed, of course, is the range of businesses which can be operated with little or no physical presence in a source country (and the level of profits which can be remotely derived by such businesses). This change relates principally to the increasing value derived from intellectual property, both as used internally and in the form of technology (particularly communications technology) by business and also as externally exploited by business.

The change also means that withholding taxes in relation to intellectual property do not necessarily operate to capture a tax charge; where the intellectual property underlies a product, rather than being the product itself, the payment for that product is broadly recognised as business profits (outside the scope of traditional withholding taxes) rather than royalties.

Schedule 3 to the Finance Act 2019 (FA 2019) represents a further attempt by the UK to capture tax on income which has its source in the UK, where the income is ultimately derived from intellectual property held in a low tax jurisdiction. In that context, it follows (arguably) in the tradition of the 2016 expansion of withholding taxes, the diverted profits tax and the proposed digital services tax.

Section 15 and Schedule 3 FA 2019

Schedule 3 FA 2019 introduces a new Chapter 2A into Part 5 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA), and imposes an income tax charge on gross receipts in respect of certain intangible rights which underlie UK sales, where the payments are received in certain jurisdictions outside the UK. The provisions apply for the 2019–20 tax year onwards.

The provisions mean that income tax is charged on "UK-derived amounts"[1] which are received by a person who is resident outside the UK in a territory that does not have a full treaty with the UK (that is, where there is no treaty with a non-discrimination article). The intangible owner is described merely as a "person" and so could be an individual, trust or other non-corporate entity.

The "UK derived amounts" are the income received for intangibles which are (in effect) made available to another person which in turn uses it in some way to make sales in the UK either directly or indirectly.[2] "Intangibles" is broadly defined, including any intangible other than financial assets or shares. As "UK sales" may be made indirectly, and there is no requirement

[1] ITTOIA s.608A.
[2] ITTOIA s.608F.

that the relevant UK sales be made by a person connected to the intangible owner, it appears that the charge could apply where goods are sold to an unconnected third party and then sold by that third party in the UK. It could also apply where sales are made to UK-based entities who ultimately sell the services or goods outside the UK.

There are some limitations on the scope of the charge: in the first place, UK sales must be at least £10 million in the relevant tax year.[3] However, "UK sales" means any services, goods or property provided in the UK or provided to persons in the UK by either the intangibles' owner or a person related to them. This threshold may be met by sales which have little or nothing to do with the intangible assets in that particular year.

An exemption applies also to entities which have substance in their territory of residence, provided that the intangibles have not been transferred from a related party, and the intangibles are not derived from intangibles which have been transferred from a related party, and the intangibles are not derived from intangibles which continue to be held by a related party. In effect, the intangibles must have been wholly independently generated by the entity for this exemption to apply.[4]

There is also an exemption where the foreign tax paid by the entity is at least half of the UK tax.[5] The effectiveness of this exemption is limited: any foreign tax is likely to be based on profits earned, after deduction of expenses, whereas the UK tax in this case is charged on the gross receipt with no deduction for any relevant expenses. The intangibles' owner could be in a high tax non-treaty jurisdiction and still not meet this exemption.

The charge is self-assessed by the intangibles' owner and accounted for to HMRC in the usual way, such that the tax will be due by 31 January following the end of the tax year in which the charge arises.

The problem of enforcement has, of course, occurred to HMRC. If the income tax charge is not paid within six months of the due date, there are provisions which allow HMRC to give a notice to a UK entity in the same group (that is, within consolidated accounts, or connected via a 51 per cent plus shareholding) requiring that UK entity to pay the income tax charge.[6]

There is, finally, a targeted anti-avoidance rule which imposes the charge even if arrangements are put in place with the intention of obtaining a tax advantage.[7] This apparently encompasses the position where a group restructures to bring the intangibles into a full treaty jurisdiction where tax is paid on the receipts. It would seem that such restructuring could still allow HMRC to impose a tax charge under these provisions. Damned if you do, damned if you don't, it seems.

Impact of the charge

This is an astonishingly wide charge: some aspects of that breadth are noted above, but in addition there is no requirement that the amounts which are subject to income tax directly relate to any UK sales in the same tax year or indeed to any UK sales by any person connected with the intangible owner—only that, at some point in time, UK sales have been "enabled, facilitated or

[3] ITTOIA s.608J.
[4] ITTOIA s.608K.
[5] ITTOIA s.608L.
[6] ITTOIA s.608O.
[7] ITTOIA s.608W.

promoted" through the use of those rights.[8] There must be UK sales of at least £10 million, but there need be no specific correlation between the amount charged and the level of UK sales. The charge may also apply where a third party sells goods based on the intangibles into the UK, where there may be no involvement on the part of the rights holder in those sales.

The policy rationale for the tax was described as being to deal with large multinational groups holding intangible property in low tax jurisdictions where the income arising from those intangibles relates to the sale of goods or services in the UK. As is clear, the measures apply far beyond that relatively narrow description.

It is questionable whether the legislation is really needed, following the implementation of the OECD/G20 BEPS framework and also the changes in US tax law which have arguably reduced tax benefits of owning intangibles in a low tax jurisdiction without adequate (or indeed substantial) substance in that jurisdiction. No clear definition of the scope of the problem to be tackled has been given; there is an estimate that the measure will raise £450 million in 2020–21 (from amounts chargeable for 2019–20).

It seems more likely that the immediate impact of the rules could be that foreign businesses will simply refuse to participate in the UK economy (for example, by refusing to allow UK sales of services or products—in the same way that some non-EU businesses simply block their websites to EU IP addresses following the implementation of the EU General Data Protection Regulation (GDPR)[9]).

Anne Fairpo[*]

Section 16 and Schedule 4: avoidance involving profit fragmentation arrangements

These provisions represent the offspring of a ménage à trois between the legislation on transfer pricing,[1] the diverted profits tax (DPT),[2] and the "transfer of assets abroad" legislation.[3] The writer leaves it to the reader to decide whether the offspring is legitimate or illegitimate. Transfer pricing and the DPT apply only to large, multinational enterprises; these new provisions extend the approaches of transfer pricing and the DPT to individuals and small- or medium-sized enterprises. Many of the concepts utilised in the new legislation are lifted out of the context of multinational businesses and applied to individuals in the new legislation.

The introduction of these new anti-avoidance measures can be traced back to the Autumn Budget in 2017 when an announcement was made that a consultation would take place on "tax

[8] ITTOIA s.608F(1)(b).

[9] 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.

Income tax; Intangible assets; Offshore companies; Royalties

[*] Temple Tax Chambers.

[1] TIOPA Pt 4.

[2] FA 2015 Pt 3.

[3] ITA 2007 Pt 13, Ch.2.

avoidance involving profit fragmentation". A consultation document was published on 10 April 2018.[4] This original consultation document gave examples of the type of avoidance arrangements it was designed to counter. One example was a management consultant who provides professional services to UK and overseas customers. He enters into an arrangement with an offshore company in a tax haven to provide services through that company, and payment is made to that company. The management consultant then takes only a relatively small fee from that company, which is the only part of the payment that is subject to UK tax. The proposed legislation would attribute the full payment to the management consultant and tax him on those sums.

The consultation document stated expressly that such arrangements would usually be caught by the transfer of assets abroad provisions. However, it asserted that such provisions are difficult to apply, and it was time consuming to gather the information needed to apply the existing provisions. For that reason, new, additional legislation was being proposed. In the example given, the management consultant would already be taxable under the transfer of assets provisions unless he had no power to enjoy the income of the overseas person or could satisfy one of the defences to the legislation. It is very hard to see any valid reason why this new charge to tax was required.

The original consultation document threatened draconian consequences for arrangements that fell within the scope of the proposed legislation. There was to be an obligation to disclose any arrangements falling within the legislation, and an obligation to pay tax up-front (in the same way that tax is collected from large multinationals under the DPT). Fortunately, the most swingeing elements of the proposals were dropped by the time there was a response document in July 2018.[5] The removal of those elements—so that the normal process of assessment and information gathering applies—makes it even harder to justify an additional, and largely overlapping, set of provisions.

The new provisions contained in Schedule 4 to the Finance Act 2019 are detailed and complex. As explained, in many situations they will apply to arrangements that are already caught by existing anti-avoidance legislation. To that extent, therefore, they simply represent another hurdle that advisers must consider when advising on bona fide overseas arrangements to ensure that those arrangements are not caught accidentally by these new charging provisions. ☙

Philip Baker

[4] HMRC, *Tax Avoidance involving Profit Fragmentation* (10 April 2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/698175/Tax_Avoidance_involving_Profit_Fragmentation_consultation_document.pdf* [Accessed 15 July 2019].

[5] See HMRC, *Tax Avoidance involving Profit Fragmentation: Summary of Responses* (6 July 2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/722457/Tax_Avoidance_involving_Profit_Fragmentation_summary_of_responses.pdf* [Accessed 15 July 2019].

☙ Diverted profits tax; Offshore companies; Tax avoidance; Transfer of assets abroad; Transfer pricing

Section 18 and Schedule 6: diverted profits tax

Part 3 of the Finance Act 2015 (FA 2015) introduced an entirely new tax on cross-border businesses and transactions. Four years later, the diverted profits tax (DPT) remains largely unique amongst national tax codes, with Australia the only other country to have followed the UK's approach. Commentators—the writer included—who at the time expressed concern at the DPT's radical scope, complexity, and "hair-trigger" conditions,[1] would have been forgiven for thinking that the actual impact of the DPT would become clear within a few years. This has notably not been the case.

One of the few concrete things we do know is that the tax—quickly christened the "Google Tax" by media outlets following George Osborne's commitment to tackle "technology companies [who] go to extraordinary lengths to pay little or no tax"[2]—does not apply to Google.[3] Everything else is speculation. Anecdotal evidence suggests that the DPT is, in the main, being used by HMRC as an additional negotiation lever in transfer pricing disputes (using the section 80 FA 2015 charge), rather than to counter permanent establishment avoidance (using the section 86 FA 2015 charge).

The actual yields from the DPT add to the impression that the DPT is more of a negotiating tool for HMRC than the revolutionary counter to profit shifting that Mr Osborne originally suggested.

At Committee Stage of the Finance (No.3) Bill 2018, the former Financial Secretary to the Treasury, Mel Stride, declared that:

> "DPT has been a success…it has raised more than originally forecast [and] continues to prevent multinationals from exploiting our tax system".[4]

The yield does indeed exceed forecasts. DPT raised £388 million in 2017–18 compared with the projected £360 million[5] (£219 million of DPT was collected, and HMRC estimates that a further £169 million of corporation tax was raised as the result of behavioural change[6]). However, viewed in the context of overall UK onshore corporation tax receipts for 2017–18 of £55 billion, these amounts are immaterial. Either the cost of "multinationals…exploiting our tax system"[7] is much less than commonly thought, or the DPT has not in fact been as successful as Mr Stride believes.

[1] D. Neidle, "The diverted profits tax: flawed by design?" [2015] BTR 147.
[2] G. Osborne, *Speech to Conservative Party Conference* (29 September 2014, Birmingham).
[3] A. Mostrous, "Osborne's 'Google tax' does not tax…Google", *The Times*, 29 January 2016.
[4] *Hansard*, Public Bill Committee, Finance (No.3) Bill (Third Sitting), col 106 (29 November 2018).
[5] HM Treasury, *Autumn Statement 2014* (December 2014), Cm.8961, available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/382327/44695_Accessible.pdf* [Accessed 18 June 2019], 64.
[6] HMRC, *Transfer Pricing and Diverted Profits Tax statistics, 2017 to 2018* (2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/729876/Transfer_Pricing_and_Diverted_Profits_Tax_statistics.pdf* [Accessed 20 June 2019], 5.
[7] *Hansard*, above fn.4.

The amendments to the DPT introduced by Schedule 6 to the Finance Act 2019 (FA 2019) are consistent with this view of the DPT as bargaining chip rather than game-changer.

The first amendment, in paragraph 11 of Schedule 6 FA 2019, slightly slows down the (relatively fast) pace of DPT procedures. Following issue of a DPT charging notice, any tax assessed as due must be paid within 30 days. Subsequently, a "review period" commences during which a taxpayer's representations are considered, at the end of which a balancing payment in respect of over- or under-paid tax may be due. It has been suggested HMRC were finding the timelines challenging,[8] and so paragraph 11 extends this review period from 12 to 15 months.

The second amendment, in paragraph 12 of Schedule 6 FA 2019, permits a taxpayer in receipt of a charging notice to amend its corporation tax return within the first 12 months of the review period window. Thus providing a taxpayer facing a 25 per cent DPT charge with an escape route, if they can self-assess themselves into a 19 per cent corporation tax charge instead. It is easy to see how this can be done where the DPT charge is, in essence, a transfer pricing matter; less easy to see how this can be done in an avoided permanent establishment case (although paragraph 12 expressly contemplates that it could be).

The third amendment, contained in paragraphs 2 to 8 and paragraph 10 of Schedule 6 FA 2019, is intended to make clear that diverted profits will not be subject to double-counting. Profits are to be subject either to the DPT or to corporation tax, but not to both. The writer is surprised by the contention that such double-counting would have arisen.

Finally, paragraph 9 of Schedule 6 FA 2019 removes an (apparently unused[9]) tax planning opportunity which permitted amendments to be made to a taxpayer's corporation tax return once the window for HMRC to issue a preliminary DPT notice had closed. Hence a sufficiently brave (or, more likely, foolish) taxpayer could have taken an aggressive pricing position, perhaps one outside traditional transfer pricing rules, in a corporation tax return amendment that was made so late as to be immune from DPT attack. No longer.

We are unlikely to learn much more about the DPT until we start seeing it tested in the courts. All we have to date is the rather unsatisfyingly procedural decision in *Glencore Energy UK Ltd v HMRC*[10]; however the writer is aware of at least two substantive cases that are expected to reach trial in the next couple of years. The shame of it is that, thanks to Brexit, the DPT's vulnerability to EU law challenge may never be properly tested.

Dan Neidle[*]

[8] H. Self, "In conversation with HMRC's Jim Harra", *Tax Journal*, 6 September 2018, available at: *https://www.taxjournal.com/articles/conversation-hmrc-s-jim-harra-06092018* [Accessed 20 June 2019].
[9] *Hansard*, above fn.4, col 107.
[10] *Glencore Energy UK Ltd v HMRC* [2017] EWHC 1476 (Admin); [2017] STC 1824.

Corporation tax; Cross-border transactions; Diverted profits tax

[*] Partner, Clifford Chance LLP.

Section 19: hybrid and other mismatches: scope of Chapter 8 and "financial instrument"

A. Introduction

International hybrid mismatches and related tax arbitrage are among the primary areas identified in the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) Project. Action 2 of the OECD's BEPS Final Report *Neutralising the Effects of Hybrid Mismatch Arrangements* (the Action 2 Final Report)[1] addresses tax arbitrage with a view to avoiding the exploitation of the different ways in which tax instruments are treated by entities in different jurisdictions. Model treaty provisions were developed and recommendations were set out regarding the design of domestic rules to neutralise the effect (that is, double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities.

In 2017, the UK implemented a detailed set of hybrid mismatch rules to combat cross-border tax advantages arising from hybrid mismatches. The UK's hybrid mismatch rules under Part 6A of the Taxation (International and Other Provisions) Act 2010 (TIOPA) derive from the recommendations of the Action 2 Final Report.

On 12 July 2016, the Anti-Tax Avoidance Directive (ATAD I)[2] came into force and it included measures to implement the recommendations of a number of BEPS action items including Action 2 on hybrid mismatch arrangements. ATAD I contains the basic measures for implementation of the hybrid action points, to be implemented from 1 January 2019. The general aim of the ATAD I provisions is to target double deduction or deduction/no inclusion situations in an intra-EU context. The Anti-Tax Avoidance Directive II (ATAD II)[3] was subsequently implemented, which amended ATAD I and required that EU Member States introduce comprehensive hybrid mismatch rules under a prescriptive set of principles.

As the requirements of ATAD II are also based substantively on BEPS Action 2 principles, the vast majority of the detailed requirements are already satisfied by the UK's existing rules. However, amendments were required to comply with specific aspects of ATAD II. This note considers the amendments made to the UK's hybrid mismatch rules by the Finance Act 2019 (FA 2019) in order to ensure that these rules conform with the requirements of ATAD II.

[1] OECD/G20 Base Erosion and Profit Shifting Project, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report* (Paris: OECD Publishing, 2015), available at: *https://doi.org/10.1787/9789264241138-en* [Accessed 21 June 2019].

[2] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market [2016] OJ L193/1 (19.7.2016).

[3] Anti-Tax Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries [2017] OJ L144/1. Member States should apply these measures as from 1 January 2019.

B. OECD BEPS and EU ATAD I and II measures relating to hybrid mismatches

BEPS Action 2 overview

The Action 2 Final Report consists of two parts each containing detailed recommendations to address hybrid mismatch arrangements.[4] Part I of the Action 2 Final Report contains recommendations on domestic law rules to address hybrid mismatch arrangements. Part II of the Action 2 Final Report contains recommended changes to the OECD Model Tax Convention.

The principal targets of the Action 2 Final Report are tax mismatches resulting from:

1. arrangements involving tax deductions for expenses (normally interest) with no corresponding taxation of the receipt (deduction/no-inclusion or "D/NI");
2. a tax deduction for the same expense in two or more jurisdictions (double deduction or "DD");
3. indirect hybrid mismatches where a mismatch arrangement is imported into a third jurisdiction. The key objective of the imported mismatch rule is to maintain the integrity of the other hybrid mismatch rules by removing any incentive for multinational groups to enter into hybrid mismatch arrangements.

Part I of the Action 2 Final Report sets out recommendations for rules to address mismatches in tax outcomes where they arise in respect of payments made under a hybrid financial instrument or payments made to or by a hybrid entity.

The recommendations take the form of "linking rules" the purpose of which is to align the tax treatment of an instrument or entity with the tax treatment in the counterparty jurisdiction but which otherwise do not disturb the commercial outcomes.

The rules apply automatically and there is a rule order in the form of a primary rule and a secondary or defensive rule. The recommended primary rule is that countries deny the taxpayer's deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction or it is also deductible in the counterparty jurisdiction. If the primary rule is not applied, then the counterparty jurisdiction can generally apply a defensive rule, requiring the deductible payment to be included in income or denying the duplicate deduction depending on the nature of the mismatch. The Action 2 Final Report also includes specific recommendations that jurisdictions could incorporate into their domestic law to reduce the frequency of hybrid mismatches.[5]

Article 1(4) and (5) ATAD II overview

ATAD II amends ATAD I with complex measures in relation to hybrid mismatches (to be implemented from January 2020) and reverse hybrids (to be implemented from January 2022). The principal amendments made by ATAD II to ATAD I are that: 1. hybrid mismatch situations are targeted in a global context; and 2. ATAD I now also applies to hybrid permanent establishments (PEs), imported mismatches and reverse hybrids.

[4] Action 2 Final Report, above fn.1.
[5] An overview of the Action 2 Recommendations can be found in the Action 2 Final Report, above fn.1, 20.

Article 1(4) ATAD II replaces Article 9 ATAD I with new Article 9 and Article 1(5) ATAD II inserts new Articles 9a and 9b ATAD I, which address the additional hybrid mismatch rules. The majority of the UK hybrid mismatch rules set out in Part 6A TIOPA meet or exceed the minimum standards set by the new provisions introduced by ATAD II.

However, changes have been made to the UK hybrid mismatch rules to ensure that the UK rules are fully aligned with ATAD II requirements specifically in relation to Article 9(5) ATAD I as introduced by Article 1(4) ATAD II (treatment of disregarded PEs) and Article 9(4) ATAD I as introduced by Article 1(4) ATAD II (exemption of certain regulatory capital). Further amendments to the UK rules may be required in respect to the treatment of certain "reverse hybrids" pursuant to Article 9a ATAD I as inserted by Article 1(5) ATAD II.

The newly inserted Article 9(5) ATAD I contains specific requirements in relation to the treatment of disregarded PEs:

> "To the extent that a hybrid mismatch involves disregarded permanent establishment income which is not subject to tax in the Member State in which the taxpayer is resident for tax purposes, that Member State shall require the taxpayer to include the income that would otherwise be attributed to the disregarded permanent establishment. This applies unless the Member State is required to exempt the income under a double taxation treaty entered into by the Member State with a third country."

The newly inserted Article 9(4) ATAD I contains specific requirements in relation to the exemption of certain regulatory capital:

> "A Member State may exclude from the scope of:
>
> (a) point (b) of paragraph 2 of this Article hybrid mismatches as defined in points (b), (c), (d) or (f) of the first subparagraph of Article 2(9);
>
> (b) points (a) and (b) of paragraph 2 of this Article hybrid mismatches resulting from a payment of interest under a financial instrument to an associated enterprise where:
>
> (i) the financial instrument has conversion, bail-in or write down features;
>
> (ii) the financial instrument has been issued with the sole purpose of satisfying loss absorbing capacity requirements applicable to the banking sector and the financial instrument is recognised as such in the taxpayer's loss absorbing capacity requirements;
>
> (iii) the financial instrument has been issued
>
> - in connection with financial instruments with conversion, bail-in or write down features at the level of a parent undertaking,
> - at a level necessary to satisfy applicable loss absorbing capacity requirements,
> - not as part of a structured arrangement; and
>
> (iv) the overall net deduction for the consolidated group under the arrangement does not exceed the amount that it would have been had the taxpayer issued such financial instrument directly to the market.
>
> Point (b) shall apply until 31 December 2022."

C. UK hybrid mismatch amendments—FA 2019 amendments

FA 2019 makes provision for two amendments to the UK hybrid mismatch rules in order to comply with Articles 9(4) and 9(5) ATAD I as inserted by Article 1(4) ATAD II.

The relevant legislation is set out in section 19 FA 2019:

"19: **Hybrid and other mismatches: scope of Chapter 8 and 'financial instrument'**

(1) Part 6A of TIOPA 2010 (hybrid and other mismatches) is amended as follows.

(2) In section 259HA (circumstances in which Chapter 8 applies)—

(a) for subsection (5) substitute—

'(5) Condition C is that—

(a) the payer is within the charge to corporation tax for the payment period, or

(b) the multinational company—

(i) is UK resident for the payment period, and

(ii) under the law of the parent jurisdiction, is regarded as carrying on a business in the PE jurisdiction through a permanent establishment in that territory but, under the law of the PE jurisdiction, is not regarded as doing so.', and

(b) in subsection (9)(a), for 'company' substitute 'payee'.

(3) For section 259HC (counteraction of the multinational payee deduction/non-inclusion mismatch) substitute—

'259HC **Counteraction of the multinational payee deduction/non-inclusion mismatch**

For corporation tax purposes—

(a) if paragraph (b) of Condition C in subsection (5) of section 259HA is met, an amount equal to the multinational payee deduction/non-inclusion mismatch mentioned in subsection (6) of that section is to be treated as income arising to the multinational company in the United Kingdom (and nowhere else) for the payment period, and

(b) in any other case, the relevant deduction that may be deducted from the payer's income for that period is to be reduced by that amount.'

(4) In section 259N (meaning of 'financial instrument')—

(a) in subsection (3), for paragraph (b) substitute—

'(b) anything of a description specified in regulations made by the Treasury.', and

(b) omit subsection (4).

(5) The amendments made by subsections (2)(a) and (3) have effect in relation to—

(a) payments made on or after 1 January 2020, and

(b) quasi-payments in relation to which the payment period begins on or after that date.

(6) For the purposes of subsection (5)(b), where a payment period begins before 1 January 2020 and ends after that date ('the straddling period')—

(a) so much of the straddling period as falls before that date, and so much of it as falls on or after that date, are to be treated as separate taxable periods, and

(b) if it is necessary to apportion an amount for the straddling period to the two separate taxable periods, it is to be apportioned—

(i) on a time basis according to the respective length of the separate taxable periods, or

(ii) if that would produce a result that is unjust or unreasonable, on a just and reasonable basis.

(7) The amendment made by subsection (2)(b) is to be regarded as always having had effect.

(8) The first regulations under section 259N(3)(b) may have effect in relation to times before they come into force, but not times before 1 January 2019.

(9) Until those regulations come into force section 259N continues to have effect (other than for the purposes of making those regulations) as if—

(a) the amendments made by subsection (4) had not been made, and

(b) the Taxation of Regulatory Capital Securities Regulations 2013 (S.I. 2013/3209) had not been revoked by paragraph 1 of Schedule 20 to this Act."

Treatment of disregarded PEs

Chapter 8 of Part 6A TIOPA has been amended by section 19(2) FA 2019. Section 19(2) FA 2019 provides that the deduction/non-inclusion mismatch rules will apply to multinationals that are UK resident companies and which have a disregarded PE. Previously, the rules only applied to companies within the charge to UK corporation tax.

The aim of the new provision is to capture structures involving payments to a company with a PE of an entity in a third country. The mismatch generally arises because of discrepancies relating to the attribution of income to the PE. For example, the parent jurisdiction views the income as arising to the PE and thus exempts it from tax, while the PE jurisdiction does not recognise that a PE exists at all, or does not treat the income as effectively connected to it. Action

2 of the BEPS Inclusive Framework Report on *Neutralising the Effects of Branch Mismatch Arrangements* stated that a deductible payment made to a PE will give rise to a deductible/non-inclusion outcome where that payment is not included in ordinary income by either the residence or PE jurisdiction.[6]

Accordingly, Condition C of section 259HA TIOPA now applies in situations where a multinational company payee is a UK resident company, and it has a "disregarded" PE elsewhere. This amendment addresses the newly inserted Article 9(5) ATAD I which provides that in circumstances where a hybrid mismatch involves disregarded PE income which is not subject to tax in the parent jurisdiction, such jurisdiction shall require the taxpayer to include the income that would otherwise be attributed to the disregarded PE.

Chapter 8 of Part 6A TIOPA has also been amended by section 19(3) FA 2019 to counteract mismatches which fall within new section 259HA(5)(b) TIOPA by treating an amount equal to the mismatch as income arising to the UK resident multinational company in the UK. The primary counteraction where Condition C of section 259HA TIOPA is met is to treat that amount as income arising to the multinational company in the UK for the relevant payment period. This amendment provides that mismatches which arise in relation to "disregarded" PEs are counteracted by bringing amounts back into charge for corporation tax purposes.

Exemption of certain regulatory capital

Article 9(4) ATAD I (as inserted by Article 1(4) ATAD II) contains an exemption for certain regulatory capital instruments, namely additional Tier 1 (AT1) and Tier 2 (T2) instruments. AT1 and T2 instruments were regulated pursuant to the Taxation of Regulatory Capital Securities Regulations 2013 (RCS Regulations).[7] Hybrid mismatches arising from payments under AT1 and T2 instruments were not within the scope of UK hybrid mismatch rules as per the definition of "financial instrument" in section 259N(3) TIOPA. The RCS Regulations did not provide for such an exemption within their provisions.

The RCS Regulations were revoked with effect from 1 January 2019, subject to some limited transitional provisions, and were replaced by the new Hybrid Capital Instruments (HCI) regime.[8] The HCI regime incorporates the exemption for the relevant regulatory capital securities in accordance with Article 9(4) ATAD I (as inserted by Article 1(4) ATAD II). Accordingly, section 19(4) FA 2019 amended section 259N(3) TIOPA to omit the exclusion for regulatory capital securities.

Imported mismatches

As the UK implemented domestic hybrid mismatch rules in advance of many other jurisdictions, the imported mismatch rule had to be applied in order to counteract hybrid mismatches that arose in offshore jurisdictions. Imported mismatches rely on the absence of effective hybrid mismatch rules in such offshore jurisdictions in order to generate a hybrid tax mismatch. The imported

[6] OECD/G20 Base Erosion and Profit Shifting Project, *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS* (Paris: OECD Publishing, 2017), available at: *http://dx.doi.org/10.1787/9789264278790-en* [Accessed 21 June 2019], 28.
[7] The Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209).
[8] Pursuant to FA 2019 Sch.20.

mismatch rule disallows deductions for a broad range of payments if the income from such payments is set-off, directly or indirectly, against a deduction that arises under a hybrid mismatch arrangement in an offshore jurisdiction.

The implementation of hybrid rules by EU Member States pursuant to the amendments made by ATAD II will mean that the UK may not have to rely on its imported mismatch rules in order to disallow deductions for relevant payments on an EU-wide level as all EU Member States will also have to operate anti-hybrid rules in accordance with the changes made by ATAD II. Anti-hybrid rules are also being implemented worldwide. For example, the US adopted anti-hybrid mismatch rules in tax legislation signed into law in December 2017, disallowing deductions for certain interest and royalties paid by or to a hybrid entity. Accordingly, the application of anti-hybrid rules in the UK may change as more jurisdictions start implementing anti-hybrid rules into domestic laws.

D. Conclusion

The UK was an early adopter of the BEPS Project recommendations and has a comprehensive set of rules arising from the BEPS Action 2 recommendations. Accordingly, the changes required as a consequence of the ATAD II provisions were relatively minor. However, there may be challenges arising from the interaction between UK hybrid domestic law and the EU ATAD provisions.

Notwithstanding the uncertainty regarding Brexit, the UK has implemented the provisions of Article 9(4) and 9(5) ATAD I as introduced by Article 1(4) ATAD II in advance of their commencement date in January 2020. This is understandable because the updates to the ATAD I provisions made by ATAD II may result in a more level playing field in relation to hybrid mismatch rules across the EU. However, the outcome of the Brexit negotiations may mean that the UK is once again not aligned with the anti-hybrid rules on an EU level. For example, the rules pertaining to reverse hybrids as amended by ATAD II have not yet been considered by the UK as their implementation date is in January 2022. It will remain to be seen whether these provisions and subsequent EU-wide anti-hybrid rules will continue to be implemented by the UK following an exit from the EU.

Barbara Onuonga*

Section 21: permanent establishments: preparatory or auxiliary activities

Non-resident companies are liable to corporation tax if they are trading in the UK through a permanent establishment. The definition of "permanent establishment" is contained in sections 1141 through to 1153 of the Corporation Tax Act 2010 (CTA 2010). This definition broadly

Base erosion and profit shifting; EU law; Hybrid mismatch arrangements; OECD; Permanent establishment; Regulatory capital securities; Tax avoidance

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follows the outline of the definition contained in Article 5 of the OECD Model.[1] Since the earliest OECD Draft in 1963 (and the history can be traced even further into the League of Nations period) this definition has contained an exception for "preparatory or auxiliary activities". The equivalent exception is found in section 1143 CTA 2010. Section 21 of the Finance Act 2019 (FA 2019) amends this definition to exclude preparatory or auxiliary activities that constitute part of a "fragmented business operation".[2]

Action 7 of the OECD Base Erosion and Profit Shifting Project targeted "the artificial avoidance of permanent establishment status".[3] One of the changes it proposed was to include in tax treaties explicit provision to prevent the avoidance of permanent establishment status by fragmenting business operations so that the separate parts of the operation each benefited from the preparatory and auxiliary exception.[4] Strictly speaking, no such amendment to tax treaties was actually necessary because the existing Commentary on Article 5 of the OECD Model already contains wording to the effect that permanent establishment status could not be avoided by fragmenting business activities.[5] Nevertheless, it was thought appropriate to include an anti-fragmentation rule in the wording of the Model itself. The UK has not adopted the major changes which the BEPS Project proposed should be made to Article 5 (and which are now reflected in the 2017 Model[6]). However, the UK did decide to adopt the anti-fragmentation approach and wording to that effect will, presumably, soon start to appear in new tax treaties concluded by the UK. Meanwhile, Section 21 FA 2019 makes the equivalent amendment in domestic law.

Thus, even though the activities carried on by a company in the UK are only of a preparatory or auxiliary character, they will still constitute a permanent establishment if they are part of a fragmented business operation. New sub-sections (2A) and (2B) of section 1143 CTA 2010[7] explain what activities are "part of a fragmented business operation": they must "constitute complementary functions that are part of a cohesive business operation",[8] carried on by the company itself or by a person closely related to the company,[9] and the overall activity resulting from the combination of the functions is not of a preparatory or auxiliary character.[10] The phrases "complementary functions" and "cohesive business operation" are also found in new paragraph 4.1 of Article 5 of the 2017 version of the OECD Model. Similarly, the concept of a "closely related person" is also now found in paragraph 8 of Article 5 of the 2017 version of the OECD Model. All these phrases are discussed in the Commentary to the 2017 version of the OECD Model.[11] An interesting question is this: how far may the discussion found in the Commentary

[1] OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (OECD Model 2017) (Paris: OECD Publishing, 2017).
[2] FA 2019 s.21(2) amending CTA 2010 s.1143(2).
[3] See OECD/G20 Base Erosion and Profit Shifting Project, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report* (Action 7—2015 Final Report) (Paris: OECD Publishing, 2015).
[4] Action 7—2015 Final Report, above fn.3, 39–41.
[5] See OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2010* (OECD, 2010), Commentary on Article 5, para.27.1.
[6] OECD Model 2017, above fn.1, Art.5 para.4.1.
[7] FA 2019 s.21(3) inserting new CTA 2010 s.1143(2A) and (2B).
[8] New CTA 2010 s.1143(2A)(b).
[9] New CTA 2010 s.1143(2A)(a).
[10] New CTA 2010 s.1143(2A)(c) and (2B)(a).
[11] OECD Model 2017, above fn.1, Commentary on Article 5, paras 79–81 and paras 119–121.

be taken into account in interpreting the equivalent phrases found in UK domestic legislation? Since it is clear that the domestic legislation was intended to introduce into domestic law exactly the same concepts that are found in the OECD Model (and, consequently, presumably specific treaties concluded by the UK), it might be argued that Parliament's intention was to give those phrases an "international fiscal meaning", consistent with the OECD Commentary. That, in turn, raises an interesting question: if the Commentary on these phrases is subsequently amended, would the amendments influence the interpretation of the concept in domestic law?

In one sense, it is entirely understandable that a government might wish to prevent taxpayers from avoiding permanent establishment status by fragmenting their business activities into separate activities, carried out perhaps on different sites, with the objective of utilising the preparatory and auxiliary exemptions to avoid UK tax. An example might be a non-resident company which establishes a warehouse for the storage, display or delivery of goods at one location, and has a separate representative office at a different site for the purpose of purchasing goods or collecting information. Separately, each of these activities, carried on at different sites, would not constitute a permanent establishment. However, if they had been carried on at the same premises then they might well have constituted a permanent establishment unless the activities were still only of a preparatory or auxiliary character. Of course, the carrying on of activities at different sites might have nothing to do with the avoidance of permanent establishment status: neither the change to the OECD Model nor the change brought about by Section 21 FA 2019 requires that the business operations have been fragmented for the deliberate purpose of avoiding permanent establishment status. Thus, a non-resident group of companies might find that they fell foul of this provision even if they were not intentionally seeking to avoid a permanent establishment.

This problem is compounded by the fact that this new legislation uses terminology that is imprecise. It remains an ongoing puzzle, for example, what activities are "preparatory or auxiliary". The OECD Model is of relatively little help: it simply states that "the decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole".[12] It then goes on to say that "[e]ach individual case will have to be examined on its own merits".[13] The new legislation adds the phrases "complementary functions" and "cohesive business operation" which, though there is some discussion and some examples in the OECD Model, remain relatively vague concepts. Overall, therefore, this change makes it somewhat more likely that non-resident groups will be found to have a permanent establishment in the UK if they (or closely related members of the group) carry on different activities at different locations in this country.

Philip Baker[*]

[12] OECD Model 2017, above fn.1, Commentary on Article 5, para.59.
[13] OECD Model 2017, above fn.1, Commentary on Article 5, para.59.

Commercial activities; Non-resident companies; Permanent establishment; Tax avoidance

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Section 22 and Schedule 7: payment of CGT exit charges; Section 23 and Schedule 8: corporation tax exit charges

It may be well over two years since the UK notified the EU of its intention to withdraw from the EU but Schedules 7 and 8 to the Finance Act 2019 (FA 2019) exist because the UK still wishes to fulfil its EU law obligations. At a time when freedom of movement of both individuals and companies is controversial in some quarters, the fact that the UK's compliance does not appear to be unreservedly enthusiastic is hardly surprising.

Schedule 7 FA 2019 introduces into the Taxes Management Act 1970 (TMA 1970), by a new section 59BB, a new Schedule 3ZAA entitled "CGT exit charge payment plans".[1] These plans allow capital gains tax (CGT) to be paid in instalments when, for example, a trust ceases to be tax resident in the UK or when assets cease to be used in the UK branch of a trade carried on by a non-UK resident. According to the *Finance (No. 3) Bill Explanatory Notes* (Explanatory Notes)[2] this change "ensures that UK rules taxing such gains are compatible with EU law".[3] Of course, no one will take that statement at face value.

Schedule 8 FA 2019 amends Schedule 3ZB TMA 1970 and is concerned with corporation tax (CT) exit charge payment plans introduced by the Finance Act 2013. The Explanatory Notes state that the changes "adapt existing rules to implement the EU Anti-Tax Avoidance Directive".[4]

Both Schedules are "EU-derived domestic legislation" as that phrase is used in section 2(2) of the European Union (Withdrawal) Act 2018. They implement EU rights and fulfil EU obligations and deal with matters which arise out of and are related to such rights and obligations.[5] As such they will continue to have the same effect in domestic law on and after exit day as they had before exit day.[6] That, of course, is in accordance with what the Explanatory Notes to the European Union (Withdrawal) Act 2018 call the "principal purpose" of the Act. That purpose is described, with a pragmatism as uncommon as it is understated, as being "to provide a functioning statute book on the day the UK leaves the EU". The result is that:

[1] FA 2019 Sch.7, paras 1 and 2.

[2] HM Treasury, *Finance (No. 3) Bill Explanatory Notes* (November 2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/754255/Finance__No__3__Bill_Explanatory_Notes.pdf* [Accessed 2 July 2019].

[3] Explanatory Notes, above fn.2, "Clause 22 and Schedule 7: Payment of CGT exit charges", 87, para.1.

[4] Explanatory Notes, above fn. 2, "Clause 23 and Schedule 8: Corporation tax exit charges", 90, para.1.

[5] See the European Union (Withdrawal) Act 2018 s.2(2) and the European Communities Act 1972 s.2(2)(b) and (c). The definition of "EU-derived domestic legislation" in the European Union (Withdrawal) Act 2018 s.2(2) concludes by confirming that it means "any enactment so far as…(d) relating otherwise to the EU or the EEA". FA 2019 Schs 7 and 8 are firmly within the definition.

[6] European Union (Withdrawal) Act 2018 s.2(1). The definition of exit day in the European Union (Withdrawal) Act 2018 was 29 March 2019 at 23.00 (see s.20(1)). It was capable of amendment and has been amended first by the European Union (Withdrawal) Act 2018 (Exit Day) (Amendment) Regulations 2019 (SI 2019/718 of 28 March 2019). Subsequently it has been amended by the European Union (Withdrawal) Act 2018 (Exit Day) (Amendment) (No. 2) Regulations 2019 (SI 2019/859 of 11 April 2019). The exit date is now 31 October 2019 at 23.00 subject, of course, to amendment.

> "As a general rule, the same rules and laws will apply on the day after exit as on the day before. It will then be for Parliament and, where appropriate, the devolved legislatures to make any future changes."[7]

Apparently, Schedules 7 and 8 FA 2019 are here to stay.

The status of Schedules 7 and 8 FA 2019 as EU-derived domestic legislation has, though, significant practical importance. They are to be regarded as "EU retained law".[8] Consequently, so far as they are unmodified after exit day, any question as to their validity, meaning or effect is to be determined, in accordance with retained case law and retained general principles of EU law and having regard, among other things, to the limits of EU competences.[9] Retained case law includes "retained EU case law"[10] which in turn includes *Trustees of the P Panayi Accumulation & Maintenance Settlements v HMRC* (*Panayi*).[11] The case is of particular significance in relation to Schedule 7.

Schedule 7 FA 2019

Returning to the Explanatory Notes related to Schedule 7 FA 2019, we are told that:

> "The proposed changes set out in the schedule implement recent decisions of the Court of Justice of the European Union where the compatibility of member state exit charges with Article 49 of the Treaty on the Functioning of the European Union was considered. Article 49 is concerned with the Freedom of Establishment of EU nationals."[12]

Most readers of the Explanatory Notes are not readers of this *Review*. Neither are they specialists in the case law of the Court of Justice of the European Union (CJEU). One should not expect them instantly to recall, therefore, the case of *Panayi* in which the UK failed in its attempts to impose an immediate charge on trustees leaving the EU. Other states failed in their attempts to impose exit charges before *Panayi*. As Kokott AG observed in her Opinion in that case: "There is now an extensive body of case-law on the subject of exit taxation…."[13] That body of law was not, however, compelling enough to induce the UK to introduce provisions permitting exit charge payment plans. It appears to have been the specific failure of the UK in *Panayi* which led to the introduction of the provisions of Schedule 7 FA 2019.

[7] Explanatory Notes, European Union (Withdrawal) Act 2018, para.10.
[8] See the European Union (Withdrawal) Act 2018 s.6(7).
[9] European Union (Withdrawal) Act 2018 s.6(3).
[10] European Union (Withdrawal) Act s.6(7).
[11] *Trustees of the P Panayi Accumulation & Maintenance Settlements v HMRC* (C-646/15) EU:C:2017:682 (14 September 2017) considered in this Review in T. Lyons, "Trustees of the P Panayi Accumulation & Maintenance Settlements v HMRC: UK trustees protected by the Court of Justice" [2017] BTR 631.
[12] Explanatory Notes, above fn.2, 89, para.22.
[13] Opinion of Kokott AG in *Panayi* (C-646/15), above fn.11, EU:C:2016:1000 (21 December 2016) at [2].

Payment plans for exit charges on deemed disposals

The new Schedule 3ZAA TMA 1970 deals with two types of deemed disposal which result in a disposal of assets and their reacquisition at market value under the Taxation of Chargeable Gains Act 1992 (TCGA).[14]

The first type arises under sub-sections (1) and (3) of section 25 TCGA. The operation of section 25 is to be understood in the light of the territorial scope of CGT. This is established by section 1A TCGA, and in particular sub-section (3) of section 1A. They form part of a new Part 1 TCGA introduced by section 13 FA 2019 and Schedule 1 FA 2019.

Section 1A TCGA provides that one of the ways in which a person who is non-UK resident in a tax year can become liable to CGT is if there is a disposal of assets situated in the UK and those assets have a relevant connection to the person's UK branch or agency. The assets of the person who is non-UK resident will move outside the scope of CGT if the assets cease to be situated in the UK or if the person ceases to trade through a branch or agency in the UK. In both of those situations, by virtue of section 25 TCGA, there is a deemed disposal and reacquisition at market value of the assets.

The second type of deemed disposal arises under section 80 TCGA which applies if trustees cease at any time to be non-resident in the UK. It was this provision which was relevant in *Panayi*.[15]

Payment plans: freedom of establishment beneficiaries only

The exit charge under section 25 TCGA is imposed on persons who are UK non-resident prior to the event giving rise to the charge. Under section 80 TCGA the exit charge is imposed on the trustees of the settlement who become UK non-resident. In the first case, payment plans are available to those who are resident in a European Economic Area (EEA) state other than the UK. In the second case the plans are available to trustees who become resident in another EEA state "for the purposes of" the TCGA.[16] It should be noted that if a person is treated as resident in a territory other than an EEA state for the purposes of double taxation arrangements, then the person is treated as resident there for the purposes of Schedule 3ZAA TMA 1970.[17]

The eligibility to enter into a payment plan is dealt with separately in relation to the two types of deemed disposal. So far as trustees are concerned it is necessary that they "had a right to freedom of establishment" at the time trustees ceased to be UK resident for the purposes of section 80 TCGA.[18] The right to freedom of establishment is defined as a right protected by Article 49 of the Treaty on the Functioning of the European Union[19] or Article 31 of the EEA Agreement.[20] So far as other persons are concerned, they must either have the right to freedom

[14] TMA 1970 Sch.3ZAA, para.1(1).
[15] *Panayi* (C-646/15), above fn.11, EU:C:2017:682.
[16] TMA 1970 Sch.3ZAA, para.3(2)(c)(i).
[17] TMA 1970 Sch.3ZAA, para.9.
[18] TMA 1970 Sch.3ZAA, para.3(2)(a).
[19] Consolidated version of the Treaty on the Functioning of the European Union [2016] OJ C202/47.
[20] Agreement on the European Economic Area of 17 March 1993. The latest consolidated version of the Agreement is available at: *https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:01994A0103(01)-20190207&from=EN* [Accessed 16 July 2019]. The definition of "right to freedom of establishment" is in TMA 1970 Sch.3ZAA, para.10.

of establishment at the time of the event giving rise to the exit charge or satisfy other requirements relating to the carrying on of a business in an EEA state other than the UK after that event noted below.[21]

The requirement that the person or trustees had a right to freedom of establishment is worth examining. The question which the CJEU was asked in *Panayi* concerned the compatibility of section 80 TCGA with freedom of establishment, freedom to provide services and free movement of capital.[22] The CJEU concluded that section 80 TCGA was incompatible with the freedom of establishment and so did not comment on the other two freedoms. Advocate General Kokott, however, said that:

> "In purely intra-community situations such as that in the present case, the relationship between the freedom of establishment, the free movement of capital and the freedom to provide services need not be resolved, since the conditions governing those fundamental freedoms are largely identical."[23]

The UK contended unsuccessfully in *Panayi* that the freedom of establishment was not applicable because the trustees were not persons. Having been told that the freedom of establishment had been infringed, the UK now requires in this legislation that the benefit of payment plans is available only where a person had a right to freedom of establishment. It is difficult to use *Panayi* to justify that limitation. It may conceivably give rise to another case challenging the imposition of an exit charge under section 80 TCGA at some point in the future.

Other eligibility conditions for payment plans

In relation to payment plans concerning deemed disposals under section 25 TCGA, if the person does not have a right of establishment at the required time there is an alternative eligibility condition which may be met as was indicated above. This alternative requirement demands that the person in question must, at any time after the event giving rise to the charge, carry on a trade in an EEA state, other than the UK, through a branch or agency and that the assets must be used in or for the purposes of that trade or used or held for the purposes of the branch or agency.[24] "Branch or agency" in the UK may exist in relation to a trade, profession or vocation and is defined as meaning in the TCGA[25] subject to certain exclusions, "any factorship, agency, receivership, branch or management".

So far as trustees are concerned, the right to freedom of establishment is not one of alternative conditions for eligibility to enter into a payment plan. It is one of a number of cumulative conditions. There are two further conditions to be met. First, immediately before the trustees ceased to be resident in the UK they must have used the asset or assets for an economically significant activity carried on in the UK. Secondly, immediately after they ceased to be UK

[21] TMA 1970 Sch.3ZAA, para.2(2)(a).
[22] *Panayi* (C-646/15), above fn.11, EU:C:2017:682 at [24].
[23] Opinion of Kokott AG in *Panayi* (C-646/15), above fn.11, EU:C:2016:1000 at [41].
[24] TMA 1970 Sch.3ZAA, para.2(2)(b).
[25] By virtue of the new TCGA Pt 1, s.1B(5).

resident they must have become resident in another EEA state for the purposes of the TCGA and used the asset or assets for an economically significant activity carried on there.[26]

The concept of an economically significant activity is defined in relation to trustees as it is in section 13A(4) TCGA in relation to companies.[27] The activities in question must be those which consist of the provision by the trustees of goods or services to others on a commercial basis. They must involve the use of staff in numbers, with competence and authority, and the use of premises and equipment, as well as the addition of economic value by the trustees, to those to whom the goods or services are provided, all commensurate with the size and nature of the activities. No doubt the provisions of section 13A(4) TCGA have their place in Schedule 3ZAA TMA 1970 but they ought not to be regarded as determinative.

In *Panayi* Kokott AG noted that the freedom of establishment includes among its benefits the right of a national of an EU Member State to take up and pursue activities as a self-employed person in another Member State. She went on to consider that active management of external assets by trustees would constitute the necessary participation in the economic life of a Member State.[28]

The CJEU took a different approach to the issue. It said that a trust could rely on freedom of establishment if "it possesses rights and obligations that enable it to act in its own right, and…actually carries on an economic activity".[29] Furthermore, so far as the need for an economic activity to be carried on in the host state was concerned, there was no need for the referring court to find any further facts as Kokott AG had suggested. Instead the CJEU was clear that:

> "…the Court's case-law relating to the taxation of gains in the value of assets of a company or firm on the occasion of the transfer of the place of effective management of that company or firm to another Member State also applies in a situation where a Member State taxes gains in the value of assets held in trust by reason of the transfer of the place of management of the trust to another Member State. It follows that freedom of establishment is applicable to a situation such as that at issue in the main proceedings."[30]

Once the concept of economically significant activity is construed in conformity with EU law it may not play the role that was envisaged for it.

The scope of a payment plan

A payment plan may relate to the whole of an exit charge, or where a plan is available only in relation to part of the gain, then to part of it.[31] The charge to which a plan relates is called the deferred exit charge.[32] A plan must provide for the deferred exit charge to be payable in six equal instalments. The first instalment is to be due and payable on the day on which the exit charge is

[26] TMA 1970 Sch.3ZAA, para.3(2).
[27] TMA 1970 Sch.3ZAA, para.10, which contains a number of definitions.
[28] Opinion of Kokott AG in *Panayi* (C-646/15), above fn.11, EU:C:2016:1000 at [38]. The comments at [39]–[41] are also of significance.
[29] *Panayi* (C-646/15), above fn.11, EU:C:2017:682 at [34].
[30] *Panayi* (C-646/15), above fn.11, EU:C:2017:682 at [39].
[31] TMA 1970 Sch.3ZAA, para.4.
[32] TMA 1970 Sch.3ZAA, para.4(2).

otherwise due and payable under section 59B TMA 1970. The other five instalments are due on each of the subsequent five anniversaries of that day.[33]

Entry into a plan

Entry into a payment plan is to be made by way of an application to HMRC. An application is to be made before the exit charge is to be paid and must contain all the information specified in paragraph 7 of Schedule 3ZAA TMA 1970. The time at which a plan is entered into is when, on the one hand, the taxpayer agrees to pay the deferred exit charge and interest on it in accordance with the plan and, on the other hand, an officer of Revenue and Customs agrees to accept payment of the deferred exit charge in accordance with the plan.[34]

Void plans, main purposes and abuse

A plan is void in two situations. The first situation is if an event giving rise to the exit charge is part of arrangements the main purpose of which, or one of the main purposes of which, is to defer the payment by the taxpayer of the exit charge.[35] The meaning of this provision is, perhaps, less than clear. Under one interpretation it could have a very broad application. The provision, however, is another one which must be construed in the light of EU law.

The purpose of the payment plan is to ensure that the exit charge provisions comply with the requirements of the freedom of establishment. If a taxpayer is seeking to abuse its freedom of establishment then it should not benefit from a payment plan. If a taxpayer is seeking to use its freedom of establishment then it should benefit from a payment plan. The issue is, fundamentally, one of EU law not domestic UK law.[36] In this context it is worth recalling that retained general principles of EU law, such as abuse of law, are part of retained EU law and, subject to certain limitations, are to be used in relation to questions governing the validity, meaning or effect of the law on payment plans.[37]

The second situation in which a payment plan is void is if any information furnished by the taxpayer in connection with the plan does not fully and accurately disclose all facts and considerations material to the decision of the officer of Revenue and Customs to accept payment in accordance with the plan.[38]

The contents of plans: amounts of tax and security

Plans which are entered into in relation to section 25 TCGA must specify the EEA state in which the person is resident and the date on which the person ceased to carry on a trade through a

[33] TMA 1970 Sch.3ZAA, para.5.
[34] TMA 1970 Sch.3ZAA, para.6(1)-(3).
[35] TMA 1970 Sch.3ZAA, para.6(4)(a).
[36] It is not possible here to consider the law of abuse in EU law. In relation to the fundamental freedoms one judgment of note was given in *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v IRC* (C-196/04) EU:C:2006:544; [2006] ECR I-7995.
[37] See the European Union (Withdrawal) Act 2018 s.6(3). For the effects of this provision in relation to VAT and abuse see Taxation (Cross-border Trade) Act 2018 s.42(4) which specifically refers to "the cases of *Halifax* and *Kittel*".
[38] TMA 1970 Sch.3ZAA, para.6(4)(b).

branch or agency in the UK if the person has done so. Plans entered into in relation to section 80 TCGA must state the date on which the trustees became non-UK resident and the EEA state in which the trustees have become resident. All plans should state the amount of the exit charge to which, in the taxpayer's opinion, the taxpayer is liable and the deferred exit charge.[39]

If an officer of Revenue and Customs considers that there would be a serious risk to collection of any amount of deferred exit charge without provision for security, then the plan may make provision for security.[40]

The provisions which make payment plans available have effect in relation to events occurring on or after 6 April 2019.[41]

The effect of a plan and interest on the charge

Where a payment plan is entered into, the deferred exit charge remains due and payable under section 59B TMA 1970. However, the Commissioners may not seek payment of the charge otherwise than in accordance with the plan. They may also make repayments in respect of any of the deferred exit charge paid, or any amount paid on account of it, before the plan is entered into.[42] So far as interest is concerned, the deferred exit charge carries interest in accordance with Part 9 TMA 1970 as if the plan had not been entered into. Each payment under the plan is to be made together with the interest due in respect of it.[43] Early payment of any of the deferred exit charge is permitted.[44] Provision is also made for penalties and the bankruptcy of the taxpayer.[45]

Schedule 8 FA 2019

As is well known, it is not just trustees who suffer exit charges. Companies do too. Part 1 of Schedule 8 FA 2019 amends Schedule 3ZB TMA 1970 concerned with CT exit charge payment plans and has effect in relation to accounting periods ending on or after 1 January 2020.[46] As noted above, the Explanatory Notes link the changes to the implementation of the EU Anti Tax Avoidance Directive (ATAD). Legislation implementing ATAD must be in effect as from 1 January 2020.[47]

Schedule 8 Part 1 FA 2019: eligibility for payment plans

The amendments to Schedule 3ZB TMA 1970 start with amendments to the circumstances in which payment plans may be entered into. In the future, the requirements related to EEA Member

[39] TMA 1970 Sch.3ZAA, para.7(1)-(3).
[40] TMA 1970 Sch.3ZAA, para.7(4).
[41] FA 2019 Sch.7, para.7.
[42] TMA 1970 Sch.3ZAA, para.8(1)-(3).
[43] TMA 1970 Sch.3ZAA, para.8(4).
[44] TMA 1970 Sch.3ZAA, para.8(6).
[45] TMA 1970 Sch.3ZAA, para.8(5) and (7) and FA 2019 Sch.7, para.3.
[46] FA 2019 Sch.8, para.8. In *Gallaher Ltd v HMRC* [2019] UKFTT 207 (TC) the First-tier Tribunal (Tax) decided that conforming interpretation could not be used so as to apply to intra-group transfers the legislation on CT plans for exit taxes. The judge noted that the rules on exit taxes were to be amended and said this "does somewhat highlight the fact that this is a matter which can be addressed only by Parliament" (at [219]).
[47] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market [2016] OJ L193/1 Art.11.5.

States, for example that an eligible company must become resident in an EEA Member State, are changed. The EEA Member State will have to be a relevant EEA Member State. This is defined to encompass either an EU Member State or one which is party to an agreement with the UK that provides for mutual assistance equivalent to that provided for by Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes.[48] The provisions of Article 5 ATAD state that Article 5(2), which permits deferral of tax

> "shall apply to third countries that are party to the EEA Agreement if they have concluded an agreement with the Member State of the taxpayer or with the Union on the mutual assistance for the recovery of tax claims, equivalent to the mutual assistance provided for in Council Directive 2010/24/EU".[49]

The circumstances in which payment plans may be entered into by non-UK resident companies with UK permanent establishments are also altered. An additional requirement is imposed in relation to the asset or liability in relation to which the "PE qualifying event" occurs. It must be held or owed by the company for the purposes of a permanent establishment of the company in a relevant EEA state, or held or owed by the company otherwise than for the purposes of a permanent establishment of the company and the company is resident in a relevant EEA state defined as noted above.[50]

Part 1 of Schedule 8 FA 2019 goes on to alter the contents of a payment plan. A reference to a "relevant" EEA state is inserted into the requirements in this context.[51] A plan will also have to specify requirements as to the ongoing provision of information by the company to HMRC in relation to the exit charge assets and liabilities.[52]

Furthermore, instead of stating the method by which the tax is to be paid, the plan must state an amount of tax attributable to each asset or liability in question.[53] The provisions on the payment of tax by the standard instalment method, the realisation method or a combination of the two methods are to be repealed.[54] In their place is a provision on payment method which specifies that the tax is due in six instalments of equal amounts. The first instalment will be due on the first day after the period of nine months beginning immediately after the end of the migration accounting period. The subsequent instalments will be due on the five anniversaries of that day.[55]

Provision is made for outstanding balances to become due on the happening of certain events and for amounts to become due in whole or part in relation to an exit charge asset or liability.[56]

[48] Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures [2010] OJ L84/1. TMA 1970 Sch.3ZB, para.1(7).
[49] Council Directive (EU) 2016/1164, ATAD, above fn.47, Art.5(2).
[50] TMA 1970 Sch.3ZB, para.4(4)(d) and (6).
[51] TMA 1970 Sch.3ZB, para.10 as amended.
[52] TMA 1970 Sch.3ZB, para.10(2A).
[53] TMA 1970 Sch.3ZB, para.10(2A).
[54] FA 2019 Sch.8, para.6.
[55] TMA 1970 Sch.3ZB, para.11.
[56] TMA 1970 Sch.3ZB, para.12–14.

Schedule 8 Part 2 FA 2019: deferral outside ATAD Article 5

Part 2 of Schedule 8 FA 2019 repeals section 187 TCGA and sections 860 to 862 of the Corporation Tax Act 2009 (CTA 2009).[57] These provisions give some relief from a deemed disposal and reacquisition of assets in circumstances which include a company ceasing to be UK resident. Certain consequential amendments are also made. The amendments apply to a company ceasing to be resident in the UK on or after 1 January 2020.[58]

Section 185 TCGA provides for a deemed disposal of company assets and their immediate reacquisition at market value when a company ceases to be resident in the UK. Section 187 TCGA, which is repealed by paragraph 9(1) of Schedule 8 FA 2019, provides for postponement of the charge, in certain circumstances, where the company is a 75 per cent subsidiary of a UK resident company.

Under section 859 CTA 2009, there is a deemed disposal and reacquisition at market value when an asset ceases to be a chargeable intangible asset in relation to a company in circumstances including the company ceasing to be UK resident. Section 860 CTA 2009 provides relief in circumstances which include the company which ceases to be UK resident being, immediately afterwards, a 75 per cent subsidiary of a UK resident company. Sections 860 to 862 CTA 2009 are repealed by paragraph 10(1) of Schedule 8 FA 2019.

The apparent and possibly questionable justification of these provisions, derives from Article 5 ATAD which cannot be considered in detail here. It is headed "Exit taxation" and requires tax to be imposed at an amount equal to the market value of assets transferred at the time of exit, less their value for tax purposes, in a number of specific situations. These cover certain asset transfers, the transfer of tax residence and the transfer of a business, but not all the circumstances envisaged by Schedule 8 Part 2. The Article permits a right to defer tax, in such specific situations only as it mentions, by payment in instalments over five years with interest being chargeable. Provision is made for the immediate payment of the debt in a number of circumstances.

Schedule 8 Part 3 FA 2019: EU exit charges

Part 3 of Schedule 8 FA 2019 contains amendments to provisions concerning the treatment of assets that are the subject of EU exit charges. An EU exit charge is

> "a charge to tax under the law of a member State in accordance with Article 5(1) of Directive (EU) 2016/1164 of the European Parliament and of the Council of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market".[59]

The first change made by Part 3 of Schedule 8 FA 2019 is to introduce section 184J into the TCGA. Its purpose, broadly speaking, is to ensure that where an EU exit charge is imposed in relation to certain chargeable assets, UK tax is imposed only on increases in their value after they have become chargeable assets. Consequently, the assets in question are to be treated as if

[57] FA 2019 Sch.8, paras 9(1) and 10(1).
[58] FA 2019 Sch.8, paras 9(5) and 10(5).
[59] See TCGA s.184J(5) and CTA 2009 s.863A(3). TCGA s.184J is inserted by FA 2019 Sch.8, para.11 and s.863A is inserted into CTA 2009 by FA 2019 Sch.8, para.12.

they had been acquired for market value at the time that they become such chargeable assets.[60] A chargeable asset for these purposes is one which, on its disposal, gives rise to a gain chargeable to corporation tax.[61]

Section 184J TCGA is said to apply if two conditions are satisfied. The first is that an asset becomes a chargeable asset in relation to a company by reason of a specified event. The second is that, on the occurrence of that event, the company becomes subject to an EU exit charge in relation to the asset.[62] The specified events are that the company becomes resident in the UK and, in the case of a company that is not UK resident, the asset begins to be held for the purposes of a trade carried on in the UK through a permanent establishment.[63]

In the event that section 184J TCGA applies, the company is to be treated as if it had acquired the asset for its market value at the time the asset became a chargeable asset in relation to it.[64] The provisions have effect in relation to assets that become chargeable assets on or after 1 January 2020.[65]

The second change made by Part 3 of Schedule 8 FA 2019 is to amend section 863(2)(b) CTA 2009 to make it subject to the new section 863A CTA 2009. Section 863 CTA 2009 applies where an asset becomes a chargeable intangible asset in relation to a company in a number of situations. Section 863(2)(b) CTA 2009 provides that, in the relevant circumstances, Part 8 CTA 2009 applies as if, immediately after that time, the company had acquired the asset for its accounting value at that time.

Section 863A CTA 2009 provides that Part 8 CTA 2009 on intangible fixed assets (which includes sections 711 to 906 CTA 2009 and, therefore, includes section 863 CTA 2009) is to apply as if the company had acquired the asset for its market value at the time it became a chargeable intangible asset in relation to the company.[66] The section applies if either of two events occur[67] and if, on their occurrence, the company becomes subject to an EU exit charge.[68] The first event is that the company in question becomes UK resident. The second event is that, in respect of a company which is not UK resident, the asset in question begins to be held for the purposes of a trade carried on by the company in the UK through a permanent establishment.[69]

[60] TCGA s.184J(3).
[61] TCGA s.184J(4).
[62] TCGA s.184J(1).
[63] TCGA s.184J(2).
[64] TCGA s.184J(3).
[65] FA 2019 Sch.8, para.11(2).
[66] CTA 2009 s.863A(2).
[67] As set out in CTA 2009 s.863(1)(a) and (b) and referred to in CTA 2009 s.863A(1)(a). The event referred to in CTA 2009 s.863(1)(c), namely, an asset ceasing to be held for the purposes of a mutual trade or business does not engage CTA 2009 s.863A and is not referred to in CTA 2009 s.863A(1).
[68] CTA 2009 s.863A(1).
[69] CTA 2009 s.863(1) is amended so that it, but not CTA 2009 s.863A, may operate in respect of assets held for other purposes as from 6 April 2020, subject to transitional provisions. See FA 2019 Sch.5, para.27 and the transitional provisions at FA 2019 Sch.5, paras 36–50. The provisions of FA 2019 Sch.5 are not considered in this note.

The amendments to the provisions of CTA 2009 and other amendments contained in paragraph 12 of Schedule 8 FA 2019 are to take effect in relation to assets that become chargeable intangible assets on or after 1 January 2020[70]. ☞

Timothy Lyons

Section 24: group relief etc: meaning of "UK related" company

Section 24 of the Finance Act 2019 extends the scope for group relief surrenders and claims beyond UK resident companies and companies carrying on a trade through a UK permanent establishment (PE) to companies treated as liable to corporation tax on UK land development profits.[1] The change is retrospective to July 2016 when extension of land development profits to non-residents became effective. (Not dissimilar provisions now apply, of course, to non-residents recently brought within the chargeable gains regime on UK real estate.[2]) It is a logical consequence of that change and of course, following the *Marks & Spencer*[3] litigation, the strict limitation to UK residents and non-residents trading via a UK PE had already been "breached".[4]

A more significant development is the decision in *Gallaher Ltd v HMRC*[5] where the First-tier Tribunal (Tax Chamber) concluded the restriction on intra-group transfers to such companies was incompatible with EU law and therefore, as regards assets within the chargeable gains legislation (but not the intangibles legislation), these may be transferred on a no gain:no loss basis to persons outside the UK tax net. However, that case merits a case note on its own (and of course may be liable to appeal). ☞

Gary Richards

[70] FA 2019 Sch.8, para.12(4).

☞ Capital gains tax; Corporation tax; Deemed disposals; EU law; Exit charge; Freedom of establishment; Tax avoidance

[1] CTA 2009 ss.5(2A) and 5B; also see CTA 2010 ss.356OA–-356OT.

[2] G. Clarke, "Section 13: disposals by non-UK residents etc; and Schedule 1: chargeable gains accruing to non-residents etc" [2019] BTR 268; S. Squires, "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.

[3] *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)* (C-446/03) EU:C:2005:763 (13 December 2005).

[4] CTA 2010 Pt 5, Ch.10.

[5] *Gallaher Ltd v HMRC* [2019] UKFTT 207 (TC) Appeal numbers: TC/2018/01443 and TC/2018/05432 (29, 30 and 31 January 2019 and 1 February 2019).

☞ Corporation tax; Development; Group relief; Related parties; Surrender

Section 25 and Schedule 9: intangible fixed assets: restrictions on goodwill and certain other assets

Background

When the corporate intangibles tax regime (now Part 8 of the Corporation Tax Act 2009 (CTA 2009)) was introduced in 2002, it brought deductions for accounts amortisation into the ambit of tax. This included amortisation of goodwill and similar customer related intangible assets, without restriction beyond the general restrictions applicable within the regime to any type of intangible assets. In particular, deductions were available for goodwill acquired from a related party, such as on incorporation of a partnership or sole trader business.

It apparently took HMRC 12 years to become concerned that the availability of this deduction might encourage such businesses to incorporate, as the changes detailed below were described as removing an "unintended tax benefit"[1]—although that benefit had been pointed out by many commentators from 2002 onwards.[2]

Perhaps it took a while for the implications to register with HMRC (despite the commentary) because the value of such deductions will have taken time to accumulate as the deduction was only available for goodwill arising in businesses which commenced on or after 1 April 2002 (or which were acquired from third parties after that date). Goodwill of a business that existed at 31 March 2002 would continue to be outside the scope of the intangibles regime even if transferred to a connected party (such as on incorporation).

Accordingly, in the *Autumn Statement* in 2014,[3] the Chancellor announced that amortisation of goodwill and customer-related intangibles would not be deductible for tax purposes where the amortisation arose on incorporation of a business. This was subsequently enacted by section 26 of the Finance Act 2015 with effect from 3 December 2014.

This was followed very shortly afterwards by an announcement in the *Summer Budget 2015*[4] (enacted by section 33 of the Finance Act (No.2) 2015 with effect from 8 July 2015) that deductions for amortisation of goodwill and customer-related intangible assets would be removed for all, on the basis that it would remove an artificial incentive to buy assets rather than shares. Again, this potential benefit had been known—and pointed out[5]—since the introduction of the intangible assets regime in 2002. It was questionable whether it really was a widely available benefit as the incentives for vendors to sell shares were (and continue to be) substantial: vendors will generally prefer to sell shares to obtain the substantial shareholdings exemption, or entrepreneurs' relief, with an immediate benefit outweighing any likely benefit of longer term deductions for amortisation for the purchaser.

[1] HMRC, *Tax Information and Impact Note, Corporation tax: restricting relief for internally-generated goodwill transfers between related parties on incorporation* (3 December 2014).
[2] See P. Miller, "Finance Act 2015 Notes: Section 26: intangible fixed assets: goodwill etc acquired from a related party; Sections 41–43: entrepreneurs' relief" [2015] BTR 489.
[3] HM Treasury, *Autumn Statement 2014* (December 2014), Cm.8961.
[4] HM Treasury, *Summer Budget 2015* (July 2015), HC 264.
[5] See Miller, above fn.2.

That absolute prohibition on amortisation deductions for goodwill, and customer-related intangibles, was (perhaps unsurprisingly) not well-received. Two years later, the *Autumn Budget 2017*[6] announced a consultation to review the intangibles asset regime[7]; this was undertaken between February and May 2018. The consultation document included questions as to the impact of the removal of these amortisation deductions; the responses to the consultation highlighted the points noted above, that any perceived advantage to the acquisition of assets was not as distortive as the Government had suggested, as commercial considerations generally outweighed any tax advantage that might have been available. The responses also noted that the removal of the deduction meant that the UK was out of line with other comparable jurisdictions.

The Government response was a limited reintroduction of amortisation deductions, enacted in Schedule 9 to the Finance Act 2019 (FA 2019), which inserts a new Chapter 15A into Part 8 CTA 2009.

Section 25 and Schedule 9 FA 2019

Chapter 15A of Part 8 CTA 2009 provides relief for the acquisition or creation of goodwill, customer information, customer relationships, unregistered trademarks and licences in relation to these types of intangible assets (relevant assets).

The relief is given by allowing a company acquiring or creating such assets, in specific circumstances, on or after 1 April 2019 to write down the cost of the relevant assets at a fixed rate of 6.5 per cent.[8] This is subject to a cap on the qualifying cost of the relevant assets, set out below. There is no option to use the accounts deduction (if there is one) instead. It should be noted that, before the abolition of the relief in 2014 and 2015, amortisation deductions for relevant assets were often only available through an election for the fixed rate of 4 per cent as UK Generally Accepted Accounting Practice (GAAP) only provided limited scope for amortisation of such assets. The position changed with the introduction of Financial Reporting Standard 102 (FRS102) which includes a wider scope for such amortisation deductions.

The legislation is clear that it is intended to apply only to newly created or newly acquired relevant assets: there is no revival of deductions in respect of assets which qualified for deductions prior to July 2015. There are detailed rules which set out when a relevant asset will be regarded as a pre-1 April 2019 asset. There is also no deduction available if the assets are acquired from a related party, such as on incorporation.[9]

The deduction is not universally available for newly created or acquired assets, however: it is only available where those relevant assets are acquired as part of the acquisition of a business which also includes qualifying intellectual property assets which are within the scope of the corporate intangibles asset rules.[10] The qualifying intellectual property assets are patents, registered designs, copyright, design rights, plant breeders' rights and plant variety rights. The consultation

[6] HM Treasury, *Autumn Budget 2017* (November 2017), HC 587.
[7] HMRC and HM Treasury, *Review of the corporate Intangible Fixed Assets regime: Summary of Responses* (November 2018).
[8] CTA 2009 s.879B.
[9] CTA 2009 s.879K.
[10] CTA 2009 s.879I.

had suggested that registered trademarks would also be included, but that suggestion did not survive into the legislation.

The requirement that intellectual property assets be acquired together with the relevant assets is factored into the cost restriction noted above. The cost of the goodwill (and other relevant intangibles) for which the 6.5 per cent fixed rate deduction is available is capped at six times the value of the specific intellectual property assets (as above) acquired.[11] A formula is used to establish the amount for which amortisation is available, being the ratio of six times the expenditure on qualifying intellectual property assets to the expenditure on goodwill and relevant assets.

Impact on transactions

The requirement that the relevant assets be acquired as part of the acquisition of a business might appear otiose, given that goodwill cannot exist independently of a business and so cannot be transferred separately to that business. The requirement is, clearly, intended to target the customer-focussed relevant assets which could be separately transferred. Of more importance (arguably) is the requirement that the goodwill be acquired as part of a transaction which includes the acquisition of qualifying intellectual property, and also that such qualifying intellectual property can have expenditure attributed to it. This will, presumably, substantially limit the scope of this relief in relation to smaller businesses which tend, in general, to have (or recognise) fewer such intellectual property assets.

Anne Fairpo[*]

Section 26: intangible fixed assets: exceptions to degrouping charges etc

Section 26 of the Finance Act 2019 (FA 2019) addresses an annoying anomaly left over from the reform of the chargeable gains degrouping rules in 2011.[1]

Readers will recall that for many disposals potentially within section 179 of the Taxation of Chargeable Gains Act 1992 (TCGA), including previous intra-group disposals of "old intangibles",[2] any exit charge was transposed to the disponor of shares or "washed out" if the disponor benefited from Substantial Shareholdings Exemption (SSE).[3] However "new intangibles" were (and are) dealt with under Part 8 of the Corporation Tax Act 2009 (CTA 2009) which provides for relief from, and charges to, corporation tax on income on certain transactions affecting "new intangibles".[4] So because Chapter 9 of Part 8 CTA 2009 contains, inter alia, degrouping provisions which in some respects have effects similar to those of section 179 TCGA,

[11] CTA 2009 s.879M.

Amortisation; Corporation tax; Goodwill; Intangible assets

[*] Temple Tax Chambers.

[1] FA 2011 Sch.10, paras 3–6.

[2] Broadly intangibles created or acquired before 1 April 2002: CTA 2009 s.882.

[3] See TCGA s.179(3)A–(3)E.

[4] That is, post 31 March 2002.

a disposal of shares in a company owning new intangibles previously transferred tax free intra-group remain subject to a charge at the asset, not share, level.

Since HMRC were, understandably, not keen to grant relief on assets which if then transferred intra-group and then sold in a corporate "envelope" might avoid clawback of the relief whereas if the same assets had been sold direct that relief could be clawed back, it was not obvious what steps could be taken. Now eight years later and with more intangible assets being created/brought into a new regime it became imperative to act.

Section 26 FA 2019 operates differently in some respects to the changes made in 2011 to the chargeable gains regime, simply because the way in which the degrouping charge under the new intangibles regime operates is different. In both cases the basic charge operates to substitute the market value of the asset at the time of the intra-group transfer for the "no gain:no loss" treatment. However, this is where the new intangibles regime differs: any ongoing relief under the intangibles regime that was based on the value originally adopted at the time of the "no gain:no loss" transfer is re-worked for the periods that have elapsed since the intra-group transfer by reference to the market value deemed to have been used at the time of intra-group transfer. The effect of this is to reduce the amount of the degrouping charge and, assuming the intangibles have appreciated in value, provide higher ongoing relief in the future.[5]

Accordingly section 26 FA 2019, which inserts a new exception from the degrouping charge,[6] causes no tax charge to arise (and consequently no restating of values at the time of the intra-group transfer for future tax relief purposes) provided there is a "relevant disposal of shares" by another company, that is, the seller can benefit from SSE and there is no arrangement, in effect, to "warehouse" the shares in the hands of the immediate buyer with a view to onward disposal to a third party. In working out for these purposes whether a disposal will benefit from SSE, paragraph 6 of Schedule 7AC TCGA (which prevents the SSE from applying, inter alia where there is a no gain:no loss transfer under another provision) is to be disregarded. This is principally aimed at circumstances where, because of the application of another no gain:no loss basis transaction (principally section 139 TCGA), a degrouping charge would otherwise remain.

The question now is whether there may be circumstances in which there has been a prior re-organisation which causes, for instance, the "SSE clock" to start again and the company that owns the transferred assets is not the company directly sold by the disponor. In other words the drafting of the section may mean that there are circumstances that should benefit from exemption but do not; so practitioners need to work through the steps of any reorganisation painstakingly in order not to be caught out. ☞

Gary Richards

[5] See, respectively, CTA 2009 ss.775–776 and CTA 2009 s.780.
[6] New CTA 2009 s.782A.

☞ Degrouping charge; Intangible assets

Section 27 and Schedule 10: corporation tax relief for carried-forward losses

Section 27 of and Schedule 10 to the Finance Act 2019 (FA 2019) amend the provisions in the Corporation Tax Act 2010 (CTA 2010) which govern the way in which a company's revenue losses can be carried forward and set against its profits in later periods for corporation tax purposes or surrendered by way of group relief to other members of its group. These provisions do not make any changes to the use of capital losses, although the Government is planning separately to reform the capital loss rules from 1 April 2020.[1]

This note provides a summary of the main changes made to the rules by FA 2019. It is not comprehensive. In particular, it does not seek to address the specific provisions that apply to insurance companies and oil and gas companies.

The carried-forward losses regime that is the subject of these amendments was itself radically reformed in Finance (No.2) Act 2017 (F(No.2)A 2017). The main features of that reform were as follows:

- to enable companies to set carried-forward losses arising from 1 April 2017 onwards against profits from other income streams (referred to here as "total profits") both within the loss making company and by way of group relief;
- to restrict the extent to which profits arising from 1 April 2017 onwards can be relieved by carried-forward losses to 50 per cent of such profits exceeding an annual "deductions allowance" of £5 million (which applies per group or per stand-alone company);
- to introduce a targeted anti-avoidance rule (TAAR) and extend existing anti-avoidance rules.

The Notes on F(No.2)A 2017 in this *Review*[2] provide an overview and analysis of the reforms.

The Government's stated aim of those reforms was to "modernise one of the most outdated elements of the tax regime, and bring the UK into line with international best practice".[3] The reformed rules are, however, complex. The main reasons for this are that: the old regime continues to apply to pre-April 2017 losses and operates in parallel to the new regime; and, even within the new regime, there remains a requirement to distinguish between different types of losses.

[1] HMRC, *Corporate Capital Loss Restriction: Consultation on Delivery* (29 October 2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767242/Corporate_Capital_Loss_Restriction_-_consultation_on_delivery.pdf* [Accessed 20 June 2019].

[2] 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.

[3] HM Treasury, *Budget 2016* (March 2016), HC 901, available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/508193/HMT_Budget_2016_Web_Accessible.pdf* [Accessed 20 June 2019], paras 1.174–1.178.

The effect of the FA 2019 amendments, although designed to ensure that the new regime meets the Government's original policy objectives and prevent claims for loss relief that are "in excess of that intended",[4] is to build upon this complexity.

The principal amendments made by FA 2019 are summarised below.

Commencement dates

The first point to note is that the changes have varying commencement dates. Some provisions are backdated to the start of the reformed regime on 1 April 2017, whereas others came into effect on 6 July 2018 or 1 April 2019. In all cases, where a company's accounting period straddles the particular commencement date, the period is divided in two with amounts apportioned on a time basis, except where doing so would not be just and reasonable.[5]

The deductions allowance: companies that are members of more than one group

Under the new regime, as a general rule, groups of companies can allocate the £5 million deductions allowance amongst companies within the group as they see fit. The new section 269ZV(5A) CTA 2010[6] restricts the ability of a group to allocate in cases where the "ultimate parent"[7] of the group is also a member of another group.

For accounting periods beginning on or after 1 April 2019, an ultimate parent company cannot be allocated a share of the group's deductions allowance in respect of any period during which the company was also a member of another group; it can only be allocated a share of the deductions allowance of the other group of which it is also a member. Given the definitions of "group"[8] and "ultimate parent", this provision is only likely to have effect in limited circumstances, but the Government sees it as an appropriate measure to "prevent groups from acquiring new members to boost the amount of the deductions allowance available".[9]

Terminal losses: straddling periods

Terminal loss relief allows a company that has ceased trading to carry back any unused carried-forward trading losses and set these without restriction against profits of the three years ending with the date of cessation.[10] Section 45G CTA 2010 deals with the calculation of terminal loss relief where only a part of an accounting period falls within the three year maximum period for which relief is allowed.

The FA 2019 amendments replace section 45G CTA 2010 with an entirely new provision for accounting periods beginning on or after 1 April 2019.[11] The new provision limits the amount

[4] HMRC, Policy paper, *Corporation Tax: amendments to reform of loss relief rules* (29 October 2018), available at: *https://www.gov.uk/government/publications/corporation-tax-amendments-to-reform-of-loss-relief-rules/corporation-tax-amendments-to-reform-of-loss-relief-rules* [Accessed 20 June 2019].
[5] FA 2019 Sch.10, para.32(2).
[6] Introduced by FA 2019 Sch.10, para.12.
[7] CTA 2010 s.269ZZB(3).
[8] CTA 2010 s.269ZZB.
[9] HMRC, above fn.4.
[10] CTA 2010 s.45F.
[11] FA 2019 Sch.10, para.21.

of relief available where only part of an accounting period falls within the three year maximum period (a "straddle period"). The precise limitation depends on whether the terminal losses comprise pre-April 2017 losses[12] or post-April 2017 losses that can only be set-off against trading profits,[13] or post-April 2017 losses that are available for set-off against total profits.[14]

For pre-April 2017 losses and post-April 2017 losses that can only be set against trading profits, the maximum relief available is the "overlapping proportion"[15] of the trading profits for the straddle period. The "overlapping proportion" is the proportion that the part of the straddle period falling within the three year maximum period bears to the straddle period as a whole. So, for example, where three months out of a 12 month accounting period fall within the three year period, the proportion is three-twelfths.[16] For post-April 2017 losses that can be set against total profits, the maximum relief available is the overlapping proportion of the total profits for the straddle period.

The total deductions available for all losses together must not exceed the "overlapping proportion" of the total profits in the straddle period.

Group relief for carried-forward losses

Part 5A CTA 2010 provides for group relief[17] and consortium claims[18] in respect of carried-forward post-April 2017 losses. Limits on the amounts of profits that may be relieved are set out in Chapter 4 of Part 5A CTA 2010 for group relief and in Chapter 5 of Part 5A CTA 2010 for consortium claims. These limits are amended by FA 2019,[19] and apply in respect of accounting periods beginning on or after 1 April 2017.

The amendments replace the concept of "relevant profits" in the relevant limitation provisions with a concept of "qualifying profits" for determining the amount of profits that may be relieved by a group relief or consortium relief claim. "Qualifying profits"[20] are more narrowly defined than "relevant profits" and consist of "modified total profits"[21] less the amount of all in-year reliefs, which are amounts that could be relieved against the company's total profits of the accounting period. The amendments limit in certain circumstances the amount of profits which can be relieved to the "qualifying profits" where "qualifying profits" for the period are less than the amount of the deductions allowance.

[12] CTA 2010 s.45.
[13] CTA 2010 s.45B.
[14] CTA 2010 s.45A.
[15] New CTA 2010 s.45G(4).
[16] HM Treasury, *Finance (No. 3) Bill Explanatory Notes* (7 November 2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/754255/Finance__No__3__Bill_Explanatory_Notes.pdf* [Accessed 20 June 2019].
[17] CTA 2010 s.188CB.
[18] CTA 2010 s.188CC.
[19] Specifically, by amending CTA 2010 s.188DD and s.188ED.
[20] New CTA 2010 s.188DD(3A) and s.188ED(3A).
[21] CTA 2010 s.269ZF(3).

Transferred trades

FA 2019 also makes amendments to the anti-avoidance provisions in CTA 2010 which restrict the use of carried-forward losses following a change in ownership of the company.[22]

In particular, section 676AF CTA 2010 (restriction on use of carried-forward post-1 April 2017 trade losses) and section 676BC CTA 2010 (disallowance of relief for carried-forward post-1 April 2017 trade losses against certain capital gains) limit the use by a company of a loss made before a change of ownership in a period after the change of ownership. These provisions have been extended[23] to apply also to losses of any other company (the "predecessor" company) made in an accounting period beginning before the change of ownership and which were transferred to the company under the rules which govern transfers of trade without a change of ownership.[24]

These changes come into force for accounting periods beginning on or after 1 April 2019.

Ashley Greenbank[*]

Section 32 and Schedule 13: temporary increase in annual investment allowance

See A. Harper and L. Liu, "UK accelerated depreciation policy in an international context" [2019] BTR 257.

Andrew Harper and Li Liu

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

In 2010 the UK's Coalition Government announced ambitious plans "to create the most competitive corporate tax regime in the G20".[1] The centrepiece of the plan was reducing the

[22] CTA 2010 Pt 14.
[23] New CTA 2010 s.676AF(2) and s.676BC(5).
[24] CTA 2010 Pt 22 Ch.1.

Carry-forward reliefs; Corporation tax; Groups of companies; Tax avoidance

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Annual investment allowances

[1] 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.

statutory rate of corporate tax from 28 per cent to 24 per cent.[2] Successive Conservative governments continued reducing the rate to its present 19 per cent and it is due to drop further to 17 per cent in 2020.[3] This gradual but substantial reduction in the headline rate of corporation tax has been financed in part by broadening the tax base, including reducing writing down allowances for the main pool of plant and machinery from 20 per cent to 18 per cent and for the small pool from 10 per cent to 8 per cent.[4] The Finance Act 2019 (FA 2019) continues along these lines by reducing the small pool rate from 8 to 6 per cent[5] and eliminating first-year allowances and first-year tax credits for energy-saving and environmentally beneficial plant or machinery.[6]

Importantly, the Coalition Government also maintained the previous Labour Government's decision to abolish allowances for "industrial buildings" (Part 3 of the Capital Allowances Act 2001 (CAA 2001)) and "agricultural buildings" (Part 4 CAA 2001)[7]; these allowances were gradually phased out from 2008 to 2011.[8] Focusing on industrial buildings allowances (IBA), the rules used to permit capital allowances to be claimed where capital expenditure had been incurred on the construction of an industrial building or structure which was to be occupied, principally, for the purposes of a trade.[9] To qualify, the building must have been an industrial building or structure, which was elaborately defined in section 274 CAA 2001, Tables A and B. The result was that only a relatively narrow class of commercial buildings was eligible for this relief. This area has been the subject of litigation, for example, on whether certain types of warehouses were industrial buildings.[10] The courts generally have taken a quite restrictive view of what can come within this category.[11]

Writing in this *Review* in 2012, Bilicka and Devereux stated that "[t]he UK has the least generous treatment of industrial buildings of all G20 and OECD countries".[12] In 2015 Maffini characterised the UK's overall capital allowances regime as "one of the least generous in the

[2] HM Treasury, *Part 1: Corporate tax road map* (November 2010), 7.
[3] FA 2016 ss.45–46.
[4] Maffini, above fn.1, 16 and CAA 2001 s.104D(1).
[5] FA 2019 s.31, amending CAA 2001 s.104D(1), with effect for chargeable periods beginning on or after 1 April 2019 for corporation tax and 6 April 2019 for income tax.
[6] FA 2019 s.33, repealing CAA 2001 ss.45A–45C (energy-saving plant or machinery), ss45H–45J (environmentally beneficial plant or machinery), and s.262A and Sch.A1 (first-year tax credits). FA 2019 s.33 also makes a host of consequential amendments to remove references to these first-year allowances and first-year tax credits in other sections. These changes take effect for chargeable periods beginning on or after 1 April 2019 for corporation tax and 6 April 2019 for income tax.
[7] Formerly CAA 2001 s.361. The allowances could be claimed by a person with a relevant interest in agricultural land who incurred capital expenditure on the construction of a building such as a farmhouse, farm building or cottage, fences and other works, e.g. drainage. A person with a "relevant interest" was defined in former CAA 2001 s.364 and included an owner in fee simple, a lessee and the Scottish equivalents; allowances for forestry land were abolished for chargeable periods beginning on or after 20 June 1989 (FA 1989 s.120).
[8] Maffini, above fn.1, 16.
[9] Formerly CAA 2001 s.309.
[10] See, e.g. *Girobank plc v Clarke (Inspector of Taxes)* [1996] STC 540 (Ch) (data processing centre not an industrial building); *Bestway (Holdings) Ltd v David Alexander Luff (Inspector of Taxes)* [1998] STC 357 (Ch) (cash-and-carry warehouse building not an industrial building); and *Maco Door and Window Hardware (UK) Ltd v HMRC* [2008] UKHL 54; [2008] STC 2594 (warehouse used to store goods for import/export not an industrial building).
[11] G. Loutzenhiser (ed.), *Tiley's Revenue Law*, 8th edn (Oxford: Hart Publishing, 2016), 553.
[12] 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.

OECD".[13] Consequently, whilst the UK has indeed become very competitive in recent years on statutory corporate tax rates relative to the other G20 and OECD countries, the UK ranks much lower on another measure, effective marginal tax rate (EMTR), which takes into account both tax rate and tax base.[14] Further, as Gammie highlighted in this *Review* in 2013, the main beneficiaries of this strategy are those companies without large capital expenditure on industrial buildings and equipment; manufacturing companies have not fared as well.[15]

At Budget 2018 the Chancellor finally responded to longstanding requests from business representative groups that capital investment to construct structures and buildings should be relieved[16] by announcing a new relief that "addresses a significant gap in the UK's current capital allowances regime, and will improve the international competitiveness of the UK's tax system".[17] Section 30 FA 2019 (re)introduces capital allowances for commercial buildings, in the form of a non-residential structures and buildings allowance (SBA). Unusually, FA 2019 is short on details; section 30 sets out just the primary features of the SBA and then empowers the Treasury to make regulations to implement it. HMRC published a technical note on SBA accompanying the Budget (Technical Note)[18] and in March 2019 published draft legislation in the form of new sections 270AA and following, Part 2A CAA 2001.[19] Strangely there is no mention in the Budget or Technical Note of the former IBA—this is all presented as a new relief to address an apparently newly discovered gap in the legislation. The Technical Note even says:

> "The aim of the SBA is to relieve the costs of physically constructing new structures and buildings…These assets are already depreciated in many businesses' accounts, but until now without tax relief being given on all the expenditure."[20]

Talk about a short memory!

Essentially, SBA is 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 is brought into qualifying use.[21] In contrast to the more elaborate rules for IBA,[22] the 2 per cent SBA applies irrespective of any changes in ownership; the purchaser just takes over the

[13] Maffini, above fn.1, 17

[14] Maffini, above fn.1, 17. According to Maffini, "the EMTR measures the proportionate increase in the cost of capital due to the tax. It accounts for both the statutory rate and for capital allowances. It affects the size of the investment, given the decision to locate in the UK." See also M.P. Devereux, K. Habu, S. Lepoev and G. Maffini, *G20 Corporation Tax Ranking* (Oxford University Centre for Business Taxation, March 2016).

[15] M. Gammie, "Taxing corporate profits in a global economy" [2013] BTR 42, 50.

[16] HMRC, *Capital allowances for structures and buildings: Technical Note* (Technical Note) (29 October 2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752092/Capital_allowances_for_structures_and_buildings_technical_note.pdf* [Accessed 1 July 2019], 2.

[17] HM Treasury, *Budget 2018* (October 2018), HC 1629, para.3.23.

[18] Technical Note, above fn.16.

[19] HMRC, *Capital allowances for structures and buildings: Introductory note to draft secondary legislation* (13 March 2019), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/785034/Capital_allowances_for_structures_and_buildings_-_Introductory_note_to_draft_secondary_legislation_and_draft_secondary_legislation.pdf* [Accessed 1 July 2019]. Following the consultation period the final version of this legislation is expected by implemented by statutory instrument: see para.4.

[20] Technical Note, above fn.16, 2.

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

[22] Formerly CAA 2001 s.311.

remaining allowances.[23] Before the phase-out started in 2008, IBA was a writing-down allowance over 25 years, that is, 4 per cent per annum[24]—twice as generous as the new SBA rates but on a narrower subset of commercial buildings.

Expenditure on renovations or conversions of existing commercial structures or buildings qualifies for SBA,[25] but not expenditure on land or rights in or over land,[26] or dwellings or buildings that function as dwellings.[27] SBA expenditure does not qualify for the annual investment allowance.[28] Overseas commercial structures or buildings can qualify if the business is within the charge to UK tax.[29] A qualifying use is use in a trade, profession, vocation, UK or overseas property business, mine/quarry, or in managing the investments of a company with investment business.[30] The draft legislation provides for apportionment between qualifying and non-qualifying expenditure on a just and reasonable basis,[31] rules for writing off of qualifying expenditure,[32] as well as allowances in respect of a building that is only partly in qualifying use or in respect of periods when a building is not in qualifying use.[33] Special rules apply to leases granted for 35 years or more.[34] Finally, there is the obligatory anti-avoidance rule.[35]

Two other minor changes to the capital allowances regime made in FA 2019 should be noted for completeness. First, the availability of first-year allowance for expenditure on electric vehicle charge points is extended from 2019 to 2023.[36] Secondly, section 35 FA 2019 clarifies that the potential exceptions from the exclusions for expenditure on the provision of buildings, structures and alterations to land in section 23 CAA 2001 are not intended to enable allowances to be claimed on costs relating to assets for which the expenditure on the provision is excluded from

[23] FA 2019 s.30(6) and (8)(b). See also HMRC, *Capital allowances for structures and buildings: Introductory note to draft secondary legislation*, above fn.19, para.5(j).
[24] Formerly CAA 2001 s.310.
[25] FA 2019 s.30(12). See also draft CAA 2001 s.270BJ.
[26] FA 2019 s.30(3). See also draft CAA 2001 s.270BG.
[27] FA 2019 s.30(4). See also draft CAA 2001 s.270CF.
[28] HMRC, *Capital allowances for structures and buildings: Introductory note to draft secondary legislation*, above fn.19, para.5(l).
[29] HMRC, *Capital allowances for structures and buildings: Introductory note to draft secondary legislation*, above fn.19, para.5(c).
[30] FA 2019 s.30(1)(b). See the definition of "qualifying activity" in draft CAA 2001 s.270CA and "qualifying use" in draft CAA 2001 s.270CE.
[31] FA 2019 s.30(8)(a). See also draft CAA 2001 s.270BL.
[32] FA 2019 s.30(8)(c). Unrelieved expenditure is to be claimed as a deduction in arriving at the capital gains computation: see draft CAA 2001 s.270AA(3) and HMRC, *Capital allowances for structures and buildings: Introductory note to draft secondary legislation*, above fn.19, para.7.
[33] FA 2019 s.30(4)(c). See also draft CAA 2001 ss.270EA and 270EB.
[34] FA 2019 s.30(7). See also draft CAA 2001 s.270DD and HMRC, *Capital allowances for structures and buildings: Introductory note to draft secondary legislation*, above fn.19, paras 8–9.
[35] FA 2019 s.30(8)(f). See also draft CAA 2001 s.270IB.
[36] FA 2019 s.34.

allowances by sections 21 or 22 CAA 2001.[37] According to the Explanatory Notes, the amendment is aimed in particular at land excavation costs[38]. ☙

Glen Loutzenhiser

Section 36 and Schedule 14: leases: changes to accounting standards etc

This legislation was prompted by changes to International Financial Reporting Standard (IFRS) lease accounting. The stated goal of HMRC was to preserve existing tax policy principles where possible.

By way of background, for accounting periods beginning on or after 1 January 2019, all companies using IFRS must follow IFRS 16.[1] This accounting standard requires lessees to bring on balance sheet lease liabilities under most leases including those previously accounted for as operating leases. There are exemptions for short leases and low value assets. A corresponding right-of-use asset is recognised in respect of the period of use of the asset which the lease provides. Leases accounted for in this way give rise to a profit and loss account expense for: 1. depreciation (of the right-of-use asset); and 2. a finance charge (in respect of the reducing financial liability to pay lease rentals).

There have been several years of consultation in this area, following the issue of the accounting standard.

Treatment of IFRS 16 lessees

The tax treatment of a lessee under an IFRS 16 lease follows the principles familiar as Statement of Practice 3/91 (SP 3/91)[2] for finance lessees. HMRC's guidance, BLM32210–BLM32215,[3] confirms SP 3/91 applies to IFRS leases as well as those using Statement of Standard Accounting Practice (SSAP) 21. So, rather unusually in an international context, the UK will follow the

[37] FA 2019 s.35 and HM Treasury, *Finance (No. 3) Bill Explanatory Notes* (7 November 2018), cl.34. This is accomplished by amending CAA 2001 ss.21 and 22, which are subject to CAA 2001 s.23, so that any reference to "plant" in List C in CAA 2001 s.23(4) does not include anything where expenditure on its provision is excluded by CAA 2001 ss.21 or 22. These changes are treated as always having had effect, but do not have effect in relation to claims for capital allowances made before 29 October 2018: FA 2019 s.35(3).

[38] *Finance (No. 3) Bill Explanatory Notes*, above fn.37, cl.34.

☙ Capital allowances; Corporation tax; Electric vehicles; Qualifying expenditure; Special rate expenditure; Structures and buildings allowances

[1] KPMG, *IFRS 16 — Leases handbook*, available at: *https://home.kpmg/xx/en/home/services/audit/international-financial-reporting-standards/leases/lease-accounting-handbook-ifrs16-231018.html* [Accessed 3 July 2019].

[2] HMRC, Policy paper, *Statement of Practice 3 (1991)* (11 April 1991), available at: *https://www.gov.uk/government/publications/statement-of-practice-3-1991/statement-of-practice-3-1991* [Accessed 3 July 2019].

[3] HMRC, internal manual, *Business Leasing Manual* (published 10 April 2016; updated 26 July 2016), BLM32210, "Taxation of leases that are not long funding leases: finance lessees: taxation generally: following generally accepted accounting practice", available at: *https://www.gov.uk/hmrc-internal-manuals/business-leasing-manual/blm32210* [Accessed 3 July 2019]; HMRC, internal manual, *Business Leasing Manual* (published 10 April 2016; updated 26 July 2016), BLM32215, "Taxation of leases that are not long funding leases: finance lessees: taxation generally: SP3/91 and IAS", available at: *https://www.gov.uk/hmrc-internal-manuals/business-leasing-manual/blm32215* [Accessed 11 July 2019].

lessee's IFRS 16 profit and loss account treatment of rentals for tax purposes. As a consequence, by comparison with the historic position for an operating lease, there is inevitably some up-fronting of deductions due to the method of recognising finance costs on a declining liability, together with a straight line depreciation. This is not discussed in the Finance Act 2019 (FA 2019) but flows from established principles.

Transitional adjustments

There are three ways to transition to IFRS 16, two of which are retrospective and involve taking a debit to reserves (for what would otherwise have been a future rental deduction, or in IFRS 16 terms depreciation). In the case of some corporates the size of these debits runs to billions. The effect of taking a debit to reserves on the future profit and loss account is helpful, although it requires the taxpayer to run some onerous recalculations.

Part 3 of Schedule 14 FA 2019 disapplies the normal change of basis rules in Corporation Tax Act 2009 (CTA 2009). Government felt that allowing the normal rules to apply would have given a tax deduction "windfall" in terms of timing. Instead Schedule 14 spreads any transitional adjustments over a fixed period which is calculated based on the weighted average remaining lease term. This is done separately for each UK company which has any IFRS 16 transitional adjustments. Each company needs to consider its leases which have transitional adjustments and calculate the weighted average remaining lease period. HMRC have supplied the following helpful example in paragraph 49 of the *Finance (No.3) Bill Explanatory Notes* in relation to clause 35 Schedule 13,[4] which became Schedule 14:

	Step 1	**Step 2**	**Step 3**	**Step 4**
Lease	**Transitional accounting adjustment**	**Weighting percentage A/SUM (A1-An)**	**Remaining lease term on IFRS 16 adoption**	**Mean lease period**
Lease 1	£(10,000,000) credit	26.32% (=10m ÷ 38m)	1,826 days	481 (=1826 × 26.32%)
Lease 2	£8,000,000 debit	21.05% (=8m ÷ 38m)	730 days	154 (=730 × 21.05%)
Lease 3	Nil	Excluded	1,826 days	Excluded
Lease portfolio	£20,000,000 debit	52.63% (=20m ÷ 38m)	1,461 days	769 (=1461 × 52.63%)
Overall	*£18,000,000 debit*	*100%*		*1,404 days*

Note that the weighting percentage is by reference to each adjustment as a percentage of the sum of the absolute adjustments (that is, ignoring whether they are debits or credits). In practice most will be debits.

The overall net debit, spread over the weighted average remaining lease term, is not automatically deductible: one must still consider normal tax rules which disallow for example 15 per cent of polluting car hire payments, and capital elements of payments under leases (such as dilapidations).

[4] HM Treasury, *Finance (No.3) Bill Explanatory Notes* (7 November 2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/754255/Finance__No__3__Bill_Explanatory_Notes.pdf* [Accessed 3 July 2019], "Clause 35 and Schedule 13: Changes to accounting standards etc", para.49.

Deferred tax issues

For a UK company the SP 3/91 principle should mean there are no deferred tax consequences of IFRS 16 treatment on a going forward basis.

UK companies which have a transitional adjustment on adopting IFRS 16 should expect a deferred tax asset in respect of the tax deductible element of the adjustment. This asset will unwind over the weighted average period.

Overseas companies will need to calculate deferred tax where their local tax is calculated based on non-IFRS compliant local generally accepted accounting principles (GAAP) or on lease payments. The IFRS Interpretations Committee discussions and press releases on IAS 12 in 2018[5] indicated the initial recognition exemption will not apply where a jurisdiction has a difference between profit and loss (P&L) and tax deductions in respect of an IFRS 16 lease. Therefore a gross deferred tax liability and asset will need to be disclosed, albeit it should be possible to achieve netting.

Issues for early adopters

It was possible to adopt IFRS 16 one year early, that is, for the period ending on or after 1 January 2018. Companies which did so are taxed following section 53 of the Finance Act 2011 (FA 2011). They had to base tax computations on the accounts on the assumption that IFRS 16 was not adopted.

Schedule 14 FA 2019 has repealed section 53 FA 2011 for periods commencing on or after 1 January 2019.[6] So for example an early adopter with a 31 December year end would follow old GAAP in 2018. Paragraph 14 of Schedule 14 FA 2019 requires the change of basis provisions to be applied on the assumption that transition occurred at this date (1 January 2019 in the writer's example). The writer understands that this has the effect that a notional debit (or credit) needs to be calculated based on the IFRS 16 asset and liability at 1 January 2019, and a tax spreading calculation will need to be performed based on this notional debit (or credit). This debit (or credit) will reflect any actual transitional adjustment in the accounts on early adoption, but will also take account of the further divergence between P&L and tax in the early adoption period. The legislation is quite brief in its instructions on these points and HMRC guidance is expected to fill in some of the detail. HMRC's intended result is to ensure that over the life of the lease the amounts taken as tax deductions are not restricted to the profit and loss account expense but also take account of the difference between P&L and tax numbers in the early adoption period. This deemed transitional adjustment will also typically create a deferred tax asset.

Preservation of old operating lease concept

Schedule 14 FA 2019 maintains the operating lease concept for tax purposes in several places with a view to preserving existing tax policy. In these places the taxpayer must ask whether a lease would be an operating lease or a finance lease if that question were relevant: the writer

[5] IFRS, *IFRIC Update March 2018*, available at: *https://www.ifrs.org/news-and-events/updates/ifric-updates/march-2018/* [Accessed 3 July 2019]; IFRS, *IFRIC Update June 2018*, available at: *https://www.ifrs.org/news-and-events/updates/ifric-updates/june-2018/* [Accessed 3 July 2018].

[6] FA 2019 Sch.14, Pt 3, para.11.

presumes this analysis is to be performed by applying Financial Reporting Standard 102 principles.[7]

One of the most important of these areas is the corporate interest restriction (CIR). The issue was that potentially all IFRS 16 leases would give rise to further interest expense that would be taken into account for calculating any CIR restriction. To prevent this, Schedule 14 FA 2019 amends section 494 of the Taxation (International and Other Provisions) Act 2010 so that only those IFRS 16 leases which would have been finance leases under old GAAP are treated as giving rise to interest expense for CIR purposes. Those filing CIR returns thus have to rework their numbers to reverse the impact of IFRS 16 "operating" leases.

Similarly, the Type 1 finance arrangement rules in section 758 of the Corporation Tax Act 2010 (CTA 2010) would have applied to all property sale and leasebacks under IFRS because all IFRS 16 leases give rise to a financial liability. To prevent this, section 771 CTA 2010 is amended so that only those IFRS 16 leases which would have been finance leases under old GAAP are treated as finance leases for the purposes of the Type 1 finance arrangement rules.

Similar provisions are made in several other areas:

- Section 67 of the Capital Allowances Act 2001 (CAA 2001): hire purchase, etc. rules (in determining whether a lease is a finance lease in which case the asset can be treated as owned by the lessee).
- Section 228J CAA 2001: specific anti-avoidance applying to sale and finance leasebacks involving a subsequent operating lease; largely only of historic interest.
- Section 288 CTA 2010: definition of finance lease for oil and gas ring-fence sale and lease-backs.
- Section 331 CTA 2010: finance lease finance costs disallowed for purposes of supplementary charge (SCT).
- Section 437 CTA 2010: definition of finance lease for sale of lessor rules purposes.
- Section 544 CTA 2010: definition of finance lease in the real estate investment trusts (REIT) context.

Long funding lease rules

Some changes are made largely to accommodate the technical distinction between a finance lease and an IFRS 16 lease.

One notable change is that the lessee's entitlement to capital allowances under a new IFRS 16 lease will no longer be market value as is the case for a long funding operating lease but will be "PVMLP": the present value of the minimum lease payments. This is regardless of the hypothetical old GAAP position. By contrast for such a lessee there should not be a section 70E CAA 2001 clawback of allowances on the natural termination of the lease (as there is currently for long funding operating leases) as the capital allowances due should be the same as the "capital" rents paid.

[7] FRC, *FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland* (September 2015), available at: *https://www.frc.org.uk/getattachment/e1d6b167-6cdb-4550-bde3-f94484226fbd/FRS-102-WEB-Ready-2015.pdf* [Accessed 3 July 2019].

New leases will be "long" for long funding lease purposes simply if they have a term of over seven years in future. This simplification applies from 1 January 2019 and applies equally to IFRS 16 leases and those accounted for under UK GAAP. The change was not necessitated by IFRS 16 but it is helpful as it removes the detailed tests for finance leases with terms between five and seven years.

Because an IFRS 16 lease is not strictly a "finance lease" it cannot meet the finance lease test in section 70N CAA 2001. Lessees under right-of-use leases will thus need to test whether their lease meets the "funding" tests based on the other two tests, being: 1. lease term as a percentage of asset life; and 2. the present value of minimum rentals as a percentage of the asset fair value. Such lessees will not use the finance lease test nor will old GAAP be preserved for this purpose.

If a new IFRS 16 right-of-use lease qualifies as a long funding lease it is treated as a long funding finance lease for the purposes of the long funding lease calculations.

On a change in the accounting classification of a long funding lease there is normally a deemed termination and recommencement of the lease. The "new" lease is then automatically a long funding lease for the lessor. These rules have been adjusted so that they do not apply when an accounting standard changes or a person adopts a new accounting standard. Thus an existing long funding operating lease which moves into IFRS 16 will not automatically become a long funding finance lease. This is good news as otherwise there could potentially be early clawbacks of allowances. The impact would have been particularly harsh for taxpayers who had claimed 100 per cent first year allowances under a long funding operating lease. (An exception to this rule is where a right-of-use long funding finance lease becomes an operating lease: this appears only likely to apply in the fairly unusual circumstance of a company moving from IFRS to UK GAAP.) ☞

Michael Everett[*]

Section 39 and Schedule 16: entrepreneurs' relief

Introduction

Schedule 16 to the Finance Act 2019 (FA 2019) makes various amendments to the qualifying entrepreneurs' relief (ER) conditions and enables shareholders to make special elections to protect their ER before a qualifying "dilution event".

The earlier Finance Bill proposals to tighten up the qualifying ER conditions for shareholders were completely unexpected. The lack of consultation on these proposals was evidenced by the fact that they had to be amended significantly in December 2018. Special rules enabling shareholders to "bank" their accrued ER entitlement prior to being diluted by a commercial share issue had already been trailed in draft clauses issued on Legislation Day 2018.

☞ Accounting standards; Corporation tax; Deferred taxation; International financial reporting standards; Leasing; Long funding leases

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Under the post-FA 2019 regime, owner-managers, shareholders and their advisers will need to be even more vigilant where there are proposed changes in shareholdings and shareholders rights. This will enable them to take appropriate action to ensure that ER entitlements are protected as far as possible.

Periods throughout which ER conditions must be met

Paragraph 1 of Schedule 16 FA 2019 makes various amendments to section 169I of the Taxation of Chargeable Gains Act 1992 (TCGA), which require business owners, partners, and shareholders to satisfy the relevant ER conditions throughout a new qualifying period of two years. This applies for all disposals after 5 April 2019,[1] thus increasing the qualifying period by a further 12 months from the one year period for pre-6 April 2019 disposals.

A special transitional measure applies for companies that ceased trading before 29 October 2018 (Budget Day 2018). In such cases, where shareholders wish to claim ER on their capital (liquidation) distributions, the one year ER qualification period is retained. The shareholders would therefore need to satisfy the (pre-FA 2019) ER conditions in the one year period before the trade ceased. Furthermore, the relevant capital distribution must be made within three years of cessation in the normal way.[2] Where the trade ceases after 28 October 2018, the relevant ER conditions must be satisfied for two years before cessation.

The FA 2019 brings a welcome "look-through" rule for share sales occurring shortly after a company has been incorporated.[3] For post-5 April 2019 disposals, it is possible to include the seller's qualifying period(s) for ER *before* the trade was transferred to the company. Thus, for the purposes of the two year ownership test, a shareholder can now include the period they carried on the trade as a sole-trader or in partnership together with the qualifying shareholding period post-incorporation.

However, this "aggregation" rule only applies where the sole trader or partnership has incorporated the trade wholly or partly in exchange for shares. This would typically be under an incorporation using section 162 TCGA relief. On the other hand, where companies were incorporated by gifting the goodwill to the company (using the section 165 TCGA hold-over relief) or selling the goodwill at market value (with the proceeds being left outstanding on loan account), it will not be possible to use this special "aggregation" rule.

Example 1

Mike has carried on his electronics repair and installation business as a sole trader for many years. On 1 May 2018, he transferred the trade and all its assets (including goodwill) to his new company, Mike Electronics Ltd, wholly in exchange for an issue of shares.

The net asset value of the assets transferred to the company (including goodwill valued at £500,000) was £850,000. The capital gain arising on the goodwill was £500,000 which was "rolled-over" under the Section 162 TCGA incorporation relief.

[1] FA 2016 Sch.16, para.4.
[2] TCGA s.169I(7) and FA 2019 Sch.16 para.4(2).
[3] FA 2019 Sch.16, para.1(2)(d) inserting new TCGA s.169I(7ZA) and (7ZB).

In June 2019, Mike sold all his shares in Mike Electronics Ltd for £1.1 million net of disposal costs.

Mike has held his shares in the company only for some 14 months. However, since he incorporated the trade in consideration for an issue of shares, he is treated as satisfying the "two year" ownership period since he can include his earlier qualifying ER period as a sole trader.

His capital gain on the sale of the company would therefore be eligible for ER and is computed as follows:

	£'000	£'000
Net sale proceeds		1,100
Allowable base cost (= net value of business on incorporation)	850	
Less: section 162 TCGA incorporation relief	(500)	(350)
Chargeable gain (eligible for ER)		750

Additional requirements relating to beneficial ownership of companies

Since ER was introduced in April 2008, the "personal company" requirement in section 169S(3) TCGA for share disposals has remained unchanged. This requires the seller to hold (in their own right) at least 5 per cent of the company's:

- ordinary share capital (measured in terms of nominal value[4]); and
- voting rights.

Where a company has more than one class of shares, the definition of ordinary shares becomes very important for ER. The definition is widely drawn in the Corporation Tax Act 2010 (CTA 2010) and states that ordinary shares comprise

> "all the company's issued share capital (however described), other than capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the company's profits".[5]

This area has been subject to judicial scrutiny in many cases, including *HMRC v McQuillan* (*McQuillan*)[6] and *Castledine v HMRC* (*Castledine*).[7] It is now well settled that shares carrying *no right* to a dividend would still qualify as ordinary shares. This is because the "carve-out" in the above definition essentially envisages shares carrying *fixed rate dividends*, that is, a right to no dividend is not akin to a dividend with a fixed rate of 0 per cent.[8]

Cumulative compounding preference shares were also held in *Stephen Warshaw v HMRC* (*Warshaw*)[9] to be ordinary shares for ER purposes. The First-tier Tribunal in *Warshaw* concluded that the shares did not have a right to a fixed rate dividend since the company's articles provided

[4] More recently confirmed in *Hunt v HMRC* [2019] UKFTT 210 (TC).
[5] ITA 2007 s.989 (TCGA s.169S(5)).
[6] *HMRC v McQuillan* [2017] UKUT 344 (TCC).
[7] *Castledine v HMRC* [2016] UKFTT 145 (TC).
[8] *McQuillan*, above fn.6, [2017] UKUT 344 (TCC); *Castledine*, above fn.7, [2016] UKFTT 145 (TC).
[9] *Stephen Warshaw v HMRC* [2019] UKFTT 268 (TC).

that the dividend amount also included any cumulative compounded unpaid preference dividends. Thus, the dividend rights on the shares could be a variable figure.[10]

For shares sold after 28 October 2018, paragraph 2(4) of Schedule 16 FA 2019 amends the "personal company" definition in section 169S(3) and (4) TCGA by including two *alternative* additional "economic interest" tests. For simplicity, the writer will call them Economic Test 1 and Economic Test 2.

Economic Test 1

This requires sellers to be beneficially entitled to at least 5 per cent of:

- the profits available for distribution to the company's equity holders; and
- the company's assets available for distribution to its equity holders on a winding-up.[11]

As with all the relevant "personal company" tests, this economic condition must be satisfied throughout the qualifying ER period.

For these purposes the legislation applies a modified version of the "economic ownership' conditions used for the corporation tax "group relief" rules found in Chapter 6 of Part 5 CTA 2010.[12]

"Equity holders" would typically cover:

- all the ordinary shareholders (which includes some types of preference shares but excludes "restricted preference shares"); and
- loan creditors (except most bank borrowing and other commercial loans).[13]

There should be no particular difficulty with this economic test in straightforward situations. Where a company has a single class of ordinary shares, shareholders should simply be able to demonstrate they satisfy the 5 per cent "distributable profits" and "assets on a winding-up" test.

Under the original Finance Bill proposals, Economic Test 1 was the only test. This provoked considerable criticism from the leading professional bodies. This was because the test was unlikely to be satisfied where companies had "alphabet share" arrangements. These normally involved the board of directors having the discretion to propose different rates of dividend on each separate class of shares (for example, A ordinary shares, B ordinary shares and so on). Since the shareholders were reliant on the directors' exercising their *discretion* over dividend payments on each separate class, it could be argued that they had no ongoing entitlement to the company's distributable profits. Consequently, the argument went that each class of shareholding would fail this condition and lose its qualifying ER status. Clearly, this ran contrary to HMRC's policy intention. Fortunately, this problem was solved by the introduction of an *alternative* economic test at a late stage in the Finance Bill process—Economic Test 2.

[10] *Warshaw*, above fn.9, [2019] UKFTT 268 (TC).
[11] TCGA s.169S(3)(c)(i).
[12] TCGA s.169S(3D) and (3E).
[13] CTA 2010 ss.160–164.

Economic Test 2

Under this test, based on the assumption that the entire ordinary share capital of the company is sold, sellers must be able to show that they would reasonably expect to obtain at least 5 per cent of the total disposal proceeds.[14] This seller must meet this economic condition throughout the ER qualifying period.

In applying this provision, the sale value of the company is taken to be the market value at the end of that period. Where the seller is selling as part of a disposal of the entire company it is expected that the arm's length sale price would be used.

The allocation of the "market value" sale price during the qualifying period is based on the arrangements in place for every day of the two year (or one year) ER qualifying period. Consequently, the seller's share of the sale proceeds would be based on all the prevailing circumstances that existed at the relevant times. The effect of any "avoidance arrangements" is ignored in applying this rule.[15]

Economic Test 2 is likely to be the preferred test for most holders of alphabet shares and similar share structures, since it identifies the true 5 per cent economic owners and avoids having to consider the potential uncertainties of applying the two-pronged Economic Test 1.

Example 2

Eagle Traders Ltd (ETL) has had two classes of ordinary shares since it was incorporated in July 1969. The A and B ordinary shares rank pari passu for dividend and voting rights. The dividends declared on each class of shares must be proposed by a unanimous resolution of the board of directors.

However, the A ordinary shares carry 96 per cent of the capital rights (on a sale of the company or surplus on winding-up) and the B ordinary shares carry 4 per cent of these capital rights.

The shares are held as follows:

	A ordinary shares of £1 each	**B ordinary shares of £1 each**	**Total ordinary shares**	**Ordinary voting %**	**Capital rights %**
Neil	100		100	41.7	53.3
Edwin	80		80	33.3	42.7
Mike		60	60	25.0	4.0
	180	60	240	100.0	100.0

All shareholders would have qualified for ER on a disposal under the pre-FA 2019 legislation since they each held at least 5 per cent of the ordinary shares and voting rights (the old "personal company" test).

However, from 29 October 2018, only Neil and Edwin will qualify for ER. Each of them will satisfy the relevant 5 per cent ordinary share capital, 5 per cent voting rights, and (using Economic Test 2) "5 per cent of sale proceeds" tests.

[14] TCGA s.169S(3)(c)(ii).
[15] TCGA s.169S(3A) and (3B)(a).

Mike does not satisfy either Economic Test 1 (no beneficial entitlement to 5 per cent of distributable profits) or Economic Test 2 (only entitled to 4 per cent of the sale proceeds on a sale of the company).

Relief where company ceases to be individual's personal company

As part of the response to the Treasury's *Patient Capital Review*,[16] paragraph 3 of Schedule 16 FA 2019 inserts a new Chapter 3A to Part 5 TCGA. This brings in a useful measure enabling shareholders to capture their ER entitlement before they become diluted below the 5 per cent threshold on an equity funding exercise. The policy aim here is to remove a potential obstacle for entrepreneurs seeking external investment.

From 6 April 2019, shareholders are able to make two separate elections.

Section 169SC TCGA election

Immediately before a "dilution-event", shareholders can treat their shares as having been sold and immediately reacquired at market value. This would give rise to an ER-eligible chargeable gain on their shares at that point.

It is important to stress that the "minority discounts" that typically apply for fiscal share valuation purposes are "switched off" here. The market value used for the deemed disposal effectively represents the shareholder's pro rata proportion of the total company valuation.[17] In the vast majority of equity fund-raising exercises, a formal company valuation would normally have been prepared to calculate the terms on which the new shares are being issued to the venture capital provider.

This election, which should be beneficial in most cases, is available provided the "equity funding" share issue is made wholly for cash. The share issue must also be made for commercial reasons and not as part of arrangements mainly driven by tax avoidance.[18] Broadly, the section 169SC TCGA election must be made by 12 months after the 31 January following the tax year in which the relevant share issue is made.[19]

Section 169SD TCGA election

Shareholders can also make a supplementary election under section 169SD TCGA to defer the capital gains tax (CGT) triggered as a result of the above section 169SC TCGA election until they subsequently dispose of their shares on an actual sale. This supplementary CGT deferral election is likely to be made in almost all cases, since shareholders will wish to avoid a "dry" 10 per cent tax charge resulting from the section 169SC TCGA "deemed disposal" election.

There are computational rules that with the allocation of the deferred gain amongst separate classes of shares etc.[20] Similarly, separate provisions deal with cases where the (elected) shares

[16] HM Treasury, Policy paper, *Patient Capital Review* (23 January 2017), available at: *http://www.gov.uk/government/publications/patient-capital-review* [Accessed 8 July 2019].
[17] TCGA s.169SC(5).
[18] TCGA s.169SC(6).
[19] TCGA s.169SG(2).
[20] TCGA s.169SD(2).

are subsequently sold in consideration of an issue of qualifying corporate bonds and/or under a share exchange or similar CGT share reorganisation.[21]

The "CGT deferral" election must be made within four years of the end of the tax year of the "deemed disposal".[22]

A special procedure can apply where shareholders wish to make both section 169SC TCGA and section 169SD TCGA elections but have no other reason to file a tax return.[23]

Example 3

Frank has always held 48 per cent of Apollo 8 Ltd's issued ordinary share capital since the company was formed in December 2008.

In June 2019, the company's directors reached broad agreement for £5 million worth of debt and equity funding to finance a major capital expenditure programme. The private equity fund will inject £5 million into the company by way of 500,000 £1 A ordinary shares, 3,500,000 £1 preference shares, and £1 million loan notes. For the purposes of the funding exercise, Apollo 8 Ltd has been valued at around £10.2 million.

After the company issues shares to the private equity provider, all its existing original shareholders (who are directors) would be heavily diluted so that they would cease to hold at least 5 per cent of the company's issued ordinary share capital for ER purposes. Apollo 8 Ltd would therefore no longer be their "personal company".

Assuming Frank makes a competent section 169SC TCGA election, he could capture his ER-eligible gains immediately before the new share issue. For these purposes Frank's deemed disposal consideration would be a pro rata share of the value of the company at that date.

Thus, assuming the market value of the entire company is £10.2 million, Frank's ER-protected gain would be calculated as follows:

	£'000
Deemed MV proceeds (48% x £10.2 million)	4,896
Allowable base cost – negligible	(-)
Capital gain	4,896

Frank's base cost for future CGT purposes would be £4,896,000, since he is deemed to reacquire the shares at the same value.

[21] TCGA ss.169SE and 169SF.
[22] TCGA s.169SG(3).
[23] TCGA s.169SG(4).

It is also likely that Frank would wish to make a supplementary election under section 169SD TCGA to defer the 10 per cent ER-CGT on his gain of £4,896,000 until he makes an actual sale of this Apollo 8 Ltd shareholding. ☙

Peter Rayney[*]

Section 42: relief for first-time buyers in cases of shared ownership

Section 41 of the Finance Act 2018 introduced a new relief from stamp duty land tax (SDLT) on purchases by first-time buyers of a single residential property where the aggregate price paid is not more than £500,000.[1] This relief was made available to first-time buyers purchasing in shared ownership transactions, but only where the purchaser elected to pay SDLT on the full market value in a one-off payment up-front. Where the purchaser did not make such an election, but instead paid the SDLT in stages, no first-time buyers' relief was available.

New section 42 of the Finance Act 2019 (FA 2019) extends first-time buyers' relief to shared ownership transactions where no election is made and the SDLT is paid in stages. It also provides relief from any SDLT attributable to rent in a shared ownership transaction where "staircasing" (that is, the acquisition of a greater percentage interest in the property pursuant to the provisions of the shared ownership lease during the term of the lease) is allowed.

Section 42(3) FA 2019 introduces a new paragraph 15 to Schedule 9 to the Finance Act 2003 (FA 2003). Schedule 9 FA 2003 deals with SDLT on shared ownership transactions. Under paragraph 4 of Schedule 9 FA 2003, in a shared ownership transaction where staircasing is allowed, and an election is made for SDLT to be paid on the full market value in an up-front payment, the SDLT payable includes an element attributable to the rent payable under the shared ownership lease, but calculated by reference to the minimum rent payable after the staircasing has been completed. New paragraph 15 provides that where SDLT is paid in accordance with an election under paragraph 4, and first-time buyers' relief is claimed under Schedule 6ZA FA 2003 on the grant of the lease, no tax is chargeable in respect of so much of the chargeable consideration for the grant as consists of rent.

The basic extension of first-time buyers' relief is made by section 42(6) FA 2019, which amends paragraph 16 of Schedule 9 FA 2003. Paragraph 16 as originally enacted provided that first-time buyers' relief was not available for any element of a shared ownership transaction where no election was made for the SDLT to be paid up-front. As amended, paragraph 16 now does not apply to the initial grant of a shared ownership lease or the initial acquisition under a shared ownership trust, so that a claim for such relief can be made in respect of such transactions even though no election is made. However, paragraph 16 as amended still prevents such relief being available for later staircasing acquisitions.

☙ Beneficial ownership; Capital gains tax; Dilution; Entrepreneurs' relief; Share capital

[*] FCA CTA (Fellow) TEP, independent tax consultant.

[1] The relief is provided for in FA 2003 Sch.6ZA.

Section 42(4) introduces new paragraphs 15A and 15B to Schedule 9 FA 2003; these deal with the grant of a shared ownership lease and the declaration of a shared ownership trust respectively. They provide that where no election for up-front payment of SDLT is made, then for the purposes of determining whether the second condition for first-time buyers' relief has been satisfied—that the relevant non-rent consideration is not more that £500,000— the chargeable consideration is to be taken to be the market value stated in the lease or trust (that is the amount which would be taken to be the chargeable consideration if an election for up-front payment were made). Paragraphs 15A and 15B also provide that if first-time buyers' relief is claimed, no SDLT will be charged in respect of any rental element of the transaction.

The amendments made by section 42 FA 2019 apply to any land transaction of which the effective date is on or after 29 October 2018 and to any land transaction of which the effective date is earlier than 29 October 2018 but in respect of which a land transaction return has not been given by that date[2]. ☞

Susan Ball

Section 43: repayment to first-time buyers in cases of shared ownership

The extension of first-time buyers' relief provided for in section 42 of the Finance Act 2019 (FA 2019) applies, as detailed in a separate note by the writer,[1] with effect from 29 October 2018. The relief first applied to any land transaction of which the effective date was on or after 22 November 2017.[2] Section 43 FA 2019 effectively backdates the extension to the introduction of the relief, by providing for a claim for repayment of stamp duty land tax to be made in respect of a land transaction which falls within the section.

Section 43(2) FA 2019 covers the extension of the relief contained in section 42(3) FA 2019: the exclusion from tax of so much of the chargeable consideration as consists of rent, in cases where an election for up-front payment has been made. It applies to a transaction where the amount of tax chargeable in respect of the transaction would have been less if section 42(3) FA 2019 had been in force at the effective date of the transaction.

Section 43(3) FA 2019 covers the extension of the relief contained in section 42(4) FA 2019 to cases where no election for up-front payment was made. It applies to land transactions where first-time buyers' relief could not have been claimed for the transaction but could have been claimed if the amendments made by sub-sections 42(4) to (6) FA 2019 had been in force from the effective date of the transaction.

Where a repayment claim under section 43 FA 2019 is made, HMRC must repay so much of the tax paid as exceeds what would have been payable if section 42 FA 2019 had been in force

[2] FA 2019 s.42(7).

☞ First-time buyers; Reliefs; Shared ownership; Stamp duty land tax

[1] S. Ball, "Section 42: relief for first-time buyers in cases of shared ownership" [2019] BTR 346.

[2] FA 2018 s.41(8).

from the effective date of the transaction and (in the case of a transaction falling within section 43(3) FA 2019) if a claim for first-time buyers' relief had been made.[3]

A repayment claim under section 43 FA 2019 must be made by amendment of the original land transaction return[4] and can be made until 29 October 2019[5]. ☙

Susan Ball

Section 44: higher rates of tax for additional dwellings etc

Higher rates of stamp duty land tax (SDLT) may be payable when a major interest in residential property is acquired by a company or by a person other than a company who already has or has had a major interest in a residential property.[1] Section 44 of the Finance Act 2019 (FA 2019) makes two amendments to these provisions (the HRAD provisions).

Section 44(2) FA 2019 clarifies the definition of "higher rates transaction" by providing that references in the HRAD provisions to a major interest in a dwelling include references to an undivided share in such a major interest, thus putting it beyond doubt that the acquisition of a major interest by tenants in common is potentially within the HRAD provisions.[2] This amendment has effect in relation to any land transaction of which the effective date is on or after 29 October 2018.[3]

The HRAD provisions contain a relief from the higher rates of SDLT for persons who are changing their main residence. In particular, where a new main residence is acquired before the old one is disposed of, but the old one is disposed of within three years of the acquisition of the new, it may be possible to claim repayment of the higher rate element of the SDLT paid on the earlier acquisition of the new main residence.[4] Such a claim must, under the HRAD provisions as originally enacted, be made before the later of the expiry of three months from the effective date of the disposal of the old main residence or the expiry of 12 months from the filing date of the land transaction return in respect of the acquisition of the new main residence.[5] Section 44(4) FA 2019 alters these time limits so that the amendment of the land transaction return may now be made within 12 months after the effective date of the disposal of the old main residence. This

[3] FA 2019 s.43(4).
[4] FA 2019 s.43(5).
[5] FA 2019 s.43(1).

☙ First-time buyers; Repayments; Shared ownership; Stamp duty land tax

[1] FA 2003 Sch.4ZA, introduced by FA 2016 s.128.
[2] New FA 2003 Sch.4ZA para.2(5) inserted by FA 2019 s.44(2)
[3] FA 2019 s.44(3).
[4] FA 2003 Sch.4ZA para.3(7).
[5] FA 2003 Sch.4ZA para.8.

amendment has effect in a case where the effective date of the "subsequent transaction" (the disposal of the old main residence) is on or after 29 October 2018[6].

Susan Ball

Section 45: exemption in respect of financial institutions in resolution

The Banking Act 2009 establishes the "special resolution regime for banks", the purpose of which is

> "to address the situation where all or part of the business of a bank has encountered, or is likely to encounter, financial difficulties".[1]

The regime confers various powers on, inter alia, the Bank of England, including the power to make instruments transferring the property of the failing bank. Section 74 of the Banking Act 2009 empowers the Treasury by regulation to make provision about the fiscal consequences of the exercise of a stabilisation power, including restricting a charge to stamp duty land tax (SDLT).[2]

Section 45 of the Finance Act 2019 (FA 2019) inserts a new section 66A into the Finance Act 2003 (FA 2003). This new section provides that a land transaction is exempt from SDLT if it is made under an instrument specified in the new section, basically one made under the various provisions of the Banking Act 2009 which authorise property transfers to be made in the application of the special resolution regime. It thus removes the need for every such transfer to be exempted from SDLT by a statutory instrument made under section 74 of the Banking Act 2009.

Section 45 FA 2019 has effect in relation to any land transaction the effective date of which is on or after Royal Assent (12 February 2019)[3].

Susan Ball

Section 46: changes to periods for delivering returns and paying tax

The stamp duty land tax (SDLT) legislation requires a land transaction return to be made in respect of every "notifiable transaction" as defined in sections 77 and 77A of the Finance Act 2003.[1] The land transaction return must include a self-assessment of the tax that, on the basis of the information contained in the return, is chargeable in respect of the transaction, and be

[6] FA 2019 s.44(5).

Higher rate; Principal residence; Reliefs; Second homes; Stamp duty land tax; Tax rates; Tenants in common

[1] Banking Act 2009 s.1(1).

[2] Banking Act 2009 ss.74(2), 74(4).

[3] FA 2019 s.45(2).

Banks; Exemptions; Financial institutions; Special resolution regime; Stamp duty land tax

[1] FA 2003 s.76.

accompanied by payment of the amount chargeable.[2] The legislation also requires returns or further returns to be made: when an adjustment is required because a contingency ceases or unascertainable consideration is ascertained[3]; when certain reliefs are withdrawn[4]; in consequence of later linked transactions[5]; and under the special provisions relating to leases.[6]

In all these cases, the land transaction return or further return has, prior to the enactment of section 46 of the Finance Act 2019 (FA 2019), been required to be made (and hence the tax to be paid) within 30 days of the effective date of the relevant transaction. The principal change made by section 46 FA 2019 is to reduce this 30 day period to 14 days in cases where the land transaction return is required because the transaction is or becomes a notifiable transaction. However, where a transaction has already been a notifiable transaction and the legislation requires a further return to be made, being a further return under which tax becomes payable in respect of a transaction where none was payable before or under which additional tax becomes payable, in general the 30 day period continues to apply, as it generally does in the case of a withdrawal of relief.[7] Where the effect of section 46 FA 2019 is to reduce the time for filing a return and paying the tax from 30 days to 14 days, the provisions charging interest on late-paid SDLT are correspondingly amended.[8]

Section 46 FA 2019 operates by amending, in sub-sections (2) to (9), the numerous provisions relating to SDLT returns to give effect to these changes. The amendments made by section 46 have effect in relation to any land transaction with an effective date on or after 1 March 2019[9] and any land transaction with an earlier effective date which becomes notifiable on or after 1 March 2019[10]. ☙

Susan Ball

Section 47: stamp duty: transfers of listed securities and connected persons; Section 48: SDRT: listed securities and connected persons

Background

On 7 November 2018 HMRC issued a consultation document entitled *Stamp Taxes on Shares Consideration Rules*.[1] The closing date for comments was 30 January 2019, and between those

[2] FA 2003 s.76(3).
[3] FA 2003 s.80.
[4] FA 2003 s. 81.
[5] FA 2003 s.81A.
[6] FA 2003 Sch.17A.
[7] The exception is withdrawal of relief under FA 2009 Sch.61 in respect of alternative finance investment bonds: FA 2019 s.46(9).
[8] FA 2019 s.46(7).
[9] FA 2019 s.46(10)(a).
[10] FA 2019 s.46(10)(b).

☙ Land transaction returns; Payments; Stamp duty land tax; Time limits

[1] HMRC, *Stamp Taxes on Shares Consideration Rules: Consultation document* (Publication date: 7 November 2018; closing date for comments: 30 January 2019), available at: *https://assets.publishing.service.gov.uk/government/uploads*

two dates HMRC, as is their usual practice, hosted a number of meetings with interested parties at which those parties were able to express their views on the proposals in the consultation document.

At the date of writing this note (30 April 2019) HMRC have published no further proposals or any response to the comments which were submitted to them before 30 January 2019.

The consultation document "seeks…views on changes to the Stamp Duty and Stamp Duty Reserve Tax (SDRT) consideration rules".[2]

There are three elements to the consultation:

1. The first is the impact of extending the market value rule which was introduced in sections 47 (stamp duty) and 48 (SDRT) of the Finance Act 2019 (FA 2019). These sections provide for a market value charge (broadly speaking) on a transfer of listed securities from a person to a connected company. The proposal is to extend this market value rule to unlisted securities, and also to transfers of listed and unlisted securities to connected parties which are not companies.
2. The second element of the consultation concerns the definition of consideration for stamp duty and SDRT and seeks views as to whether this should be aligned with, for example, the SDRT provisions of "money or money's worth".
3. The final element is the alignment of the stamp duty and SDRT treatment of contingent, uncertain and unascertainable payments.

The provisions of section 47 and section 48 FA 2019 were introduced because HMRC had become aware of contrived arrangements involving the transfer of listed securities to connected companies for low consideration in order to minimise stamp duty and SDRT.

The justification for seeking views on the alignment of the concept of consideration for stamp duty and SDRT and, similarly, on the way in which contingent, uncertain and unascertained consideration should be dealt with for stamp duty and SDRT purposes reflects comments made in the Office of Tax Simplification (OTS) report entitled *Stamp duty on paper documents: a way forward to reform, digitise and simplify*.[3]

General market value rule

Sections 47 and 48 FA 2019 provide that where there is an instrument (section 47) or an agreement (section 48) transferring listed securities to a company or a company as a nominee and the person transferring the securities is connected with the company or is the nominee of the person connected with the company, then the consideration is to be treated as being equal to the amount or value of the consideration for the transfer or, if higher, the value of the listed securities.

The consultation document suggests that this should be extended in two ways:

1. First, it should be extended to transfers of unlisted securities.

/system/uploads/attachment_data/file/754212/Stamp_Taxes_on_Shares_Consideration_Rules.pdf [Accessed 20 June 2019].

[2] HMRC, above fn.1, para.1.1.

[3] OTS, *Stamp duty on paper documents: a way forward to reform, digitise and simplify*, presented to Parliament pursuant to section 186(4)(b) of Finance Act 2016 (July 2017), available at: *https://www.gov.uk/government/publications/ots-publishes-its-report-on-paper-stamp-duty* [Accessed 19 June 2019].

2. Secondly, it welcomes "views on the impact of a limited extension of the market value rule to transfers to individuals and other persons which are not companies".[4]

Although not entirely clear, the writer thinks this is intended to deal with the transfers of both listed and unlisted securities to connected persons.

HMRC suggest that existing reliefs and exemptions will continue to apply (many of which reflect transfers which were once the subject of the Stamp Duty (Exempt Instruments) Regulations 1987[5]).

Interestingly, the consultation document does not provide an exemption for transfers of (or agreements to transfer) listed or unlisted securities between spouses (and the same for transfers between civil partners).

So the proof of this particular pudding will be the extent of the exemptions which will, no doubt, be published in HMRC's response.

One justification for the extension of the market value rule to unlisted securities is that most other taxes have a market value rule for connected party transfers and this proposal therefore brings stamp duty and SDRT treatment into line with more general tax treatment between connected parties.

However there are a considerable number of reliefs available for direct taxes which mean that in practice there is often no requirement to undertake a market valuation of unlisted securities. Equally, and as importantly, the time for payment of stamp duty and SDRT is considerably sooner than the time for payment of, for example, capital gains tax or corporation tax on chargeable gains.

So transfers of unlisted securities between connected parties will require market valuations to be carried out on shares which, as readers will know, can be an expensive and time consuming process. Valuing unlisted securities is clearly a great deal more complicated than valuing, for example, land (compare the market value rule for stamp duty land tax (SDLT)). There are difficulties surrounding minority shares, restrictions attaching to them and a lack of comparables.

Furthermore, unless specific exemptions are included, there may well be double taxation on, for example, group reorganisations which are not contrived but simply act as a pre-arrangement to a subsequent sale. Concerns have also been expressed that extending the tax base in the way suggested has the potential to discourage initial public offerings where partnership and individuals take flotation vehicles from a holding company by way of a distribution.

But the overall feeling amongst the professionals with whom the writer has discussed these proposals is that HMRC have not made out a convincing policy justification for the changes. Focussing on the safe harbours, something HMRC have suggested, may mean that something will slip through the net. The writer's experience of this is that broadly drafted legislation seldom brings with it sufficiently broadly drafted safe harbours, and the result is that what are ostensibly good transactions (which ought to be exempted) suddenly become taxable, not pursuant to any policy objective but just by default.

[4] HMRC, above fn.1, para.3.7.
[5] The Stamp Duty (Exempt Instruments) Regulations 1987 (SI 1987/516).

Aligning the definitions of consideration for stamp duty and SDRT

In its report, the OTS states

> "almost everyone we have spoken to has suggested adopting 'money or money's worth' across the board, on the basis that this is a more modern concept and simpler to understand than cash, stock, marketable securities and debt".[6]

The OTS broadly agrees with this and recommends

> "that a digitised stamp duty adopts the 'money or money's worth' concept of consideration as its starting point…coupled with specific rules and exemptions to address certain issues".[7]

In their consultation document, HMRC recognise that certain exemptions that apply for stamp duty (and thus enable a document which benefits from that exemption to frank an SDRT charge) might no longer apply (for example: "contributions to a partnership in return for a membership interest"; "distributions in specie out of a partnership in return for a redemption of partnership capital"; or "contributions of assets to a fund vehicle in consideration for an issue of units in the fund that do not comprise stock").[8]

The OTS make it expressly clear that, as part of any modernisation, the reliefs for stamp duty and SDRT should be aligned and in particular, group relief and reconstruction relief should be introduced directly to SDRT.

Aligning the rules on contingent, uncertain and unascertained consideration

Without putting it in such colloquial terms, both HMRC and the OTS (and indeed many practitioners (if put on the spot)) recognise that the three different rules which apply to stamp duty, SDRT and SDLT for contingent, uncertain and unascertained consideration are a bit of a "dog's dinner".

The OTS recommends that the SDLT provisions should be adopted for both stamp duty and SDRT which addresses the issue of unknown consideration by permitting a reasonable estimate of the value of the consideration to be made at the date of completion and for this to be adjusted once a contingency ceases or the consideration becomes ascertained. It also permits a taxpayer to defer payment of SDLT where the contingent or uncertain consideration falls to be paid more than six months after completion.

Digitisation?

The OTS report's central recommendation was that the stamp duty process should be digitised. In other words, a transfer instrument (for example, a stock transfer form) would be submitted online to HMRC (perhaps by scanning it). Relevant information about the transferor and the transferee would also be sent electronically to HMRC. These submissions would generate a unique transaction reference (UTR) which would then be used to confirm that notification had been made to HMRC. Payment of the relevant duty would then be made using the UTR, within

[6] OTS, above fn.3, para.3.4.
[7] OTS, above fn.3, para.3.5.
[8] HMRC, above fn.1, para.4.8.

the relevant time limit, with the UTR enabling the payment and the transaction to be married up more easily.

There is no mention of this recommendation in the HMRC consultation document. And practitioners with whom this writer has spoken were concerned that the consultation document, whilst it deals with the two peripheral issues mentioned above,[9] does not deal with the central recommendation.

On 22 April 2019, the Stamp Duty (Method of Denoting Duty) Regulations 2019[10] came into force.

These Regulations amend both the Stamp Duties Management Act 1891 and the Stamp Act 1891. The amendments to the former replace references to impressed stamps with references to stamps produced by means of a die and extend the definition of "die" so that it includes any machine used under the direction of the Commissioners to denote duty. The amendments to the latter ensure that, in cases where duty is required to be denoted by impressed stamps, instruments are not to be treated as not being duly stamped for the purposes of the relevant statutory provisions, where duty is denoted by a different method which was permitted at the time of stamping.

It seems the writing is on the wall for the old stamp duty presses, and the extension and amendments to this legislation will, according to HMRC, provide flexibility in the method by which stamp duty is denoted. And:

> "This flexibility will provide scope to easily implement any changes in the future and will allow use of modern machinery for stamping. This will increase operational efficiency and reduce operational costs incurred by HMRC."[11]

It seems to the writer that this is an approach which is inconsistent with the OTS report's central recommendation of digitising stamping. HMRC's response, as evidenced by the Stamp Duty (Method of Denoting Duty) Regulations 2019, is to retain stamping but to streamline the process.

Nigel Popplewell[*]

Section 52 and Schedule 17: VAT treatment of vouchers

Introduction

As HMRC's powers have widened through Code of Practice (COP) 9 procedures and the introduction of accelerated payment and follower notices, VAT legislation has not escaped HMRC's focus in terms of targeting fraud. Part of the problem has been the lack of clarity

[9] HMRC, above fn.1, ss.4 and 5.
[10] The Stamp Duty (Method of Denoting Duty) Regulations 2019 (SI 2019/719).
[11] Explanatory Memorandum to The Stamp Duty (Method of Denoting Duty) Regulations 2019 (SI 2019/719), para.7.3.

Connected persons; Consideration; Digitisation; HMRC; Market value; Share transfers; Stamp duty; Stamp duty reserve tax
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concerning how vouchers are treated across Member States, leading to avoidance or double taxation. Traditionally, it is case law that has provided some clarification as to the treatment of vouchers but the relevant cases only dealt with specific issues. Critically, the decisions in these cases have not been uniformly applied across the EU.[1]

The EU Vouchers Directive (the Directive),[2] agreed on 27 June 2016, aims to standardise the VAT rules for vouchers in all Member States, even providing a standard definition of what constitutes a "voucher".[3] Subsequently, HMRC issued a consultation document, *VAT and Vouchers*,[4] which was intended to be the first step in the implementation of the Directive into the UK's VAT law.

Section 52 of and Schedule 17 to the Finance Act 2019 (FA 2019) implement the Directive and create a new Schedule 10B to the Value Added Tax Act 1994 (VATA 1994),[5] thus changing the way vouchers are treated for VAT purposes. Schedule 10B VATA 1994 affects both single-purpose vouchers (SPVs) and multi-purpose vouchers (MPVs).[6] The adoption of common rules and definitions will undoubtedly increase legal certainty and reduce the risk of divergent determinations and decisions across Member States.

State of play (pre-EU Directive 2016/1065)

Prior to the Directive coming into force, the law concerning vouchers in the UK was as set out in Schedule 10A VATA 1994. This Schedule remains in force for all vouchers issued *prior* to 1 January 2019. Under this legislation in the UK, the customer was deemed to be receiving two supplies: first, the voucher itself; and, secondly, the underlying supply of goods or services which was attached to the voucher.

Cases such as *Elida Gibbs Ltd v CC&E*[7] and *Commission of the European Communities v Federal Republic of Germany*[8] presented rulings which were inconsistent with harmonised VAT laws. The dilemma arose from the fact that the latter case upheld the former, in that the Courts ruled that when a customer presents a voucher issued by a person other than the seller, the value of the goods for VAT purposes would be the value paid for the goods *less* the discount. In other words, VAT could not be more than the consideration paid by a customer. The rulings in these cases did not, however, resolve the numerous issues relating to VAT on vouchers. Following the case of *Argos Distributors Ltd v CC&E*,[9] the CJEU ruled that the retailer must only charge

[1] R. Cowley, "European Commission Review of VAT on Vouchers" (2012) 25(3) *Irish Tax Review* 96, 97.
[2] Council Directive (EU) 2016/1065 of 27 June 2016 amending Directive 2006/112/EC as regards the treatment of vouchers [2016] OJ L177/9.
[3] The Directive, above fn.2, Art.1(1) inserting Art.30a into Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax [2006] OJ L347/1 (11.12.2006) (the EU VAT Directive).
[4] HMRC, *VAT and Vouchers: Consultation document* (publication date: 1 December 2017; closing date for comments: 23 February 2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/664160/VAT_and_Vouchers_-_consultation.pdf* [Accessed 9 July 2019].
[5] VATA 1994 Sch.10A remains in force for the VAT treatment of vouchers issued before 1 January 2019, whilst VATA 1994 Sch.10B is for the VAT treatment of vouchers issued on or after 1 January 2019.
[6] SPV meaning that the goods/services purchased are at a single VAT rate, and MPV meaning that the goods/services purchased could be subject to different VAT rates or territories.
[7] *Elida Gibbs Ltd v CC&E* (C-317/94) [1996] ECR I-5339.
[8] *Commission of the European Communities v Federal Republic of Germany* (C-427/98) [2002] ECR I-8315.
[9] *Argos Distributors Ltd v CC&E* (C-288/94) [1996] ECR I-5311; [1996] STC 1359.

VAT on the amount received on the *sale of the vouchers*, *not* on the face value. Again, it was not necessarily a clear line, and the abuses in the use of "face-value vouchers" prompted the UK to amend its legislation in 2003.[10] A definition of what is considered to be a "face-value voucher"[11] was introduced, constituting it as a supply for VAT purposes and thus taxable on issuance (or subsequent supply). However, without further detailed clarification and no harmonisation across the EU, this only added to the layer of complexity in some respects.

VAT vouchers have for some time been considered a risk area with respect to avoidance. The body of case law evidences the difficulties that Member States have had, and the aim to harmonise will no doubt be broadly welcomed. Prior to 1 January 2019, as a result of Member States having different VAT rules regarding vouchers, a number of cases involving double taxation or non-taxation arose in relation to cross-border transactions, and non-taxation scenarios being taken advantage of for cross-border VAT planning schemes.

Originally, the VAT treatment of vouchers was viewed from a transaction perspective of purchase of the voucher and subsequent redemption of it, with the former being disregarded for VAT purposes and the liability for VAT only arising on the latter. However, this narrower treatment was in place at a time when the type of voucher that could be purchased was limited. There has been an evolution both in the types of vouchers that are available (and which can be broadly categorised as SPVs or MPVs), and in the flexibility and manner in which these vouchers can be redeemed. The VAT treatment of these vouchers has also evolved concurrently but this evolution has been difficult, occasionally messy, and has required a deeper consideration of the real commercial reality and the underlying transaction or series of transactions. Case law has been instrumental in how the law has developed.

EU Directive 2016/1065: define, define, define…

The aim of the Directive is to promote some level of harmonisation across Member States. It provides greater clarity than the European Commission's earlier voucher proposal of 2012.[12] That proposal did not provide a definition, nor did it give consideration to the special rules regarding the tax treatment of vouchers.

Vouchers have traditionally been problematic for the tax authorities (including HMRC) because there is a real risk of double taxation or non-taxation. There are two transactions that take place with a voucher: first, when a voucher is issued (or transferred); and, secondly, when a voucher is redeemed. However, only one payment is ever made in exchange for the voucher, so both transactions cannot be taxed. The questions that tax authorities have traditionally been asked to grapple with and determine generally revolve around what creates the taxable event and what

[10] A. Schenk, V. Thoronyi and W. Cui, *Value Added Tax: A Comparative Approach*, 2nd edn (Cambridge: CUP, 2015), 247.

[11] VATA 1994 Sch.10A, para.1(1) defines "face-value voucher" as "a token, stamp or voucher (whether in physical or electronic form) that represents a right to receive goods or services to the value of an amount stated on it or recorded in it".

[12] European Commission, *Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax, as regards the treatment of vouchers* (Brussels: 10.5.2012, COM(2012) 206 final, 2012/0102 (CNS)), available at: *http://ec.europa.eu/transparency/regdoc/rep/1/2012/EN/1-2012-206-EN-F1-1.Pdf* [Accessed 9 July 2019].

then is the taxable amount.[13] Consistency and certainty have been missing in so far as the treatment of vouchers is concerned, and the Directive is an attempt to introduce these attributes.

Section 52 and Schedule 17 FA 2019: determine and decide

Section 52 and Schedule 17 FA 2019 insert a new Schedule, Schedule 10B, in to VATA 1994 which deals with vouchers issued on or after 1 January 2019. For vouchers issued on or after 1 January 2019, the principal change to be considered is the definition, which will be harmonised across all Member States. Critically, the definition will change from "a right" to receive goods or services, to representing the goods or services that can be obtained.[14] For SPVs, this means that the amount of VAT to be declared will not change, but that the time of the declaration will shift to when the voucher is sold, as opposed to when it is redeemed. For MPVs, VAT will be accounted for at the time of redemption.

The new legislation also places particular importance on whether a voucher is truly a SPV (and thus taxed on issue (and transfer)), or a MPV (and therefore taxed on redemption). The rules seek to define not only what constitutes a "voucher",[15] but also the difference between a SPV and a MPV, and these will be taxed at different points—be that the point of issuance, transfer or redemption—depending on what is being supplied. For a voucher to be deemed a SPV, two conditions are listed as needing to be satisfied: 1. at the time of issue, the place of supply of the relevant good(s)/service(s) must be known; and, 2. the (single) supply category of the good(s)/service(s) must also be known.[16]

As noted above, as vouchers have continued to increase in their diversity and complexity, so too has the VAT landscape accompanying them. The definition of a "voucher" is central to understanding the amendments in the legislation. How vouchers are characterised and what they are, and more importantly what they are *not*, is critical.

The new Schedule 10B VATA 1994 now lists three conditions which need to be met in order for the vouchers rule to take effect:

1. first, that there is an "obligation to accept" the voucher as "consideration for the provision of goods or services"[17];
2. secondly, that either the goods and services related to the voucher and/or the obligation to accept the voucher as consideration, are limited and stated or recorded on the voucher (by way of terms and conditions)[18]; and,
3. thirdly, that the instrument in question must be "transferable by gift".[19]

This final condition is an addition under UK legislation and appears to have no basis under the EU legislative framework. However, closer inspection of the explanatory notes accompanying

[13] Examples of such questions include: Should the right that the voucher represents be taxed? Should the goods or services attaching to the voucher be taxed? Does one treat the voucher as if it was actually the relevant good(s)/service(s) being acquired?
[14] VATA 1994 Sch.10B, para.1(3).
[15] VATA 1994 Sch.10B. See also, VATA 1994 Sch.10B, para.1(5) for what is *not* a voucher.
[16] VATA 1994 Sch.10B, para.4(1).
[17] VATA 1994 Sch.10B, para.1(2).
[18] VATA 1994 Sch.10B, para.1(3).
[19] VATA 1994 Sch.10B, para.1(4).

the Directive, reveals that reference is made to the exclusion of payment instruments from the definition of a voucher.[20] This must raise questions as to how the exclusion of such transactions can be justified, when all the other attributes and characteristics of a voucher are present, with the only distinction being that they are not transferable. If that is indeed to be the position, the VAT treatment of the non-voucher transaction must still need to be determined by reference to first principles and the existing EU case law on when a chargeable event takes place.

What does this mean?

Brexit

The EU Referendum which took place on 23 June 2016 raised a number of questions, particularly in relation to VAT. The UK's current form of VAT finds its historic origins in Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (the EU VAT Directive).[21] This effectively adopts and is part of what is known as the "EU VAT Model", with a relatively harmonised approach to VAT across Member States. Certain questions are at the forefront of the VAT debate, including: will the UK continue to retain VAT in the EU Model form; will the UK continue to derive benefits from that Model together with other Member States; and, critically, how will VAT be altered to adapt to a post-Brexit UK?

The position remains that, until exit negotiations are concluded, the UK retains its rights and obligations as a full member of the EU. As a result, the harmonisation of VAT vouchers will be effective for all vouchers issued *after* 1 January 2019.

Definition impact

EU law requires that "the VAT due on those goods or services [to which the voucher relates], [is] known at the time of issue of the voucher".[22] There is an underlying implication here that in order for a voucher to qualify as a SPV, the price of the specific goods or services for which the voucher is to be used must be fixed; otherwise, the "VAT due on those goods and services" remains an unknown. There is potential scope for avoidance tactics to be engaged here, as this difference could result in vouchers issued in the UK being classed as SPVs, whilst the same type of voucher in another Member State will not be so categorised. It could be argued that there is a real risk that this difference creates unequal treatment, and thus is a bar to fiscal neutrality.[23]

The other critical impact that the new definition will have is that the definition of a MPV, as compared to a SPV, will be fairly broad and will encompass anything which is not a SPV.[24] This underscores the importance of ensuring that the definition of what constitutes a SPV is correct,

[20] The Directive, above fn.2, L177/9–L177/10, para.6, explanatory notes; K. Killington and C. Vogelaar-Kelly, "The puzzle of the new VAT voucher rules", *Tax Journal*, 28 September 2018.
[21] EU VAT Directive, above fn.3. This Directive (the Sixth Directive) sought to harmonise VAT within the EU VAT area.
[22] The Directive, above fn.2, Art.1 amending Directive 2006/112/EC (EU VAT Directive, above fn.3) by the insertion of Ch.5, Art.30a(2).
[23] Killington and Vogelaar-Kelly, above fn.20.
[24] The Directive, above fn.2, Art.1 amending Directive 2006/112/EC (EU VAT Directive, above fn.3) by the insertion of Ch.5, Art.30a(3).

noting that both SPVs and MPVs have special rules to consider under Schedule 10B VATA 1994 (not just the new standardised definition).

The new legislation has made it clear that it is not concerned with the scope of VAT and whether VAT is due, but rather with the question of *when* VAT is due, and, for MPVs, the amount of the consideration upon which any VAT will be subsequently payable. The new EU Directive[25] and the UK legislation which implements it[26] are intended ultimately to resolve those circumstances in which a voucher is issued in one Member State but used in another, and where vouchers may be traded.

Tax point impact

Critical to *when* VAT is due is another key difference which arises out of the clarity provided by defining SPVs and MPVs as "breakage"[27]; that is, the value represented by vouchers that go unredeemed. In the case of SPVs, the VAT liability arises at the point of issue so an unredeemed SPV is unlikely to cause significant concern with respect to VAT obligations. However, for MPVs, the liability to VAT does not arise until the point of redemption.

Value of the voucher impact

Whether the liability to VAT arises on issuance or redemption, how much VAT is due, and on what, is also key. Again, complexity arises with regard to MPVs. Whilst for SPVs the VAT will generally be treated as the amount due on any consideration received on issuance of the voucher, for MPVs there are layers of supply chains, which can blur the lines.

The UK legislation states that the value may be the consideration for the last transfer of the voucher, in circumstances where that value is actually known.[28] If the consideration is not known (usually where there are numerous intermediaries in the supply chain), and transfers may take place for less than the face value, the onus will be upon the person redeeming the voucher to obtain relevant documentation to evidence this.

Input tax recovery

Crucial to most businesses will be the input tax recovery position. The definition certainly widens the scope of what falls within the embrace of a SPV, which means that issuers will have to account for VAT much earlier than under the previous regime. This is likely to impact working capital, with many issuers no longer able to obtain the benefit of non-redemption (that is, no VAT being due in circumstances where a voucher is not redeemed).

For MPVs, the legislation states that there is a taxable supply on redemption, *and* an untaxed transaction on issuance of the voucher and any intermediary transfer of it. The conclusion that the legislation lends itself to is that the latter should give rise to some sort of input tax restriction. In other words, because VAT is only due when the voucher is redeemed for MPVs, the value of the voucher will be either: the amount paid by the last person in the supply chain; or, if this is

[25] The Directive, above fn.2.
[26] FA 2019 s.52 and Sch.17 inserting new VATA 1994 Sch.10B.
[27] Killington and Vogelaar-Kelly, above fn.20.
[28] VATA 1994 Sch.10B, para.8(2).

unknown, then the face value of the voucher. As the legislation now states that the actual issuance or resale of a MPV will in itself no longer be treated as a supply for VAT purposes, this means that a tax point does not arise and a VAT invoice cannot be issued. For businesses, this means that input tax incurred may not be recoverable.

Conclusion

The harmonised definition will hopefully provide some clarity and homogeneity in both the legislation and the future body of case law. However, the difference in when the tax point arises (on issuance or redemption) means that getting the "type" of voucher correct is essential (that is, whether it is a SPV or MPV). Careful consideration then needs to be given to when the tax point arises, and on what value VAT is liable. It is anticipated that whilst creating some additions to the burden of tax administration, the harmonisation will remove distortions of competition across Member States and remove the scope for anti-avoidance measures. It is critical for businesses to reconsider their supply chains to ensure that they are robust from a VAT perspective, and to ensure that vouchers have been classified correctly.

Dilpreet K. Dhanoa*

Section 53 and Schedule 18: VAT groups: eligibility

Introduction: current UK VAT grouping rules

When you get to the end of this note you might look back and think the title is a bit misleading. Like Gaul in the famous books about Caesar's Gallic War,[1] so familiar to anyone who took Latin O level at a certain time, this note is divided into different parts, but only one part (the VAT grouping eligibility changes) is in section 53 of the Finance Act 2019 (FA 2019)[2] and even that part has not been implemented yet (the Act simply says the changes will apply from a date to be announced). The writers have, however, included various other recent VAT grouping changes that are not in FA 2019, to give the reader a more rounded and complete picture of the current UK VAT grouping landscape, so, if you bear with the writers, it is hoped you will nevertheless find the content of the note useful and interesting.

Under Article 11 of the Principal VAT Directive 2006/112/EC (PVD),[3] Member States may regard—after consulting the VAT advisory committee—as

EU law; Harmonisation; VAT; Vouchers

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[1] Caesar, *The Gallic War*, translation by H.J. Edwards, Loeb Classical Library 72 (Cambridge, MA: Harvard University Press, 1917).

[2] FA 2019 will take effect after it receives Royal Assent (expected Spring 2019).

[3] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax [2006] OJ L347/1.

> "a single taxable person any persons established in the territory of that Member State who, while legally independent, are closely bound to one another by financial, economic and organisational links.
>
> A Member State exercising the option provided for in the first paragraph, may adopt any measures needed to prevent tax evasion or avoidance through the use of this provision."

The UK has enshrined such provision under sections 43A to 43D of the Value Added Tax Act 1994 (VATA 1994).

VAT group registration aims at reducing the burden on businesses by allowing two or more associated companies to account for VAT as a single taxable person. The registration is made in the name of the representative member, who is responsible for completing and rendering the single return on behalf of the group. One of the main benefits of a VAT group consists in intra-group supplies being disregarded for VAT purposes.[4] Supplies to third parties are made by the representative member.[5] The VAT group provisions, however, set out that VAT group members each take on joint and several liability for each other's VAT obligations.[6]

The current UK grouping eligibility rules allow two or more bodies corporate (that is, companies of all types and limited liability partnerships) to register as a VAT group if each body is established, or has a fixed establishment, in the UK, and when they are under common control (for example, a parent company and its subsidiaries). A body corporate is deemed to control another body corporate if it is empowered by statute to do so or it is that body's holding company within the meaning of section 6 of and Schedule 6 to the Companies Act 2006.[7] An individual is deemed to control a body corporate if that individual would be the parent company of the group member if that group member were a company.[8] There are additional eligibility rules for "specified bodies" that are larger businesses (a VAT group whose turnover exceeds £10 million a year) with more complex ownership structures and where specific benefits accrue to third parties.[9]

In 2015, the CJEU opined in *Beteiligungsgesellschaft Larentia + Minerva mbH & Co KG v Finanzamt Nordenham and Finanzamt Hamburg-Mitte v Marenave Schiffahrts AG* (*Larentia + Minerva*)[10] that Article 11 PVD did not restrict the VAT group membership to persons having legal personality. As a result, in December 2016, HMRC published a consultation document, *Scope of VAT Grouping*,[11] which sought views on the future structure of UK VAT grouping. One of the main focus points was to consider potential changes to UK VAT grouping eligibility rules

[4] VATA 1994 s.43(1)(a).
[5] VATA 1994 s.43(1)(b).
[6] VATA 1994 s.43(1).
[7] VATA 1994 s.43A(2).
[8] VATA 1994 s.43A(3).
[9] The Value Added Tax (Groups: eligibility) Order 2004 SI 2004/1931 (with effect from 1 August 2004) has tightened the rules governing eligibility for VAT grouping by the introduction of complex new tests designed to prevent certain types of avoidance schemes which were becoming prevalent.
[10] *Beteiligungsgesellschaft Larentia + Minerva mbH & Co KG v Finanzamt Nordenham* and *Finanzamt Hamburg-Mitte v Marenave Schiffahrts AG* (Joined Cases C-108/14 and C-109/14) EU:C:2015:496.
[11] HMRC, *Scope of VAT Grouping: Consultation document* (5 December 2016), available at: *https://www.gov.uk/government/consultations/scope-of-vat-grouping* [Accessed 3 July 2019].

following *Larentia + Minerva*. In December 2017, HMRC published a summary of responses,[12] which ultimately led the UK legislator to incorporate changes to the eligibility rules in FA 2019. The writers herewith analyse these forthcoming changes and some related issues with respect to UK VAT grouping.

VAT group eligibility broadened to allow membership of UK non-corporate bodies

FA 2019 amends the group rules set out in sections 43A to 43D VATA 1994 as regards the scope of the aforesaid eligibility condition by allowing non-corporate bodies to join a VAT group[13] and by setting out a corresponding control test.[14] FA 2019 extends the scope *ratione personae* of UK VAT grouping membership to "individuals" and "partnerships" by inserting the following into section 43A VATA 1994:

> "(4) An individual carrying on a business and one or more UK bodies corporate are eligible to be treated as members of a group if the individual—
>
> (a) controls the UK body corporate or all of the UK bodies corporate, and
>
> (b) is established, or has a fixed establishment, in the United Kingdom in relation to the business.
>
> (5) Two or more relevant persons carrying on a business in partnership…and one or more UK bodies corporate are eligible to be treated as members of a group if the partnership—
>
> (a) controls the UK body corporate or all of the UK bodies corporate, and
>
> (b) is established, or has a fixed establishment, in the United Kingdom in relation to the business."[15]

FA 2019 also inserts section 43AZA VATA 1994 as regards the control test for individuals and partnerships:

> "(3) An individual ('Y') controls a UK body corporate if Y would, were Y a company, be the UK body corporate's holding company.
>
> (4) Two or more relevant persons carrying on a business in partnership ('the partnership') control a UK body corporate if the partnership would, were it a company, be the UK body corporate's holding company."[16]

The possibility of UK non-corporate bodies joining a VAT group should be welcomed. Individuals and general[17] partnerships will enjoy the benefits associated with VAT grouping.

[12] HMRC, *Scope of VAT Grouping: Summary of responses* (December 2017) (last consultation 9 April 2019), available at: *https://www.gov.uk/government/consultations/scope-of-vat-grouping* [Accessed 3 July 2019].
[13] FA 2019 s.53 and Sch.18, para.1.
[14] FA 2019 s.53 and Sch.18, para.2.
[15] FA 2019 s.53 and Sch.18, para.1(4).
[16] FA 2019 s.53 and Sch.18, para.2.
[17] It is assumed that the new legislation refers to general partnerships in light of the Partnership Act 1890 in which all partners manage the business and are personally liable for their debts. Limited partnerships (LPs) (governed by the Limited Partnership Act 1907) and Limited Liability Partnerships (LLPs) (governed by the Limited Liability Partnership Act 2000) must be registered at Companies House and are subject to different rules. In relation to LPs containing at least one general partner and at least one limited partner, where the general partner is an incorporated company and a member of a VAT group, the business activities of the LP are part of that VAT group (see also HMRC, Guidance,

They will benefit from the fact that supplies between VAT group members are indeed disregarded for VAT purposes and also from expected administrative simplifications regarding the preparation and submission of one single VAT return for the whole group. However, this change in legislation also creates challenges and difficulties. The writers consider key elements below.

Individuals and partnerships must be "carrying on a business"

At first sight, the legislative amendments appear to ensure compliance with the *Larentia + Minerva* judgment.[18] The CJEU held indeed that, unlike other provisions of the PVD which expressly refer to "legal persons", Article 11 of the same directive refers to "persons" and does not exclude, of itself, from its scope of application, entities which do not have legal personality.[19]

The extension of UK VAT grouping membership to individuals and partnerships must thus be approved in so far as it ensures that VATA 1994 no longer discriminates between bodies corporate and non-bodies corporate.

However, it is unfortunate that the new provisions subordinate the inclusion of both individuals and partnerships in a VAT group to the condition of them "carrying on a business". So as to be eligible for VAT grouping, one would think that—from a VAT point of view—individuals and partnerships would have to be taxable persons through the undertaking of an economic activity for VAT purposes in accordance with Article 9 PVD. In the writers' view, the addition of such a condition restricting the inclusion of members in a VAT group to taxable persons does not conform to the EU judicature as it stands today. The CJEU held in *Commission v Ireland*[20] and *Commission v UK*[21] that "the first paragraph of Article 11 of the [PVD] does not make a distinction between taxable persons and non-taxable persons" in so far as VAT group membership is concerned.[22] The CJEU further stated that "it is not possible to uphold [that]…Article 11…must be interpreted as meaning that non-taxable persons cannot be included in a VAT group".[23] If the wording used in FA 2019, "carrying on a business",[24] must be construed in light of Article 9

Group and divisional registration (VAT Notice 700/2) (Group and divisional registration) (published 8 August 2014; last updated 19 March 2019), available at: *https://www.gov.uk/guidance/group-and-divisional-registration-vat-notice-7002* [Accessed 3 July 2019], paras 3.5 and 3.6). Note that some uncertainty exists as to whether LPs with more than one general partner and private fund limited partnerships (PFLPs) could join a VAT group. In relation to LLPs, since they are treated as bodies corporate, their inclusion in a VAT group is de facto possible. It must be pointed out that Scottish partnerships (general, LPs and PFLPs) have distinct legal personality and are as such allowed to be members of other partnerships.

[18] *Larentia + Minerva* (Joined Cases C-108/14 and C-109/14), above fn.10, EU:C:2015:496.

[19] *Larentia + Minerva* (Joined Cases C-108/14 and C-109/14), above fn.10, EU:C:2015:496 at [37]. Note that this view contrasts with the arguments raised in Advocate General (AG) Wathelet's Opinion in *Skandia America Corp (USA), filial Sverige v Skatteverket* (C-7/13) [2014] EU:C:2014:311 at [45]. The AG opined that the scope *ratione personae* of Article 11 PVD is narrower than Article 9 PVD (with regard to the concept of economic activity which refers to "*quiconque*" in French). The AG argued that the term "*personne*" (in French) in Article 11 PVD can only be understood in its ordinary sense, that is, being with legal personality. His view has, however, not been followed by the Court in *Skandia America Corp (USA), filial Sverige v Skatteverket* (*Skandia*) (C-7/13) EU:C:2014:2225.

[20] *Commission v Ireland* (C-85/11) EU:C:2013:217.

[21] *Commission v UK* (C-86/11) EU:C:2013:267.

[22] *Commission v Ireland* (C-85/11), above fn.20 EU:C:2013:217 at [36].

[23] *Commission v Ireland* (C-85/11), above fn.20, EU:C:2013:217 at [46] and *Commission v UK* (C-86/11), above fn.21, EU:C:2013:267 at [42].

[24] FA 2019 s.53 and Sch.18, para.1(4) and para.2.

PVD, it is the writers' view that the new legislation is too restrictive and is, it seems, not in compliance with CJEU case law.

Alternatively one may consider that the wording "carrying on a business"[25] should not necessarily have to be interpreted by reference to Article 9 PVD in the absence of an explicit quotation or clearer reference to the latter provision. The choice made by the UK legislator to opt for the word "business" rather than the words "economic activity" perhaps strengthens such an assertion.[26] One could be of the view that "business" simply means that an individual is in a position to control UK bodies corporates. According to this approach, individuals could be eligible for VAT group membership if they are merely holding shares and not engaged in an economic activity as a result.[27] On the other hand, it could mean business for "partnership purposes"[28] rather than for "VAT purposes" as regards partnerships. A partnership of course is by definition in business (the partnership is defined as "the relation which exists between persons carrying on a business in common with a view to profit"[29]), but an individual may not be, and to treat bodies corporate and non-bodies corporate differently (as dormant companies and passive holding companies can join UK VAT groups if the other conditions are met) seems odd.

In the writers' view, the ambiguity in the text is sadly unhelpful. The meaning and scope of "carrying on a business" will have to be clarified by HMRC upon entry into force of the new legislation.

The control test

In order to be eligible for VAT grouping, individuals and partnerships must "control" the UK body corporate or all UK bodies corporate. The control test inserted by FA 2019[30] does not amount to any new test. An individual or partnership is treated as controlling a body corporate if it would be the body corporate's holding company, were it a company. The perspective taken in the UK therefore mainly focuses on the "financial link" (that is, control aspect) without much regard being given to the organisational and economic links as it may be the case in other EU Member States.[31]

In the writers' view, the control test may be too narrow in some circumstances. For instance, suppose an individual is a 51 per cent partner in a partnership and also owns 100 per cent of a

[25] FA 2019 s.53 and Sch.18, para.1(4) and para.2.

[26] One must also underline that although the original draft legislation foresaw a condition that the individual or partnership be liable to be, or entitled to be, VAT registered according to VATA 1994 Sch.1 this has not been carried into the final legislation which suggests at least, that no taxable activity must be undertaken by the individual or partnership.

[27] The mere holding of shares does not represent an economic activity for VAT purposes. See inter alia *Cibo Participations SA v Directeur régional des impôts du Nord-Pas-de-Calais* (C-16/00) EU:C:2001:495 at [19] and *Portugal Telecom SGPS SA v Fazenda Pública* (C-496/11) EU:C:2012:557 at [32]).

[28] Partnership Act 1890 s.1(1) defines Partnership as "the relation which subsists between persons carrying on a business in common with a view of profit".

[29] Partnership Act 1980 s.(1).

[30] FA 2019 s.53 and Sch.18, para.2.

[31] For instance, in Germany, Italy and Sweden, the financial link (that is, generally 50% of the voting rights) must also encompass additional requirements such as the carrying out of the same type of activity by group members, and the subsidiaries must act as departments with respect to the overall business of the group or even with respect to joint management or joint marketing.

corporate body. The corporate body is not be eligible to be in a VAT group with the partnership under the new legislation.[32] It must be added that the control test also means that an individual cannot be VAT grouped with only a partnership[33] (in which all partners manage the business and are personally liable for their debts) since it must be VAT grouped with one or more bodies corporate. On the flip side, since the existing control test has not changed, current VAT group structures will not have to reassess whether existing members are still eligible for grouping, which provides legal certainty.

Individuals and partnerships must be established or have a fixed establishment in the UK

In order to be eligible for VAT grouping, individuals and partnerships must also be established or have a fixed establishment in the UK. This condition is likely to be fraught with great practical and technical difficulties.

First, from a practical standpoint, the inclusion of individuals and partnerships (which may be comprised of both natural and artificial (legal) persons) raises the question as to how one should determine whether they are established in the UK.

As regards individuals, one should consider their place of residence. This would require HMRC to monitor and police the physical presence of these individuals in the UK. Presumably one would consider their establishment in the UK based on whether they are tax resident in the UK for income tax purposes? HMRC would have to cross-reference information available for income tax purposes in order to ascertain the eligibility criterion for VAT group. If no tax information is available, would HMRC require the individual to confirm its residence in the UK via a declaration? In relation to partnerships, similar issues arise. Since partnerships may have partners that are both UK and non-UK resident, how will HMRC determine whether a partnership is indeed established in the UK? For instance, by considering whether the majority of partners are UK-resident for income tax purposes or where the essential day-to-day decisions concerning the general management of the business are taken? It is hoped that HMRC will shed light on these questions in order to bring legal certainty for eligibility purposes.

Secondly, the determination of whether non-UK based individuals and partnerships have a fixed establishment in the UK in order to be eligible for UK VAT grouping is likely to trigger difficulties. HMRC currently state that a company has a "fixed establishment" in the UK if it has a real and permanent trading presence in the UK[34]; for instance, if either it has a permanent place of business or a branch/office which has sufficient permanent human and technical resources to carry on one or more of the business activities of the company as a whole and make supplies directly from the UK establishment.[35] HMRC further highlight that it is not sufficient for the fixed establishment to merely receive supplies, it also needs to make supplies.[36] The approach taken by HMRC is hardly reconcilable with the concept of "passive" fixed establishment (a

[32] ICAEW, *VAT group registration (CL18 and Sch10, F3B17-19)* (28 August 2018), 3, para.11.
[33] It would thus be possible to VAT group with a LLP which is of course a body corporate, see S. Welsh, "FA 2019: VAT groups" [2019] 1439 *Tax Journal* 8.
[34] HMRC, *Group and divisional registration*, above fn.17, para.10.4.
[35] HMRC, *Group and divisional registration*, above fn.17.
[36] HMRC, *Group and divisional registration*, above fn.17.

concept clearly envisaged in Implementing Regulation 282/2011) which does not require the establishment to make any supplies but rather simply to receive supplies for its own needs.[37]

The writers would expect HMRC to apply the same reasoning as regards individuals and partnerships so that they would be required to carry out supplies to third parties from their UK fixed establishment in order to be eligible for UK VAT grouping. In the writers' view, HMRC's abovementioned position would probably impede the right for overseas individuals or partnerships to be seen as having a UK fixed establishment for VAT grouping purposes in the situation where the UK establishment would not generate any income from third parties in the UK.[38]

It is also at present unclear whether this revised concept of the meaning of fixed establishment is limited to VAT grouping eligibility or will have a wider effect (on the ability of UK representative offices with human and technical resources in the UK to register for UK VAT based on the taxable supplies made outside the UK from other non UK establishments, for instance). Based on the writers' recent practical experience, and extant guidance for non VAT group registrations, HMRC's position seems to suggest that a fixed establishment for VAT grouping purposes would differ from a fixed establishment registered on a standalone basis under Schedule 1 VATA 1994. HMRC seem to draw a distinction between these two categories of fixed establishments without convincing legal grounds. That said, HMRC will probably more and more require any type of fixed establishment—that is, within a VAT group or not—to undertake supplies instead of merely receiving services in order to either register for UK VAT or to be eligible for VAT grouping.

This raises another issue, as if a passive fixed establishment is not a fixed establishment for registration purposes, it presumably has no liability to account for reverse charge VAT on any taxable services it receives from abroad. Reverse charge services can create a liability to register for UK VAT, even in the absence of any other supplies, if the value is high enough. The writers respectfully opine that one should instead rely on a single definition of fixed establishment in light of CJEU case law and the UK[39] and EU legal framework.

Joint and several liability as a barrier?

As set forth above, VAT grouping membership entails a joint and several liability between VAT group members for VAT debts.[40] In practice, VAT group members would usually conclude an agreement between themselves which sets out the rules with regard to any issues that could arise between them and/or vis-à-vis HMRC.

[37] 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 Art.11 sets out that "[f]or the application of Article 44 of [PVD], 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 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*" (writers' emphasis). See also R. Mikutiené, "The preferred treatment of the fixed establishment in European VAT" (2014) 3(3) *World Journal of VAT/GST Law* 166, 180.

[38] Intra-entity supplies should be disregarded for VAT purposes as per the judgment in *Ministero dell'Economia e delle Finanze and Agenzia delle Entrate v FCE Bank plc* (C-210/04) EU:C:2006:196.

[39] VATA 1994 Sch.1 provides for the possibility to register for VAT a UK fixed establishment even though supplies to third parties are not made from such an establishment but rather from the overseas head-office, as longs as the supplies would be taxable if made in the UK.

[40] VATA 1994 s.43(1).

The exposure to joint and several liability is likely to prove unattractive for individuals and partnerships since they do not benefit from limited liability. For limited companies and LLPs, it is the corporate body that is liable for debts, not the directors, whereas individuals will be personally liable (on their personal assets, including residential property). This may cause serious issues should any liabilities arise in other companies which could then rest with the individual to discharge.[41] As regards partnerships, a similar concern applies. The risk of joining a VAT group may be too high for a partnership whose general partners bear joint liability without limits for debts of the partnership. One possibility could be to limit the joint and several liability to specific assets, and exclude for instance the residential property of an individual. This should be possible since HMRC currently set out an exception in respect of corporate trustees in a VAT group following which the liability does not extend to the assets of the pension fund, except where the debt is attributable in whole or in part to the administration of the trust.[42]

HMRC's recent changes in VAT Notice 700/2

The final part of this note briefly considers some updates announced by HMRC in respect of an anti-avoidance provisions in sections 43(2A) and 43C VATA 1994.

Section 43(2A) VATA 1994 is complex legislation intended to block a particular type of VAT planning which relies on the UK's approach to treating a UK VAT group as including all the establishments of the members, no matter where they are located (in the UK or overseas).

Without section 43(2A) VATA 1994, the services that would be subject to VAT if supplied in the UK could be bought VAT free by a non UK establishment of a VAT group member, and then imported into the UK VAT free as transactions between parts of the same entity are not supplies, and then used to make VAT free supplies to the other group members as supplies between VAT group members are disregarded.[43] Section 43(2A) VATA 1994 disapplies the disregard in this situation. Since the UK has not applied the CJEU decision in *Skandia America Corp (USA), filial Sverige v Skatteverket* (*Skandia*) (which said that a VAT group is a separate taxable person from any establishments of its members elsewhere)[44] across the board, section 43(2A) VATA 1994 is needed. The UK only applies *Skandia* where the overseas establishment is a member of a VAT group in a Member State which has a territorial approach to VAT grouping ("Swedish-style approach").

Calculating the value on which VAT is due can prove difficult. The law allows the value of the supply to be reduced to the amount that is the sum of the "bought-in" services that are used in the making of the onward intra group supply. HMRC have recently updated their guidance in *Group and divisional registration (VAT Notice 700/2)*[45] on section 43(2A) VATA 1994 to set out what is meant by "bought-in" and to clarify that trifling charges can be excluded. The revised HMRC VAT Notice 700/2 includes the following statements:

[41] S. Beusch and S. Addison, "VAT grouping: where we are now?" [2018] 1396 *Tax Journal* 17.
[42] HMRC, Internal Manual, *VAT Input Tax* (published 13 April 2016; updated 11 April 2019), VIT45440.
[43] This practice is also known as "channelling".
[44] *Skandia* (C-7/13), above fn.19, EU:C:2014:2225.
[45] HMRC, *Group and divisional registration*, above fn.17.

- Section 43(2A) VATA 1994 is not restricted to instances of avoidance and has always applied to relevant transactions regardless of subjective purpose.
- The charge is on the whole of the intra-group supply, but can be reduced to the value of the bought-in services used in making the onward supply (paragraph 8A of Schedule 6 VATA 1994). Bought-in services include agency and contract staff in certain circumstances, telecoms, legal and professional services, IT costs, consultancies and marketing services.
- VAT need not be accounted for where the charge is "trifling" (under £7,500 per year).[46]

HMRC have also updated section 4 of VAT Notice 700/2 on use of their revenue protection powers (section 43C VATA 1994). Specifically, HMRC will exercise these powers where they consider that revenue loss does not follow the normal operation of grouping or there is a significant VAT advantage; for instance, where the parties' essential aim in VAT grouping a particular company is to disregard supplies from overseas establishments of that company, or where the supplies in the UK between the UK establishment and other VAT group companies are disproportionately small compared to the supplies between an overseas establishment and other VAT group companies.

The updated VAT Notice 700/2 applies from 1 April 2019 and will be further updated to reflect the FA 2019 changes to VAT group eligibility.

Conclusion

VAT grouping is a valuable easement for many UK businesses but as with any structures that result in VAT savings, complex anti-avoidance provisions apply. The widening of the eligibility for grouping membership as announced in FA 2019 is welcome but creates other complexities which the writers hope HMRC will endeavour to resolve. The policy change on the meaning of fixed establishment is less welcome and seems, in the view of the writers, to be flawed. The additional clarity with regard to sections 43(2A) and 43C VATA 1994 is appreciated.

To return to where the writers started, Cicero wrote admiringly:

> "The Gallic War is splendid. It is bare, straight and handsome, stripped of rhetorical ornament like an athlete of his clothes.…There is nothing in a history more attractive than clean and lucid brevity."[47]

One could say the same of VAT law… ☙

Philippe Gamito[*] and Karen Killington[**]

[46] HMRC, *Group and divisional registration*, above fn.17, "7. Section 43(2A) intra-group charges on supplies of services."
[47] *The Gallic War*, above fn.1.

☙ Entitlement; Tax avoidance; VAT groups

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Section 66: residence nil-rate band

The inheritance tax (IHT) residence nil-rate band rules cry out for simplification, either by total abolition or by turning them into extra nil-rate band for property of any kind left to descendants. Unfortunately the former would mean broken promises to the "grey vote", and the latter would mean a reduction in tax revenue, and in any case the Government appears far too busy thinking about Brexit to think about simplifying tax law. Meanwhile there is, in this section, a small mixed bag of minor amendments, which apply to the estates of persons dying after 29 October 2018.[1]

Background

The term residence nil-rate band refers to an extra amount of the estate of anyone dying on or after 6 April 2017 which is charged to IHT at a nil rate, where there is property in the estate falling into either or both of two categories, and various complicated conditions are fulfilled. The first category is a "qualifying residential interest" comprised in the deceased person's estate which is "closely inherited".[2] The second is property in the estate other than a "qualifying residential interest" which is "closely inherited" where a "qualifying residential interest" was sold or given away on or after 8 July 2015 by the deceased during his or her life.[3] The extra nil-rate band in the latter case is known as a "downsizing addition". The amount of available residence nil-rate band is limited by the value of the relevant qualifying residential interest and also by a cash limit which was £100,000 for deaths in the tax year 2017–18, and is increased in instalments of £25,000 for deaths in each succeeding tax year until it becomes £175,000 for deaths in 2020–21 (subject to indexation thereafter).[4] To this may be added any "brought-forward allowance" not used by a predeceasing spouse or civil partner (this operates as a percentage increase, not exceeding 100 per cent, of the survivor's allowance on the same lines as nil-rate band transfer under section 8A of the Inheritance Tax Act 1984 (IHTA)).[5] The resulting cash limit is the "default allowance". The amount of available extra nil-rate band is then reduced by £1 for every £2 by which the value of the deceased's estate exceeds the "taper threshold" (initially £2 million, subject to indexation after 2020–21), turning the "default allowance" into an "adjusted allowance",[6] or no allowance at all where the estate is large enough. A "qualifying residential interest" is an interest or interests in a residence in which the deceased lived at a time when he or she owned an interest in it.[7] Property is "closely inherited" if it is inherited by descendants, including stepchildren, foster children, and children subject to guardianship, or by spouses or civil partners of descendants.[8]

[1] FA 2019 s.66(6).
[2] IHTA ss.8D–8M inserted by F(No.2)A 2015 s.9.
[3] IHTA ss.8FA–8FE inserted by FA 2016 Sch.15.
[4] IHTA s.8D(5)(a).
[5] IHTA ss.8D(5)(f) and 8G.
[6] IHTA ss.8D(5)(g) and 8E.
[7] IHTA s.8H.
[8] IHTA s.8K.

The downsizing addition comes in two alternative categories: "low value death-interest in home"; and "no residential interest at death". There has to be worked out the "lost relievable amount" based on the value of the residential interest disposed of.[9] There is then included in the calculations whichever is the less of the lost relievable amount, or the amount of the estate apart from any qualifying residential interest which is closely inherited.[10]

Section 66(2) and (3) FA 2019

These are amendments to the rules for the downsizing addition in the "low value death-interest in home" category. They substitute the value of the whole estate (that is, including any exempt property) for "VT" (that is, the value of such of the estate as is chargeable to IHT) at certain points in some complex rules. It is not obvious at first glance what the consequences of these amendments are, and in particular whether they favour the taxpayer or the Treasury. An example is needed.

George and Caroline live in, and own as tenants in common in equal shares, Mega House. It is a second marriage for both, the first marriages having ended in divorce. George has a son, Fred, by a previous wife. George and Caroline sell Mega House for £600,000 in March 2016. They then buy, as tenants in common in equal shares, Ty Bach in rural Wales for £190,000. They go to live there. George dies in January 2019. He had not made any lifetime gifts above the IHT annual exemption in the seven years preceding his death. He leaves his share of Ty Bach to Caroline, a pecuniary legacy of £700,000 to Fred, and the residue of his estate to Caroline. At George's death his estate is worth £1,500,000 including his half share of Ty Bach worth £100,000. His share of Ty Bach and his residue apart from the pecuniary legacies are exempt from IHT as gifts to his spouse, with the consequence that they form part of the transfer of value by him on his death but do not form part of the chargeable part of his estate or "VT" as it is called in this context.

Chasing through the legislation, this example is not a section 8E IHTA case because none of George's share of Ty Bach is closely inherited. The next section to look at is section 8FA 1984, which sets out the conditions for a downsizing addition where there is a qualifying residential interest comprised in the estate. Condition A in section 8FA IHTA is fulfilled in this example by virtue of section 8FA(2)(b)(i) IHTA: the value transferred by the transfer of value on George's death attributable to his share of Ty Bach is less than his default allowance of £125,000 by £25,000. If George had died before the amendment made by this section had come into force, the difference would have been the whole of the £125,000 default allowance since none of "VT" (the part of the estate chargeable to IHT) is attributable to his share of Ty Bach. Conditions B and C are satisfied as none of VT (the part of the estate chargeable to IHT) is attributable to George's share of Ty Bach, and his share of Mega House is a qualifying former residential interest in relation to him. Condition D, which is also amended by section 66(2) of the Finance Act 2019 (FA 2019), is satisfied in that the value of George's share of Mega House (£300,000) is greater than the value of his share of Ty Bach by £200,000. If George had died before the amendments made by this section had come into force, the difference would have been the whole

[9] IHTA ss.8FA(8), 8FB(7), 8FE.
[10] IHTA ss.8FC, 8FD.

of his £300,000 share of Mega House. Condition E is satisfied in that a £700,000 part of the estate is closely inherited in the form of the gift to Fred. Assume a claim for the downsizing addition satisfying Condition F.

The next stage is to calculate the "lost relievable amount" in accordance with the steps set out in section 8FE(9) IHTA:

- *Step 1*: express the value of George's former residential interest as a percentage of his former allowance, but take it to be 100 per cent if it would otherwise be higher. His "former allowance" is £100,000.[11] The value of his share of Mega House on completion of the sale was £300,000. Accordingly this percentage is 100 per cent.
- *Step 2*: express the qualifying residential interest as a percentage of George's allowance on death, where the qualifying residential interest is so much of the value transferred by the transfer of value on death as is attributable to the person's qualifying residential interest, taking 100 per cent if it would otherwise be higher. George's allowance on death is the default allowance of £125,000.[12] His qualifying residential interest (his share of Ty Bach) is £100,000. This percentage is thus 80 per cent. This is another place where the transfer of value on death, including exempt property, has been substituted for VT, the chargeable part of the estate, in this case by section 66(3) FA 2019. If George had died before these amendments came into force this percentage would be zero.
- *Step 3*: subtract the Step 2 percentage from the Step 1 percentage: 100 per cent – 80 per cent = 20 per cent. If George had died before these amendments came into force this would have come out as 100 per cent.
- *Step 4*: the percentage arrived at in Step 3 is applied to the allowance on death to ascertain the lost relievable amount. 20 per cent of £125,000 is £25,000. If George had died before these amendments came into force, this would have been the full £125,000.

Next go to section 8FA(8) IHTA. The downsizing addition on George's death is equal to the lost relievable amount of £25,000. In other words, the chargeable part of the estate, which is Fred's £700,000 legacy, has the benefit of the general nil-rate band of £325,000 and a downsizing addition of £25,000. If George had died before these amendments came into force the downsizing addition would have been £125,000.

Conclusion on Section 66(2) and (3) FA 2019 (for those who do not have the time or patience to work through the example above)

These amendments are loophole-closing provisions which favour the Treasury. Although in the above example the unused proportion of George's allowance can be carried forward to Caroline's estate on her death, what cannot be carried forward is the potential benefit in any downsizing addition calculations of the sale of his share of Mega House. On facts such as those in the above

[11] IHTA s.8FE(3)(a) and (6).
[12] IHTA s.8FE(7)(a).

example, these amendments defer to the second death much of the benefit of the residence nil-rate band. Also, on some facts (though not on those in this example) the amendments will reduce the aggregate amount of residence nil-rate band available over both deaths. The amendments have the justification that they remove an anomaly, and make the legislation more consistent with the policy of only allowing downsizing addition to the extent that the value of any former residential interest exceeds that of any qualifying residential interest possessed at death.

Section 66(4) FA 2019

This seems to be a piece of draftsman's tidying. It is very hard to see how the effect of section 8E(1) IHTA is changed by the insertion of the words "on the person's death" after "section 4".

Section 66(5) FA 2019

Section 8J(6) IHTA defines what counts as inheritance by a person, "B", for the purposes of the residence nil-rate band rules where the property in question has been the subject of a lifetime disposal by way of gift by a deceased person, but, because it is property subject to a reservation under section 102 of the Finance Act 1986, the gifted property is treated as part of the estate on death of the deceased person. This amendment provides that such property is treated as inherited by B only if the property became comprised in the (IHT taxable) estate of B when the lifetime disposal by way of gift was made. The wording which is replaced was that the property would be treated as inherited by B where B is the person to whom the disposal was made. The latter wording arguably left open the possibility that the criterion for inheritance by B would be fulfilled where, for example, the disposal was a gift in settlement where B was a trustee and had an interest in possession, but the settled property was subject to IHT under the "relevant property" regime and thus not part of the estate of B. ☙

Richard Wallington[*]

Section 83: resolution of double taxation disputes

This section amends the Taxation (International and Other Provisions) Act 2010 by making provision for regulations, and for consequential amendments, to give effect to Council Directive 2017/1852[1] on tax dispute resolution mechanisms.[2] That Directive requires Member States to bring laws into force to comply with the Directive by 30 June 2019. The UK has already published

☙ Inheritance tax; Residence nil-rate band

[*] Barrister.

[1] Council Directive (EU) 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union [2017] OJ L265/1. The text is available at: *https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017L1852&from=ES* [Accessed 15 July 2019].

[2] A full discussion of dispute resolution mechanisms within the EU is beyond the scope of this note. However, there is an excellent and comprehensive discussion of this topic in the recently published book: Harm Mark Pit, *Dispute Resolution in the EU* (Amsterdam: IBFD, 2018).

for consultation draft regulations to give effect to the Directive: the Draft Double Taxation Dispute Resolution (EU) Regulations 2019.[3]

Section 83 of the Finance Act 2019 has quite a long provenance. In 1990, the then Member States of the European Economic Community adopted the Arbitration Convention.[4] That introduced the concept of arbitration of cross-border tax disputes concerning transfer pricing where it had not proved possible to resolve the dispute through the normal mutual agreement procedure. In recent years there have been discussions about either extending the Arbitration Convention to other forms of disputes, or replacing it by a Directive. Finally, Directive 2017/1852 was adopted in October 2017. It provides for various procedures (including arbitration and alternative dispute resolution mechanisms) to be introduced for the resolution of cross-border, business tax disputes.

The Directive has entered into force while the UK is still a member of the EU; the UK is, therefore, obliged to give effect to the Directive. If the UK leaves the EU, whether with or without a transitional period, an ultimate decision will need to be taken as to the continuation of provisions for the resolution of cross-border tax disputes. Since the UK is broadly committed to the arbitration of tax disputes, it seems likely that equivalent arrangements will continue to be implemented if the UK does eventually leave the EU. ☙

Philip Baker

Section 84: international tax enforcement: disclosable arrangements

This section makes provision for regulations extending the disclosure of tax avoidance schemes (DOTAS) to various cross-border arrangements where the UK has an obligation to introduce legislation and make provision for exchange of such disclosures under certain international tax provisions.

The background is interesting. In 2014 the OECD introduced the Common Reporting Standard (CRS) as part of the automatic exchange of financial information for tax purposes. Shortly after that, the OECD picked up rumours that various intermediaries were devising schemes to protect client confidentiality or to frustrate the purposes of automatic exchange (depending on how you look at it). The OECD then took a leaf out of the practice of a number of countries (including the UK) in respect of domestic tax avoidance, and proposed rules for the automatic disclosure of schemes that were developed for CRS avoidance. In 2018,[1] the OECD issued Model Mandatory

[3] HMRC, *Double Taxation Dispute Resolution (EU) Regulations* (1 July 2019), available at: *https://www.gov.uk/government/consultations/double-taxation-dispute-resolution-eu-regulations* [Accessed 15 July 2019].

[4] Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises [1990] OJ L225/10.

☙ Arbitration; Brexit; Cross-border disputes; Dispute resolution; Double taxation; EU law

[1] For the press release on these model rules, see OECD, *Game over for CRS avoidance! OECD adopts tax disclosure rules for advisors* (2018), available at: *https://www.oecd.org/tax/exchange-of-tax-information/game-over-for-crs-avoidance-oecd-adopts-tax-disclosure-rules-for-advisors.htm* [Accessed 15 July 2019].

Disclosure Rules[2] that require various intermediaries to disclose arrangements for the avoidance of CRS or that involve the creation of opaque offshore structures.

As has frequently been seen in the last few years since the start of the BEPS Project, the EU then decided to go one further than the OECD on this matter. Council Directive 2018/822[3]—usually referred to as "DAC6"—introduced a general requirement for Member States to require disclosure of tax avoidance schemes which involve cross-border arrangements and display certain hallmarks. This is broader than the OECD Model Mandatory Disclosure Rules.

The Directive requires Member States to adopt legislation to give effect to it by 31 December 2019, and for those rules to apply from 1 July 2020.[4] By those dates, the UK may have left the EU, with or without a withdrawal agreement and with or without a transitional period. It is not clear, therefore, whether the UK will ultimately be obliged to comply with this Directive.

The UK has not yet decided whether to adopt the OECD Model Mandatory Disclosure Rules. However, if the UK decides to do so, or if the UK is ultimately bound to apply the Directive, section 84 of the Finance Act 2019 makes provision for regulations to give effect to the obligations undertaken.

Philip Baker

Section 87: voluntary returns

A curious hole in the self-assessment return framework has been exposed by the First-tier Tribunal (FTT) over the past few years.[1] The hole concerns so-called "voluntary" tax returns, that is, returns which are not submitted in response to a notice to file issued by HMRC which, it turns out, are not tax returns at all.[2] There are all sorts of reasons why such a return might be submitted, most obviously where the taxpayer is not already in the self-assessment system, and it appears that there are many such returns submitted each year.[3]

Although the general practice of HMRC is to treat these returns as equivalent to those made in response to a notice to file,[4] many of the legal processes which follow a tax return are not

[2] OECD, *Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures* (Paris: OECD, 2018), available at: *https://www.oecd.org/tax/exchange-of-tax-information/model-mandatory-disclosure-rules-for-crs-avoidance-arrangements-and-opaque-offshore-structures.htm* [Accessed 15 July 2019].

[3] Council Directive (EU) 2018/822 of 25 May 2018 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements [2018] OJ L139/1, available at: *https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32018L0822* [Accessed 15 July 2019].

[4] Directive 2018/822, above fn.3, Art.2.

Brexit; Common Reporting Standard; Cross-border transactions; Disclosure; EU law; Exchange of information; International taxation

[1] *Patel v HMRC* (*Patel*) [2018] UKFTT 185 (TC); *Revell v HMRC* [2016] UKFTT 97 (TC); and *Bloomsbury Verlag GmbH v HMRC* (*Bloomsbury*) [2015] UKFTT 660 (TC).

[2] In relation to income tax returns, the notice is issued under TMA 1970 s.8 (individuals), s.8A (trustees) and s.12AA (partnerships). In relation to corporation tax, the relevant provision is FA 1998 Sch.18 para.3.

[3] *Patel*, above fn.1, [2018] UKFTT 185 (TC) at [38].

[4] HMRC, Policy paper, *Income Tax, Capital Gains Tax and Corporation Tax: voluntary tax returns* (29 October 2018).

strictly available, for example HMRC's right to open an enquiry[5] and consequently issue a closure notice. It is not only HMRC which find their statutory rights curtailed: for example, if a return is not a return under legislation, penalties for failure to submit a return might be sought from the taxpayer, or the taxpayer might fail to establish a loss.[6]

As a result of HMRC practice, the hole does seem to have been successfully navigated to a very large extent over the two decades or so since the introduction of self-assessment, but in order to put things on a more secure footing, it has been decided that it is time to fill it.

Section 87 of the Finance Act 2019 inserts section 12D into the Taxes Management Act 1970[7] and paragraph 20A into Schedule 18 to the Finance Act 1998.[8] The amendments provide that where a "purported" return is treated by HMRC as a return subsequent to a notice to file, notice is deemed to have been given on the date that the return was made and the return is deemed to have been made in pursuance of that notice.[9] In order to receive this treatment, the return must "purport" to be a return, and must be "delivered in a way…that a corresponding return could have been made and delivered had a relevant notice been given".[10]

The meaning of "purported tax return" is likely to be unproblematic. The requirement that it must be "treated"[11] by HMRC as a return is slightly odd, as it is not entirely clear what it means to treat something as a return, although in practice such treatment will likely be some sort of response such as an enquiry or a call for the tax due.

The amendments are treated as always having been in force,[12] except where, before 29 October 2018, the taxpayer started legal proceedings (appeal or judicial review) on the basis that the return was *not* a return.[13]

To a large extent the amendments provide statutory authority for HMRC's general practice of treating unsolicited returns as valid returns. ☙

Sandra Eden

[5] TMA 1970 s.9A provides that HMRC "may enquire into a return under section 8 or 8A of this Act". TMA 1970 s.8, for example, provides: "(1) For the purpose of establishing the amounts in which a person is chargeable to income tax and capital gains tax for a year of assessment, and the amount payable by him by way of income tax for that year, he may be required by a notice given to him by an officer of the Board—(a) to make and deliver to the officer, a return containing such information as may reasonably be required in pursuance of the notice,…." Thus a return submitted without a notice to file is not a return within TMA 1970 s.8.

[6] Although the taxpayer successfully established the loss in *Bloomsbury*, above fn.1, [2015] UKFTT 660 (TC) despite the "return" not actually being a return, this may not always be possible.

[7] FA 2019 s.87(1).

[8] FA 2019 s.87(2).

[9] TMA 1970 s.12D(2); FA 1998 Sch.18 para.20A(2).

[10] TMA 1970 s.12D(4)(a) and (b); FA 1998 Sch.18 para.20A(4)(a) and (b).

[11] TMA 1970 s.12D(1)(c); FA 1998 Sch.18 para.20A(1)(c).

[12] FA 2019 s.87(3).

[13] FA 2019 s.87(4).

☙ Self-assessment; Tax returns

Section 90: minor amendments in consequence of EU withdrawal

A section which has as its short title the heading above may give the impression of insignificance. The body of section 90 of the Finance Act 2019 (FA 2019) does not, however, use the word "minor". It simply gives the Treasury power to make regulations in a number of areas. The *Finance (No.3) Bill Explanatory Notes* (Explanatory Notes) give the following assurance:

> "This clause allows the government to make minor amendments, for example to EU references, within tax law to keep tax law working in the same way as it does now if the UK leaves the EU without a deal."[1]

As an example of a minor amendment the Explanatory Notes give the replacement of references to the EU with references to the EU and the UK. Perhaps the references will be minor in linguistic terms. It seems that they are unlikely, necessarily, to be minor in practical terms.

For those who find the concept of Parliamentary intention of enduring interest it may be worth noting that the Background Note in the Explanatory Notes states:

> "This clause will ensures [sic] that tax law can continue to have the effect intended by Parliament after the UK has exited the EU."[2]

Only a naive reader would take that as some indication that Parliament, long ago, had some premonition that the UK would leave the EU.

Section 90(1) FA 2019 sets out five areas of tax law in respect of which the regulations may make provision. They may be made for the purposes of maintaining the effect of any relevant tax legislation on the withdrawal of the UK from the EU and for the purpose of any relevant tax in connection with regulations, made under section 8 of the European Union (Withdrawal) Act 2018, to remedy deficiencies in retained EU law.[3] Other purposes follow relating to references to euros, removing references to the EU in legislation concerned with overpayments of excise duty, insurance premium tax and landfill tax and amending section 173 of the Finance Act 2006 on international enforcement arrangements, for certain purposes to do with disclosure of information.[4]

The regulations may amend any enactment, contain incidental, transitional or saving provisions or "make different provision for different purposes".[5] They are to be subject to the negative resolution procedure.[6]

The provisions of section 90 FA 2019 "only come into force"[7] in three situations. These are, first, if

[1] HM Treasury, *Finance (No.3) Bill Explanatory Notes* (November 2018), available at: *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/754255/Finance__No__3__Bill_Explanatory_Notes.pdf* [Accessed 3 July 2019], "Clause 89: Minor amendments in consequence of EU withdrawal", 258, para.1.
[2] Explanatory Notes, above fn.1, 259, para.11.
[3] FA 2019 s.90(1)(a)(b).
[4] FA 2019 s.90(1)(c)-(e)
[5] FA 2019 s.90(2)(a)-(c).
[6] FA 2019 s.90(5).
[7] FA 2019 s.90(7).

> "a negotiated withdrawal agreement and a framework for the future relationship have been approved by a resolution of the House of Commons on a motion moved by a Minister of the Crown for the purposes of section 13(1)(b) of the European Union (Withdrawal) Act 2018".[8]

The second situation is that there has been a request to extend the Article 50 period pursuant to Article 50(3) of the Treaty on European Union. The third is that

> "leaving the European Union without a withdrawal agreement and a framework for the future relationship has been approved by a resolution of the House of Commons on a motion moved by a Minister of the Crown".[9]

So, whatever one may have assumed from reading the Explanatory Note quoted at the beginning, section 90 FA 2019 does not have effect only "if the UK leaves the EU without a deal". Furthermore, it may do little to defuse the controversy surrounding the use of statutory instruments in the Brexit process.

Timothy Lyons

[8] FA 2019 s.90(7)(a).
[9] FA 2019 s.90(7)(c).

Brexit; Negative resolution procedure; Regulations; Tax administration

Case Notes

Praesto Consulting UK Ltd v HMRC: input tax credit—a focus on substance and reality

Introduction

Praesto Consulting UK Ltd v HMRC (*Praesto CA*)[1] concerned a claim for an input tax credit in relation to legal services supplied to a company. The person subject to the legal proceedings was, however, the director of the company, rather than the company itself. How did this affect the VAT position?

Mr Ranson was a former employee of Customer Systems plc (CSP). He resigned and set up Praesto in direct competition with CSP as it was also a consultancy business in the same field. On 4 November 2009 solicitors acting for CSP wrote a letter before action to Mr Ranson (who was identified as the proposed defendant). It alleged that Mr Ranson had breached his contract of employment and fiduciary duties owed to CSP. Notably, the letter also referred to the possibility of "further matters warranting claims against you and/or against Praesto". However, Praesto was never in fact formally joined as a party. Praesto paid the legal fees relating to Mr Ranson in civil proceedings brought by CSP. Praesto then claimed an input tax credit totalling £79,932 in its VAT return, and HMRC issued a notice of assessment (the assessment which was the subject of this appeal) in order to recover the input tax claimed.

In summary, the basis of the assessment against Praesto was HMRC's conclusion that the legal fees were not incurred by Praesto for the purposes of its business. Praesto maintained that they had in fact been incurred for the purposes of its business, as the reality was that CSP was pursuing both Mr Ranson and Praesto, even if Praesto was never formally joined as a party.

In the first instance, the First-tier Tribunal (FTT) held in favour of Praesto, holding that the economic reality was such that services had been supplied to Praesto and that there was a direct and immediate link between the services supplied and the taxable activities of Praesto.[2] The Upper Tribunal (UT)[3] reversed this decision, holding that not only had the services not been supplied to Praesto, but the case of *Finanzamt Köln-Nord v Becker* (*Becker*)[4] applied such that there was no such direct and immediate link. The majority in the Court of Appeal found in favour of Praesto for the reasons given by the FTT. Sir Terence Etherton MR dissented.

This case note will set out the findings of the Court of Appeal, before commenting on the wider implications (or lack thereof in a practical sense) of the case.

[1] *Praesto Consulting UK Ltd v HMRC* [2019] EWCA Civ 353.
[2] *Praesto Consulting UK Ltd v HMRC* [2016] UKFTT 495 (TC).
[3] *HMRC v Praesto Consulting UK Ltd* [2017] UKUT 395 (TCC).
[4] *Finanzamt Köln-Nord v Becker* (C-104/12) EU:C:2013:99.

The decision of the Court of Appeal

In the Court of Appeal, Lord Justice Hamblen gave the following judgment. First, as in the lower courts, it was held that there were two issues to be determined: did the FTT err in law in concluding that the invoices related to services supplied to Praesto (Issue 1); and did the FTT err in law in concluding that the services supplied by Sintons, the firm of solicitors instructed by Mr Ranson and Praesto had a direct and immediate link to Praesto's taxable activities (Issue 2)?[5]

It was noted regarding Issue 1 that it was hardly surprising that the evidence relating to this was not as extensive as it might have been, as it was raised shortly before the FTT hearing.[6] The judgment goes on to find that, despite the FTT making no express finding of a contractual relationship between Sintons and Praesto, the findings made (such as instructions being given throughout on behalf of Mr Ranson and Praesto, Sintons acting on behalf of both regarding the litigation, both parties being clients of Sintons and all work completed on behalf of both parties) clearly established such a relationship.[7] The UT had ignored "a number of critical findings made by the FTT".[8]

It was also held that the contractual relationship reflected the economic reality, as the FTT had found that the reality was that Sintons acted on behalf of *both* parties, "in relation to what was effectively litigation brought against both of them by a trade competitor".[9] The fact that Praesto was not joined as a party and the invoices were addressed to Mr Ranson were things to be taken into account by the FTT in reaching their conclusion, but they were not to be considered as legal bars to the conclusion reached.[10]

As a matter of economic reality, there were "good reasons for the FTT reaching the conclusion which it did".[11] This includes that the FTT found Praesto were the main target of the litigation (as a result of their profits which CSP sought to claim), and that the real value of the claim was against Praesto's profits and seeking to put Praesto out of business.[12]

It was held that there was no proper basis for a further argument advanced by HMRC (that if the FTT's findings meant there was a legal relationship, they had erred in their assessment and come to an "irrational and perverse conclusion"[13]). It was held that the FTT was entitled to reach the conclusions that it did with the material before it.[14]

It was consequently held that the appeal should be allowed on Issue 1.

On Issue 2, the findings of fact of the FTT were set out with regard to why the FTT had held there was a direct and immediate link between the services supplied by Sintons and Praesto's taxable activities. In particular, it was stated that the litigation was effectively brought against Mr Ranson and Praesto, with phase 1 of the litigation to establish a breach of fiduciary duty

[5] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [33].
[6] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [35].
[7] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [36].
[8] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [39].
[9] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [40].
[10] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [41].
[11] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [42].
[12] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [42].
[13] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [45].
[14] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [46].

against Mr Ranson, and phase 2 being to pursue Praesto for all profits made as a result of that breach.[15] These "knock on effects"[16] for Praesto were not present in *Becker*[17] (which was considered to be directly on point and therefore binding in the UT).[18]

Moreover, there was no suggestion in *Becker*[19] that a finding of criminal liability on the part of Mr Becker might lead to proceedings against the company (and therefore, any benefit to the company of the successful defence by Mr Becker was necessarily indirect).[20]

The FTT had further held that the factual circumstances bore a resemblance to the case of *P&O Ferries (Dover) Ltd v CC&E* (*P&O*)[21] (as *P&O* had formed the view that the success or otherwise of the possible prosecution of the company depended largely on the outcome of the prosecution against the individual employees).[22] In *P&O* it was found that the legal services in question were used for the purpose of the Company's business, which was directly analogous to the position of Praesto as the consequence of a finding of liability against an individual would lead to a real risk of proceedings against the company with "disastrous consequences for its business activities".[23]

It was therefore held that the UT had been incorrect not to distinguish *Becker* and that the FTT had made the correct decision in doing so (as the benefit was not "merely incidental" as the UT had found).[24]

Finally, it was held that the "only remaining question" was whether there was a direct and immediate link between the services supplied by Sintons and Praesto's taxable activities. It was held that the FTT had applied the right legal test, as it had regard to "all the circumstances surrounding the transactions at issue", looked for an objective link, and found that "objectively the reason Praesto obtained Sinton's services was to limit any liability arising from its taxable activities".[25]

In concluding, it was held that in light of *Becker*,[26] it is likely that in many cases a company which pays the legal fees for the defence of proceedings brought against a director will *not* be entitled to credit for VAT input tax charged in relation to those fees: however, the FTT was "entitled to decide otherwise".[27] The facts of this case were unusual as ordinarily in such proceedings, a claim is brought against both the individual and the company (which consequently renders it likely that there would be no issue as to the entitlement of the company to claim recovery of VAT). It was held that the FTT had understandably focused on substance and reality.[28]

Hamblen LJ accordingly held that he would allow the appeal.[29]

[15] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [49].
[16] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [50].
[17] *Becker*, above fn.4, (C-104/12) EU:C:2013:99.
[18] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [50].
[19] *Becker* (C-104/12), above fn.4, EU:C:2013:99.
[20] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [51].
[21] *P&O Ferries (Dover) Ltd v CC&E* [1992] VATTR 221.
[22] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [53].
[23] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [54].
[24] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [56].
[25] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [57].
[26] *Becker* (C-104/12), above fn.4, EU:C:2013:99.
[27] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [59].
[28] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [60].
[29] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [62].

Lord Justice Haddon-Cave agreed with the judgment of Hamblen LJ, holding that the FTT findings of fact were "clear, unequivocal and directly relevant to the issues in question".[30] Haddon-Cave LJ further stated that he had read with care the dissenting judgment and disagreed with it, as the analysis would "inevitably draw this Court into seeking to go behind the findings of fact in the first instance tribunal".[31] It was not open to the Court to speculate post hoc as to the chances of Praesto being successfully sued by CSP, as this would cut across the findings of the FTT that if CSP had been successful against Mr Ranson, Praesto would have been joined.[32]

In contrast, Sir Terence Etherton MR held that he would have dismissed the appeal. Applying *Becker*, the critical legal principles were that there must be a "direct and immediate link" between the particular input transaction and one or more output transactions giving a right to deduct, or the costs of the services are part of the taxpayer's general costs and have a direct and immediate link with the economic activity as a whole, and that the direct and immediate link must be established objectively in light of the content of the supply.[33]

Sir Terence Etherton MR held that these conditions were not satisfied: the relevant invoices were addressed to Mr Ranson and Praesto was not a defendant. The judgment goes on to state that he would regard it as at best "highly speculative" whether any application to join Praesto could possibly have succeeded.[34] Moreover, the FTT had not attempted to analyse the likelihood of a claim for an account of profits succeeding against Praesto.[35]

Etherton MR disagreed that the UT was not open to find as it did. This was because the issue was a legal one, not one of fact, and secondly, on a proper analysis, he did not consider that any of the findings of fact of the FTT precluded the UT's finding in favour of HMRC.[36]

The dissenting judgment goes on to state that it cannot be said that there was any direct link between the supply of services in the invoices addressed to Mr Ranson and one or more particular output transactions of Praesto. The FTT's description of Praesto as a "party to proceedings in all but name" is not a meaningful statement of fact: the objective fact was that Praesto was not a party to proceedings.[37] Moreover, the objective link between the services provided and the success of Praesto's business was not direct but indirect and not immediate but consequential—it was also "well established" that the payment of costs by the taxpayer for a service provided to a third party instructed by the taxpayer, which is in the economic interests of the taxpayer, may not satisfy the objective direct and immediate link test (relying on *Airtours Holidays Transport Ltd v HMRC*[38]).[39]

Finally, relying on *P&O* (a non-binding VAT tribunal decision decided many years before *Becker*) was not a useful analogy, particularly as it did not purport to apply the objective direct and immediate link test.[40]

[30] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [65].
[31] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [69].
[32] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [70].
[33] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [75].
[34] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [79].
[35] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [81].
[36] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [84].
[37] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [85].
[38] *Airtours Holidays Transport Ltd v HMRC* [2016] UKSC 21.
[39] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [88].
[40] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [89].

Assessment of the reasoning in the Court of Appeal

The first thing to note is that the wider impact of this case is somewhat limited. This was captured by Hamblen LJ's judgment, where he stated that:

> "I do not consider that the FTT decision establishes *any general proposition, still less a proposition of law, as to the circumstances in which a company will or will not be able to claim VAT in comparable factual circumstances*. The decision turns on the findings of fact made by the FTT in this specific case."[41] (Emphasis added.)

The key facts of this case are clearly unusual and are unlikely to arise often, as there is no real reason why, in the circumstances, Praesto was not also joined as a party to the original proceedings against Mr Ranson. The findings of fact in the FTT make it clear that Praesto was the ultimate target as it was there that the real value of the claim lay. Moreover, the rationale for not including Praesto in the eight invoices subject to HMRC's assessment (despite it having been found that there was a contractual relationship between Sintons and both Praesto and Mr Ranson) is also unusual. The alignment of both of these uncommon circumstances gave HMRC the scope to pursue the argument that the legal fees were not incurred by Praesto for the purposes of its business (where, if just one is removed, the argument would have been significantly less clear).

The majority judgment in the Court of Appeal was both sensible and, in the writer's opinion, correct. On the facts found by the FTT, there was very clearly a contractual relationship between Sintons and Praesto (even if, as commented upon by Hamblen LJ, this was not expressly stated, which perhaps it should have been if only for the sake of clarity). There are also very clearly very good reasons for the FTT finding as it did with regard to economic reality: why was CSP suing Mr Ranson for breach of duty if not to ultimately recoup as much as possible from Praesto, who had profited from the alleged breaches?

It was also correct in the writer's view for the majority in the Court of Appeal to refuse to cut across the findings of the FTT (as the UT's judgment and the dissenting judgment arguably did).

There is however some potential difficulty with the language adopted by the majority in using terminology such as a "*real* risk of proceedings being successfully brought against the company".[42] Whatever is meant by a real risk is not defined: whether a 50 per cent likelihood or a 90 per cent likelihood would be sufficient is left unconsidered. Although the wider implications of this case are limited, it would have been useful if "real risk" had been more accurately outlined, so that if a factually similar case were to arise in the future it could be determined more easily one way or the other without recourse to litigation.

Rebecca Sheldon[*]

[41] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [61].
[42] *Praesto CA*, above fn.1, [2019] EWCA Civ 353 at [54].

Business purpose; Directors; Fees; Input tax; Legal services; VAT

[*] Barrister, Old Square Tax Chambers.

Ball UK Holdings Ltd v HMRC (FTT and UT): tax law and accounting standards

Introduction

In the last 25 years accounting standards have been transformed from statements of principle, providing guidance to preparers and auditors of companies' annual accounts, to long, complex, sophisticated prescriptions of detail with which the standard-setter, the Financial Reporting Council (FRC), requires strict compliance, save "in special circumstances…" where there is inconsistency "…with the requirement to give a true and fair view".[1] Hitherto the interpretation and application of the new-style standards have not been subjected to the scrutiny of the courts in the context of directors and auditors complying with their obligations under the Companies Acts. Tax cases, however, not infrequently involve attention to standards but it is rare for a case to turn entirely on the true meaning of the standard rather than on its application by accountants to particular facts. This recent tax case before the First-tier Tribunal (FTT)[2] and the Upper Tribunal (Tax and Chancery Chamber) (UT)[3] is one such, involving close study by both tribunals of the meaning and effect of Financial Reporting Standard 23 (FRS 23), the standard governing the choice of currency—"the functional currency"—in which companies' annual figures are measured. The standard was prescriptive as to selection of a single currency, leaving no room for judgement in opting for one out of two or more possible currencies. The case, consequently, raised starkly the issue of the correct approach to the interpretation of standards, an issue which has, of course, wide practical significance far beyond the boundaries of tax law itself.

Facts

The appellant, Ball UK Holdings Ltd (Ball UK), failed to persuade the FTT that a disclosed tax avoidance scheme[4] had enabled it to create an allowable foreign exchange loss of some £24 million in its accounts for the year ended 31 December 2006, and the FTT's decision was upheld by the UT. Ball UK was an intermediate holding company with subsidiaries having an aggregate value of some US$0.5 billion, it, itself, paying a dividend in 2005 to its immediate parent of some £43 million. But it was a derivative transaction involving merely US$30,000 that, it was argued, triggered the ability to adopt fair value accounting and the application of a different accounting standard to that previously governing the selection of the functional currency for the calculation of its results. For the years up to 31 December 2005 Ball UK had followed Statement of Standard Accounting Practice 20 (SSAP 20) in treating sterling as its functional currency but FRS 23, the relevant standard on the adoption of fair value accounting, required, so it was argued, a switch to US dollars and this switch, with the necessary restatement of all accounts figures in

[1] FRC, *FRS 102: The Financial Reporting Standard applicable in the UK and Republic of Ireland* (FRS 102) (March 2018), para.3.4.
[2] *Ball UK Holdings Ltd v HMRC* (*Ball UK FTT*) [2017] UKFTT 457 (TC); [2018] 1 BCLC 229.
[3] *Ball UK Holdings Ltd v HMRC* (*Ball UK UT*) [2018] UKUT 407 (TCC); [2019] STC 193.
[4] Disclosed under the regime introduced under FA 2004 Pt 7.

US dollars, produced the foreign currency loss in the 2006 accounts. HMRC amended Ball UK's corporation tax return to remove this loss on the basis that the functional currency should have remained sterling; and this amendment occasioned Ball UK's appeal.

Ball UK's ultimate holding company was a US publicly listed company (Ball US), its consolidated accounts being prepared under US generally accepted accounting principle (US GAAP) and the applicable accounting standard, Financial Accounting Standards Board Statement No.52 (FAS 52), required the functional currency for the inclusion of Ball UK's figures in the consolidation to be sterling. A switch to US dollars in these accounts would have introduced the foreign exchange loss into the reported figures at the top, listed level and might have affected the share price. And so a dual course was run; for the listed company's consolidated accounts Ball UK's functional currency continued to be sterling and for Ball UK's own independent accounts it became US dollars. The artificial opportunistic nature of the tax avoidance scheme was plain[5] but HMRC's case in no way turned on this. Their argument addressed the fundamental issue of the correct computation of profits for tax purposes.

The issue

Taxing statutes have never contained a detailed code as to the precise calculation of the results of a trade or business. From the outset of tax litigation the courts recognised that the computation of profit or loss raised, primarily, questions of fact and fell to be determined in accordance with the ordinary principles of commercial accountancy and to ascertain these the courts looked to the evidence of accountants. In *Odeon Associated Theatres Ltd v Jones (Inspector of Taxes)* (*Odeon*)[6] Pennycuick V-C said:

> "In so ascertaining the true profit of a trade the court applies the correct principles of the prevailing system of commercial accountancy. I use the word 'correct' deliberately. In order to ascertain what are the correct principles it has recourse to the evidence of accountants. The evidence is conclusive on the practice of accountants in the sense of the principles on which accountants act in practice. That is a question of pure fact, but the court itself has to make a final decision as to whether that practice corresponds to the correct principles of commercial accountancy. No doubt in the vast proportion of cases the court will agree with the accountants but it will not necessarily do so."[7]

The leading professional body in the UK, the Institute of Chartered Accountants in England and Wales (ICAEW) was founded in 1880 and began in the early 20th century to issue "Recommendations on Accounting Principles". It was not until 1970 that formal accounting standards began to be promulgated (originally under the auspices of a joint body representing ICAEW and other professional accounting organisations and, in due course, by the Accounting Standards Board within the FRC).[8] The first set of standards were Statements of Standard Accounting Practice (SSAPs): the current regime involves Financial Reporting Standards (FRSs).

[5] *Ball UK FTT*, above fn.2, [2018] 1 BCLC 229 at [41].
[6] *Odeon Associated Theatres Ltd v Jones (Inspector of Taxes)* [1971] 1 WLR 442 (Ch).
[7] *Odeon*, above fn.6, [1971] 1 WLR 442 (Ch) at 454.
[8] At the relevant time the standard-setter was the Accounting Standards Board (ASB) within the FRC and the decisions of both the FTT and the UT referred to documents issued by the ASB. The Department of Business Energy and

The authority of accounting standards in a computation of profits and losses of a trade for tax purposes was conclusively established in *Gallagher v Jones (Inspector of Taxes)* (*Gallagher*).[9] SSAP 21, which expressed the distinction (as it was then understood) between a finance lease and an operating lease, was quoted extensively and treated as expressing the accepted principles of commercial accountancy. Tax law was a creature of statute and there was nothing in the statute law, as Nolan LJ put it, to "…enable or require us to ascertain the profit of a trade on a basis divorced from the principles of commercial accountancy".[10]

Ball UK was an investment holding company and did not engage in the manufacturing and selling activities of the wider Ball group (packaging for food, drinks and household products). It held shares in subsidiaries; it made and received loans to and from other Ball group companies; it received dividends which enabled it to fund the interest on its borrowings. Its tax computations fell, consequently, squarely within the loan relationship regime introduced by the Finance Act 1996 (FA 1996) which radically transformed the tax treatment of debt and interest.[11] FA 1996 put on a statutory basis, for the first time, the case law principle expressed in *Odeon*[12] and *Gallagher*,[13] and provided at section 84(1) for credits and debits in respect of loan relationships to be brought into account "in accordance with an authorised accounting method". As originally enacted, section 85(2) FA 1996 provided that an accounting method should be treated as authorised only if, inter alia, it "conforms…to normal accountancy practice". This requirement in section 85(2) was amended by the Finance Act 2002 (FA 2002),[14] and replaced with a requirement that the accounting method applied be "in conformity with generally accepted accounting practice".

Sections 85 and 86 FA 1996 were substituted by sections 85A and 85B, by the Finance Act 2004.[15] Section 85A(1) FA 1996 provided that

> "…the amounts to be brought into account by a company for any period for the purposes of this Chapter are those that, in accordance with generally accepted accounting practice, are recognised in determining the company's profit or loss for the period".

It was on the application of this section that Ball UK's appeal turned.

The extension of statute's adoption of the principle to the computation of trading profits came in the Finance Act 1998, section 42(1) providing:

> "For the purposes of Case I or II of Schedule D the profits of a trade, profession or vocation must be computed on an accounting basis which gives a true and fair view, subject to any adjustments required or authorised by law in computing profits for those purposes."

Industrial Strategy announced on 11 March 2019 that the FRC is to be replaced by a new statute-based body called the Audit Reporting and Governance Authority.

[9] *Gallagher v Jones (Inspector of Taxes)* [1994] 2 WLR 160 (CA).

[10] *Gallagher*, above fn.9, [1994] 2 WLR 160 (CA) at 186C.

[11] As the UT explained in *Greene King plc & another v HMRC* [2014] UKUT 178 (TCC); [2014] STC 2439 at [10], FA 1996 introduced "…the concept of a 'loan relationship'….If such a relationship exists then all profits, losses and gains arising out of that relationship are dealt with under a self-contained regime."

[12] *Odeon*, above fn.6, [1971] 1 WLR 442 (Ch).

[13] *Gallagher*, above fn.9, [1994] 2 WLR 160 (CA).

[14] FA 2002 Sch.25 para.5(2).

[15] FA 2004 Sch.10 para.3.

The "true and fair view" formula was changed by FA 2002[16] to the "generally accepted accounting practice" (GAAP) formula of the loan relationship regime which has remained in place ever since. The FTT's decision dismissing Ball UK's appeal and the UT's decision upholding that dismissal have, therefore, a wide tax significance.[17]

The decisions of the FTT and the UT

It was not in dispute that compliance with GAAP required the application of FRS 23 which was the relevant standard; what was disputed was how the standard applied. FRS 23 defined "Functional currency" as "the currency of the primary economic environment in which the entity operates…".[18] It explained that the "primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash"[19]; and there were listed a series of "factors" falling to be considered. The one with most relevance to an investment holding company engaged, only, in financing activities pointed to "…the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated".[20]

The intention of the definition was made clear in two paragraphs, one dealing with the possibility of the factors pointing in different directions and a second dealing with circumstances allowing a change in currency. The first, ("when the above indicators are mixed and the functional currency is not obvious"[21]) required management to use "its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions events and conditions".[22] The second stated: "An entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it. Accordingly, once determined, the functional currency is not changed unless there is a change in those underlying transactions events and conditions…."[23] Given that, with the exception of one short-term loan made in euros and the small derivative transaction in US dollars that triggered the operation of the avoidance scheme, all transactions conducted by Ball UK (dividends received, dividends paid, loans made and received and interest payments in respect of them) were in sterling, both tribunals were robustly clear that the standard required sterling to be the functional currency.

The argument presented by Ball UK turned on one of the factors listed in the standard which was asserted to "trump" all the others, it being argued that a number of the other factors had no application since Ball UK had no operations and was simply an intermediate holding company. This factor dealt with the parent/subsidiary relationship (characterising the parent as "the reporting entity" and the subsidiary as "the foreign operation"). The factor involved consideration "…whether the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy. An example of the

[16] FA 2002 s.103(5).
[17] Of course FA 1998 s.42(1) and its successor provisions concern "the profits of a *trade*" (emphasis added) and HMRC do not recognise all business activities as inevitably having the character of trading activities. Other tax regimes, such as those for intangibles and derivatives, make reference to GAAP-based accounting.
[18] Financial Reporting Standard 23 (IAS 21) the Effects of Changes in Foreign Exchange Rates (FRS 23), para.8.
[19] FRS 23, above fn.18, para.9.
[20] FRS 23, above fn.18, para.10(a).
[21] FRS 23, above fn.18, para.12.
[22] FRS 23, above fn.18, para.12.
[23] FRS 23, above fn.18, para.13.

former is when the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it. An example of the latter is when the operation accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency."[24] Notwithstanding that the example given of "a significant degree of autonomy" seemed to fit Ball UK's circumstances exactly, it was its case that "autonomy" pointed to management independence and that every day management decisions within Ball UK were under the control of Ball US.

The FTT's rejection of Ball UK's argument and the UT's confirmation of that rejection are unremarkable and would not warrant special attention. The importance of the case lies in the approach of the courts to the interpretation of accounting standards. The FTT stated (and it was common ground) that it was GAAP to apply accounting standards. The tax code now adopts the concept of computing profits by reference to GAAP.[25] FRS 23, substantially unamended, is incorporated, as section 30, in FRS 102[26] the comprehensive single accounting standard governing the annual accounts of all companies[27] not required or electing to apply international accounting standards. Such companies, in discharging the annual obligation to produce "true and fair view" accounts, must interpret and apply the accounting standard. It follows that the reasoning of both the FTT and the UT has significance not simply in the field of tax law but also in relation to the general law governing annual accounts, their preparation and audit and directors' and auditors' responsibilities.

The FTT's decision is principally taken up with an account of an assessment of the accountancy evidence. Ball UK could point to a number of accountants who supported its selection of US dollars as functional currency: two partners from KPMG who provided expert evidence; two accountants from within the Ball group; the audit partner of PwC who signed the audit report in Ball UK's accounts; and the author of a Deloitte's report, who was not called as an expert witness but whose report was put in evidence. This support, it was argued, indicated that the use of US dollars was a reasonable application of the standard by accountants: it was within the reasonable range of conclusions that accountants could adopt.

The FTT drew a clear distinction between the interpretation of the standard (what does it mean?) on the one hand and the application of the standard (how does it apply, correctly interpreted, to the particular circumstances of the case?) on the other. "We do accept, however, that in borderline cases there may be a range of conclusions permitted by the application of FRS 23. In other words, in borderline cases, two different accounting professionals faced with identical facts and giving the standard the *same and correct interpretation* might nevertheless reach

[24] FRS 23, above fn.18, para.11(a).

[25] Nothing turns on the distinction between GAAP and "true and fair view" accounting, two expressions used by the Companies Act 2006 (CA 2006) in different contexts (e.g. "true and fair view" for annual accounts in CA 2006 s.393 and GAAP for "realised profits" in CA 2006 s.853). GAAP includes "true and fair" and the position taken by the FRC, as standard-setter, set out in its document *True and Fair* (June 2014) is that "true and fair view" requires compliance with standards, except in rare exceptional circumstances (FRC document available at: *https://www.frc.org.uk/getattachment/f08eecd2-6e3a-46d9-a3f8-73f82c09f624/True-and-fair-June-2014.pdf* [Accessed 8 July 2019]).

[26] FRS 102, above fn.1.

[27] With minor exceptions such as micro-entities.

different conclusions on its application."[28] But: "To be GAAP-compliant, it must be a reasonable application of a *correctly interpreted* standard."[29] (Emphasis added.)

With one important exception, there is no rule in the statutory provisions or statutory regulations governing companies' preparation of annual accounts requiring compliance with accounting standards. The exception concerns the consolidated accounts of listed companies, which, pursuant to the IAS Regulation,[30] must be prepared in accordance with international accounting standards.[31] For the generality of accounts (that is individual company accounts and consolidated accounts for unlisted groups) there is only one legally prescribed link to standards. The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 provide, as regards large companies:

> "[I]t must be stated whether the accounts have been prepared in accordance with applicable accounting standards and particulars of any material departure from those standards and the reasons for it must be given."[32]

The UT had no doubt about what was the key issue before it: "At the heart of this appeal is the question whether the correct interpretation of accounting standards, and specifically FRS 23, can be characterised as a matter of law or fact. If it is a question of law then this Tribunal may consider the question afresh."[33] Appeals to the Upper Tribunal lie, only, on a point of law. The *Edwards (Inspector of Taxes) v Bairstow*[34] approach (that is that the FTT acted without any evidence or upon a view of the facts which could not reasonably be entertained) was plainly not attractive: and so it was necessary for Ball UK to argue that the interpretation of accounting standards was a matter of law.

The approach of the FTT came close to the expression of a legal view on the correct interpretation as opposed to the making of findings of fact on expert accountancy evidence. It summarised its conclusion as between the rival views of the experts in these terms:

> "…[T]he reason we accepted [HMRC's expert's] evidence over [Ball UK's experts'] was because [HMRC's expert's] interpretation was consistent with the wording of and notes to the relevant accounting standard, and we found that the appellant's experts' was not."[35]

This is close to "consistent with the wording of the standard and the notes as we, the Tribunal, find them", which would of course amount to a court deciding interpretation. Some further citations from the FTT's decision illustrate this. In looking at the contrasted examples of parent/subsidiary relationship the FTT said: "We found this approach [that of HMRC's expert] to be entirely logical and completely in accordance with the wording…."[36] In supporting HMRC's

[28] *Ball UK FTT*, above fn.2, [2018] 1 BCLC 229 at [13].
[29] *Ball UK FTT*, above fn.2, [2018] 1 BCLC 229 at [63].
[30] International accounting standards: Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards [2002] OJ L/243/1.
[31] These are "Adopted IFRSs" that is International Financial Reporting Standards adopted by the European Commission.
[32] The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) Sch.1, para.45.
[33] *Ball UK UT*, above fn.3, [2019] STC 193 at [30].
[34] *Edwards (Inspector of Taxes) v Bairstow* [1956] AC 14 (HL).
[35] *Ball UK FTT*, above fn.2, [2018] 1 BCLC 229 at [52].
[36] *Ball UK FTT*, above fn.2, [2018] 1 BCLC 229 at [69].

expert in treating a company which, in accordance with the example given in the standard, "accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency" as an example of what the standards meant by a company acting with a "significant degree of autonomy", the FTT said: "This was an entirely logical approach and clearly intended by [the standard] on its face."[37] Again HMRC's approach was described as "logical and consistent with the meaning…" of the standard "…insofar as it can be deduced from the wording…"[38]; Ball UK expert's approach, on the other hand, "lacks logic and is inconsistent with the meaning given by the drafters of the standard".[39] His reading of the standard "… meant decision-making was elevated to be almost the only relevant indicator….This is not a reasonable or even possible interpretation of FRS 23."[40] "We reject his views as unreliable. We do not think they were a reasonable or possible interpretation of FRS 23."[41]

It is not, therefore, surprising that the UT found it necessary to comment:

> "As we have explained, our conclusion is that the FTT's findings about the meaning as well as the practical application of FRS 23 are properly matters of fact. A number of the statements made in the FTT decision need to be read with this in mind, so as to avoid an incorrect impression being obtained that the FTT was expressing legal views about the correct accounting approach, rather than making findings of fact."[42]

The UT's judgment on the law or fact issue was emphatic:

> "Accounting standards are not legal documents. They are not statutes or contracts. This is also not a case where public law concepts, such as the doctrine of legitimate expectation, are engaged in a way that means that the document in question may form the basis of a legal right. So it is not necessary to construe them to determine any legal effect to be given to them. They are documents written by accountants for accountants, and are intended to identify proper accounting practice, not law. No accountant would consider turning to a lawyer for assistance in their interpretation, nor should they."[43]

The UT looked briefly at the legal position under the Companies Act 2006 (CA 2006), referring to section 393's requirement that accounts give "a true and fair view" and to opinions of counsel dealing with that expression, noting that their thrust was that "the courts will treat compliance with accepted accounting principles as prima facie evidence that the accounts are true and fair".[44]

The UT said:

[37] *Ball UK FTT*, above fn.2, [2018] 1 BCLC 229 at [70].
[38] *Ball UK FTT*, above fn.2, [2018] 1 BCLC 229 at [73].
[39] *Ball UK FTT*, above fn.2, [2018] 1 BCLC 229 at [75].
[40] *Ball UK FTT*, above fn.2, [2018] 1 BCLC 229 at [93].
[41] *Ball UK FTT*, above fn.2, [2018] 1 BCLC 229 at [105].
[42] *Ball UK UT*, above fn.3, [2019] STC 193 at [85].
[43] *Ball UK UT*, above fn.3, [2019] STC 193 at [37].
[44] *Ball UK UT*, above fn.3, [2019] STC 193 at [38]. The UT's decision mentions "…highly influential opinions written by the then Leonard Hoffman[n] QC [now Lord Hoffmann] and Miss Mary Arden [now Lady Arden JSC], originally in 1983 and subsequently updated". The full sequence of opinions was: joint Hoffmann and Arden opinions in 1983 and 1984; an opinion by Mary Arden QC, alone, in 1993; and two opinions by Martin Moore QC in 2008 and 2013.

> "In our view the question of what is generally accepted accounting practice, as well as the question whether a particular set of accounts are prepared in accordance with it, is a question of fact to be determined with the assistance of expert evidence. Professional accountants are best placed to understand accounting statements in their context and in particular their 'spirit and reasoning'."[45]

The UT went on:

> "What is a matter for a court or tribunal, however, is the proper assessment of expert evidence. Clearly a judge may prefer the evidence of one expert to that of another, but this should be fully reasoned and the judge should not simply 'develop his own theory'…."[46]

The UT concluded: "The role of this Tribunal is to determine whether the conclusions reached by the FTT were ones that could properly be reached on the evidence."[47]

Comment

The distinction between an issue of law and an issue of fact often has procedural significance. It can determine whether, as in this case, an appeal lies and in criminal cases it determines what is for the judge and what is for the jury. In *R. v Spens* (*Spens*)[48] the Court of Appeal upheld the trial judge's dismissal of a contention made on behalf of the defendant that the City Code on Takeovers and Mergers (the Takeover Code) was a matter of fact for the jury to be decided by them on expert evidence. At the time the Takeover Code had no legal effect and was, as its introduction explained, a statement of "…collective opinion of those professionally involved in the field of takeovers on a range of business standards". So, in the way that the UT characterised accounting standards as "documents written by accountants for accountants", the Takeover Code was a document written by specialists (investment bankers) for specialists (investment bankers). The Court of Appeal stated that its view was "…that the Code sufficiently resembles legislation as to be likewise regarded as demanding construction of its provisions by a judge".[49]

The possibility of accounting standards raising issues of law rather than of fact is also suggested in the Arden opinion of 1993[50] which ended with this sentence: "Just as a custom which is upheld by the courts may properly be regarded as a source of law, so too, in my view, does an accounting standard which the court holds must be complied with to meet the true and fair requirement become, in cases where it is applicable, a source of law in itself in the widest sense of that term."[51]

It seems clear, consequently, that the distinction between fact and law is not entirely straightforward, even as regards the status of accounting standards. And in practice there may be a thin line between, on the one hand, an assessment that there is material (necessarily material

[45] *Ball UK UT*, above fn.3, [2019] STC 193 at [40].
[46] *Ball UK UT*, above fn.3, [2019] STC 193 at [41].
[47] *Ball UK UT*, above fn.3, [2019] STC 193 at [42].
[48] *R. v Spens* [1991] 1 WLR 624 (CA).
[49] *Spens*, above fn.48, [1991] 1 WLR 624 (CA) at 632.
[50] See above fn.44.
[51] M. Arden, *Accounting Standards Board: The True and Fair Requirement: Opinion* (Erskine Chambers, Lincoln's Inn, 21 April 1993), available at: *https://www.frc.org.uk/getattachment/37378397-de7d-4376-9c22-74318f1bc433/T-F-Opinion-21-April-1993.pdf* [Accessed 24 June 2019].

bearing on interpretation) sufficient to warrant a court's preference for one expert's view over another's and, on the other, a direct interpretation by the court of the words themselves. Indeed in this case the UT, in concluding "that the FTT was entitled to prefer [HMRC's expert's] approach", went on to direct interpretation of its own in declaring that: "The term 'functional' currency itself gives something of a clue of the need to concentrate on what the entity actually does."[52]

Perhaps the paradigm class of case of specialist speaking to specialist is to be found in patent litigation. Here the specialist is "the person skilled in the art". Construction issues concerning a patent specification are matters of law for the court. However, as Lord Hoffmann said in the leading case on the principles of construction, *Kirin-Amgen Inc and others v Hoechst Marion Roussel Ltd and others* (*Kirin-Amgen*),[53] the question is "what the person skilled in the art would have understood the patentee to mean by the language of the claims".[54] The natural and ordinary meaning of words as indicated by dictionary and rules of syntax and grammar are not in point. A patent specification is a unilateral document in words of the patentee's own choosing and the words are usually chosen on skilled advice, that is, from a person skilled in the art. So experts as to the understanding and knowledge at the relevant time of persons skilled in the art give evidence on each side and the court has to choose which it prefers. The judge will be educated and assisted by the expert evidence but in the end, in choosing between two rival constructions, he or she will be relying on his or her legal training and reason and logic and not on any deep understanding of the specific "art" involved.

Foreign law questions provide, perhaps, the clearest example of the court's readiness to disregard the distinction between factual and legal issues and to do so without resort to an apparent choice between experts. The courts treat questions concerning the interpretation and effect of foreign law as questions of fact, normally determined by reference to expert evidence. However where there is material to be interpreted the material must be placed before the court and the court is not inhibited from "using its own intelligence as on any other question of evidence".[55] *Macmillan Inc v Bishopsgate Investment Trust plc and others (No.3)*[56] provides an example of a judge disregarding both sides' expert witnesses and making a finding—as fact—of the nature and impact of foreign law on the basis of his own reading of the relevant material.

The UT was clear that accounting standards were "documents written by accountants for accountants" and that "[n]o accountant would consider turning to a lawyer for assistance in their interpretation and nor should they".[57] The approach of the courts to interpretation issues has long been influenced by consideration of the identity of the person to whom the relevant statement is addressed and the context within which the statement has been made. In the commercial context regard is had to business common sense. The principles were well stated by Lord Hoffmann in the *Kirin-Amgen* case where he said:

[52] *Ball UK UT*, above fn.3, [2019] STC 193 at [62].
[53] *Kirin-Amgen Inc and others v Hoechst Marion Roussel Ltd and others* [2004] UKHL 46; [2005] 1 All ER 667.
[54] *Kirin-Amgen*, above fn.53, [2005] 1 All ER 667 at [71].
[55] *A/S Tallinna Laevauhisus v Estonian State Steamship Line* (1947) 80 Ll. L. Rep. 99 (CA) at 107.
[56] *Macmillan Inc v Bishopsgate Investment Trust plc and others (No.3)* [1995] 1 WLR 978 (Ch).
[57] *Ball UK UT*, above fn.3, [2019] STC 193 at [37].

> "Construction is objective in the sense that it is concerned with what a reasonable person to whom the utterance was addressed would have understood the author to be using the words to mean. Notice, however, that it is not, as is sometimes said, 'the meaning of the words the author used', but rather what the notional addressee would have understood the author to mean by using those words. The meaning of words is a matter of convention, governed by rules, which can be found in dictionaries and grammars. What the author would have been understood to mean by using those words is not simply a matter of rules. It is highly sensitive to the context of and background to the particular utterance. It depends not only upon the words the author has chosen but also upon the identity of the audience he is taken to have been addressing and the knowledge and assumptions which one attributes to that audience."[58]

The audience to whom accounting standards are addressed is not however limited to accountants. SSAPs constituted professional guidance to accountants as to good or standard practice; and, as referred to in the UT's decision, compliance with them constituted prima facie evidence that accounts gave a true and fair view. FRSs however are in effect "soft" regulation. They are detailed and often complex prescriptions. FRS 102, which applies to the group and individual accounts of all large companies that either are not required to adopt IAS accounts or have not elected to adopt them, uses the language of rules and not guidance and is addressed to "entities": "An entity *shall* apply this FRS for accounting periods beginning on or after 1 January 2015" (emphasis added)[59]; "An entity whose financial statements comply with this FRS *shall* make an explicit and unreserved statement of such compliance in the notes. Financial statements *shall* not be described as complying with this FRS unless they comply with all the requirements of this FRS"[60] (emphasis added).

Annual accounts must give a true and fair view; and the orthodoxy of the FRC, the standard-setter, is that, save in very limited cases, accounts cannot give a true and fair view unless there is compliance with standards.[61] However under CA 2006 it is the directors who have the responsibility for preparing accounts (section 394 CA 2006) and it is the directors to whom the statutory injunction that accounts must not be approved unless they give a true and fair view (section 393 CA 2006) is addressed. The accounts are the directors', not the accountants'. It is clear, consequently, that standards are not only speaking to accountants. That this is so was recognised in the Australian *Centro* case, *Australian Securities and Investments Commission v Healey*,[62] where the court made declarations against all the directors of Centro Properties Ltd, a public company with shares listed on the Australian Securities Exchange. The judge was clear that approval of accounts is not delegable. A director could not ensure that annual accounts record and reflect all those material points his involvement has brought to his attention unless he read the accounts through. On knowledge of accounting standards the judge was not explicit. He suggested the obligation imposed on directors "does not involve a director being familiar

[58] *Kirin-Amgen*, above fn.53, [2005] 1 All ER 667 at [32].
[59] FRS 102, above fn.1, para.1.14.
[60] FRS 102, above fn.1, para.3.3.
[61] FRS 102, above fn.1, para.3.4.
[62] *Australian Securities and Investments Commission v Healey* (2011) 196 FCR 291. Australian law on Companies' annual accounts is broadly the same as UK law.

with every standard but sufficiently aware and knowledgeable to understand what is being approved or adopted". However he spoke of "financial literacy" and understanding of "basic accounting conventions" and "relevant accounting principles"; and it is clear that the currency in which assets, liabilities and results are measured—an essential tool in computation—would be included within these.

The decisions of the UT and the FTT do not disclose whether any individual was both a director of the US parent which, as indicated earlier, included Ball UK's figures with sterling as the functional currency and a director of Ball UK which used US dollars. Such a director would surely, on the *Centro* approach, have needed to ask why he or she was blessing one measure in one set of accounts and a different one in another, when addressing precisely the same results.

The decision of the UT in this case will be welcomed by the accountancy world of profession, standard-setters and regulator. Remarkably the regulator (the FRC) for its part has never exercised the power which it has held since 1989 to submit a company's defective annual accounts to the court for an order that they be revised,[63] perhaps fearful of the intervention of lawyers. And the UK Government has been persuaded not to prescribe standards as a legal requirement, in contrast to the EU which has so prescribed in relation to consolidated accounts of listed companies. The philosophy may well be that accounts should be left to accountants and lawyers and judges cannot be trusted in a specialist field. If so the apparent comfort that this case gives is illusory. ☙

Edward Walker-Arnott[*] and Michael Hunt[**]

[63] Now in CA 2006 s.456.

☙ Accounting standards; Corporation tax; Currencies; Foreign exchange; Generally Accepted Accounting Principles; Holding companies

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The Relevant Economic Activity Test and its Impact on the International Corporate Tax Policy Framework

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Abstract

A core objective of the Base Erosion and Profit Shifting (BEPS) Project was to ensure that profits are taxed where activities generating the profits take place. In this regard, international policy making organisations, such as the OECD and EU Commission, have reinforced the application of certain activity-based concepts, such as substantial activities, core commercial activity, controls over risks, economic reality and substantial economic activities, in soft and hard law instruments. If these concepts were to be consolidated it could be argued that, if the taxpayer were to comply with the relevant economic activities test, as developed in this article, then that taxpayer entity should be: 1. allocated the returns (income) from a transfer pricing perspective; 2. given access to tax treaty benefits in relation to the income it derives; 3. given access to benefits offered by EU law, in particular, the non-application of selected national anti-abuse rules (such as Controlled Foreign Company Rules) and anti-avoidance rules found in the corporate tax directives such as the Parent Subsidiary Directive and the Interest and Royalty Directive as well as the European Anti-Tax Avoidance Directive (for instance, the General Anti-Abuse Rule); and 4. the taxpayer entity should obtain access to economic activity-based preferential regimes. This article supports this proposition by taking into consideration the latest versions of the OECD Transfer Pricing Guidelines, the OECD Commentary, the case law of several courts, in particular the Court of Justice of the European Union, state practices as well as scholarly literature. Essentially, multinational enterprises (MNEs) can continue to engage in profit shifting activities post-BEPS. Furthermore, tax competition intensifies between states to attract economic activities, either through tax incentives or corporate tax rate/withholding tax rate reductions. Moreover, given that the activity-based concepts are subjective, both tax uncertainty and tax disputes will be on the rise. Interestingly, the activity-based concepts do not alter the allocation of the taxing rights framework agreed by states. Nevertheless, in light of the digital debate, there is pressure to reconsider the allocation of the taxing rights framework (Pillar I) and to find solutions to counter genuine profit shifting strategies to low tax jurisdictions/tax competition among states (Pillar II). Thus, the movement from BEPS 1.0 to BEPS 2.0 (Base Expansion and Profit

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Sharing) is already being witnessed. The challenges raised by digitalisation will be discussed in a later article.

1. Introduction and scope of the article

1.1. The post-BEPS international corporate tax framework

A core objective of the BEPS Project was "to ensure that profits are taxed where economic activities generating the profits take place and value is created".[1] In this regard, international policy making organisations, such as the OECD and EU Commission, have reinforced the application of certain activity-based concepts in the international corporate tax framework.

At the domestic tax policy level, BEPS Action 5,[2] which is a minimum standard, introduced the *substantial activities test*. The test provides that states can introduce/offer preferential tax incentives only when the taxpayer entity undertakes core income generating economic activities.

In relation to tax treaty policy, BEPS Action 6,[3] which is a minimum standard, obligated states to modify the preamble of their tax treaties to reflect that the purpose of tax treaties, in addition to the elimination of double taxation, is to prevent the creation of opportunities for tax evasion or tax avoidance (especially, treaty-shopping arrangements).[4] Additionally, states were required to include in their tax treaties either: 1. the Principal Purpose Test (PPT)[5]; 2. the PPT and the limitation on benefits (LOB) clause[6] (the latter being drafted in a simplified version[7]); 3. a detailed LOB clause and anti-abuse measures to counteract conduit arrangements.[8] The anti-abuse measures could stem from domestic law (such as the US conduit financing rules[9]) or could be treaty based (such as the anti-conduit rule contained in Article 3(1)(n) of the 2001 US–UK tax treaty[10]). In order to meet this minimum standard, 87 jurisdictions have signed the Multilateral Instrument[11] (as at 9 April 2019) and will adopt the revised preamble[12] and, for the

[1] OECD/G20 Base Erosion and Profit Shifting Project, *BEPS Project Explanatory Statement—2015 Final Reports* (Paris: OECD Publishing, 2015), 4.
[2] OECD/G20 Base Erosion and Profit Shifting Project, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5—2015 Final Report* (Action 5) (Paris: OECD Publishing, 2015), available at: *http://dx.doi.org/10.1787/9789264241190-en* [Accessed 18 June 2019].
[3] OECD/G20 Base Erosion and Profit Shifting Project, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report* (Action 6) (Paris: OECD Publishing, 2015).
[4] Action 6, above fn.3, paras 72–74.
[5] Action 6, above fn.3, para.26; OECD, *Model Tax Convention on Income and on Capital 2017 (Full Version)* (Paris: OECD Publishing, 2019) (OECD MC 2017), available at: *https://doi.org/10.1787/g2g972ee-en* [Accessed 13 June 2019] Art.29(9).
[6] OECD MC 2017, above fn.5, Art.29(1)–(7).
[7] Action 6, above fn.3, para.25 (Commentary in para.2); OECD MC 2017, above fn.5, Commentary on Article 29, para.2.
[8] Action 6, above fn.3, para.25 (Commentary in para.3); OECD MC 2017, above fn.5, Commentary on Article 29, para.3.
[9] See US IRC s.881 read in conjunction with US Treasury regulations, 1.881-3.
[10] See Art.3(1)(n), UK–US Double Taxation Convention (2001) as amended by the 2002 protocol. The provision provides for an objective and motive test.
[11] OECD, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (Multilateral Convention 2016) (24 November 2016).
[12] See Multilateral Convention 2016, above fn.11, Art.6(1); OECD MC 2017, above fn.5, Title and Preamble.

most part, the PPT rule.[13] To the extent that the PPT will form part of a tax treaty, arrangements that are linked to *core commercial activity*[14] will be allowed to claim treaty benefits. In other words, transactions through shell companies or back-to-back arrangements that lack a commercial rationale will not be granted treaty benefits. As the PPT has already been discussed extensively, the authors will focus on its subjective and objective elements and will not undertake a critical analysis of all its elements.[15] Moreover, as only a few states[16] have opted for the LOB clause (in particular, the simplified LOB clause), this provision will also not be discussed hereinafter.

With respect to the policy surrounding the arm's length principle, BEPS Actions 8–10[17] were dedicated to ensuring that transfer pricing outcomes are in line with *value creation*. In this regard, the revised Transfer Pricing Guidelines,[18] in addition to several other changes, provide that an entity will be allocated risks (and the underlying income associated therewith) only to the extent that the entity through its personnel *controls the risks* and has the financial means, that is, the financial capacity, to assume those risks.[19]

Last, with respect to EU Tax Policy, the EU Commission released an anti-tax avoidance package.[20] Among several initiatives, the package consisted of an Anti-Tax Avoidance Directive (ATAD).[21] The main purpose of the ATAD,[22] which was adopted in July 2016, is to ensure efficient, coherent, co-ordinated and swift incorporation of BEPS measures within the EU.[23] Towards this end, the ATAD lays out a minimum framework (set of rules) that Member States have to transpose in to their domestic law. Essentially, Member States are required to implement a statutory General Anti-Abuse Rule (GAAR)[24] and controlled foreign company (CFC) rules[25]

[13] See Multilateral Convention 2016, above fn.11, Art.7(1); OECD MC 2017, above fn.5, Art.29(9).
[14] OECD MC 2017, above fn.5, Commentary on Article 29, para.181.
[15] B. Kuźniacki, "The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application" (2018) 10 *World Tax Journal* 233; R. Danon, "Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups" (2018) 72(1) *Bulletin for International Taxation* 31; R. Danon and H. Salomé, "The BEPS Multilateral Instrument — General overview and focus on treaty abuse" [2017] *IFF Forum für Steurrecht* 197, 223–235; L. De Broe and J. Luts, "BEPS Action 6: Tax Treaty Abuse" (2015) 43(2) *Intertax* 122; L. De Broe, "Tax Treaty and the EU Law aspects of the LOB and PPT provision proposed by BEPS Action 6" in R. Danon (ed.), *Base Erosion and Profit Shifting (BEPS) – Impact for European and international tax policy* (Geneva, Zurich and Basel: Schulthess, 2016); M. Lang, "BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties" (2014) 74(7) *Tax Notes International* 655.
[16] Namely Argentina, India, Norway and Russia.
[17] OECD/G20 Base Erosion and Profit Shifting Project, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10: 2015 Final Reports* (Paris: OECD Publishing, 5 October 2015). The OECD Council approved these amendments on 23 May 2016.
[18] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* (OECD, TP Guidelines 2017) (Paris: OECD Publishing, 2017).
[19] OECD, TP Guidelines 2017, above fn.18, paras 1.64–1.66.
[20] For further information, see EU Commission, *Anti Tax Avoidance Package*, available at: *https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package_en* [Accessed 26 June 2019].
[21] For a general discussion on the ATAD see P. Pistone (ed.), *European Tax Integration: Law, Policy and Politics* (Amsterdam: IBFD, 2018).
[22] Council Directive (EU) 2016/1164/EU of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market [2016] OJ L193/1.
[23] Directive 2016/1164/EU, above fn.22, 2.
[24] Directive 2016/1164/EU, above fn.22, Art.6.
[25] Directive 2016/1164/EU, above fn.22, Arts 7–8.

among other measures.[26] However, according to the ATAD, these anti-abuse rules may not apply if the arrangements undertaken by taxpayers are for *valid commercial reasons which reflect economic reality* or reflect *substantial economic activities* respectively.[27]

1.2. The relevant economic activity test

If one consolidates the concepts of *substantial activities*, *core commercial activity*, *controls over risks*, *economic reality* and *substantial economic activities*, it could be argued that if the taxpayer demonstrates not only the commercial rationale of the arrangement (non-fiscal purposes) but also its economic rationale, then that taxpayer should be given access to the benefits offered by the international corporate tax framework. To elaborate, from an economic standpoint, the taxpayer can demonstrate that it carries out the *relevant economic activities* (or core income generating activities) with respect to the underlying income that it receives. This would typically be the case when a taxpayer entity in a corporate group demonstrates that: 1. its personnel (board and/or operating staff to the extent relevant) make key decisions with respect to the risks associated with that entity's activities; 2. the core income generating functions of the entity are carried out by the entity's personnel; 3. the entity owns/leases the necessary office space and/or equipment to carry out its activities. In these circumstances, the taxpayer entity should be:

- allocated substantial returns (income) from a transfer pricing perspective;
- given access to tax treaty benefits for the income it derives;
- given access to benefits granted by EU law that is, selected anti-abuse rules found in the Parent-Subsidiary Directive (PSD)[28] and the Interest and Royalties Directive (IRD)[29] should not apply. Moreover, the EU ATAD GAAR and CFC Rules (within the EU) should not apply to this entity; and
- given access to substance based preferential regimes.

The next part of this article will substantiate the foregoing argument. The authors will also make certain recommendations in the form of minimum functional profile safeguards to multinational enterprises that make use of holding, financing, intellectual property (IP) and principal structures (see section 2). The issues that arise with respect to the relevant economic activities test will be discussed thereafter, specifically, issues pertaining to tax competition and tax uncertainty (see section 3). Finally, the authors conclude their analysis and discuss the way forward (see section 4).

[26] The other measures relate to an interest limitation rule (Directive 2016/1164/EU, above fn.22, Art.4); an immediate exit tax rule (Directive 2016/1164/EU, above fn.22, Art.5); and anti-hybrid rules (Directive 2016/1164/EU, above fn.22, Art.9). As highlighted in s.1.3, a discussion on these measures is beyond the scope of this article.

[27] The exclusion for CFC rules only applies to intra-EU situations. Therefore, Member States could implement the CFC rule without a carve-out for genuine activities of subsidiaries or permanent establishments outside the EU. For a criticism of this form of "fiscal protectionism", see R. Danon, "Some Observations on the Carve-Out Clause of Article 7(2)(a) of the ATAD with Regard to Third Countries" in P. Pistone and D. Weber (eds), *The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study* (Amsterdam: IBFD, 2018), 387–407.

[28] Council Directive (EU) 2015/121 of 27 January 2015 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [2015] OJ L21/1.

[29] 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.

1.3. Further matters not discussed in this article

As this article focuses on economic activities carried out in a taxpayer entity, the authors will not include a discussion of rules relating to hybrid entities and instruments,[30] rules limiting interest deductions,[31] rules to counter artificial avoidance of the permanent establishment status[32] and the international corporate tax policy debate triggered by the digitalisation of the economy.[33] Neither will the authors include a discussion of the concept of beneficial ownership as found in Articles 10, 11 and 12 of the OECD Model[34] and the EU IRD.[35] Moreover, *with respect to EU law*, the authors will not engage in a debate on EU state aid rules.

2. The arguable impact of the relevant economic activities test on the international corporate tax framework

2.1. Risk and income allocation from a transfer pricing perspective

Article 9 of the OECD Model provides for the application of the arm's length principle for transactions among associated enterprises. Specifically, Article 9(1) discusses those situations in which the tax administration may invoke a primary adjustment. It is clear that price adjustments are permitted. Disputably, structural adjustments are also allowed.[36] This being said, such

[30] OECD/G20 Base Erosion and Profit Shifting Project, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report* (Paris: OECD Publishing, 2015).
[31] OECD/G20 Base Erosion and Profit Shifting Project, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4—2016 Update: Inclusive Framework on BEPS* (Paris: OECD Publishing, 2017).
[32] OECD/G20 Base Erosion and Profit Shifting Project, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report* (Paris: OECD Publishing, 2015).
[33] 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); OECD, *Tax Challenges Arising from Digitalisation—Interim Report 2018* (Paris: OECD Publishing, 2018).
[34] For an analysis of the concept see A. Meindl-Ringler, *Beneficial Ownership in International Tax Law* (Alphen aan den Rijn: Kluwer, 2016).
[35] See I. Lazarov, "(Un)Tangling Tax Avoidance Under the Interest and Royalties Directive: the Opinion of AG Kokott in N Luxembourg 1" (2018) 46(11) *Intertax* 873.
[36] Transactions undertaken by the taxpayer should be respected. However, at the outset, the question arises as to whether OECD MC 2017, above fn.5, Art.9(1) allows a state to re-characterise the transaction as structured by the taxpayer (entire arrangement or a part of the arrangement) if it is not at arm's length. The OECD believes that this is indeed possible in "exceptional" cases. See OECD, *Transfer Pricing Guidelines* (1979), para.23 and OECD, *Transfer Pricing Guidelines* (2010), para.1.64. According to the 2010 Guidelines, transactions can be re-characterised when: 1. their form does not correspond to the underlying economic substance; or 2. when they are commercially irrational, and the structure of the transaction practically impedes the tax administration from determining an appropriate transfer price. See OECD, *Transfer Pricing Guidelines* (2010), para.1.65. However, the 2017 Guidelines seem to have modified the OECD's position on these two exceptions. First, the economic substance exception has been deleted. Arguably, this seems justified given that the focus of the revised guidance on accurately delineating the transaction seems to be on factual substance, that is, identifying the legal substance of the commercial or financial relations between the parties and understanding the controlled transaction by analysing all the economically relevant characteristics. See OECD, TP Guidelines 2017, above fn.18, paras 1.119–1.120. Also see, R. Collier and J.L. Andrus, *Transfer Pricing and the Arm's Length Principle* (Oxford: OUP, 2017), 199. Secondly, the scope of the commercially irrational exception has been redrafted. Essentially, the tax administration will have to prove that, in addition to the transaction being commercially irrational, the structure of the transaction prevents the determination of the price that would be acceptable to both parties given their respective realistically available options. The guidance on non-recognition will not apply when a comparable transaction exists. See OECD, TP Guidelines 2017, above fn.18, paras 1.121–1.123;

adjustments can only be made to the extent authorised by the domestic transfer pricing legislation.[37] On the other hand, if a state makes a price or structural adjustment under Article 9(1), the other state, to the extent that it agrees with the primary adjustment, will be required to provide, in accordance with Article 9(2), a corresponding adjustment.

The application of the arm's length principle is a two-step process. The first step involves an accurate delineation of the transaction whereas the second step involves reaching an arm's length outcome for the transaction. With respect to the first step, in order to accurately delineate a transaction or find the real deal, the post-BEPS transfer pricing guidance establishes a strong link between income (return) allocation and risk assumption.[38] In this regard, a detailed framework for analysing the relevant or economically significant risks is provided.[39] Essentially, the framework provides that the risks and returns should be allocated to the entity that "controls"[40] the risk and has the financial means[41] to bear the risk even if the intra group contracts allocate the risk to another party.[42]

Arguably the "control" test[43] is met when the entity employs relevant personnel[44] (directors and/or employees) and the functions of this personnel demonstrate that they not only have the capability to perform and make decisions but they also make decisions with respect to: 1. taking on, laying off or declining the key risks associated with the relevant economic activities; and 2. deciding whether and how to respond to the risks associated with their decision-making opportunity. Even if the day-to-day functions/economic activities associated with the risks are outsourced, the outcome should also be similar as long as the personnel in the entity (claiming control over risk) are able to demonstrate that they can oversee and manage the outsourced risks.[45] Moreover, it could be argued that the entity would have the financial means[46] when the entity has the appropriate access to the funding to take on or to lay off the risk, to pay for the risk

also see Collier and Andrus, above, 201–202. In the authors' opinion, the wording of Art.9 does permit structural adjustments.

[37] OECD MC 2017, above fn.5, Art.9(1) does not create "new" taxing rights. The provision, similar to other treaty provisions, restricts the application of domestic law provisions. Therefore, structural adjustments can be made only to the extent authorised by the domestic law. V. Chand, "Transfer Pricing Aspects of Inter company Loans in light of the BEPS Action Plan" (2016) 44(12) *Intertax* 885, 885-–889.

[38] OECD, TP Guidelines 2017, above fn.18, paras 1.56–1.59; UN, *Practical Manual on Transfer Pricing for Developing Countries* (UN, TP Manual (2017)) (2017), paras B.2.3.2.23-B.2.3.2.24.

[39] OECD, TP Guidelines 2017, above fn.18, para.1.60; UN, TP Manual (2017), above fn.38, para.B.2.3.2.25. It should be noted that the pre-BEPS chapter on business restructurings only indicated these requirements as potential indicators to allocate risks. See Collier and Andrus, above fn.36, 203.

[40] OECD, TP Guidelines 2017, above fn.18, para.1.65; UN, TP Manual (2017), above fn.38, para.B.2.3.2.35.

[41] OECD, TP Guidelines 2017, above fn.18, para.1.64; UN, TP Manual (2017), above fn.38, paras B.2.3.2.38–B.2.3.2.40.

[42] I. Verlinden, D. Ledure and M. Dessy, "The Risky Side of Transfer Pricing: The OECD Base Erosion and Profit Shifting Reports Sharpen the Rules on Risk Allocation under the Arm's Length Standard" (2016) 23 *International Transfer Pricing Journal* 109, 110-–112.

[43] Also see W. Schön, "International Taxation of Risk" (2014) 68 *Bulletin for International Taxation* 280, 288–290; J. Monsenego, "The Substance Requirement in the OECD Transfer Pricing Guidelines: What Is the Substance of the Substance Requirement?" (2014) 21 *International Transfer Pricing Journal* 9, 14–15.

[44] Such decision makers need to have the right competence and experience to make the decisions. See OECD, TP Guidelines 2017, above fn.18, para.1.66; UN, TP Manual (2017), above fn.38, para.B.2.3.2.36. For a detailed discussion on this matter, see Monsenego, above fn.43, 12–13.

[45] OECD, TP Guidelines 2017, above fn.18, para.1.65; UN, TP Manual (2017), above fn.38, paras B.2.3.2.35–B.2.3.2.37.

[46] A commentator has argued that the guidance on the financial capacity test is rather limited. See Monsenego, above fn.43, 15–16.

mitigation functions (insurance or hedging) and to bear the consequences of the risk if it materialises.[47] Thus, if a functional analysis leads to the finding that the personnel of an entity make key decisions vis-à-vis the economically significantly risks associated with the *relevant economic activities* and the entity has the financial means to assume those risks, then, from a transfer pricing perspective the risks and the underlying income connected with those risks should be allocated to that entity.[48] Conversely, if a functional analysis in all of the aforementioned situations leads to the finding that the key decisions vis-à-vis the economically significant risks associated with the entity's business are not made by the entity's personnel but rather the personnel of another entity in a MNE group then the tax administration of the other entity's state may initiate an assessment to accurately delineate the transaction. Essentially, an accurate delineation would reallocate the underlying income associated with those risks to the other entity.[49]

2.2. Access to tax treaty benefits

The PPT states that a treaty benefit[50] will be denied to the taxpayer when "one of the principal purposes" of the transaction/arrangement/structure is to obtain that benefit (subjective element[51]). In which case the taxpayer is given the opportunity to prove that "granting the benefit is in accordance with the object and purpose of the relevant provisions" (objective element[52]).

The expression "one of the principal purposes" raises questions with regard to its interpretation. It could be argued that the subjective element of the PPT is not satisfied if the taxpayer is able to demonstrate that its transaction is rational from a commercial and/or economic perspective. To illustrate this, the authors differentiate between the following two situations[53]: 1. genuine intermediary structures used by corporate groups that reflect commercial and economic reality (economic nexus to a state); and 2. back-to-back arrangements, which are structured through economic operators and which may not or may lack commercial rationale (these being abusive arrangements).[54]

With respect to the first situation, if an objective analysis of all facts and circumstances leads to the conclusion that the structure is commercially and economically rational then the taxpayer will not satisfy the subjective element and consequently the treaty benefit will be granted.[55] The OECD Commentary supports this position and indicates:

[47] OECD, TP Guidelines 2017, above fn.18, para.1.64; UN, TP Manual (2017), above fn.38, paras B.2.3.2.38–B.2.3.2.40.
[48] See Collier and Andrus, above fn.36, 229.
[49] OECD, TP Guidelines 2017, above fn.18, para.1.66; UN, TP Manual (2017), above fn.38, para.B.2.3.2.36.
[50] OECD MC 2017, above fn.5, Commentary on Article 29, para.175. For a detailed discussion on this matter, see V. Chand, *The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties (with special considerations for the BEPS project)* (Zurich: Schulthess, 2018), s.9.3.2; De Broe (2016), above fn.15, 210; Danon (2018), above fn.15, 42.
[51] For a critical discussion on this element, see De Broe and Luts, above fn.15, 132; De Broe (2016), above fn.15, 237–238; Chand, above fn.50, s.9.3.3.
[52] For a critical discussion on this element, see Chand, above fn.50, s. 9.3.4; De Broe, above fn.15, *EU Law*, 213.
[53] The authors restrict themselves to these two situations for the purpose of the contribution. Other fact patterns can of course also be analysed under the PPT (such as rule shopping schemes).
[54] Another author has recently differentiated between these two situations while analysing the PPT, see S. van Weeghel, "A Deconstruction of the Principal Purposes Test" (2019) 11 *World Tax Journal* 3.
[55] See, e.g. *Carrefour* decision (South Korea, 2012du16466, 2014.7.10), where the court ruled that a Dutch BV was not a conduit company as it had several subsidiaries, physical substance, discretionary authority over cash and was not established for the purpose of tax avoidance.

> "[W]here an arrangement is inextricably linked to *a core commercial activity*,…it is unlikely that its principal purpose will be considered to be to obtain that benefit." (Emphasis added.)[56]

This conclusion can also be derived from several examples discussed in the OECD Commentary with respect to the PPT.[57] For instance, referring to the fact patterns that deal with intermediary companies, that are owned by third state residents, and which have been set up to carry out core economic activities:

- Example G[58] deals with provision of genuine intra group services. In that example, the intermediary entity (RCO) in State R is given access to treaty benefits. This is because of commercial and economic aspects. The first aspect relates to commercial reasons for selecting State R. After considering different locations, TCO chooses State R because of the availability of a skilled work force, a dependable legal system, a business friendly setting, political stability, membership of a regional block, a sophisticated banking industry and the comprehensive double taxation treaty network of State R, including its tax treaties with the five states in which TCO owns subsidiaries. The second aspect relates to the relevant economic activities carried out by the intermediary in State R. The Commentary states:

  > "Assuming that the intra-group services to be provided by RCO, including the making of decisions necessary for the conduct of its business, constitute a real business through which RCO exercises substantive economic functions, using real assets and assuming real risks, and that business is carried on by RCO through its own personnel located in State R, it would not be reasonable to deny the benefits of the treaties concluded [by] State R."[59]

- Example H[60] deals with investment activities carried out by an operating entity through debt and equity investments. In that example, the intermediary entity (RCO) in State R is given access to treaty benefits on the interest and dividend income. This is because of the following two main aspects. The first aspect relates to commercial aspects, that is, non-tax reasons for the establishment of RCO in State R and the reasons for selecting State R. The facts indicate that TCO had difficulties in conducting its international business from State T mainly because of issues related to transportation, time differences, limited availability of personnel fluent in foreign languages and the foreign location of business partners. Thus, in order to develop a base for its foreign business activities, TCO establishes RCO. Moreover, State R is selected because of its developed international trade and financial markets and abundance of highly qualified human resources. The second aspect relates to the relevant economic activities carried out by the intermediary in State R. The facts state that RCO carries on diverse business activities such as

[56] OECD MC 2017, above fn.5, Commentary on Article 29, para.181.
[57] On the importance of the OECD Commentary, see Danon (2018), above fn.15, 48–50.
[58] OECD MC 2017, above fn.5, Commentary on Article 29, para.182, Example G.
[59] OECD MC 2017, above fn.5, Commentary on Article 29, para.182, Example G.
[60] OECD MC 2017, above fn.5, Commentary on Article 29, para.182, Example H.

wholesaling, retailing, manufacturing, financing and domestic and international investment. RCO's employees (personnel working in areas such as legal, finance, accounting, taxation, risk management, auditing and internal control) perform these activities. Furthermore, RCO possesses the necessary financial resources to conduct its activities. Consequently, in light of these aspects, it is clear that RCO carries out genuine economic activities that may constitute an active conduct of business. Given these facts, RCO's creation in State R and its investment in SCO are not driven by the avoidance of taxes in State S. Therefore, the subjective element should not be satisfied, and the treaty benefit should be granted.

- In Example K,[61] the intermediary entity (RCO) that acts as a regional investment platform is given access to treaty benefits. This is because of the following two considerations. The first consideration relates to commercial reasons for selecting State R. The facts indicate that State R was selected because of the availability of knowledgeable directors with experience of regional business practices and regulations, the existence of a skilled multilingual workforce, State R's membership of a regional grouping and the extensive tax convention network of State R, including its tax convention with State S, which provides for low withholding tax rates. The second consideration relates to the relevant economic activities carried out by the intermediary in State R. The facts state that RCO's activities are carried out by: 1. a board of directors that are comprised of a majority of State R residents (with expertise in investment management) and the members of the Fund's global management team; and 2. an experienced local management team that reviews investment recommendations from the Fund and performs various other functions such as approving and monitoring investments, carrying on treasury functions, maintaining RCO's books and records, and ensuring compliance with regulatory requirements in states where it invests. Given these facts, it is clear that RCO's creation in State R and its investment in SCO are not driven by the purpose of avoiding taxes in State S. Therefore, the subjective element should not be satisfied based on these facts and the treaty benefit should be granted.

On the contrary, if an objective analysis of all facts and circumstances leads to the conclusion that the main purpose of the arrangement was to obtain a tax benefit then the taxpayer will satisfy the subjective element.[62]

Similarly, with respect to the second situation, it is obvious that if a factual analysis of all facts and circumstances surrounding the transaction leads to the conclusion that the back-to-back arrangement has been entered into with the principal purpose of obtaining a tax benefit then there is no doubt that the subjective element should be satisfied. This would typically be the case when a third state resident uses an economic operator (financial institution or a related entity)

[61] OECD MC 2017, above fn.5, Commentary on Article 29, para.182, Example K.
[62] See for instance the fact patterns in *MIL (Investments) SA v Canada* [2006] 9 ITLR 25 and *Alta Energy Luxembourg SARL v R* [2018] 21 ITLR 219.

for artificial arrangements. For instance, see example A[63] and B[64] in the Commentary to the PPT as well as examples A,[65] C[66] and D[67] in the Commentary on anti-conduits. These arrangements are carried out with the sole purpose of obtaining tax advantages. On the other hand, if the commercial rationale of such back-to-back arrangements can be demonstrated then the subjective element should not be satisfied. For instance, refer to the fact patterns that deal with following back-to-back arrangements:

- Example E[68] in the Commentary on anti-conduit arrangements discusses a back-to-back licensing situation. The Commentary states that treaty benefits should be granted to the royalty income as RCO (intermediary)

  > "is conforming to the standard commercial organisation and behaviour of the group in the way that it structures its licensing and sub-licensing activities and assuming the same structure is employed with respect to other subsidiaries carrying out similar activities in countries which have treaties which offer similar or more favourable benefits".

  In this example, it seems that the treaty benefit is available as long as the taxpayer is able to demonstrate commercial reasons for setting up the licensing arrangements. Arguably, from a transfer pricing perspective the majority of the income should be allocated to the relevant subsidiary as it bears the risks associated with the development of the intellectual property.
- Example F[69] in the Commentary on anti-conduits discusses a back-to-back financing situation. In this case, treaty benefits are granted to the intermediary treasury (RCO)

[63] OECD MC 2017, above fn.5, Commentary on Article 29, para.182, Example A. The facts in this example are similar to the facts of the *1994 Royal Dutch Oil Company/Marketmaker* judgment (Netherlands, Hoge Raad judgment of 6 June 1994, BNB 1994/217). For a detailed analysis of the judgment see L. De Broe, *International Tax Planning and Prevention of Abuse: A Study under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, Doctoral Series Vol.14 (Amsterdam: IBFD, 2007), 694–697.

[64] OECD MC 2017, above fn.5, Commentary on Article 29, para.182, Example B. The facts in this example are similar to the facts of the 2006 *Bank of Scotland* judgment. See *Ministre de l'Economie, des Finances et de l'Industrie v Société Bank of Scotland* [2006] 9 ITLR 683.

[65] OECD MC 2017, above fn.5, Commentary on Article 29, para.187, Example A. The example directly resembles the fact pattern contained in Example 1 of the Exchange of Letters with respect to the interpretation of the anti-conduit provision (Art.3(1)(n)) in the 2001 US–UK Tax Treaty.

[66] OECD MC 2017, above fn.5, Commentary on Article29, para.187, Example C. The example directly resembles the fact pattern contained in Example 3 of the Exchange of Letters with respect to the interpretation of the anti-conduit provision (Art.3(1)(n)) in the 2001 US–UK Tax Treaty.

[67] OECD MC 2017, above fn.5, Commentary on Article 29, para.187, Example D. The example directly resembles the fact pattern contained in Example 4 of the Exchange of Letters with respect to the interpretation of the anti-conduit provision (Art.3(1)(n)) in the 2001 US–UK Tax Treaty. Also see Rev. Rul. 87–89, 1987–2, C.B. 195.

[68] OECD MC 2017, above fn.5, Commentary on Article 29, para.187, Example E. The example directly resembles the fact pattern contained in Example 5 of the Exchange of Letters with respect to the interpretation of the anti-conduit provision (Art.3(1)(n)) in the 2001 US–UK Tax Treaty. For a detailed analysis of Example E, see R. Danon, "Intellectual Property (IP) Income and Tax Treaty Abuse: Relevance of BEPS Action 5 and 8–10 for the Principal Purpose Test" in G. Maisto (ed.), *Taxation of Intellectual Property under Domestic Law, EU Law and Tax Treaties* (Amsterdam: IBFD, 2018), 17–34.

[69] OECD MC 2017, above fn.5, Commentary on Article 29, para.187, Example F. The example directly resembles the fact pattern contained in Example 6 of the Exchange of Letters with respect to the interpretation of the anti-conduit provision (Art.3(1)(n)) in the 2001 US–UK Tax Treaty.

> entity on the interest income it receives from State S. This is because: 1. RCO is established with the purpose of carrying out financing activities; 2. RCO carries out these activities through several employees; 3. RCO employs the relevant assets; and 4. RCO, through its personnel, assumes the financial risks associated with those activities such as interest rate and currency risks. Arguably, treaty benefits are allowed as RCO has demonstrated, through its personnel, that it takes business-related risks with respect to the underlying income.

If the taxpayer satisfies the subjective element, the question arises as to how the objective element is to be interpreted. In this regard, the authors submit that a two-stage analysis[70] will be required to ascertain the object and purpose of the "relevant provisions". Under the first stage, the taxpayer has to determine the object and purpose of the "relevant provisions"[71] in light of the objectives pursued by the tax treaty (legal analysis). In this context, to the extent that the new preamble is incorporated in tax treaties, it could be argued that the following objectives shall be considered in the treaty interpretation process (while interpreting the PPT) as opposed to giving preference to one particular objective: 1. allocating taxing rights and eliminating double taxation with a view to promoting cross border flows (such as investments); 2. the prevention of tax evasion; and 3. prevention of tax avoidance (in particular, treaty shopping). The addition of the tax avoidance objective will ensure that

> "tax conventions apply in accordance with the purpose for which they were entered into, i.e. to provide benefits in respect of bona fide exchanges of goods and services, and movements of capital and persons…".[72]

Thus, the object and purpose of the "relevant provisions" have to be read in light of the object and purpose of the entire tax treaty.[73] Thereafter, under the second stage, the taxpayer will have to demonstrate that the transaction/arrangement respects the object and purpose of the "relevant provisions" at stake (application of the legal analysis to the facts at stake).

For instance, consider a case where a resident of a third state (TCO in State T) sets up a shell entity/letterbox (RCO in State R) which then invests in shares of a subsidiary (SCO in State S). The main reason for choosing State R is its tax treaty with State S (Article 13 of the tax treaty allocates taxing rights on capital gains to the state of residence). Let us assume that the facts indicate that one of the principal purposes (or the sole purpose) for interposing RCO was to obtain a tax benefit and hence the subjective element is satisfied. With respect to the application of the objective element, under the first stage, the taxpayer will establish that: 1. the object and

[70] See *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601; 2005 SCC 54 (CanLII) at [44]–[62]; Chand, above fn.50, s.9.3.4.

[71] Arguably, the PPT becomes redundant if only the object and purpose of the "relevant provisions" are considered. This is because, in a tax avoidance scheme, a resident taxpayer always respects the formal conditions of tax treaties such as the conditions imposed by the time limit provisions (OECD MC 2017, above fn.5, Art.5(3)), ownership threshold (OECD MC 2017 Art.10(2)) or the relevant distributive rule (for instance, OECD MC 2017 Arts 10, 11, 12 and 13). Accordingly, such an approach that focuses on a literal interpretation of ordinary treaty terms should be rejected. See Chand, above fn.50, s.9.3.4.

[72] OECD MC 2017, above fn.5, Commentary on Article 29, para.174.

[73] Moreover, to the extent relevant, other treaty objectives such as elimination of tax discrimination as provided in OECD MC 2017, above fn.5, Art.24 and the establishment of a mutual agreement procedure (MAP) as per OECD MC 2017 Art.25 should be taken into consideration. See Chand, above fn.50, s.9.3.4.

purpose of Article 13 is to allocate taxing rights vis-à-vis capital gains; and 2. the object and purpose of tax treaties is to: (a) allocate taxing rights and eliminate double taxation with a view to promoting cross border investments; (b) prevent tax evasion; and (c) prevent tax avoidance. Under the second stage, RCO will be able to demonstrate that it has acted in accordance with: 1. the object and purpose of Article 13 as it has complied with its formal conditions for applying the treaty in the sense that it is a person, a resident and its income falls under the distributive rule that deals with capital gains; and 2. the object and purpose of tax treaties as: (a) it has complied with the intent of such tax treaties which is to promote cross border investment, that is, it invests in State S; and (b) the transaction does not represent a tax evasion scheme. With respect to (c) it will be difficult for RCO to prove that its transaction represents a "genuine"/"bona fide" transaction, as an objective analysis of the facts would indicate the presence of a high degree of "artificiality" (as it is a letterbox). Therefore, the PPT would apply as the taxpayer may not be able to establish that the principal purpose of seeking the tax benefit was within the object, spirit and purpose of the provisions that confer the tax benefit. This said, the analysis of the subjective and objective element will be different if the taxpayer is able to demonstrate a commercial and/or economic rationale with respect to the arrangements (for instance, as explained in examples G, H and K above).

Similarly, in back-to-back arrangements as discussed in examples A and B in the Commentary to the PPT as well as examples A and C in the Commentary on anti-conduits, it will be difficult for the taxpayer to prove that the principal purpose of seeking the tax benefit was within the object, spirit and purpose of the provisions that confer the tax benefit. This said, the analysis of the objective element will be different if the taxpayer is able to demonstrate a commercial rationale of its arrangements (for instance, as explained in examples E and F above).

2.3. Access to EU tax law

2.3.1. Abuse of rights doctrine in EU law

It is clear from CJEU case law that a taxpayer entity (an economic operator) cannot invoke EU law (treaty freedoms) in fraudulent situations (for instance sham/simulated transactions or false declarations).[74] On the other hand, for transactions that are legally effective, an economic operator cannot access treaty freedoms in abusive situations. In this regard, it is argued that the CJEU

[74] For instance, see the following CJEU decisions: *Van Binsbergen v Bedrijfsvereniging voor de Metaalnijverheid* (C-33/74) [1974] ECR 1299 at [13]; *Alexandros Kefalas and Others v Elliniko Dimosio (Greek State) and Organismos Oikonomikis Anasygkrotisis Epicheiriseon AE (OAE)* (C-367/96) [1998] ECR I-2843 at [20]; *Dionysios Diamantis v Elliniko Dimosio (Greek State) and Organismos Ikonomikis Anasygkrotisis Epicheiriseon AE (OAE)* (C-373/97) [2000] ECR I-1705 at [33]; *I/S Fini H v Skatteministeriet* (C-32/03) [2005] ECR I-1599 at [32].

has created an "abuse of rights" doctrine[75] and that this doctrine may be used to interpret EU law.[76]

With respect to the application of the doctrine in non-direct tax matters, the CJEU in *Emsland-Stärke GmbH v Hauptzollamt Hamburg-Jonas*[77] and *Halifax plc and others v CC&E* (*Halifax*)[78] has developed a two-fold, that is, subjective and objective, test in order to determine whether or not abuse has arisen. Abuse will be determined to have arisen when the economic operator exercises its right to free movement with the sole intention (or principal, essential or predominant intention)[79] of obtaining benefits through artificial schemes and granting the benefits would be contrary to the object and purpose of the relevant provisions of EU law (primary or secondary law).[80]

Recent judgments of the CJEU in the context of the IRD[81] and PSD[82] confirm the position that this doctrine can be invoked by Member States to deny protection in harmonised areas of direct taxation within the EU.[83] This said, it could be argued that the doctrine should not apply to structures or arrangements that are rational from a commercial and/or economic perspective (this matter is further discussed in section 2.3.3).

[75] For instance, see the following CJEU case law: *J. Knoors v Staatssecretaris van Economische Zaken* (C-115/78) [1979] ECR 399; *Criminal proceedings against Marc Gaston Bouchoucha* (C-61/89) [1990] ECR I-3551; *R. v Immigration Appeal Tribunal and Surinder Singh, Ex p. Secretary of State for Home Department* (C-370/90) [1992] ECR I-4265; *Vereniging Veronica Omroep Organisatie v Commissariaat voor de Media* (C-148/91) [1993] ECR I-487; *TV10 SA v Commissariaat voor de Media* (C-23/93) [1994] ECR I-4795; *Centros Ltd v Erhvervs- og Selskabsstyrelsen* (C-212/97) [1999] ECR I-1459.

[76] For a detailed analysis, see L. De Broe and D. Beckers, "The General Anti-Abuse Rule of the Anti-Tax Avoidance Directive: An Analysis Against the Wider Perspective of the European Court of Justice's Case Law on Abuse of EU Law" (2017) 26 *EC Tax Review* 133, 136–139; R. de la Feria, "Prohibition of Abuse of (Community) Law: The Creation of a New General Principle of EC Law Through Tax" (2008) 45(2) *Common Market Law Review* 395.

[77] *Emsland-Stärke GmbH v Hauptzollamt Hamburg-Jonas* (C-110/99) [2000] ECR I-11569 at [52]–[53].

[78] *Halifax plc and others v CC&E* (C-255/02) [2006] ECR I-1609 at [74]–[75].

[79] On such terminological differences, see C. Öner, "Is Tax Avoidance the Theory of Everything in Tax Law? A Terminological Analysis of EU Legislation and Case Law" (2018) 27(2) *EC Tax Review* 96, 105–107; De Broe and Beckers, above fn.76, 134–135.

[80] De Broe and Beckers, above fn.76, 133.

[81] *N Luxembourg 1 and others v Skatteministeriet* (*N Luxembourg 1 and others*) (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16) EU:C:2019:134 at [96]–[122].

[82] *Skatteministeriet v T Danmark and Y Denmark Aps* (*T Danmark and Y Denmark Aps*) (Joined Cases C-116/16 and C-117/16) EU:C:2019:135 at [70]–[95].

[83] However, whether Member States can apply this doctrine in the area of non-harmonised direct taxation is still debatable. For a detailed discussion, see: De Broe and Beckers, above fn.76, 137–139. C. Brokelind and P. Wattel in P.J. Wattel, H. Vermeulen and O. Marres (eds), *European Tax Law: Volume I (Full Edition)*, 7th edn (Alphen aan den Rijn: Kluwer Law International, 2018), 666–667.

2.3.2. Domestic anti-abuse measures (CFC rules) and EU law

Broadly, when the CJEU[84] analyses the compatibility of a domestic rule (including national anti-avoidance rules) with treaty freedoms,[85] as a first step, it analyses whether that national rule leads to a restriction or discrimination. In this regard, with respect to CFC rules, in *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v IRC* (*Cadbury Schweppes*),[86] it was held that the UK CFC rules constituted a restriction on the freedom of establishment as they deterred UK companies from setting up subsidiaries overseas whereas the rules did not apply to domestic subsidiaries.

If an obstacle to free movement arises, then the CJEU analyses whether the national law measure can be justified by overriding reasons of public interest. For national direct tax law measures that amount to obstacles, the CJEU has accepted justifications[87] such as the need to maintain the coherence of a tax system,[88] the need to protect balanced allocation of taxing rights,[89] the need for effective fiscal supervision[90] and the need to prevent tax evasion and avoidance or abuse of law. With respect to the tax avoidance justification, the CJEU has held that national legislation that reduces the risk of tax avoidance could be justified, subject to the proportionality requirement.[91]

With respect to the proportionality test, the CJEU in the *Cadbury Schweppes* judgment held that UK CFC rules could be proportional only if they apply to wholly artificial arrangements. However, if they apply to arrangements that encompass economic reality then such rules will be contrary to the freedom of establishment provisions even though the arrangement contained tax motives. In the CJEU's verdict, "wholly artificial arrangements" exist when the CFC does not have any "premises, staff and equipment"[92] and can be characterised as a "letterbox".[93]

[84] *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* (C-324/00) [2002] ECR I-11779 at [26]; *Test Claimants in the Thin Cap Group Litigation v IRC* (*Test Claimants Thin Cap Group*) (C-524/04) [2007] ECR I-2107 at [25]; *NV Lammers & Van Cleeff v Belgische Staat* (*Lammers & Van Cleeff*) (C-105/07) [2008] ECR I-173 at [12]; also see Wattel, *European Tax Law*, above fn.83, 45–49; De Broe, above fn.63, 748; A. Armenia and A. Zalasinski, "EU Report" in IFA, *The taxation of foreign passive income for groups of companies, Cahiers de droit fiscal international* (2013) Vol.98a, 58.

[85] Armenia and Zalasinski, above fn.84, 59; Wattel, *European Tax Law*, above fn.83, 61–76.

[86] *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v IRC* (C-196/04) [2006] ECR I-7995; [2006] STC 1908 at [46]. Also see *Commission v United Kingdom* (*Commission v UK*) (C-112/14) EU:C:2014:2369 at [20].

[87] Wattel, *European Tax Law*, above fn.83, 70–76.

[88] *Hanns-Martin Bachmann v Belgian State* (C-204/90) [1992] ECR I-249 at [21]–[28]. It should be noted that this justification has been rejected in several direct tax cases pursuant to this judgment. Wattel, *European Tax Law*, above fn.83, 73.

[89] *N v Inspecteur van de Belastingdienst Oost/kantoor Almelo* (C-470/04) [2006] ECR I-7409 at [41]–[49].

[90] *Futura Participations and Singer v Administration des contributions* (C-250/95) [1997] ECR I-2471 at [31]–[35]; *Skatteverket v A* (C-101/05) [2007] ECR I-11531 at [54]–[55]. Also see A. Zalasinski, "Proportionality of Anti-Avoidance and Anti-Abuse Measures in the ECJ's Direct Tax Case Law" (2007) 35(5) *Intertax* 310, 315.

[91] Zalasinski, above fn.90, 315–321. It is also foreseeable that the CJEU may accept a tax avoidance justification in conjunction with other justifications. See Brokelind and Wattel, above fn.83, 667–670.

[92] *Cadbury Schweppes* (C-196/04), above fn.86, [2006] ECR I-7995 at [67].

[93] *Cadbury Schweppes* (C-196/04), above fn.86, [2006] ECR I-7995 at [68]. In line with this argument, the attribution of gain rules, as discussed in the *Commission v UK* case, was also held to violate the free movement of capital provisions as it applied in a general way and was not restricted to wholly artificial arrangements. See *Commission v UK* (C-112/14), above fn.86, EU:C:2014:2369 at [28]–[29].

Article 7 of the ATAD provides for CFC rules. However, Article 7(2)(a) carves out the application of CFC rules when the CFC carries on "substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances". The carve-out clearly reflects the CJEU's view expressed in the *Cadbury Schweppes* case. Accordingly, it could be argued that CFC rules are incompatible with the freedom of establishment provisions[94] if they apply to entities that carry out genuine economic activities,[95] that is, entities that are rational from a commercial and/or economic perspective. In fact, the German Federal Tax Court recently also held that the German CFC rules could not be applied to a CFC in Cyprus as the Cypriot entity carried out economic activity.[96] Moreover, the income inclusion rule discussed in Article 7(2)(b) ATAD should also not be applicable as long as the taxpayer satisfies the relevant economic activities test. The ATAD, on the other hand, does not preclude Member States from excluding the above carve-out from EU–third state situations. However, if a Member State applies the ATAD CFC rule to entities in third states which carry out genuine economic activities, it could be argued that such a rule, in certain situations, conflicts with the free movement of capital provisions.[97]

2.3.3. Abuse under corporate tax directives

2.3.3.1. PSD and IRD: domestic or agreement-based measures In order to combat abuse, Article 1(4) of the PSD[98] and Article 5(1) of the IRD[99] respectively provide that the directives "shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse". These provisions therefore allow the application of domestic anti-avoidance

[94] See Öner, above fn.79, 107-110; A. Cordewener, "Anti Abuse Measures in Direct Taxation: Towards Converging Standards under Treaty Freedoms and EU Directives" (2017) 26(2) *EC Tax Review* 60, 61–63.

[95] In the context of interaction of domestic thin capitalisation rules with EU law, the CJEU has held that such rules could be incompatible with the freedom of establishment/free movement of capital provisions if they are not predicated on an assessment of objective and verifiable elements for the purposes of determining whether a transaction represents a "wholly artificial arrangement". Even if the rules provide elements for determining the existence of a "wholly artificial arrangement" such rules could be found incompatible if the taxpayer is not provided with an opportunity to provide a commercial justification (without being subject to administrative hassles) and such rules make profit adjustments to the borrower that exceed the arm's length standard. See CJEU: *Test Claimants Thin Cap Group* (C-524/04), above fn.84, [2007] ECR I-2107 at [80]–[83]; *Lammers & Van Cleeff* (C-105/07), above fn.84, [2008] ECR I-173, [28]–[29]; *Itelcar - Automóveis de Aluguer Lda v Fazenda Pública* (*Itelcar*) (C-282/12) EU:C:2013:629 at [37]–[38]; *Société de Gestion Industrielle SA (SGI) v Belgian State* (C-311/08) EU:C:2010:26 at [71]–[72]. Also see Öner, above fn.79, 110–111; moreover, if the outcome of applying a domestic anti-avoidance rule is not clear or is ambiguous such a rule may fail to be proportional; *Itelcar* (C-282/12), above, EU:C:2013:629 at [44]. Brokelind and Wattel, above fn.83, 679; De Broe and Beckers, above fn.76, 135.

[96] *Bundesfinanzhof* (Germany) judgment of 13 June 2018, I R 94/15. For the applicability of EU CFC rules to entities established outside the EU, see R. Danon, "EU Fiscal Protectionism versus Free Movement of Capital: The Case of the ATAD CFC Categorial Model" in P. Pistone (ed.), *European Tax Integration: Law, Policy and Politics* (Amsterdam: IBFD, 2018), 387–407.

[97] A commentator argues that the free movement of capital provisions would apply to a CFC rule that is designed on the basis of ATAD Art.7(1)(a). This is because that rule also applies to parent entities that are entitled to "receive more than 50 percent of the profits" of the CFC. Moreover, by referring to the SECIL case (*SECIL - Companhia Geral de Cal e Cimento SA v Fazenda Pública* (C-464/14) EU:C:2016:896), the commentator argues that a disproportional restriction arises when the CFC rules apply to genuine third state situations. See Danon, above fn.96, 397–407.

[98] Directive (EU) 2015/121.

[99] Directive 2003/49/EC.

rules (domestic safeguard clause hereinafter) as well as tax treaty anti-abuse rules (treaty safeguard clause hereinafter) to deny directive related benefits.

Prior to entering into a discussion on the domestic safeguard provision of the PSD and IRD, it should be noted that pursuant to Article 11(1)(a) (first sentence) of the Merger Directive (MD)[100] its benefits will be denied when a reorganisation "has as its principal objective or as one of its principal objectives tax evasion or tax avoidance". It is further provided (second sentence) that

> "the fact that one of the operations referred to in Article 1 is not carried out for valid commercial reasons such as the restructuring or rationalization of the activities of the companies participating in the operation may constitute a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives".

While implementing Article 11(1)(a) of the MD into their national legislation, different Member States have adopted either domestic anti-avoidance rules of a general nature or predetermined criteria in order to deny directive related benefits. This had led tax administrations to deny benefits even in non-abusive situations. However, in several cases, such as *A. Leur-Bloem v Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2* (*Leur-Bloem*),[101] *Modehuis A. Zwijnenburg BV v Staatssecretaris van Financiën* (*Zwijnenburg*),[102] *Foggia - Sociedade Gestora de Participações Sociais SA v Secretário de Estado dos Assuntos Fiscais* (*Foggia*)[103] and *Euro Park Service v Ministre des finances et des comptes publics* (*Europark*),[104] the CJEU has held that national anti-avoidance measures that are drafted as general rules or presumptions to exclude certain categories of transactions from tax advantages to deny directive benefits could be disproportionate. Moreover, it was held in Hans *Markus Kofoed v Skatteministeriet* (*Kofoed*),[105] by referring to the *Cadbury Schweppes* judgment, that the anti-abuse rules in Article 11(1)(a) "[reflect] the general Community law principle that abuse of rights is prohibited". The foregoing discussion supports the premise that domestic anti-abuse rules can be applied to the extent that they are applicable to wholly artificial arrangements.

With respect to the application of domestic anti-abuse rules to the PSD, the CJEU, in *Eqiom SAS, formerly Holcim France SAS and Enka SA v Ministre des Finances et des Comptes publics* (*Eqiom*)[106] as well as the joined cases of *Deister Holding AG and Juhler Holding A/S v*

[100] Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States [2009] OJ L310/34. See Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States [1990] OJ L225/1 Art.11; Directive 2009/133/EC Art.15.

[101] *A. Leur-Bloem v Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2* (C-28/95) EU:C:1997:369 at [48(b)].

[102] *Modehuis A. Zwijnenburg BV v Staatssecretaris van Financiën* (C-352/08) EU:C:2010:282, at [44].

[103] *Foggia - Sociedade Gestora de Participações Sociais SA v Secretário de Estado dos Assuntos Fiscais* (C-126/10) EU:C:2011:718 at [37].

[104] *Euro Park Service v Ministre des finances et des comptes publics* (C-14/16) EU:C:2017:177 at [57].

[105] *Hans Markus Kofoed v Skatteministeriet* (C-321/05) [2007] ECR I-5795 at [38].

[106] *Eqiom SAS, formerly Holcim France SAS and Enka SA v Ministre des Finances et des Comptes publics* (C-6/16) EU:C:2017:641.

Bundeszentralamt für Steuern (*Deister Holding and Juhler Holding*),[107] held, as a starting point, that the directive provision authorising a reference to the domestic safeguard clause should be interpreted strictly.[108] Specifically, by referring to the *Cadbury Schweppes* decision, the CJEU held that such domestic rules can be applied pursuant to the domestic safeguard clause only if their specific objective is to "prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality".[109] Moreover, the CJEU held that domestic anti-avoidance rules that are drafted as general rules or presumptions to deny PSD benefits could be disproportionate.[110] The CJEU then analysed the French and German domestic anti-abuse rules in light of the foregoing discussion and held that those rules were not proportional as they were based on presumptions and went beyond the wholly artificial arrangement threshold.[111] Thus, it could be argued that domestic anti-abuse rules should not apply to structures or arrangements that are rational from a commercial and/or economic perspective. Interestingly, in the context of discussing artificial arrangements, the CJEU in *Deister Holding and Juhler Holding* has held that

> "the fact that the economic activity of a non-resident parent company consists in the management of its subsidiaries' assets or that the income of that company results only from such management cannot per se indicate the existence of a wholly artificial arrangement which does not reflect economic reality".[112]

These findings of the CJEU support the contention that holding companies cannot be systematically considered as wholly artificial arrangements under EU law.[113]

In line with the principles established with respect to the domestic safeguard clause, it could be argued that the application of a treaty anti-abuse rule pursuant to the treaty safeguard clause should also be interpreted strictly. This would imply that a treaty anti-abuse clause could apply if its specific objective is to *prevent wholly artificial arrangements*. For instance, the PPT can be applied only to the extent that it denies benefits vis-à-vis wholly artificial arrangements or arrangements that are not commercially rational.[114] In fact, the EU Commission has identified that potential frictions could arise between the PPT and the CJEU's case law on abuse. Thus, it

[107] *Deister Holding AG and Juhler Holding A/S v Bundeszentralamt für Steuern* (Joined Cases C-504/16 and C-613/16) EU:C:2017:1009.

[108] *Eqiom* (C-6/16), above fn.106, EU:C:2017:641 at [26]; *Deister Holding and Juhler Holding* (Joined Cases C-504/16 and C-613/16), above fn.107, EU:C:2017:1009 at [59].

[109] *Eqiom* (C-6/16), above fn.106, EU:C:2017:641 at [30]; *Deister Holding and Juhler Holding* (Joined Cases C-504/16 and C-613/16), above fn.107, EU:C:2017:1009 at [60].

[110] *Eqiom* (C-6/16), above fn.106, EU:C:2017:641 at [31]–[32]; *Deister Holding and Juhler Holding* (Joined Cases C-504/16 and C-613/16), above fn.107, EU:C:2017:1009 at [61]–[62].

[111] *Eqiom* (C-6/16), above fn.106, EU:C:2017:641 at [33]–[38]; *Deister Holding and Juhler Holding* (Joined Cases C-504/16 and C-613/16), above fn.107, EU:C:2017:1009 at [63]–[71].

[112] *Deister Holding and Juhler Holding* (Joined Cases C-504/16 and C-613/16), above fn.107, EU:C:2017:1009 at [73].

[113] Danon (2018), above fn.15, 47.

[114] It has been argued that the PPT rule could be contrary to the proportionality principle in EU law. This is because the CJEU's case law sets a higher threshold to determine the existences of abuse, that is, abuse arises only when the essential aim, sole aim or sole purpose of the transaction/arrangement is to obtain a tax benefit. Moreover, it is argued that the PPT rule can be challenged on the basis that it creates legal uncertainty. See De Broe (2016), above fn.15, 237–238; P. Baker, "The BEPS Action Plan in the Light of EU Law: Treaty Abuse" [2015] BTR 408, 412–414; a similar analogy should also be drawn for various provisions of the simplified or detailed LOB clause.

has recommended that Member States adopt a modified version of the PPT.[115] Consequently, treaty anti-abuse rules should not apply to structures or arrangements that are rational from a commercial and/or economic perspective.

2.3.3.2. IRD, PSD and ATAD: General Anti-Abuse Rules Article 5(2) of the IRD[116] states that EU Member States can deny the benefits of the IRD

> "in the case of transactions for which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse" (subjective element).

The PSD also contains a GAAR.[117] Article 1(2) of the PSD provides that the PSD GAAR applies when an arrangement or a series of arrangements: 1. has/have been put into place for "the main purpose or one of the main purposes" of obtaining a tax advantage (subjective element); 2. that defeats the "object or purpose of this Directive" (objective element); and 3. is/are "not genuine having regard to all relevant facts and circumstances". Article 1(3) of the PSD provides that arrangements could be regarded as not genuine to the extent they are not put into place "for valid commercial reasons which reflect economic reality"[118] (non-genuine element). Similar to the PSD GAAR, Article 6(1) of the ATAD states that the GAAR applies when an arrangement or a series of arrangements: 1. has/have been put into place for "the main purpose or one of the main purposes" of obtaining a tax advantage (subjective element); 2. that "defeats the object or purpose of the applicable tax law" (objective element); 3. is/are "not genuine having regard to all relevant facts and circumstances". Article 6(2) of the ATAD provides arrangements could be regarded as not genuine to the extent they are not put into place "for valid commercial reasons which reflect economic reality" (non-genuine element).

The question arises as to how should the subjective, objective and non-genuine elements be interpreted? In this regard, it should be noted that in the Danish cases that deal with the IRD (*Z Denmark*,[119] *N Luxembourg*,[120] *X Denmark*[121] and *C Danmark*[122]) and the PSD (*T Danmark*[123] & *Y Denmark*[124]) the Advocate General (AG) has provided additional guidance on the concept of abuse, that is, criteria for determining abuse and application of those criteria to various fact patterns. In fact, while delivering her Opinion, the AG makes several references to the ATAD GAAR. Accordingly, references are made to her Opinion to understand how these elements can be interpreted in the case of directive shopping arrangements.

With respect to the criteria for determining abuse under EU law, the AG states, as a starting point, that Article 5 of the IRD and Article 1(2) of the PSD reflect the general principles of EU law (or settled case law) which provide that the application of EU law cannot be extended to

[115] See *Commission Recommendation (EU) 2016/136 of 28 January 2016 on the implementation of measures against tax treaty abuse (notified under document C(2016) 271)* [2016] OJ L25/67, 68.
[116] See Directive 2003/49/EC Art.5(2).
[117] Directive (EU) 2015/121 Art.1(2).
[118] Directive (EU) 2015/121 Art.1(3).
[119] Opinion of AG Kokott in *Z Denmark v Skatteministeriet* (C-299/16) EU:C:2018:148 (1 March 2018).
[120] Opinion of AG Kokott in *N Luxembourg 1 v Skatteministeriet* (C-115/16) EU:C:2018:143 (1 March 2018).
[121] Opinion of AG Kokott in *X Denmark A/S v Skatteministeriet* (C-118/16) EU:C:2018:146 (1 March 2018).
[122] Opinion of AG Kokott in *C Danmark I v Skatteministeriet* (C-119/16) EU:C:2018:147 (1 March 2018).
[123] Opinion of AG Kokott in *Skatteministeriet v T Danmark* (C-116/16) EU:C:2018:144 (1 March 2018).
[124] Opinion of AG Kokott in *Skatteministeriet v Y Denmark Aps* (C-117/16) EU:C:2018:145 (1 March 2018).

abusive transactions. As Article 5 of the IRD and Article 1(2) of the PSD do not define abuse and, thus, in order to lay out the criteria for determining abuse, the AG, first, makes a reference to Article 11(1)(a) of the MD (which provides that lack of commercial reasons could indicate abuse) and Article 6 of the ATAD (which defines abuse).[125] Secondly, the AG makes a reference to the CJEU's decisions in which the Court held that a taxpayer's transaction is abusive when its essential aim is to obtain a tax advantage (see section 2.3.1) or it represents a wholly artificial arrangement, which does not reflect economic reality[126] (see section 2.3.2). Thereafter, the AG applies the foregoing criteria to the various cases at stake.

With respect to the existence of a wholly artificial arrangement that does not reflect economic reality, the AG in the *C Danmark* case opines:

> "The two intermediary Swedish companies (C Sverige II and C Sverige I) did not have any employees, any office premises of their own, any telephone numbers of their own. Their post was opened by employees of a third-party company. As a result, these companies neither incurred any staff costs nor any costs for use of the premises. Moreover, they did not generate any income of their own through the asset management activities. All of this appears very artificial. A natural person would have long since ceased its business activities under these circumstances."[127]

A similar outcome is also followed in the *Y Danmark* case.[128] On the contrary, in the other cases, the AG opines:

> "If the company has been actually validly established, if it can actually be contacted at its registered office and if it has the appropriate physical and human resources at its premises in order to meet its object…, it cannot be seen as an arrangement which does not reflect economic reality."[129]

Moreover, even if the arrangement reflects economic reality, the AG, by referring to Article 6 of the EU ATAD, states that the taxpayer's transaction should have a commercial rationale, that is, non-tax reasons have to be demonstrated.[130] If not, the transaction could be abusive. Although the AG does not discuss commercial reasons, she nevertheless states that the fact that

[125] Opinions of AG Kokott in *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [61]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [62]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [62]; *C Danmark* (C-119/16), above fn.122, EU:C:2018:147 at [62]; *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [50]; *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [49].

[126] Opinions of AG Kokott in *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [62]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [63]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [63]; *C Danmark* (C-119/16), above fn.122, EU:C:2018:147 at [63]; *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [51]; *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [50].

[127] Opinion of AG Kokott in *C Danmark* (C-119/16), above fn.122, EU:C:2018:147 at [63].

[128] Opinion of AG Kokott in *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [54].

[129] Opinion of AG Kokott in *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [65]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [67]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [67]; *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [55].

[130] Opinion of AG Kokott in *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [67]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [68]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [68]; *C Danmark* (C-119/16), above fn.122, EU:C:2018:147 at [69]; *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [59]; *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [58].

the intermediary company is established in a Member State in order to take advantage of a favourable legal regime, the fact that the intermediary company is owned by third state residents or the fact that the taxpayer chose a business structure that did not lead to the highest tax burden does not in itself constitute abuse.[131]

The foregoing analysis, provided by the AG, may be used to interpret the subjective/non-genuine elements of the GAAR-type provisions found in the corporate tax directives. In line with the discussion put forward by the AG, it could be argued that the subjective element as well as the non-genuine elements should not be satisfied if the taxpayer is able to demonstrate that its transaction/structure/arrangement is rational from a commercial and/or an economic reality perspective. Once again the two situations need to be differentiated. That is, on the one hand: 1. genuine intermediary structures used by corporate groups that reflect commercial and economic reality; and, on the other 2. back-to-back arrangements, which are structured through economic operators and which may or may not lack a commercial rationale (see the discussion on the subjective element of the PPT in section 2.2). With respect to the economic reality or activities, the AG in the *Eqiom* case specifically stated that

> "an artificial arrangement can be assumed if the company is only a fictitious establishment in the form of a 'letterbox' company…But even where there is a physical presence, one might conclude, in light of the financial and staffing set-up, that the arrangement is artificial. In this regard, what appears to be relevant is, *for instance, the actual authority of the company organs to take decisions, to what extent the company is endowed with own financial means and whether any commercial risk exists*." (Emphasis added.)[132]

This outcome is not something new as a discussion along these lines seems to have already taken place in AG Léger's Opinion in the *Cadbury Schweppes* case.[133] Arguably, it becomes imperative that the personnel of the taxpayer entity make key decisions vis-à-vis the economically significant risks associated with the relevant economic activities and that the entity has the financial means to assume those risks (see section 2.1).

The AG also analyses whether the arrangement is contrary to the objective of the PSD or the IRD as implemented in Denmark. In this regard, it is stated that the taxpayers fulfilled all the requirements for applying the PSD (Article 2)[134] and the IRD (Article 3(a)(iii)).[135] The fact that Cyprus or Luxembourg do not impose withholding taxes is immaterial to the analysis as direct taxation remains largely within each Member State's competence (which could therefore lead

[131] Opinions of AG Kokott in *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [69]–[74]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [70]–[75]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [70]–[75]; *C Danmark* (C-119/16), above fn.122, EU:C:2018:147 at [70]–[74]; *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [61]–[65]; *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [61]–[65].

[132] Opinion of AG Kokott in *Eqiom SAS, formerly Holcim France SAS and Enka SA v Ministre des Finances et des Comptes publics* (C-6/16) EU:C:2017:34 at [57]. Also see *WebMindLicenses Kft v Nemzeti Adó- és Vámhivatal Kiemelt Adó- és Vám Főigazgatóság* (C-419/14) EU:C:2015:832 at [50].

[133] Opinion of AG Léger in *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v IRC* (C-196/04) EU:C:2006:278 At [110]–[114].

[134] Opinions of AG Kokott in *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [69]–[70]; *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [68]–[69].

[135] Opinions of AG Kokott in *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [79]–[82]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [80]–[83]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [80]–[83]; *C Danmark* (C-119/16), above fn.122, EU:C:2018:147 at [78]–[81].

to tax competition).[136] Moreover, the AG also analyses whether the entire arrangements, that is, third state investors investing into Denmark through an intermediary established in a EU Member State (Luxembourg or Cyprus) is contrary to the purpose of the law. In this regard, the AG states that the purpose of the law could be circumvented if the state of residence of the income recipients is not able to obtain information with respect to the amounts not taxed at source and assess that income for taxes. It seems that the AG analyses whether the arrangement is a tax evasion arrangement rather than an avoidance arrangement. The AG differentiates between EU–EU situations and third state-EU situations. For the former, the AG states that it may not be possible for the taxpayer to avoid declaring the income for tax purposes due to the presence of an appropriate exchange of information framework.[137] For the latter, the AG states that if the arrangement is structured with the purpose of ensuring that the states of residence of the investors are unable to obtain information to assess their taxpayers then an abuse of law may exist. Nevertheless, abuse will not exist if the tax related information can be provided by the taxpayer to the concerned states.[138]

The guidance provided by the AG may also be used to interpret the objective element of the GAAR-type provisions. Clearly, if the purpose of the transaction/structure/arrangement is to evade taxes then the transaction is fraudulent/abusive. However, in the context of tax avoidance arrangements that seek to take advantage of the PSD, it is not clear how the expression "object or purpose of this Directive" should be interpreted. The AG seems to indicate that PSD benefits should be granted as long as: 1. the distributing entity is subject to corporate taxes; and 2. the recipient company is subject to unlimited tax liability.[139] Such formal conditions are usually satisfied in tax avoidance structures. Accordingly, there is a risk that transactions, which have been executed with the sole purpose of obtaining directive benefits, could be "saved" from the application of the PSD GAAR. This said, if the CJEU considers the prevention of tax avoidance as an "object or purpose of this Directive" transactions that are "artificial" (or wholly artificial arrangements) may not be able to get access to directive related benefits (see the discussion on the objective element of the PPT in section 2.2). A similar approach could also be upheld for interpreting the objective element of the ATAD GAAR.

2.3.3.3. IRD and PSD: abuse of rights doctrine In February 2019, the CJEU issued its verdict on the Danish cases discussed in the previous section. The Court held that the abuse of rights doctrine can be invoked by a Member State to deny directive benefits (IRD/PSD) even if that state does

[136] Opinions of AG Kokott in *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [83]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [84]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [84]; *C Danmark* (C-119/16), above fn.122, EU:C:2018:147 at [82]; *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [71]; *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [70].

[137] Opinions of AG Kokott, *Z Denmark* (C-299/16), above fn.119, EU:C:2018:148 at [84]–[85]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [85]–[86]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [85]–[86]; *C Danmark* (C-119/16), above fn.122, EU:C:2018:147 at [83]–[84]; *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [72]–[73]; *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [72]–[73].

[138] Opinions of AG Kokott, *Z Denmark*, (C-299/16), above fn.119, EU:C:2018:148 at [86]–[88]; *N Luxembourg* (C-115/16), above fn.120, EU:C:2018:143 at [87]–[89]; *X Denmark* (C-118/16), above fn.121, EU:C:2018:146 at [87]–[89]; *C Danmark* (C-119/16), above fn.122, EU:C:2018:147 at [85]–[87]; *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [74]–[76]; *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [74]–[76].

[139] *T Danmark* (C-116/16), above fn.123, EU:C:2018:144 at [69]–[70]; *Y Denmark* (C-117/16), above fn.124, EU:C:2018:145 at [68]–[69].

not have appropriate anti-abuse rules in place to combat abusive transactions (for example, directive shopping). Thereafter, the CJEU lays out certain indicators of abuse, that is, situations wherein the arrangements of the taxpayer could be considered to be artificial. According to the Court, an artificial arrangement exists when the taxpayer (entity in a MNE group) is an artificial entity or an entity that does not reflect economic reality or a conduit entity. Essentially, this would be the case when the entity does not carry out any relevant economic activities.[140] Another factor that indicates the presence of an artificial arrangement is when the entity plays a conduit role, that is, the entity passes on income (dividends or interest), as soon as it receives it, to taxpayers (or beneficial owners) that are not eligible for the directive related benefits. This would be the case even if the conduit entity makes a small taxable profit.[141] Although this is not particularly clear, it seems that an artificial arrangement could also exist when back-to-back arrangements are structured through genuine economic operators.[142] In the authors' opinion, it can be argued that the doctrine should not apply to structures or arrangements that are rational from a commercial and/or economic perspective (see discussion on the subjective element of the PPT in section 2.2 and the subjective/non-genuine elements of the GAAR-type provisions found in the corporate tax directives in section 2.3.3.2).

2.4. Access to preferential regimes

In December 1977, the EU Code of Conduct for Business Taxation established five criteria to assess whether a national tax measure (legislative or regulatory or administrative) was potentially harmful. One criterion looked into whether the tax advantage was granted without any "real economic activity and substantial economic presence".[143] Similarly, in the 1998 *Harmful Tax Competition* report, the OECD laid out four primary and eight supplementary criteria to assess whether a measure was potentially harmful. One of the supplementary criteria pertained to looking at whether the tax measure provided for "substantial activities".[144] Since then the Code of Conduct and the OECD's Forum on Harmful Tax Practices (FHTP) have analysed several regimes of different states to assess whether they were harmful or not.[145] However, neither the

[140] The Court states that "the absence of actual economic activity must, in the light of the specific features of the economic activity in question, be inferred from an analysis of all the relevant factors relating, in particular, to the management of the company, to its balance sheet, to the structure of its costs and to expenditure actually incurred, to the staff that it employs and to the premises and equipment that it has". See *N Luxembourg 1 and others* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.81, EU:C:2019:134 at [127] and [131]; *T Danmark and Y Denmark Aps* (Joined Cases C-116/16 and C-117/16), above fn.82, EU:C:2019:135 at [100] and [104].

[141] See *N Luxembourg 1 and others* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.81, EU:C:2019:134 at [127]–[130]; *T Danmark and Y Denmark Aps* (Joined Cases C-116/16 and C-117/16), above fn.82, EU:C:2019:135 at [100]–[103].

[142] See *N Luxembourg 1 and others* (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16), above fn.81, EU:C:2019:134 at [132]; *T Danmark and Y Denmark Aps* (Joined Cases C-116/16 and C-117/16), above fn.82, EU:C:2019:135 at [105].

[143] See Council of the European Union, *Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy - Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation - Taxation of saving* [1998] OJ C2/1, 1–4.

[144] OECD, *Harmful Tax Competition, An Emerging Global Issue* (Paris: OECD Publishing, 1998), 34.

[145] See Council of European Union, *Report: Code of Conduct (Business Taxation)*, SN 4901/99 (Brussels: 23 November 1999); OECD, *Towards Global Tax Co-operation: Report to the 2000 Ministerial Council Meeting And Recommendations By The Committee On Fiscal Affairs, Progress in Identifying and Eliminating Harmful Tax Practices*

work of the EU nor that of the OECD provided guidance on how the substantial activity criterion was to be interpreted.[146]

The BEPS Project reignited the debate on harmful tax competition. Action 5 of the BEPS Plan mandated the FHTP "to revamp the work on harmful tax practices, with a priority and renewed focus on requiring substantial activity for any preferential regime".[147] As a result, the substantial activity criterion was elevated to a primary criterion.[148] The final report discusses the applicability of the substantial activity criterion in the context of IP regimes (such as IP boxes) and non-IP regimes.

In the context of IP regimes, the nexus approach was adopted.[149] Under the nexus approach, profits made by a taxpayer utilising an IP box regime are exempt only to the extent the taxpayer itself incurs the qualifying research and development (R&D) expenses that gave rise to the IP income. The idea behind the requirement is that taxpayers should actually carry out the activity and incur the related expenses in order to benefit from the regimes. Importantly, it should be noted that Action 5 rejected the transfer pricing (TP) approach.[150] Arguably, under the TP approach only high level decision-making substance in the entity was required to be demonstrated. The day-to-day activities associated with developing the IP could be outsourced to related parties. However, such outsourcing is not possible under the nexus approach.[151] Accordingly, it is reasonable to state that the substance requirements for an entity adopting the nexus approach are high.[152] In other words, merely demonstrating "control over risks" is insufficient. Post-BEPS, several states have either amended their existing regimes to reflect the nexus approach or have implemented nexus compliant IP boxes in their domestic tax law.[153]

In the context of non-IP regimes, the Action 5 final report states that the principles applied in the nexus approach should continue to apply. Accordingly, the taxpayer can access preferential regimes "to the extent those taxpayers undertook the core income generating activities required to produce the type of business income covered by the preferential regime".[154] In the follow up report, it is indicated that "[c]ore income generating activities presuppose having an adequate number of full-time employees with necessary qualifications and incurring an adequate amount of operating expenditures to undertake such activities".[155]

In the context of headquarter regimes, the core income generating activities could

(2000); OECD, *The OECDs Project on Harmful Tax Practices: 2004 Progress Report* (2004); OECD, *The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries* (2006).

[146] For a detailed discussion, see A.C. dos Santos, "What is Substantial Economic Activity for Tax Purposes in the Context of the European Union and the OECD Initiatives against Harmful Tax Competition?" (2015) 24(3) *EC Tax Review* 166, 166–171.

[147] Action 5, above fn.2, para.23.

[148] Action 5, above fn.2, paras 24–25.

[149] Action 5, above fn.2, para.27. See R. Danon, "General Report" in IFA, *Tax Incentives on Research and Development (R&D), Cahiers de droit fiscal international* (2015) Vol.100a, 43–54.

[150] Action 5, above fn.2, para.27.

[151] Action 5, above fn.2, paras 49–51.

[152] Danon, above fn.68, 25.

[153] See OECD/G20 Base Erosion and Profit Shifting Project, *Harmful Tax Practices – 2017 Progress Report on Preferential Regimes: Inclusive Framework on BEPS: Action 5* (*Harmful Tax Practices 2017 Progress Report*) (Paris: OECD Publishing, 2017), 15–18.

[154] Action 5, above fn.2, paras 70–73.

[155] See OECD/G20, *Harmful Tax Practices 2017 Progress Report*, above fn.153, 40.

> "include the key activities giving rise to the particular type of…income received by the company. For example, they could include taking relevant management decisions, incurring expenditures on behalf of group entities, and co-ordinating group activities."[156]

For instance, a reference can be made to the Global Headquarters Administration regime (GHA) available in Mauritius[157] and Singapore's Pioneer Certificate Incentive (PC) and Development and Expansion Incentive (DEI).[158] These regimes, which have been approved by the FHTP,[159] grant an eight year tax holding/reduction of corporate tax rates respectively to qualifying taxpayers. To avail itself of the benefit of the GHA, the taxpayer must employ at least 10 professionals, with at least two at managerial level, and incur an annual expenditure of MUR 5 million.[160] On the other hand, to avail itself of the benefit of the PC/DEI initiative, the taxpayer must employ skilled staff and incur substantial expenditure[161] (the number of employees and expenditure amounts are unspecified).

With respect to financing regimes, the core income generating activities could "include agreeing funding terms;…setting the terms and duration of any financing…;monitoring and revising any agreements; and managing any risks".[162] Once again, a reference can be made to the Global Treasury Activities regime (GTA) available in Mauritius[163] and Singapore's Finance and Treasury Centre Incentive (FTC).[164] These regimes, which have been approved by the FHTP,[165] grant a five year tax holding/reduction of corporate tax rates respectively to qualifying taxpayers. To avail itself of the benefit of the GTA, the taxpayer should employ at least four professionals, with at least one at managerial level, and incur annual expenditure of MUR 2 million.[166] On the other hand, to avail itself of the benefit of the FTC, the taxpayer must employ skilled staff (at least 10 personnel) and incur expenditure of SGD 3.5 million.[167]

Nevertheless, for holding companies that only own and manage participations, the Action 5 final report notes that such entities "may not in fact require much substance in order to exercise their main activity of holding and managing equity participations".[168] This being said, the Report provides that such entities should

[156] Action 5, above fn.2, paras 74–75.
[157] See Financial Services Commission, Mauritius, *Circular Letter CL29012018* (29 January 2018), available at: *https://www.fscmauritius.org/media/4268/tax-holiday-cl-02-feb-18-270416.pdf* [Accessed 18 June 2019].
[158] See Singapore Economic Development Board, *Pioneer Certificate Incentive and Development and Expansion Incentive* (2016), available at: *https://www.edb.gov.sg/content/dam/edbsite/downloads/brochures/PC%20and%20DEI%20Brochure.PDF* [Accessed 18 June 2019].
[159] OECD/G20, *Harmful Tax Practices 2017 Progress Report*, above fn.153, 18 and 42–43.
[160] See Financial Services Commission, Mauritius, *Circular Letter CL1-121018* (12 October 2018), available at: *https://lcabelheim.com/wp-content/uploads/2018/10/cl-on-substance-gb.pdf* [Accessed 18 June 2019].
[161] See Singapore Economic Development Board, above fn.158.
[162] Action 5, above fn.2, paras 78–79.
[163] See Financial Services Commission, Mauritius, *Circular Letter CL29012018*, above fn.157.
[164] See Singapore Economic Development Board, *Finance and Treasury Centre Incentive* (2016), available at: *https://www.edb.gov.sg/content/dam/edbsite/downloads/brochures/FTC%20Brochure.PDF* [Accessed 18 June 2019].
[165] See OECD/G20, *Harmful Tax Practices 2017 Progress Report*, above fn.153, 19 and 42–43.
[166] See Financial Services Commission, Mauritius, *Circular Letter CL1-121018*, above fn.160.
[167] See Singapore Economic Development Board, *Finance and Treasury Centre Incentive*, above fn.164.
[168] Action 5, above fn.2, para.87.

> "respect all applicable corporate law filing requirements and have the substance necessary to engage in holding and managing equity participations (for example, by showing that they have both the people and the premises necessary for these activities)".[169]

More recently, several jurisdictions have adopted substance requirements in their legislation and provided additional guidance thereto on core income generating activities. These requirements are similar to those suggested in BEPS Action 5.[170] In light of the foregoing analysis, it is reasonable to conclude that if the relevant economic activities exist in an entity then that entity should be given access to a preferential regime.

2.5. Synthesis and minimum safeguards for entities in a MNE

A high degree of convergence exists between the post-BEPS concepts[171] of *substantial activities*, *core commercial activity*, *controls over risks*, *economic reality* and *substantial economic activities*. Specifically, these concepts require the presence of personnel (directors and/or employees) who can contribute meaningfully towards the creation of value or the production of the core income that the entity receives.[172] However, divergences also exist. The exact personnel threshold for fulfilling each of these concepts seems to be different. Accordingly, an objective answer cannot be given to the question "how much substance is required" to gain access to the international corporate tax framework. The answer would indeed depend on the facts and circumstances of each case. This said, from an economic activity perspective, a taxpayer entity which takes a specific role within a multinational group should at a minimum perform the following activities/bear the relevant risks with respect to the underlying income it generates (besides documenting the commercial reasons for its existence and activities):

- Holding Entity that receives dividend income or capital gains: the core functions of such an entity relate typically to management activities that are important for monitoring and protecting the investments.[173] The key risks relate to investment risks to which the entity is exposed.

[169] Action 5, above fn.2, para.88.

[170] See States of Guernsey, *Guidance on aspects in relation to the economic substance requirements as issued by Guernsey, Isle of Man and Jersey* (issued 26 April 2019) available at: *https://www.gov.gg/economicsubstance* [Accessed 18 June 2019], 19 and United Arab Emirates, Cabinet of Ministers Resolution No. 31 of 2019 Concerning Economic Substance Regulations, available at: *https://www.mof.gov.ae/en/lawsAndPolitics/CabinetResolutions/Pages/312019.aspx* [Accessed 26 June 2019].

[171] On this matter, see S. Wilkie, "New Rules of Engagement? Corporate Personality and the Allocation of "International Income" and Taxing Rights" in B.J. Arnold (ed.), *Tax Treaties After the BEPS Project: a tribute to Jacques Sasseville* (Toronto: Canadian Tax Foundation, 2018), 365–371. The author argues that the BEPS recommendations lift the corporate veil when intermediation is unwarranted.

[172] On this matter, see S. Wilkie, "Transfer Pricing Aspects of Intangibles: The License Model" in M. Lang, A. Storck and R. Petruzzi (eds), *Transfer Pricing in a post BEPS World* (Alphen aan den Rijn: Kluwer Law International, 2016), 94–95.

[173] For instance, the personnel of the holding entity, among several activities, could provide non-binding advise to the management of the subsidiaries to improve their performance. It is arguable whether such an activity could be considered to confer a benefit on the subsidiary in order to justify a charge for a service fee from an arm's length perspective. See OECD, *Transfer Pricing Guidelines* (1979), para.154; OECD, *Three Taxation Issues—Transfer Pricing* (1984), paras 38–39; OECD, TP Guidelines 2017, above fn.18, para.7.4 and para.7.10; UN, TP Manual (2017), above fn.38, para.B.4.2.14.

- Financing Entity that receives interest income: the core functions of such an entity are that it is engaged in the business of providing intra group loans which relate typically to activities associated with creating[174] and managing loans.[175] The key risks relate to financial risks[176] associated with activities such as the credit risk, interest rate risk and possibly the exchange rate risk.[177]
- Intellectual Property (IP) Entities that derive royalty income or capital gains: the core functions of an entity that is engaged in the business of licensing (or selling) intangibles[178] typically relate to activities associated with development (nexus approach) or acquisition of intangibles, enhancement, maintenance, protection and exploitation of intangibles (DEMPE activities).[179] The key risks[180] relate to: 1. the development risk or acquisition risk associated with the intangible; 2. risks associated with technology obsolescence and loss of the intangible value; 3. risks associated with infringement of the intangible; 4. product liability risks occurring from the use of intangibles; and 5. risks associated with intangible exploitation.[181]

[174] For instance, the personnel of the financing entity could engage in the following loan creation activities (inclusive list): 1. negotiating the terms and conditions of the loans; 2. evaluating the various financial risks associated with the loan; 3. analysing the credit worthiness of the borrower; 4. undertaking the steps to price a loan; 5. deciding on whether collateral or securities are required; 6. undertaking steps to formalise the loans, etc.; OECD, *2010 Report on the Attribution of Profits to Permanent Establishments* (Attribution Report) (2010), available at: *https://www.oecd.org/ctp/transfer-pricing/45689524.pdf* [Accessed 26 June 2019], 65–66; Chand, above fn.37, 896–898.

[175] For instance, the personnel of the financing entity could engage in the following loan management activities (inclusive list): 1. undertaking loan support functions such as collecting the interest, monitoring repayments, determining the value of collaterals; 2. monitoring the financial risks on an ongoing basis by reviewing the credit worthiness of the borrower, analysing market interest movements, analysing the profitability of the loan; 3. undertaking necessary steps to hedge risks associated with the loan; 4. deciding on whether refinancing the loan is required or not, etc. See OECD, Attribution Report, above fn.174, 65; Chand, above fn.37, 896–898.

[176] In the context of cash boxes, the revised guidance has made it clear that, if an entity does not control the financial risks over the debt funding but simply acts on the direction of other members of the MNE group, then: 1. that entity will not be attributed the profits linked to the financial risks and therefore will be entitled to no more than a risk-free return or; 2. less than a risk-free return if, for instance, the transaction is not commercially justified and therefore the non-recognition rules apply. See OECD, TP Guidelines 2017, above fn.18, paras 1.85 and 1.103; UN, TP Manual (2017), above fn.38, para.B.5.3.35; also see OECD, TP Guidelines 2017, above fn.18, paras 6.61–6.64. Moreover see, OECD, TP Guidelines 2017, above fn.18, Example 6 in Annex to Ch.VI. Moreover, see OECD, *Public Discussion Draft BEPS Action 8–10, Financial transactions, 3 July–7 September 2018*, paras 12–21.

[177] For a discussion on these risks, see OECD, Attribution Report, above fn.174, 68; OECD, TP Guidelines 2017, above fn.18, para.1.72(c); UN, TP Manual (2017), above fn.38, 89–90, Table B.2.4.

[178] For a definition and list of common categories intangibles see OECD, TP Guidelines 2017, above fn.18, paras 6.15–6.31; UN, TP Manual (2017), above fn.38, paras B.5.2.5–B.5.2.38.

[179] See OECD, TP Guidelines 2017, above fn.18, para.6.12; UN, TP Manual (2017), above fn.38, paras B.5.3.13–B.5.3.20.

[180] See OECD, TP Guidelines 2017, above fn.18, Examples 4, 5, 14 in Annex to Ch.VI. On the other hand, in several examples it is illustrated that the royalty income (or capital gains) would be re-allocated from the legal owner to the entity that controlled the DEMPE risks. See Examples 1, 2, 3, 15 and 17 in Annex to Ch.VI; also see, UN, TP Manual (2017), above fn.38, para.B.5.3.12 and para.B.5.3.20. Furthermore, see Collier and Andrus, above fn.36, 214–215; for a detailed analysis of the ownership requirement of the intangibles see S. Wilkie, "The Definition and Ownership of Intangibles: Inside the Box? Outside the Box? What is the Box?" (2012) 4(3) *World Tax Journal* 222.

[181] OECD, TP Guidelines 2017, above fn.18, paras 6.65–6.68; UN, TP Manual (2017), above fn.38, para.B.5.3.22.

- Principal Entities[182] that receive business income: a principal entity (or the entrepreneurial entity), for example, that is engaged in the business of selling physical goods usually operates with the support of "assisting" entities[183] such as procurement entities[184] that assist in sourcing/buying raw materials, contract or toll manufactures[185] that assist in processing the raw material as well as limited risk distributors or commissionaires[186] that assist in selling the finished product. Generally, the core functions of a principal entity typically relate to key decision-making activities associated with the purchase, manufacture as well as sale of products. The other "assisting" entities usually perform their activities under the supervision and guidance of the principal. The key risks are risks pertaining to its value chain, that is, risks relevant to purchasing, processing and selling of the products.[187]

Taxpayers within a corporate group should also pay special attention to back-to-back arrangements that are structured through economic operators (such as other operating members of the group or financial institutions). The issue with respect to these transactions may not be the degree of nexus to a state but rather the commercial rationality of such arrangements. If the taxpayer is able to demonstrate that its arrangements are commercially and/or economically sound, then that taxpayer should obtain access to tax treaty or EU law related benefits.

3. The key issues in connection with the relevant economic activity test

3.1. The rise in tax uncertainty

It is obvious that if the degree of subjectivity is high in the interpretation process then the chances of the tax outcome being uncertain are also high. Consequently, the chances of tax disputes arising together with the risk of double or multiple taxation all increase. This proposition clearly holds true once the structures adopted by taxpayers become transparent to the tax administrations through the Master File (which requires the taxpayer to explain its value chain), Country-by-Country reporting[188] as well as spontaneous exchange of rulings.[189]

[182] For a discussion on the principal structure, see OECD, TP Guidelines 2017, above fn.18, para.9.51. In this contribution, it is assumed that the principal entity does not own intangibles. Nevertheless, the principal entity licenses the relevant trade or marketing intangibles from another IP entity of the MNE for its business.
[183] It should be noted that in the post-BEPS world, these "assisting" entities could trigger a permanent establishment for the principal entity pursuant to the recommendations made by BEPS Action 7.
[184] OECD, TP Guidelines 2017, above fn.18, paras 1.169 and 9.2; C. Finnerty, P. Merks, M. Petriccione and R. Russo, *Fundamentals of International Tax Planning* (Amsterdam: IBFD, 2007), 201–202.
[185] OECD, TP Guidelines 2017, above fn.18, paras 2.60, 7.40 and. 9.2; Finnerty, Merks, Petriccione and Russo, above fn.184, 184–185; M. Cotrut and L. Ambagtsheer-Pakarinen, "Business Restructurings: The Toolkit for Tackling Abusive International Tax Structures" in M. Cotrut (ed.), *International Tax Structures in the BEPS Era: An Analysis of Anti-Abuse Measures* (Amsterdam: IBFD, 2015), 190–194.
[186] OECD, TP Guidelines 2017, above fn.18, para.9.2; Finnerty, Merks, Petriccione and Russo, above fn.184, 194–198; Cotrut and Ambagtsheer-Pakarinen, above fn.185, 194–198.
[187] For a discussion on the risks that a MNE could be exposed towards see UN, TP Manual (2017), above fn.38, 89–90, Table B.2.4.
[188] OECD/G20 Base Erosion and Profit Shifting Project, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—2015 Final Report* (Paris: OECD Publishing, 2015).
[189] Action 5, above fn.2, para.89.

With respect to transfer pricing rules, prior to the BEPS Project the OECD Transfer Pricing Guidelines, recognised that it might be difficult to apply the arm's length principle in practice.[190] Since the BEPS Project, commentators have opined that the BEPS guidance has made the transfer pricing process more complex.[191] For instance, the "control" over risk requirement has received a great deal of criticism. First, it is argued that this particular requirement can be met easily by having the right people doing the right job. This could lead to the shifting of taxable bases from high tax states to low tax states. Thus, the arm's length principle promotes tax competition.[192] Secondly, the guidelines state that in situations where multiple associated enterprises control the risks, the risk should be allocated to the associated enterprise that demonstrates "most control".[193] The demonstration of this requirement could indeed be challenging from a practical perspective, especially, in MNEs where management boards are similar/spread across various entities and where consensus based decision-making takes place.[194] Thirdly, a few commentators have argued that the control test goes beyond the boundaries of the arm's length standard. It is stated that several situations exist among independent enterprises where the incidence of risk is separate from the control over risk requirement. In other words, enterprises bear risks that they do not control. Accordingly, courts may deviate from the control requirement if this is proven.[195] Fourthly, it is argued that the level of factual detail that is required to understand which party controls the risks is substantially high. Accordingly, it could be burdensome for the taxpayers and the tax administrations to undertake this analysis.[196] Fifthly, there is no clarity as regards whether the concept of control over risk for the purpose of Article 9 of the OECD Model and the significant people functions with respect to risk assumption under Article 7 of the OECD Model are similar or different. The OECD does not provide an answer to this issue. Accordingly, the approach adopted in an Article 9 and an Article 7 analysis could be different.[197]

With respect to the PPT, the authors have argued that the subjective element should not be satisfied if the transaction/arrangement/structure is rational from a commercial and/or an economic perspective. However, if a judge interprets the phrase "one of the principal purposes" in a literal manner then the subjective element may be satisfied as long as a tax benefit exists.[198] This would also be the case if a judge takes into consideration the LOB clause (and its related Commentary) to interpret the "substance" requirements for the PPT. Therefore, the level of tax certainty with respect to the test seems to be low (in other words, high tax uncertainty). In fact, the OECD has identified this issue and in a recent report on tax certainty states:

> "To increase tax certainty in the application of the PPT, the OECD has formed an informal group of interested delegates that would explore various areas where more tax certainty

[190] OECD, TP Guidelines 2017, above fn.18, paras 1.9–1.13.
[191] See Collier and Andrus, above fn.36, 246.
[192] See Collier and Andrus, above fn.36, 230.
[193] OECD, TP Guidelines 2017, above fn.18, para.1.98.
[194] See Collier and Andrus, above fn.36, 230–231.
[195] See Collier and Andrus, above fn.36, 231–232.
[196] See Collier and Andrus, above fn.36, 246–247.
[197] See L. Spinosa and V. Chand, "A Long-Term Solution for Taxing Digitalized Business Models: Should the Permanent Establishment Definition Be Modified to Resolve the Issue or Should the Focus Be on a Shared Taxing Rights Mechanism?" (2018) 46(6/7) *Intertax* 476.
[198] R. Kok, "The Principal Purpose Test in Tax Treaties under BEPS 6" (2016) 44(5) *Intertax* 406, 408–409.

could be provided in the PPT, including best practices in the area of the general anti-avoidance rules and would report back with recommendations."[199]

The Commentary to the PPT currently analyses the impact of the PPT on 13 fact patterns.[200] Moreover, the six additional fact patterns, which are discussed in the context of conduit arrangements, are also analysed in light of the PPT.[201] Out of these 19 examples, only five deal with situations where the PPT is applied to deny the treaty benefit. Therefore, the OECD would be advised to expand the Commentary by enhancing the negative list of examples. Reference could be made to the fact patterns of the following court judgments wherein the denial of a treaty benefit was heavily debated vis-à-vis holding entities: in Austria: *N AG v Regional Tax Office for Upper Austria*[202]; in Canada: *MIL (Investments) SA v Canada*[203] and the *Prévost* cases, *Prévost Car Inc v The Queen*[204]; in India: *Azadi Bacho Andolan v Union of India and another*[205]; in Israel: *Yanko-Weiss Holdings Ltd v Holon Assessing Office*[206]; and in Switzerland: *A Holding ApS v Federal Tax Administration*.[207] Furthermore, to enhance certainty, it could also be clarified that taxpayers which avail themselves of substance based preferential regimes should be entitled to treaty benefits for the underlying income. For instance, taxpayers that avail themselves of a nexus compliant IP box regime should be entitled to the treaty benefits on royalty related income.[208]

In relation to EU law, the authors have argued that if the taxpayer is able to demonstrate that its transaction/arrangement/structure is rational from a commercial and/or an economic perspective then the subjective and non-genuine elements of the PSD and ATAD GAAR-type provisions should not be satisfied. However, in line with the aforementioned discussion with respect to the PPT, the analysis is subjective. Essentially, the question arises as to how will the CJEU interpret the GAAR provisions? Will the Court interpret the phrases "the main purpose or one of the main purposes" and "for valid commercial reasons which reflect economic reality" in light of its established case law or will the Court depart from established case law and broaden the scope of abuse? Also, a similar question arises in relation to how the CJEU will interpret the phrase "substantive economic activity" in the context of the ATAD CFC rules. It seems that this threshold exceeds the wholly artificial arrangement threshold created by the CJEU.[209] Therefore, from a tax certainty perspective, it would be advisable if the EU Commission were to provide some clarification as regards the interpretation of these provisions.

Finally, the notion of *substantial activity* in relation to IP box regimes seems to be uniform among states. States forming part of the Inclusive Framework have adopted the nexus approach.

[199] See IMF/OECD, *Update on Tax Certainty: IMF/OECD Report for the G20 Finance Ministers and Central Bank Governors* (July 2018), 12.
[200] OECD MC 2017, above fn.5, Commentary on Article 29, para.182.
[201] OECD MC 2017, above fn.5, Commentary on Article 29, para.187.
[202] *N AG v Regional Tax Office for Upper Austria* [2000] 2 ITLR 884.
[203] *MIL (Investments) SA v Canada*, above fn.62, [2006] 9 ITLR 25.
[204] *Prévost Car Inc v The Queen* [2008] 10 ITLR 736 at 736–758.
[205] *Azadi Bacho Andolan v Union of India and another* [2002] 4 ITLR 878.
[206] *Yanko-Weiss Holdings Ltd v Holon Assessing Office* [2007] 10 ITLR 524.
[207] *A Holding ApS v Federal Tax Administration* [2005] 8 ITLR 536.
[208] Danon, above fn.68, 33.
[209] J. Schönfeld Bonn, "CFC Rules and the Anti-Tax Avoidance Directive" (2017) 26(3) *EC Tax Review* 145, 150; G. Ginevra, "The EU Anti-Tax Avoidance Directive and the Base Erosion and Profit Shifting (BEPS) Action Plan: Necessity and Adequacy of the Measures at EU level" (2017) 45(2) *Intertax* 120, 129–130.

However, the notion of *substantial activity* in relation to non-IP box regimes seems to have been implemented differently. For example, compare the activity requirements in the financing incentives offered by Mauritius and Singapore. Non-uniform implementation of such incentives will lead to tax competition as discussed below.

3.2. The increase in tax competition for attracting economic activities

Although the BEPS Project has achieved a high degree of international tax co-ordination/co-operation by ensuring that states adopt a common set of tax related rules, it has at the same time enhanced international tax competition.[210] Essentially, states compete by reducing fiscal burdens to attract investment/activities into their jurisdiction or discourage the outflow of investment/activities from their jurisdiction.[211] As argued in this article, a taxpayer should be given access to the entire international corporate tax framework as long as it satisfies the economic activity test (also commercial rationale requirement). Consequently, the authors expect that states will compete to attract economic activities, that is, people functions.[212] Such competition will either take the form of a reduction in corporate tax rates (as well as withholding taxes) or an increase in tax incentives, among others, preferential regimes that attract mobile tax bases.[213] In fact, the recent OECD report, *Tax Policy Reforms 2018: OECD and Selected Partner Economies* (the OECD Report) confirms this point of view.[214]

With respect to a reduction in corporate taxes, the OECD Report confirms that corporate tax rate cuts have accelerated.[215] Several states such as Argentina, Belgium, France, Japan, Luxembourg, Norway, Sweden and the US have reduced their corporate tax rates in 2018.[216] Moreover, several states such as the UK, Australia and Greece have announced corporate tax rate cuts for future years.[217] Although not mentioned in the OECD Report, Switzerland has adopted a corporate tax reform, expected to enter into force on 1 January 2020, alongside which some cantons will be dropping their corporate tax rates. The effective corporate tax rates in Switzerland, depending on the cantons, will range roughly from 13 per cent to 18 per cent.[218] The OECD Report highlights that

[210] P. Piantavigna, "Tax Competition and Tax Coordination in Aggressive Tax Planning: A False Dichotomy" (2017) 9(4) *World Tax Journal* 477, 477–496.
[211] For a detailed discussion on the merits and demerits of tax competition, see W. Schön, "Tax competition in Europe – the legal perspective" (2000) 9(2) *EC Tax Review* 89, 91–95.
[212] EY, *The outlook for global tax policy in 2018* (2018), 2–5; M.P. Devereux and J. Vella, "Implications of Digitalization for International Corporate Tax Reform" (2018) 46(6/7) *Intertax* 550, 551–552.
[213] M.J. Graetz, *Follow the money: essays on international taxation* (Yale: Lillian Goldman Law Library, 2016), 276–277; M. Keen, "Competition, Coordination and Avoidance in International Taxation" (2018) 72(4/5) *Bulletin for International Taxation* 220, 224.
[214] See OECD, *Tax Policy Reforms 2018: OECD and Selected Partner Economies* (Paris: OECD Publishing, 2018), available at: *https://doi.org/10.1787/9789264304468-en* [Accessed 18 June 2019].
[215] See the OECD Report, above fn.214, 65 and A.P. Dourado, "Taxes and Competitiveness: How Much Competitive Is European Tax Competition?" (2018) 46(12) *Intertax* 942.
[216] See the OECD Report, above fn.214, 66–67.
[217] See the OECD Report, above fn.214, 67.
[218] Swiss Federal Council, *Message concernant la loi fédérale sur le Projet fiscal 17*, 21 March 2018, Federal Gazette 2018 2565, 2679.

> "countries appear to be engaged in a 'race to the average' rather than in a 'race to the bottom', with their recent corporate tax rate cuts now placing them in the middle of the pack".[219]

With respect to a reduction of withholding taxes, the most notable reform pertains to the Netherlands, which has increased the scope of its dividend withholding tax exemption to third state treaty residents.[220]

The OECD Report also confirms that states have also increased tax incentives in order to support investment. The tax incentives pertain to research and development incentives (input incentives in the form of expensing R&D expenses and output incentives in the form of patent boxes[221]), special economic zones schemes, accelerated depreciation provisions, capital investment expensing provisions, small and medium enterprises tax base related changes and so on.[222] Moreover, in light of the various BEPS Actions, several states have issued guidelines with respect to minimum substance requirements for accessing preferential tax regimes, such as the practice adopted by Singapore, Mauritius and more recently the British Crown Dependencies as well as the UAE (section 2.4).

4. The next stage: from Base Erosion and Profit Shifting to Base Expansion and Profit Sharing

This article has argued that the taxpayer entity should be given access to the benefits offered by the international corporate tax framework if that taxpayer satisfies the relevant economic activity test. Accordingly, in the post-BEPS environment, MNEs can still engage in profit shifting activities by having the appropriate people functions in low tax jurisdictions. On the other hand, tax competition between states is intensifying in order to attract people functions. Interestingly, the activity-based concepts discussed in section 2 do not alter the allocation of taxing rights framework agreed between states. However, in light of the digitalisation of the economy,[223] there is pressure to reconsider the allocation of taxing rights framework (Pillar I) and find solutions to counter genuine profit shifting strategies to low tax jurisdictions/tax competition between states (Pillar II). Thus, we have already started to witness the movement from BEPS 1.0 to BEPS 2.0 (Base Expansion and Profit Sharing). The "core" challenges raised by digitalisation will be discussed in another article.

[219] See the OECD Report, above fn.214, 9–10.
[220] See the OECD Report, above fn.214, 74.
[221] EY, above fn.212, 3–4.
[222] See the OECD Report, above fn.214, 7, 4–77.
[223] See OECD/G20 Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges of the Digitalisation of the Economy, Public Consultation Document, 13 February–6 March 2019* (2019), available at: *https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf* [Accessed 18 June 2019].

Abuse of rights; Base erosion and profit shifting; EU law; General anti-abuse rule; International tax planning; Multinational companies; Tax policy

Book Reviews

Tax Design and Administration in a Post-BEPS Era, by K. Sadiq, A. Sawyer and B. McCredie (eds), (Birmingham: Fiscal Publications, 2019), 356pp., paperback, £35.00, ISBN: 978-1-906201-48-7.

This recent book from Fiscal Publications examines the important topic of the implementation of BEPS in specific jurisdictions.[1] The book begins with a general report chapter by Kerrie Sadiq and Richard Krever.[2] This is followed by individual chapters succinctly considering how the BEPS Actions have been implemented in each of 18 specific jurisdictions. The jurisdictions covered are a diverse mix of developed and developing economies.[3] Unusually for such a collection only two EU Member States (the Netherlands and, for now, the UK) are represented; OECD members also are in the minority.

As the editors explain in the preface,[4] the book uses a case-study method, with the result that the jurisdiction-specific chapters helpfully follow a fairly similar structure. Each jurisdictional chapter begins with an overview of the political and tax system followed by a concise analysis of that jurisdiction's response to the most relevant BEPS Actions. In some chapters the contributing authors also discuss unilateral responses in their jurisdictions. Examples include the UK's diverted profit tax[5] and the Australian transfer pricing rules, multinational anti-avoidance law, diverted profits tax and transparency measures.[6]

In their general report chapter, Sadiq and Krever synthesise the information presented in the individual chapters.[7] They work through each of the 15 Actions one-by-one, presenting their conclusions. A few key takeaways can be usefully highlighted here as representative. On Action 1: Addressing Tax Challenges of the Digital Economy, Sadiq and Krever contrast the limited measures taken in less-developed countries with how developed countries have responded, including introducing changes to their VATs requiring registration by foreign vendors of digital services.[8] The authors conclude the overall impact of Action 3: Designing Effective Controlled Company (CFC) Regimes "has been limited".[9] The general report also highlights how the US has taken "a unique path"[10] on implementing Action 4: Limiting Base Erosion Involving Interest

[1] K. Sadiq, A. Sawyer and B. McCredie (eds), *Tax Design and Administration in a Post-BEPS Era*, (Birmingham: Fiscal Publications, 2019).
[2] K. Sadiq and R. Krever, "Actions to Counter Base Erosion and Profit Shifting: A General Report" in Sadiq, Sawyer and McCredie (eds), above fn.1, 1–24.
[3] The jurisdictions with dedicated chapters are Australia, Canada, China, Hong Kong Special Administrative Region, India, Indonesia, Japan, Korea, Malaysia, the Netherlands, New Zealand, Nigeria, Singapore, South Africa, Thailand, the UK, the US and Vietnam.
[4] Sadiq, Sawyer and McCredie (eds), above fn.1,vii.
[5] A. Pirlot and J. Vella, "The Adoption of BEPS in the United Kingdom" in Sadiq, Sawyer and McCredie (eds), above fn.1, 304–5.
[6] K. Sadiq and P. Mellor, "The Adoption of BEPS in Australia" in Sadiq, Sawyer and McCredie (eds), above fn.1, 36-39.
[7] Sadiq and Krever, above fn.2, 9.
[8] Sadiq and Krever, above fn.2, 4-5.
[9] Sadiq and Krever, above fn.2, 7.
[10] Sadiq and Krever, above fn.2, 9.

Deductions and Other Financial Payments by retaining its current thin capitalisation rules for related party interest payments and introducing a new rule

> "that limits deductions on debt between unrelated parties to a maximum of business interest income and 30 per cent of adjusted taxable income".[11]

The general reporters also consider the role of the multilateral instrument, which they consider "may be the important legacy of the BEPS experience".[12] Sadiq and Krever finish with some forward-looking thoughts, including on the "untouched elephant in the room"—the current allocation of multinational enterprise income under the arm's length principle.[13] The authors ponder whether international co-operation might some day extend to an agreement on the global division of taxing rights over multinational entity income.[14]

This book is an important addition to the literature on BEPS. It will be particularly helpful for students and others new to BEPS and for those especially interested in the implementation of BEPS in developing economies.

Glen Loutzenhiser

Nexus Requirements for Taxation of Non-Residents' Business Income, by S. Gadžo, (the Netherlands: IBFD, 2019), 385pp., €115.00, ISBN: 978-90-8722-448-6.

This book[1] is based on the award winning[2] doctoral thesis of the author and explores a very important issue in international tax law: the different nexus requirements used by countries to tax non-resident business income and whether they are fit for purpose in the new economic environment. The author examines the principles set out under the existing international tax framework, as enshrined in the bilateral tax treaty model, with much focus on the concept of the permanent establishment. As explained in the beginning, the main research question is what the appropriate nexus norms for taxing non-residents' business income should be in light of developments in the contemporary global economy.[3] He proposes his own very interesting approach to deal with his question.

There are eight chapters to this book. The first chapter provides a very useful introduction to the issues to be analysed, the hypotheses and methodology of the research. The second chapter reviews the customary principles of jurisdiction to tax. In this chapter, the author goes beyond the traditional exposition of the League of Nations reports and investigates the issues also from the perspective of general international law: more specifically, the status of the nexus requirement as a norm of international law.

[11] Sadiq and Krever, above fn.2, 9.
[12] Sadiq and Krever, above fn.2, 3.
[13] Sadiq and Krever, above fn.2, 23.
[14] Sadiq and Krever, above fn.2, 23.
[1] S. Gadžo, *Nexus Requirements for Taxation of Non-Residents' Business Income* (the Netherlands: IBFD, 2019).
[2] Winner of the 2017 European Academic Tax Thesis Award, jointly awarded by the European Association of Tax Law Professors (EATLP) and the European Commission.
[3] Gadžo, above fn.1, 7.

The following chapters examine the different approaches that countries take in dealing with the nexus issue domestically (Chapter 3) or under tax treaties (Chapter 4), with a focus on the permanent establishment concept. Whilst Chapter 4 sets out a more traditional analysis of the tax treaty rules in this area, Chapter 3 contains a very interesting comparative analysis of the permanent establishment concept from the perspective of Croatian tax law, German tax law, French tax law, US tax law, Indian and Brazil tax law. Four basic approaches are identified: using the PE concept as defined in tax treaties (model 1—Croatian approach); using the PE concept in a substantially different manner than under tax treaties (model 2—German approach); using a broader approach than the PE concept that is not restricted to a fixed place of business (model 3—French, US and Indian approach); and reliance on withholding tax imposed on income derived by non-residents (Brazilian approach).

Chapter 5 examines the framework for normative analysis of the nexus norms. The author reviews some abstract tax policy principles (equity, efficiency and administrability) and considers how these are adapted to address the research question. This sets the background to analyse the appropriateness of different nexus norms used by states in the taxation of non-resident business income and in particular in the context of the global economic environment (Chapter 6). Particular attention is drawn to developments associated with the introduction and expansion of e-commerce and the rise in cross-border services trade. The analysis in these chapters is masterful, blending in established principles, the challenges shown through the BEPS Project and the new digital environment.

In the next chapter, Chapter 7, the author evaluates the traditional forms of finding PE nexus in light of this new environment and concludes that they are inappropriate. This is because the traditional forms of PE nexus do not recognise the taxing claims of market states and, as such, they are very restrictive. The main reform proposals are considered such as the modest BEPS proposals in this area and the more ambitious proposals for broader use of PE-deeming rules. The latter encompasses the introduction of a virtual PE and a proposal for a PE based on significant economic presence.

The author's own proposal is very interesting. He advocates the preservation of the PE nexus in tax treaties but with a new deeming rule as its supplement. Under this evolutionary approach

> "a new nexus based on a de minimis revenue threshold should be added to tax treaties, supplementing two basic PE concepts, namely the 'fixed place PE' and the 'agency PE'".[4]

The exact threshold amount is not determined and it is admitted that "it is hard to draw the line and specify the threshold amount".[5] As a rule of thumb, US$1 million is proposed, aligned with proposals from other scholars.[6]

In the last chapter, Chapter 8, there is an overview of the contents of each chapter to this book. The proposal for a new PE-deeming rule based on de minimis revenue threshold is reiterated and nicely summarised. The author argues that

[4] Gadžo, above fn.1, 320.
[5] Gadžo, above fn.1, 321.
[6] Namely, R.S. Avi-Yonah and O. Halabi, "A Model Treaty for the Age of BEPS" (2014) Law & Economics Working Paper 103, available at: *http://repository.law.umich.edu/law_econ_current/103* [Accessed 11 June 2019].

> "such a rule would allow a state to tax the business income of a non-resident taxpayer as soon as he has derived an ex ante specified amount of gross revenue from catering customers located in that state, irrespective of his physical presence therein".[7]

This rule would be aligned with the principle of tax equity as it recognises significant benefits that non-resident taxpayers receive from market countries. Such a rule would also be tax efficient, as the revenue threshold would be prone to less manipulation by taxpayers compared to the traditional PE concept. The proposal also suggests that the administrative concerns surrounding the application of such a rule can be resolved in a comprehensive manner; for example, by relying on an interim withholding regime in respect of business-to-business payments.

Overall, this book provides an impressive analysis of some of the important issues relating to jurisdiction to tax a non-resident's business income and especially the PE concept. The author's proposal is very well argued and quite convincing. Whilst it appears to precede the European Commission's[8] and the OECD's[9] 2018 proposals on the taxation of digital economy, it provides an excellent benchmark for further research and a solid alternative if the existing proposals do not gain consensus.

Christiana HJI Panayi[*]

Introduction to Transfer Pricing, by J. Monsenego, (the Netherlands: Wolters Kluwer, 2015), 192pp., US $100.00, ISBN: 978-9041159854.

There are not many books on transfer pricing—especially for lawyers and/or beginners in transfer pricing. This book[1] is a very welcome addition and worth bringing to readers' attention even though it was published several years ago. Although the title of the book suggests this is a merely introductory exposition of the topic, in fact, the book is much more than that.

In this book, the author explains in a very understandable and comprehensive way, all the important areas in transfer pricing. Chapters 1 and 2 examine the arm's length principle and the transfer pricing methods. Chapter 3 reviews various common types of intercompany transactions and transfer pricing models. The reviewer found this chapter to be particularly helpful for those coming from a more academic and/or theoretical background to this area. Chapters 4 and 6 examine business restructurings and the attribution of profits to permanent establishments. Chapter 5 contains an, arguably, rather brief and superficial review of the application of the substance requirement in this area. This is understandable, as this a very complex area, especially

[7] Gadžo, above fn.1, 337.

[8] European 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); European 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).

[9] 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: *http://dx.doi.org/10.1787/9789264293083-en* [Accessed 11 June 2019].

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[1] J. Monsenego, *Introduction to Transfer Pricing* (the Netherlands: Wolters Kluwer, 2015).

after the OECD/G20's BEPS Project, the completion of which this book predates.[2] The final chapter reviews advance pricing arrangements and dispute resolution in this area.

Throughout the chapters, the author goes beyond the (now voluminous) OECD Transfer Pricing Guidelines and provides a lot of background information and helpful examples. Important case law from around the world is also mentioned in most chapters.

Overall, this is an excellent companion to those studying transfer pricing. It is hoped that the author will regularly update this book to reflect the developments in the post-BEPS world and the future updates to the OECD Transfer Pricing Guidelines.

Christiana HJI Panayi[*]

Landmark Cases in Revenue Law, by J. Snape and D. de Cogan (eds), (Oxford: Hart Publishing, 2019), 576pp., hardback, £91.80, ISBN: 978-1509912261.

Once this reviewer became aware of the publication of *Landmark Cases in Revenue Law*, he was keen to secure a copy and even more delighted when offered the opportunity to review it for the *British Tax Review*. It is particularly exciting to see revenue law added to Hart Publishing's *Landmark Cases* series, which emphasises the important role of taxation in the common law. Reading this substantial work took longer than originally intended. This reviewer found that reading one chapter at a time was sufficient to enlighten one's thinking of the importance of a case (or cases), and to ponder the new insights and implications arising from the case. The publisher's statement on their website (and on the dustcover of *Landmark Cases in Revenue Law*) is one that can be fully endorsed[1]:

> "In an important addition to the series, this book tells the story of 20 leading revenue law cases. It goes well beyond technical analysis to *explore questions of philosophical depth, historical context and constitutional significance*. The editors have assembled a stellar team of tax scholars, including historians as well as lawyers, practitioners as well as academics, to provide a *wide range of fresh perspectives on familiar and unfamiliar decisions*. The whole collection is *prefaced by the editors' extended introduction on the peculiar significance of case law in revenue matters*. This publication is a *thought provoking and engaging showcase of tax writing* that is accessible equally to specialists and non-specialist." (Emphasis added.)

As noted, this book is much more than a black letter law analysis of leading cases. It demonstrates the interdisciplinary nature of taxation, including the benefits of using various theoretical and practical lenses to widening one's appreciation of revenue law.[2] There is so much

[2] As explained in the preface, the book takes into account legal developments up to 31 May 2015.

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[1] J. Snape and D. de Cogan (eds), *Landmark Cases in Revenue Law* (Oxford: Hart Publishing, 2019), available at: *https://www.bloomsburyprofessional.com/uk/landmark-cases-in-revenue-law-9781509912278/* [Accessed 12 June 2019]. A full table of contents is also available on this website.

[2] For a perspective on the importance of theory in taxation, this reviewer suggests his recent contribution as a starting point: A. Sawyer, "Who cares about Tax Theory, and Why?: The Place of Tax Disciplines within Academia – A Comment" (2018) 24(3) *New Zealand Journal of Taxation Law and Policy* 221.

that this reviewer could write about each of the contributions of the authors of each of the individual chapters, along with the extensive and insightful overview provided by the editors. However, this is something best left to the readers to explore for themselves. Nevertheless, it would be remiss not to highlight that a full appreciation of the immense effort put in by each of the contributors gradually reveals itself after reading each of the contributions. The book is extensively researched and indexed. Dedicating the book to John Snape's wife who died of cancer during the process of compilation is a wonderful tribute.

In the conclusion to their extensive introductory chapter, the editors observe[3]:

> "A full conclusion would not be fitting for an exploratory essay such as this. However, we would make three very brief concluding points. First, the *detailed study of revenue law cases gives wisdom as to the origin and purposes of particular revenue law rules*. Secondly, landmark cases are those that, in one way or another, *illuminate particularly intractable issues*. Thirdly, the significance of that illumination is not limited to the particular rules and principles: it can *reveal much about the nature and purpose of a whole system*." (Emphasis added.)

Following the introductory chapter there are 20 individual chapters focusing in most instances on a particular case of significance to revenue law. Appreciation of their significance to tax law and practice often becomes clearer many years later. The earliest case considered is *Case of Ship Money: R v Hampden* in 1637.[4] The most recent is *Jones v Garnett (HM Inspector of Taxes)* in 2007.[5] Thus, the jurisprudence spans nearly 400 years of case law!

This book offers much more than an analysis of leading revenue law cases in the UK. Authors of student texts and casebooks make significant contributions in this regard. This book goes much further to explore significant issues, both within and emanating from, revenue law cases, which as mentioned earlier, in some instances gain more prominence well after the outcome of the case is determined. These cases also may significantly influence the wider tax and legal system of a particular jurisdiction, in this instance the UK. With the UK common law system exerting a significant influence on the common law beyond its geographical boundaries (such as to jurisdictions that formed part of the British Commonwealth), this book is an important source for academics, practitioners, and advanced students of revenue law globally. An assessment of the full extent of the potential impact of this book is not possible at this time, even though the revenue cases explored in the book now largely reflect well-settled law.

As a non-UK academic, this reviewer approached the review as working within the UK tax system, where many of these cases would be fundamental to facilitating students' learning, as well as guiding tax practice and advice. This reviewer thoroughly endorses this book as essential reading to anyone interested in the historical development of the UK's revenue law through the lens of the common law. Furthermore, it is recommended to anyone with an interest in revenue law, especially where the common law operates. It is not a book for reading in a single session; its full impact on one's thinking is only achievable if a reader takes time to reflect upon the implications and insights provided by each of the chapters. This book should be part of the

[3] Snape and de Cogan (eds), above fn.1, 26.
[4] *Case of Ship Money: R v Hampden* (1637) 3 St Tr 825.
[5] *Jones v Garnett (HM Inspector of Taxes)* [2007] UKHL 35; (2007) 78 TC 597.

collections of tax practitioners, academics, officials, the judiciary and students with a keen interest in the law, especially those working with, or having an interest in, revenue law.

This reviewer would encourage revenue law specialists in other jurisdictions to consider undertaking a similar project exploring their landmark revenue cases with the goal of preparing a comparable work to *Landmark Cases in Revenue Law*. This book, however, is clear evidence of the enormity of such a task.

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