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UK TAX QUARTERLY UPDATE – JULY 2020

To Our Clients and Friends:

In this Tax Quarterly Update, we have outlined various UK and international tax developments which we consider to be of greatest significance since our April Tax Quarterly Update.

It will not have escaped the attention of readers that we find ourselves in very interesting times from a tax policy perspective. We are facing a confluence of factors - including the fall-out from the COVID-19 coronavirus pandemic, and continuing efforts to formulate a workable set of principles to tax the digital economy and counteract base erosion and profit shifting - which will reshape the domestic and international tax landscape for many.

Against the backdrop of economic recession, tax policy is and will continue to be at the forefront of measures to both stimulate growth and generate additional tax revenue.

On 8 July 2020, Chancellor Rishi Sunak delivered his Summer Economic Update with the primary aim of securing the UK's economic recovery from the COVID-19 coronavirus pandemic. The tax announcements included:

- a reduction in the rate of VAT from 20% to 5% from 15 July 2020 to 12 January 2021 for certain supplies in the hospitality and tourism sectors (notably supplies of food and non-alcoholic beverages sold for on-premises consumption, hot takeaway food and hot takeaway non-alcoholic beverages, and sleeping accommodation in hotels or similar establishments); and

- a stamp duty land tax ("SDLT") 'holiday' from 8 July 2020 until 31 March 2021, implemented by increasing the 0% threshold for 'standard' purchases of residential property by individuals from £125,000 to £500,000 (meaning that the first £500,000 of the price paid for such purchases will be free from SDLT). There are then corresponding changes to the additional residential rates for individuals buying additional dwellings and companies buying dwellings: here, the first £500,000 will now be subject to SDLT at 3%.

At the same time, we expect to see a continued focus in the UK and elsewhere on international tax measures, in particular BEPS 2.0 including the Organization for Economic Co-operation and Development's Pillar One and Pillar Two proposals. This promises to be particularly interesting in the wider context of political and global trade implications (as to which, please see further below).

From a UK perspective, we also look forward to seeing draft legislation for inclusion in Finance Bill 2021, which the Government has now confirmed for publication on Tuesday 21 July 2020.

We hope that you find this alert useful. Please do not hesitate to contact us with any questions or requests for further information.

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- *HMRC v. Wellcome Trust Ltd*
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A. Delay to DAC 6 reporting deadlines

As a result of the COVID-19 coronavirus pandemic, the EU has provided member states with the option to postpone the deadlines for reporting and exchanging information under DAC 6 for up to six months. Depending on the evolution of the pandemic, the possibility exists (subject to strict conditions) for the Council to extend the deferral period once, for a maximum of a further three months. The UK government has announced it will amend its own regulations to give effect to the deferral on the full six month basis.

The EU Council Directive 2011/16 (as amended), known as DAC 6, requires intermediaries (or failing which, taxpayers) to report, and tax authorities to exchange, information regarding cross-border tax arrangements, which meet one or more specified characteristics (hallmarks), and which concern at least one EU country.

The EU Commission had, as a result of the COVID-19 coronavirus pandemic, initially proposed to defer the reporting deadlines under DAC 6 by three months, whilst affirming that the initial date of application of the rules will remain 1 July 2020. However, political agreement has now been reached by member states to postpone the filing deadlines on an optional basis by up to six months, as follows:

- for reporting "historical" cross-border arrangements (i.e. arrangements in relation to which the first step was implemented in the period from 25 June 2018 to 30 June 2020), the filing deadline would be 28 February 2021;

  the operation of "30 day" reporting deadlines will be postponed from 1 July 2020 to 1 January 2021, with the effect that:

  - arrangements that become reportable in the period between 1 July 2020 and 31 December 2020 will need to be reported by 31 January 2021;
  - arrangements that become reportable after 31 December 2020 will need to be reported within 30 days;

- for marketable arrangements, the first periodic report would need to be reported by the intermediary by 30 April 2021; and

- the automatic exchange of information reported between member states will be postponed from 31 October 2020 to 30 April 2021.

Although approval to defer DAC 6 has been granted by the European Council, this will not automatically change the current reporting dates within member states. This will only occur if the relevant governments positively choose to implement the deferral (for example Germany has opted not to).

Depending on the evolution of the pandemic, the amended Directive also provides for the possibility, under strict conditions, for the Council to extend the deferral period once again, for a maximum of three further months.

The UK government for its part has implemented legislation to give effect to the above deferral on the full six month basis[1]. The amended regulations take effect from 30 July 2020 and HMRC has advised no action will be taken for non-reporting during the period between 1 July and the date the amended regulations come into force.

Taxpayers and intermediaries may also draw further comfort from updated HMRC guidance[2] in respect of late filing for DAC 6 purposes, which states that difficulties arising as a result of COVID-19 coronavirus may constitute a reasonable excuse to late filing of DAC 6 reports, provided that reports and filings are made without unreasonable delay after those difficulties are resolved.

It is worth clarifying that the proposals do not affect the substantive requirements of DAC 6, only the deadlines for reporting obligations. In particular, the date on which DAC 6 will start to apply will remain 1 July 2020. Nevertheless, in member states where the deferral is approved, it will be a welcome, albeit short, relief to both taxpayers and intermediaries who should have additional time to prepare reports and put reporting procedures and staff training in place.

It is somewhat regrettable that implementation of the deferral is optional, thereby creating a risk of divergence between member states. In particular, reportable cross-border arrangements that involve multiple member states, only some of which have adopted the deferral, may (subject to the relevant country-specific conditions being met) trigger a reporting obligation with a deadline that does not reflect the deferral period adopted by other relevant member state(s). As a result, the rejection of the deferral by one member state may operate to undermine the deferral offered by others. We understand that a number of stakeholders are encouraging the European Commission to make deferral mandatory and to provide more harmonised guidance.

B. International update

I. BEPS 2.0 update

In mid-June 2020, the US stepped back from negotiations relating to Pillar One of the most recent Base Erosion & Profit Shifting project ("BEPS 2.0") of the Organisation for Economic Co-operation and Development ("OECD") . The OECD affirmed their commitment to seeking a consensus-based solution to Pillars One and Two by the end of 2020, with the next meeting scheduled for October 2020. The EU Commission president has made it clear that if the OECD

fail to secure a global accord, the EU would pursue an EU digital tax, as well as a possible minimum tax on multi-national entities ("MNEs").

In January 2020, 137 countries and jurisdictions (the OECD's Inclusive Framework on BEPS 2.0, the "IF") agreed to move ahead with a two-pillar negotiation to address the tax challenges of digitalisation and to continue working toward an agreement by the end of 2020. A detailed discussion on the various facets of the Pillar One and Pillar Two proposals is set out in our previous update on digital service tax proposals. However, for current purposes, broadly:

- Pillar One proposes changes to traditional "nexus" rules for allocating taxing rights, enabling a portion of the revenue generated from digital services to be taxed in the jurisdiction in which they are used; and

- Pillar Two (also referred to as the "Global Anti-Base Erosion" or "GloBE" proposal) relates to the possible introduction of a "global minimum tax rate", by creating new taxing rights for jurisdictions whose taxpayers do business with low-tax jurisdictions (e.g. withholding tax rights in respect of payments to the latter).

At the January meeting, the members of IF (including the US) agreed to approach Pillar One on the basis of the broad architectural framework developed by the OECD Secretariat to facilitate progress towards consensus (the so-called "Unified Approach"). However, many outstanding issues are yet to be agreed, including the US's controversial "safe harbour" proposal (suggesting that taxpayers could decide whether to "opt-in" to be taxed in accordance with Pillar One as currently envisaged or an alternative (as yet unspecified) basis for taxation). In respect of Pillar Two, the IF members acknowledged that significant progress had been made towards achieving the technical design of the proposal for a global minimum tax rate, but that more work needed to be done. The next OECD BEPS 2.0 meeting has been postponed by three months to October 2020. It is intended that, at this meeting, the key policy features of the solution to Pillars One and Two will be agreed.

However, in a significant twist, in June 2020, the United States stepped away from Pillar One negotiations. The US Trade Representative, Robert Lighthizer, informed the US House Ways and Means Committee that this was on the basis that the OECD "*[was] not making headway*" on a multilateral deal on digital services taxation. Steven Mnuchin, the US Treasury Secretary, confirmed this to a group of European finance ministers, stating that the US was taking a step back from the discussions, with talks to resume "later this year". Regarding the GloBE proposal under Pillar Two, the Secretary noted that the US "*fully supports bringing those negotiations to a successful conclusion this year.*"

The head of the OECD's tax policy centre, Pascal Saint-Amans, said that the OECD and member countries would continue to collaborate on a workable draft deal, though he admitted that it was less likely that a deal would be achieved this year. Saint-Amans also floated the possibility that Pillar One and Pillar Two could be separated so that delays in agreeing Pillar One would not prevent the conclusion of the well advanced negotiations on Pillar Two.

In the absence of direct US involvement in the BEPS 2.0 process, it is difficult to see how meaningful progress could be made in respect of Pillar One at the October meeting (or more generally). For example, one of the thorniest Pillar One issues is the risk of double taxation; if the jurisdictions in which affected companies are currently taxed do not yield taxing rights, the result is likely to be double taxation. As the taxpayers most likely to be impacted by the reforms are US technology companies, US engagement is critical to finding a workable multilateral solution.

The lack of US direct involvement and the consequential low probability of a multilateral solution means that more countries are likely to adopt unilateral measures on digital taxation, thereby resulting in a fragmented and less effective international approach. The OECD Secretary-General noted that, in the absence of a multilateral solution, unilateral national measures would inevitably be implemented and these would result in increased tax disputes and heightened trade tensions.

Even though the Pillar Two negotiations are more advanced than the Pillar One talks, there are a number of pertinent issues that have yet to be agreed upon. For example, there are ongoing discussions on the proposed inclusion of some form of investment funds carve out from any GloBE tax. This is on the basis that most investment funds are structured as tax neutral investment pooling vehicles. The absence of a targeted exemption of this kind could result in potential double taxation of income received by the fund. Ultimately, the concern with such an outcome is that the differing (and adverse) tax treatment for indirect investment (over direct investment) would dissuade investors from using fund vehicles. Inherently, this would limit (and potentially eliminate) the economic benefits that funds can offer to investors via access to global markets and a diversified portfolio.

Should OECD discussions fail to produce consensus, the EU has made clear that it is willing to fill the void with its own proposals. The acting director-general of the Directorate-General for Taxation and Customs Union, Benjamin Angel, confirmed that any European solution to digital taxation will be based on the progress made in those discussions though, the European solution will not take the form of a digital services tax. In June 2020, the EU's economy commissioner, Paolo Gentiloni, confirmed that (in the absence of Pillar Two progress) the EU could also propose its own minimum tax on MNEs in 2021.

However, the path to implementing measures at an EU level is not necessarily more straightforward:

- Such measures would generally require the unanimous agreement of the EU Council under the special legislative procedure.
    - While many EU jurisdictions would, on balance, benefit from increased revenue following the introduction of a European solution to digital taxation, some jurisdictions (notably Ireland, Sweden and Denmark) opposed (and effectively blocked) the EU's digital services tax proposal in 2019. In addition, the US has been robust in its position that states implementing such measures will suffer economic counter-measures. For example, the US has reiterated its intention to impose trade sanctions on French products in response to the proposed French digital services tax. The French tax was suspended at the beginning of this year in exchange for a postponement of the retaliatory tariffs

threatened by the US, which have recently been delayed until 6 January 2021. Some member states may therefore feel that the potential economic risks outweigh the gains.

- Given difficulties with the requirement for unanimous consent generally, there have been renewed calls for the decision-making process on taxation policy to be simplified. These have included calls (i) to move to "qualified majority voting" ("QMV") which requires the approval of only a specified majority of the member states and EU population, and (ii) to move away from the special legislative procedure to the ordinary legislative procedure for tax law, under which the European Parliament has a decisive, rather than a consulting, role. However, any such changes would (ironically) require unanimous adoption by the Council and no opposition from any national Parliament. Whilst there is strong support for such changes in certain quarters, the reality is that they are unlikely to win the necessary unanimous support any time soon.

- There are some (very limited) existing EU legislative mechanisms which enable tax provisions to be adopted in the absence of unanimity. These include the so-called "enhanced cooperation procedure" (which allows proposals to take effect in the absence of unanimous member state consent, provided they have the support of at least nine member states and only take effect in those member states) and limited use of QMV (which currently can only be used under the ordinary legislative procedure to eliminate distortions of competition due to different tax rules in member states). However, these have rarely been used in respect of tax legislation and not with much success. For instance, the enhanced cooperation procedure was proposed in 2013 for the planned EU financial transaction tax (discussed further below).

It would appear, therefore, that the best route to a coherent international solution is for the EU to put its weight behind the BEPS 2.0 process and attempt to draw the US back to the negotiating table. Given the potential double tax risks posed by the failure of the OECD project, they may find unlikely allies in the US technology companies whose interests are likely to be best served by such US re-engagement.

II. EU proposal for new tax on large corporates

The EU appears keen to carve a more direct role for itself in the field of taxation. In May 2020, the EU's multi-year budget contemplated the introduction of new taxes, the proceeds of which would be added to EU, rather than member state, coffers. Proposals (which have not yet been tabled for member state approval) include a new tax on large corporates "who benefit from the single market".

In May 2020, the EU Commission published an outline of its next "multi-annual financial framework" for 2021-2027 (effectively, a budget for the EU for the relevant time period).[3] Typically, the framework garners attention for its proposed expenditure, with income predominately derived from member state contributions and a portion of the VAT collected by member states. On this occasion, however, the EU Commission projected that approximately 30% of its income for the period would come from new sources. In addition to income from the expansion of carbon trading, its seems that the EU

intends to generate revenue from levying new taxes, the proceeds of which would be directed toward its own (rather than member states') reserves.

One of the most significant revenue sources (estimated at €10 billion annually) was a proposed tax on companies operating in the single market with an annual revenue of €750 million or more, to be charged at a rate of 0.1% of annual revenue and to take effect around 2024. EU Commissioner Johannes Hahn noted that, due to their access to the single market, such firms have "*a much bigger customer base, a seamless supply chain, in many countries the same currency and a uniform regulation. Companies save costs by simply using the single market, [such that] a modest levy for this access is…a fair deal*". However, subsequent statements from an EU spokesperson about the tax (which would be used to fund the EU's COVID-19 coronavirus stimulus package) indicated that its form, and the rate at which it would be charged, are far from settled: "*Depending on the design, whether a lump sum or a fee proportional to firms' size, or a portion of a tax on profits, around 10 billion euros could be raised without excessively weighing on any individual firm. Ten billion euros is less than 0.2% of the turnover generated by the EU operations of those large companies*." Although the tax was discussed at the EU Council summit on 19 June 2020, no further statements have been made about its design, and no concrete proposals have been tabled for member state approval.

Despite the potential significance of the announcement, high level questions remain over the feasibility of the tax - or indeed any form of direct EU taxation – in the coming years. As discussed above, any EU-wide proposal would (based on current rules) require the unanimous backing of the member states, and the extent of member state support for the idea is not yet clear. They will be alive to the economic and fiscal difficulties to be faced at a national level in the wake of the COVID-19 coronavirus pandemic, and may be wary of additional taxes which risk impeding the recovery of national businesses, without the corresponding injection to national finances. Negotiations between member states are expected to continue over the summer.

III. Possible resurrection of European financial transaction tax

Germany has announced that securing a pan-European financial transaction tax is one of its priorities during its current tenure as president of the EU Council.

In April 2020, the introduction of a European financial transaction tax was included on the German agenda for its six-month term as president of the EU Council (from July to December 2020).

Proposals for an EU-wide financial transaction tax were first mooted in 2011. The original proposal was for a tax levied on each party to certain dealings in financial instruments, such as transfers of debt and equity interests (at a rate of 0.1% of the consideration), and the entry into or modification of derivative contracts (at a rate of 0.01% of the notional amount). The tax was originally intended to apply in all member states, but only gained the support of 11 (Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain, although Estonia subsequently withdrew its support). In 2013, these states moved forward using the so-called "enhanced cooperation procedure" (described

above). Nevertheless, the proposal stalled, and certain states (such as Italy and France) acted unilaterally to introduce national equivalents.

In December 2019, the proposal for an FTT was revived, when the German Finance Minister published draft legislation for its imposition by participating member states. Broadly, this iteration would apply (at a minimum rate of 0.2%) to the acquisition of shares in entities established in participating member states with a market capitalisation of €1 billion or more, if the shares were admitted to trading on a trading venue. The revised proposal included an exemption for (amongst other things) market-making activities, an optional exemption for pension funds and proposals for "mutualisation" (which guarantees participating member states a certain portion of the proceeds). Again, it did not proceed further.

It is understood that Germany's vision for the form of an FTT is largely unchanged from last year's proposals. However, it is unclear whether the other participating member states will agree with its scope and design, such that a consensus can be reached. In particular, statements following the EU Council meeting on 19 June suggested that the FTT was discussed as a possible means of funding the EU's COVID-19 coronavirus recovery package (which may cut across proposed mutualisation mechanics).

Given fiscal pressures in the wake of the COVID-19 coronavirus pandemic, the proposal may perhaps receive a warmer airing on the third attempt – although member states may equally be conscious of the risk such a tax would pose to liquidity in the capital markets (at a time when it is very much needed). However the EU chooses to proceed, it is unlikely that any proposal would progress to implementation before the end of the Brexit transitional period (currently 1 January 2021). Given London's role in European and global capital markets, the UK government is highly unlikely to have any appetite for equivalent measures.

IV. DAC 7 update & OECD publication of the "Model Rules for Reporting by Platform Operators with respect to Sellers in the Sharing and Gig Economy"

After a short delay, the EU Commission published a proposal for a Directive amending Council Directive 2011/16/EU (referred to as "DAC 7") on 15 July 2020. The proposal enhances the member states' information gathering and sharing powers in respect of income generated via digital platforms.

Meanwhile, on 3 July 2020, the OECD published model rules which jurisdictions could adopt to facilitate greater transparency in the reporting of such income and the exchange of that information between jurisdictions.

The EU Commission published a proposal for a Directive amending the European Directive on Administrative Cooperation in the Field of Taxation, Council Directive 2011/16/EU (referred to as DAC 7) on 15 July 2020. This follows completion of the public consultation on DAC 7 in April 2020. The proposal was published along with a number of other tax policy initiatives that the EU Commission intends to implement between now and 2024.

By way of reminder, the aim of DAC 7 is the fair taxation of income generated via digital platforms and it will, unlike previous versions of DAC, address VAT (in addition to direct taxes). The main problems that DAC 7 is set to tackle are:

- tax revenue losses due to some taxpayers failing to report what they earn via online platforms; and

- the weaknesses in how national tax administrations cooperate to tackle tax evasion and the inefficiencies in data exploitation.

Specifically, DAC 7 is intended to bolster the information-gathering powers of tax administrations regarding income generated via the digital platform economy, to provide for better cooperation across tax administrations, and keep business compliance costs to a minimum by providing a common EU reporting standard.

Simultaneously, the OECD has been working on a global tax reporting framework as part of a wider strategy (a) to address the tax challenges arising from the digitalisation of the economy and (b) as a basis for increasing tax transparency to develop a stable environment for the growth of the digital economy. Following the publication of the OECD 2019 report on '*The Sharing and Gig Economy: Effective Taxation of Platform Sellers'* anda consultation process earlier this year, the OECD published, on 3 July 2020, Model Rules for Reporting by Platform Operators with respect to Sellers in the Sharing and Gig Economy (the "Model Rules"). The Model Rules seek to assist tax authorities collecting information on the income realised by those offering accommodation, transport and personal services through "platforms" (namely any software, including a website and phone applications) and to report that information to the tax authorities. In particular, (given the international nature of such platforms) the aim is to facilitate the standardisation of rules across jurisdictions.

C. UK digital services tax update

At the time of writing, UK members of Parliament have, as part of amendment papers to the Finance Bill 2019-21, proposed additions to the UK digital services tax regime. These include:

- requiring all corporate groups subject to the UK digital services tax to publish a group tax strategy, including a country-by-country report (which would include information about the group's global activities, profits and taxes); and

- requiring the UK government to report on the digital services tax annually (which would include an annual assessment of the effect of the regime on UK tax revenues).

The UK introduced its current "country-by-country" reporting regime in 2016, to implement Action 13 of the wider OECD BEPS project and to provide a more standardised approach towards consistent high-level transfer pricing assessments. Broadly the regime requires UK-headed MNEs, or UK sub-groups of MNEs, to make annual reports to HMRC in certain circumstances, showing revenues, profits, taxes paid and certain other measures of economic activity in the jurisdictions in which they operate.[4] The above proposals for a "country-by-country" report to be prepared by those within the scope of the UK digital

services tax would subject such taxpayers to the same reporting obligations. This will likely increase the compliance burden for large MNEs within the scope of the UK digital services tax, but with an otherwise limited UK presence. It is also not clear at this stage what role each of the categories of information required under such reports will play in recovering UK digital services tax and the grounds under which those reports may be shared with other tax authorities or used in scrutinising wider transfer pricing arrangements of MNEs.

The UK digital services tax is still intended to be withdrawn once the OECD reaches consensus on a common approach to update the international corporate tax rules to tax the digital economy. The above proposals may (in part) have been in response to recent action by US Treasury Secretary, Steve Mnuchin, who in June 2020 reportedly wrote to the UK, France, Italy and Spain pulling the US back from wider discussions at the OECD level (see further Section B).

For our latest Client Alert on The UK Digital Services Tax click here.

D. Key COVID-19 coronavirus tax update

I. New timelines for tax policy consultations

HM Treasury and HMRC have set out revised timelines for the conclusion of open tax consultations, and the publication of other tax policy documents, in light of the COVID-19 coronavirus pandemic, in order to allow more time for stakeholders to provide feedback.

The UK government has extended deadlines in respect of ten consultations and calls for evidence currently underway by three months. Jesse Norman, Financial Secretary to the

HM Treasury, said that *"[c]onsulting on tax policy is crucial to good tax law. And a good consultation makes sure everyone with an interest in the subject has an opportunity to have their say …. That is why [HMRC is] extending these deadlines*".

The table below sets out the revised deadlines for some of the most significant consultations:

Consultation	**Revised deadline**
Tax treatment of asset holding companies in alternative fund structures	19 August 2020
Notification of uncertain tax treatment by large businesses	27 August 2020
Consultation on the taxation impacts arising from the withdrawal of LIBOR	28 August 2020

Call for evidence: raising standards in the tax market	
Tackling Construction Industry Scheme abuse	
Preventing abuse of the R&D tax relief for SMEs: second consultation	
Hybrid and other mismatches	29 August 2020

In light of the COVID-19 coronavirus, the UK government has also delayed the publication of a number of tax policy documents announced at Budget 2020, including the following:

Policy document	**Revised publication date**
A summary of responses to the call for evidence on the operation of insurance premium tax	Spring/summer
HMRC's civil information powers	
A summary of responses to the non-UK resident SDLT surcharge consultation	
The call for evidence for the fundamental review of business rates	
The consultation on the design of a carbon emissions tax	
The response to the call for evidence on simplification of the VAT partial exemption and capital goods scheme	Autumn
The call for evidence on disguised remuneration schemes	Unspecified
The review of the UK funds regime	

Details regarding the publication date of the UK government's first review of VAT charged on fund management fees (which was announced at Budget 2020 as part of a wider review to ensure the ongoing competitiveness and sustainability of the UK regime as it applies to the financial services sector) are also yet to be provided.

It is unclear whether the delays noted above will impact the implementation date of some of the proposals. However, given the current environment, the extensions will be welcomed by many stakeholders who are facing disruption due to the COVID-19 coronavirus and who would like the opportunity to submit their views.

II. OECD analysis of tax treaties and the impact of the COVID-19 coronavirus pandemic

The OECD has published an analysis (the "OECD Analysis") of how the OECD Model Convention (the "OECD Model") may be interpreted in the context of changing circumstances arising from the COVID-19 crisis, such as the dislocation of people and activities while travel restrictions remain in place. Issues addressed include: (i) the potential creation of permanent establishments; (ii) the residence status of a company (place of effective management); (iii) cross-border workers; and (iv) potential changes to the residence status of individuals.

The COVID-19 coronavirus pandemic has forced governments to restrict travel and implement strict quarantine requirements and it is clear that such measures raise difficult tax issues. The OECD Analysis outlines the OECD's view as to how the OECD Model can be interpreted and applied to certain tax treaty issues arising in the context of the pandemic.

- ***Concerns related to the creation of permanent establishments:*** As a result of government restrictions, many cross-border workers are unable to physically perform their duties in their country of employment. The OECD Analysis addresses the concern that employees working from home in jurisdictions which differ from their usual place of work will create a permanent establishment ("PE") for their employer in the former jurisdiction. According to the OECD Analysis, the temporary change of the location where employees exercise their employment because of the COVID-19 coronavirus pandemic, such as working from home, should not create new PEs for the employers pursuant to Article 5 of the OECD Model. The OECD Analysis states that a PE must have a "*certain degree of permanency and be at the disposal of an enterprise in order for that place to be considered a fixed place of business through which the business of that enterprise is wholly or partly carried on*". Under Article 5(5) of the OECD Model, the activities of an individual temporarily working from home for a non-resident employer could also give rise to a dependent agent PE. The OECD Analysis states that an evaluation is required as to whether the employee performs these activities in a "habitual" way and concludes that an employee's or agent's activity in a particular country is unlikely to be regarded as habitual if he or she is only working at home in that country for a short period because of force majeure and/or government directives extraordinarily impacting his or her normal routine. HMRC published guidance in the International Tax Manual stating that the "*existing legislation and guidance in relation to permanent establishments already provides flexibility to deal with changes in business activities necessitated by the response to the COVID-19 pandemic*".

- ***Concerns related to the residence status of a company (place of effective management):*** The OECD Analysis notes that the COVID-19 coronavirus pandemic may raise concerns about a

potential change in the "place of effective management" of a company as a result of a relocation, or inability to travel, of chief executive officers or other senior executives. The concern is that such a change may alter a company's residence under relevant domestic laws and affect the country where a company is regarded as a resident for tax treaty purposes. In the UK for example (where, for non-UK incorporated entities, the domestic test looks to the location of central management and control), HMRC has noted that it would not consider that a company will necessarily become resident in the UK because a few board meetings are held in the UK, or because some decisions are taken in the UK over a short period of time. It is not clear what HMRC will consider a short period of time, particularly as the duration of the travel restrictions is unknown. In a treaty context (where the test typically looks to the place of effective management), according to the OECD Analysis, it is unlikely that the COVID-19 coronavirus pandemic will create any changes to a company's residence status under a tax treaty. A temporary change in the location of the chief executive officers and other senior executives is an extraordinary circumstance because of the pandemic and such change of location should not trigger a change in residency. However, the OECD Analysis does note that if, due to domestic legislation, a dual residency issue appears, it would be resolved under tie-breaker rules set out in the relevant double tax treaty.

- ***Concerns related to cross border workers:*** Article 15 of the OECD Model governs the taxation of employment income, allocating the right to tax between the employee's state of residence and the place where their employment is performed. The OECD Analysis states that the starting point for the rule in Article 15 is that salaries, wages and other similar remuneration are taxable only in the person's state of residence (the "resident state") unless the "employment is exercised" in the other state (the "source state").

    - The COVID-19 coronavirus pandemic has resulted in some governments subsidising the income of employees. The OECD Analysis notes that the income received by cross-border employees in these circumstances should be attributable to the country where the employee would otherwise have worked in the absence of the crisis. In most cases, this will be the place the employee used to work prior to the COVID-19 coronavirus pandemic. The OECD Analysis states that where the source state has a taxing right, the resident state must relieve double taxation under Article 23 of the OECD Model, either by exempting the income or by taxing it and giving a credit for the source state tax.

    - The OECD Analysis acknowledges that compliance difficulties may arise whereby the country where employment was formerly exercised loses its taxing right following the application of Article 15. For example, employers may have withholding obligations which are no longer underpinned by a substantive taxing right.In these circumstances, such obligations would have to be suspended and a way found to refund the tax to employees. Employees may also have new and enhanced liabilities in the other state.

HMRC has not yet indicated their approach to the above employment and source taxation issues as a result of the travel restrictions imposed in response to the COVID-19 coronavirus pandemic.

Concerns related to a change to the residence status of individuals: The final issue addressed by the OECD Analysis relates to the impact that unforeseen changes of location may have on the tax residency status of individuals. The UK statutory residence test, for example, considers the number of days an individual spends in the UK in determining their tax residency (amongst other factors). HMRC has confirmed that certain situations arising from the COVID-19 coronavirus pandemic would constitute "exceptional circumstances", such that up to 60 days' presence in the UK can be ignored for this purpose, while the government has also stated that in this context, special treatment will be afforded to those in the UK to assist with the response to the pandemic.[5]

- The OECD Analysis states that "*it is unlikely that the COVID-19 situation will affect the treaty residence position*". However, two scenarios are noted whereby an individual's residence status may change as a result of the COVID-19 coronavirus pandemic:

    - A person is temporarily away from their home and gets stranded in the host country by reason of the COVID-19 coronavirus pandemic and attains domestic law residence there.

    - A person is working in a country (the "current home country") and has acquired residence status there, but they temporarily return to their "previous home country" because of the COVID-19 coronavirus pandemic. They may either never have lost their status as resident of their previous home country under its domestic legislation, or they may regain residence status on their return.

The OECD Analysis provides that in both scenarios, if a tax treaty is available, the treaty tie-breaker rules should solve the issue and keep the person a resident of the country he/she was before the COVID-19 coronavirus pandemic.

The application of relevant domestic law requirements will, in the first instance, determine how these issues are addressed in practice. Although there are exceptions (e.g. Ireland, Australia), many jurisdictions have yet to (and indeed may not) provide guidance to taxpayers as to how they intend to deal with the above issues as a matter of domestic law.

Recourse to treaties may operate as a second line of defence for taxpayers, should such guidance/relief not be forthcoming at a domestic level. The OECD Analysis, which broadly favours interpretations which maintain the status quo regarding allocation of taxing rights, may therefore provide some comfort to taxpayers. However, the availability of treaty relief is, in any particular case, likely to depend on the specific terms of the relevant tax treaty. Unfortunately, uncertainties are unlikely to be resolved in the short term, as issues arising now are likely to take a number of years to play out. Indeed, the pandemic may well prove to be the first true test of the more robust treaty dispute resolution mechanics (such as mandatory arbitration) which have been adopted in recent years.

III. Transfer pricing implications of COVID-19 coronavirus pandemic

Changing circumstances caused by the COVID-19 coronavirus pandemic may lead taxpayers to question whether their existing transfer pricing policies should be revisited (and if so, how). On 3 June 2020, the OECD issued a questionnaire to companies and trade associations, asking for their input on transfer pricing issues experienced in this context (the "OECD Questionnaire"). The OECD's intention is to use the information provided in response to guide discussions on how to best respond to such issues. Nevertheless, the OECD has noted that its existing transfer pricing guidelines continue to represent internationally agreed principles for the application of the arm's length principle. These will, accordingly, continue to be key reference points for taxpayers in the current circumstances.

Factors informing many MNEs' transfer pricing policies are likely to have been impacted by the COVID-19 coronavirus pandemic. These include:

- the possibility of significant people functions being located in unexpected jurisdictions;
- possible changes to supply chains in response to shortages and travel restrictions;
- possible changes in business strategies in response to changes in consumer demands;
- the emergence of new commercial risks and changes to the significance of existing risks;
- volatility in financial markets and potential liquidity shortages; and
- a general economic downturn.

Such developments may raise questions as to whether (and if so, to what extent) these changes should be reflected in amendments to existing transfer pricing policies.

The OECD Questionnaire asked MNEs and trade associations to provide information on difficulties faced as a result of the COVID-19 coronavirus pandemic, including:

1. The issues (a) causing greatest concern, together with practical examples, (b) least clearly addressed in the existing OECD guidelines, and (c) most likely to give rise to disputes with tax administrations;

2. The types and sources of information that should be utilised as the basis for comparability analyses for 2020; and

3. Examples of supplementary transfer pricing guidance published by national tax administrations that address any of the identified issues.

While the OECD Questionnaire may result in the publication of additional guidance, given that transfer pricing must be assessed at the time arrangements are entered into, it may well be too late to assist MNEs in pricing arrangements being entered into presently. For the moment at least, taxpayers will have to be guided by the OECD's existing transfer pricing guidelines - the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "2017 Guidelines") and the 2020 OECD Transfer Pricing Guidelines on Financial Transactions (the "2020 Guidelines"). In this respect, the OECD has made clear that "*irrespective of the underlying economic circumstances, [the 2017 Guidelines] provide guidance for the application of the arm's length principle of which Article 9 [of the OECD Model Tax Convention] is the authoritative statement*".

The 2017 Guidelines address whether, and if so how transfer pricing analysis should take account of future events that were unpredictable at the time of the testing, stating that this question should be resolved by reference to "*what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction"*. One of the practical difficulties with such comparative analysis, however, is that the COVID-19 coronavirus pandemic presents a unique economic challenge, its impact has varied across industries and as between MNEs and there may be little (if any) comparative data on what independent enterprises would do (and are doing). The 2017 Guidelines accept that information on contemporaneous transactions may be limited, and state that in some cases taxpayers can demonstrate that they have made "*reasonable efforts to comply with the arm's length principle … based on information that was reasonably available to them at that point"*. It further clarifies that differences that materially affect the accuracy of the comparison will need to be adjusted to the extent that such adjustments are reasonable and improve comparability.[6] It will therefore be more important than ever for taxpayers to document all decisions taken in relation to their transfer pricing policies.

Moreover, MNEs will have to consider whether *existing* transactions should be reviewed to reflect the current circumstances. Given financial market volatility and the likelihood of fewer debt transactions, this is particularly true for financial transactions. The 2020 Guidelines provide that "*a transfer pricing analysis with regard to the possibilities of the borrower or the lender to renegotiate the terms of the loan to benefit from better conditions will be informed by the options realistically available to both the borrower and the lender*". If MNEs consider that there is scope to renegotiate more favorable terms on intra-group loans or delay interest payments on a temporary basis, the decision should be contemporaneously documentedand reflect that the options realistically available to both parties have been considered.

Losses may also need to be considered. The 2017 Guidelines provides that *"associated enterprises, like independent enterprises, can sustain genuine losses"* due to unfavorable economic conditions. However, an independent enterprise would not be able to *"tolerate losses that continue indefinitely"*.[7] The COVID-19 coronavirus pandemic would certainly constitute an unfavorable economic condition. However, that alone does not justify the legitimacy and allocation of intra-group losses - the relevant test would be the consideration of what unrelated parties in the same or similar circumstances would do. This would depend on the particular facts and circumstance and would require benchmarking support – which is not readily available in the context of the pandemic. In addition to analysing the allocation of losses, MNEs are required to perform impairment testing to ensure that an entity's assets are not carried at more

than their recoverable amount. COVID-19 coronavirus has resulted in a significant change in circumstances and as such MNEs may be subject to an unscheduled impairment test which may have a consequent impact on transfer pricing policies.

Broadly, within MNEs, employees who take on more important group functions are often required to relocate to locations where the entrepreneurial group companies or companies with the most important functions are based or where there is a more beneficial regulatory environment. Certain of these employees may have returned to their home jurisdictions as a result of the lockdown restrictions. A functional and factual analysis must be undertaken to determine whether key entrepreneurial risk taking ("KERT") functions are performed by employees in their home jurisdiction and if any profits arising from such KERT functions should be attributable to the home jurisdiction. In such circumstances, it is unlikely that the relevant group company for which such employees perform KERT functions would change (i.e. that they would begin to perform such functions for a different group company in their home jurisdiction). If so, this should not change the functional profile of the group companies and the MNE's transfer pricing model should not be impacted.

While the current circumstances are certainly novel, the existing OECD transfer pricing guidance is general in its nature, and was intended to be capable of application in a variety of different contexts. As such, the key message for MNEs when considering whether to make any changes to transfer pricing policies as a result of the COVID-19 coronavirus pandemic is to some extent familiar - MNEs should document all decisions and create a contemporaneous audit file and ensure that their transfer pricing policies align with business strategies. This will be helpful to support any review of transfer pricing policies by tax authorities in the future.

IV. Tax status for EMI options granted to furloughed employees

There had been a concern that furloughing employees may result in the loss of Enterprise Management Incentive ("EMI") tax benefits. The UK government has tabled amendments to Finance Bill 2020-21 which provide that an employee having been furloughed will not result in a "disqualifying event" for the purposes of obtaining tax relief under the EMI scheme.

Broadly, EMI options are special tax-efficient options which can be granted by certain qualifying companies without giving rise to income tax or National Insurance Contribution ("NICs") charges on either grant or exercise (and only a charge to capital gains tax on the subsequent disposal of the shares acquired on exercise). However, to obtain these tax benefits, the relevant legislation under the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA") provides that recipients of EMI options must spend:

- at least 25 hours each week (the 25 hours requirement), or
- if less, 75% of their working time (the 75% requirement),

working as an employee for the company granting the option (or one of its qualifying subsidiaries).

There was a concern that a furloughed employee may no longer satisfy the above working time requirement. Given that furloughed employees are expressly prohibited from working for their employer for the furlough period, any such employees holding EMI options would not be able to meet the 25 hours (or 75% of working time) test. Such failure is a "disqualifying event", meaning that any EMI options held would have lost their tax advantaged status after 90 days.

The UK government has announced that it will introduce a time limited exception for participants in EMI schemes who are not able to meet the relevant working time requirements as a result of the COVID-19 coronavirus pandemic. The proposed measure (to be included in Finance Bill 2020-21) will ensure that failure of furloughed employees to meet the current statutory working time requirement will not result in a "disqualifying event", such that any EMI options held by furloughed employees will not lose their tax advantaged status. The proposed relief will apply from 19 March 2020 and will come to an end on 5 April 2021. If required, the relief may be extended by regulation for a further 12 months to 5 April 2022.

The proposals are welcome, and will ensure that furloughed employees holding EMI options will not be prejudiced by circumstances outside their control. It remains to be seen whether similar reliefs may be granted to other taxpayers at risk of having their tax status altered by reason of recent intervening circumstances (such as employees unexpectedly carrying out employment tasks in the UK by reason of travel restrictions, and their employees).

On 8 June, HMRC also issued a bulletin in respect of other tax advantaged share schemes:

- Save as you Earn: Where participants are unable to contribute because they are furloughed, HMRC will extend the payment holiday terms. In addition, payments of Coronavirus Job Retention Scheme ("CJRS") to employees furloughed during the coronavirus pandemic can constitute a salary and SAYE contributions can continue to be deducted from CJRS payments.

- Share Incentive Plan: Payments of CJRS to employees furloughed during the COVID-19 coronavirus pandemic can constitute a salary and contributions can continue to be deducted from CJRS payments.

- Company Share Option Plans: HMRC will accept that where employees and full-time directors, now furloughed because of the COVID-19 coronavirus pandemic, have been granted options before the pandemic, such options will continue to constitute qualifying options on the basis the recipients were full-time directors and qualifying employees at the time of grant.

V. Crisis-driven changes to trading activities

HMRC has updated its guidance on crisis-driven changes to trading activities for businesses. This includes guidance on temporary breaks in trading activity and the treatment of income and expenditure. The guidance confirms that a temporary pause in trading activity in response to the

pandemic will not result in taxpayers being treated as having ceased to trade, provided an intention to trade remains.

In response to the COVID-19 coronavirus pandemic, many businesses have had to adapt their activities. For example, businesses may have had to change product lines in response to changing consumer demands and/ or production difficulties, or temporarily close altogether.

Changes in trading activities, or the cessation of a trade, can cause issues from a tax perspective. For example, a trading company that has incurred losses may not be able to carry such losses forward to offset against future profits if it is found to have ceased one trade and to have started a new trade. In this respect, case law establishes that the line between making changes to an existing trade, and beginning a new one, can be fine. In one case, a taxpayer who had incurred losses brewing and selling beer adapted its business model so that the beer was instead produced by a third party, but sold by the taxpayer in the same manner. To the customers there had been no change. However, the courts found that the taxpayer had ceased one trade, and began another.[8]

Case law over the years has shown that the intention of the taxpayer and the extent and length of period during which the trade was dormant (if relevant) are critical factors in determining whether a trade continued or ceased. In one instance, due to the economic conditions at the time, a taxpayer was unable to obtain new business, despite having made persistent attempts. After more than five years some new business was obtained and the business returned to profitability. The taxpayer successfully claimed that the trade had continued throughout the five years because of attempts to seek business throughout.[9]

In light of the limitations imposed by the COVID-19 coronavirus pandemic, taxpayers will welcome recently published guidance in HMRC's Business Income Manual on the implications of crisis-driven changes to trading activities. The guidance sets out how HMRC will apply legislation and case law in situations where a crisis (such as the COVID-19 coronavirus) has resulted in changes to normal trading activities.

The guidance confirms the following:

- A business that starts carrying on a new activity that is broadly similar to its existing trade should not be treated as commencing a separate trade. This of course will depend on the facts of each case. The guidance includes an example of a restaurant business starting to manufacture gowns and face masks, which should be treated as the commencement of a separate trade. This is compared to a business that already manufactures clothing articles starting to manufacture gowns and face masks using the same staff and premises, which should be treated as an extension of the same trade.

- Temporary breaks in trading activity will not constitute a permanent cessation of a trade for tax purposes, provided the trading activities that resume are the same as, or similar to, those before the break. For example, if a business closed its doors to customers, or otherwise ceased trading

during the COVID-19 coronavirus lockdown period, but intended to continue trading after restrictions were lifted, then the trade should not be treated as having ceased. Any income and expenses relating to the gap in trading will be taken account of in the calculation of trade profits or losses (subject to the usual tax rules and case law). Where, in the end, that business does not resume, there will be a cessation of trade.

- If businesses have received donations of money to meet revenue expenditure or supplement trading income, these will be treated as trading receipts.

- Some businesses may offer partial refunds to customers during the lockdown period (for example on gym memberships or other subscription-based services). Where these are included as trade expenses in the taxpayer's GAAP-compliant accounts they should be deductible for tax purposes, assuming that the original receipt was included in the calculation of trade profits.

Clarifications in HMRC's guidance are welcome at a time when many businesses are adapting to survive and have, consequently, had to consider whether there has been a change or cessation of trade for tax purposes. As always, however, each case will need to be considered on its own merits.

On a related note, HMRC has now acknowledged that, in exceptional circumstances, it will consider claims for repayments of corporation tax instalments paid earlier in the current accounting period, based on losses the taxpayer anticipates it will suffer later in the period.

However, HMRC's guidance states that "*it will be extremely difficult for a company to provide adequate evidence [to support such a claim for prepayment]. Even a drastic downturn in a company's trading environment may reverse in the later part of the period, or its position could be mitigated by the recognition of an unexpected capital gain or revenue item. All claims for anticipated losses must be examined critically and in full. The evidence required to validate such a claim should be viewed strictly as there will often be considerable doubt about the company's profit position in future months*". It is, therefore, recommended that companies keep a detailed record of the reasoning and assumptions behind any figures submitted (including, for example, board reports, any public statements and detailed management accounts).

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For our client alerts on the legal and business implications of the COVID-19 coronavirus pandemic (including a high level summary of tax developments), please see here.

E. Recent notable cases

I. *Fowler v. HMRC*[10]

In *Fowler*, the Supreme Court examined the interaction between UK national law and the double tax treaty between the UK and South Africa. Specifically, the Supreme Court concluded that

certain deeming provisions in UK domestic legislation, which recharacterised employment income as trading income, did not apply for the purposes of determining the allocation of taxing rights in respect of that income under the treaty. This was because the purpose of the deeming provisions was not to adjudicate between how the States regarded the interpretation of the treaty or to alter the meaning of its terms.

Fowler involved an analysis of where income earned by an individual should be taxed pursuant to the terms of a double tax treaty. The taxpayer was resident in South Africa for tax purposes, but worked as a professional diver in the waters off the UK. The relevant UK tax law included special deeming provisions, which provided that income earned by divers in the course of their employment was to be treated as trading income, rather than income from employment.[11]

The double taxation treaty between the UK and South Africa (the "Treaty") provides for employment income to be taxed in the place where it is earned (i.e. here, in the UK) pursuant to article 14, but for the trading profits of individuals to be taxed only where they are resident under article 7. The taxpayer claimed that the income he earned from diving engagements was to be characterised as trading income for the purposes of the Treaty as well, and hence that the Treaty prevented HMRC from taxing the income.

The Supreme Court noted that (a) under article 3(2) of the Treaty, any terms which are not defined in the Treaty itself, are to be given the meaning which they have in the tax law of the state seeking to recover tax (i.e. the UK) (noting that there is no definition of employment in the Treaty) and (b) the relevant UK legislation provided for divers to be treated as if they were self-employed traders for income tax purposes.

Reversing the Court of Appeal's decision, the Supreme Court held that the taxation of the taxpayer's remuneration as trading income for UK income tax purposes did not affect its classification under the Treaty. The court concluded that nothing in the Treaty "*requires articles 7 and 14 to be applied to the fictional, deemed world which may be created by UK income tax legislation. Rather they are to be applied to the real world, unless the effect of article 3(2) of the Treaty is that a deeming provision alters the meaning which relevant terms of the Treaty would otherwise have*". In this case, the relevant UK deeming provisions were of limited effect, and in their absence, there would be "*no doubt that article 14, not article 7, would apply to [the taxpayer's] diving activities, at least on the…assumption that he really was an employee.*"

This case highlights the potentially limited effect of domestic deeming provisions in an international context. Taxpayers who are taxed pursuant to deeming provisions and who are seeking to rely on double tax treaties will need to carefully analyse not only the terms of the relevant treaty, but also the intended ambit of the domestic deeming provisions, to determine whether the latter affects their position under the former.

II. *Investec Asset Finance Plc v. HMRC*[12]

In *Investec*, the Court of Appeal found that capital contributions by taxpayers to leasing partnerships in which they held an interest were not deductible. This was because the contributions were made at least partly for the purposes of the *leasing partnership*'s trade, and accordingly not wholly and exclusively for taxpayers' financial trades. The court also found that the "no double taxation principle" applied, so that profits of the trade which the taxpayers were deemed to carry on as partners in the leasing partnerships were not also brought into account as profits of their financial trades.

The two taxpayers in *Investec* each carried on a financial trade, which included investing in partnership interests. They invested in a number of partnerships (which were each carrying on a leasing trade) and shortly thereafter made capital contributions to the partnerships, to enable the partnerships to repay debt and purchase assets. The taxpayers intended to realise the value of partnerships' businesses (and hence their investment) shortly after acquisition via the sale of the partnerships' assets.

A partnership is not itself generally subject to UK corporation tax. Rather, its partners are treated as carrying on the same notional business as the partnership, and the profits of the partnership (calculated at partnership level) are attributed to its partners, in proportion to their partnership interests. Here, for example, the taxpayers were carrying on a financial trade, and a separate notional leasing trade.

Deductible expenses

Expenses can only be deducted in calculating the profits of a trade subject to UK corporation tax if they are incurred wholly and exclusively for the purposes of that trade. Case law on the subject distinguishes, in particular, between expenses incurred for the purpose of benefitting the *taxpayer*, and expenses incurred for the purpose of benefitting the taxpayer's *trade* (with only the latter being deductible). The expenditure can benefit the taxpayer and still be deductible, but that must not have been the taxpayer's subjective *purpose* in making the outlay.

In *Investec*, the court acknowledged that the taxpayer's ultimate objective in making the capital contributions was "*to make some money quickly*" (i.e. to realise profits in their financial trades). However, "*this could best be achieved"* via a structure pursuant to which the taxpayers acquired interests in the partnerships rather than direct interests in the assets purchased by the partnerships, which was "*vital to the [taxpayer's] tax planning…however uninterested the banking people at [the taxpayer] may have been in that aspect of the transactions"*. The partnerships' trades were separate from the taxpayers' financial trades. Accordingly, the court agreed with the lower courts' conclusion that "*the capital contributions were made…at least partly for the purposes of [the partnerships'] businesses, which…[were] distinct from those carried on by [the taxpayers]. This was not an incidental consequence, it was central to the way in which the … transactions were carried out.*"

The case highlights that taxpayers making material payments which are intended to be deductible should actively consider and record the purposes for which the payment is being made. In particular, an ultimate purpose of (indirectly) benefitting the taxpayer's trade may not be sufficient if there is a parallel, more

immediate, purpose. Care should particularly be taken in group structures, where payments made by a taxpayer to benefit its wider group are unlikely to meet the "wholly and exclusively" threshold unless such benefit is merely an incidental consequence of the taxpayer's purpose of benefiting its own trade.

No double taxation principle

As a matter of UK law, the income of a partnership belongs to the partners as it arises (in proportion to profit-sharing arrangements agreed between the partners). However, for tax purposes, this basic principle is somewhat complicated by the "notional trade" fiction. Case law has, accordingly, produced the so-called "no double taxation" principle, to prevent income being taxed twice as both (a) income of the partner's notional trade and (b) income from its own (actual) trade.

In *Investec*, the principle was applied to prevent the leasing profits taxed as part of the taxpayers' notional trades from also being taxed as profits of the taxpayers' financial trades arising from the holding of partnerships interests. The court found that it did not need to reach judgment on whether (as HMRC contended) the conclusion depended on whether the receipts of the taxpayers' financial trade (deriving from the partnerships' leasing activities) were income or repayments of capital. For present purposes, it was sufficient that the relevant profits had already been taxed as part of its notional trade.

Nevertheless, (although precluded from raising the argument on procedural grounds) it is clear that HMRC considers both (i) the nature of receipts from partnership interests in the hands of the partner and (ii) the manner in which partnership interests are accounted for by the partner, to be material to the application of the "no double taxation" principle. Specifically, HMRC seems to consider that the principle should not apply where (despite there being no difference in economics) the receipts take a different form in the hands of the partnership and the partner (e.g. where receipts are income for the partnership, but capital for the partners, or vice versa).

Investec shows the practical difficulties arising from the "notional trade" fiction. Indeed the court went so far as to note that HMRC's application of these provisions was "*still, to put it kindly, a work in progress*". However, on a practical level, the case also appears to highlight that partnerships will be subject to the same stumbling blocks encountered by companies. This means that, for UK tax purposes, the income or capital nature of a receipt will often be (or at least be taken by HMRC to be) significant. Therefore, the form in which funds are extracted from investments may well materially influence the tax outcome.

III. *Centrica Overseas Holdings Ltd v. HMRC*[13]

In Centrica, the First-tier Tribunal ("FTT") found that advisers' fees incurred by the taxpayer investment company in relation to a potential disposal of the assets of a subsidiary were not deductible expenses of management for the taxpayer, because the decision to make the disposal was taken by the taxpayer's parent, rather than the taxpayer.

The taxpayer was an intermediate holding company in the group headed by Centrica plc ("Centrica"). Centrica made a strategic decision to sell the business of the taxpayer's Dutch subsidiary, and incurred expenses of £3.8 million over the period 2009–2011 in relation to the sale. The expenditure was recharged to the taxpayer, who claimed that £2.5 million of it constituted expenses of management deductible from its profits for UK corporation tax purposes.

The FTT held that the expenditure did not qualify as expenses of management of the taxpayer's investment business because the taxpayer did not itself carry out any of the management activities in relation to which it was incurred. This is because, based on the facts, it was Centrica that had made all of the decisions. The group's legal, tax and M&A teams who worked on the sale did so to give effect to Centrica's decision to sell the subsidiary's businesses. To the extent that the taxpayer's directors participated in managing the process, they did so in their group capacities as Head of Tax and General Counsel. There was no evidence to show that they had taken any relevant decisions in their capacity as directors of the taxpayer or that any of the advice the taxpayer had paid for was used by them (in their capacity as the taxpayer's directors).

This case emphasises the difficulties that can arise where the operational structure of a group does not correspond precisely to the legal structure and – once again – highlights the importance of contemporaneous and accurate record keeping.

IV. *Cape Industrial Services Limited & Robert Wiseman and Sons Limited v. HMRC*[14]

In *Cape*, the FTT relied on the *Ramsay* doctrine to defeat a "double-dip leasing scheme", intended to enable a taxpayer to claim capital allowances in respect of amounts which were more than double its expenditure. In particular, the FTT emphasised that the doctrine continues to enable courts to apply legislation by reference to the *composite* effect of transactions, and to ignore legal steps which lack commercial purpose.

In *Cape*, the taxpayer sought to claim capital allowance in excess of its actual expenditure. This involved a scheme pursuant to which (i) the taxpayer sold plant and machinery at market value to a bank, (ii) the bank granted the taxpayer a long funding finance lease in respect of those assets and (iii) the taxpayer granted the bank a put option pursuant to which the taxpayer could be required to purchase the assets at their predicted market value on termination of the lease. Four weeks after the lease was entered into, it was terminated and the put option was exercised. The taxpayer claimed capital allowances in respect of both (i) its entry into the lease (which was cancelled out by the disposal proceeds from the sale to the bank) and (ii) its purchase of the assets pursuant to the put option (which was not offset by any disposal proceeds, as the lease was terminated for nil consideration).

The FTT decided that, on a composite approach, the scheme did not involve any real disposal or acquisition of the assets by the taxpayer. Accordingly, the taxpayer was not entitled to allowances in respect of the purchase of the assets under the put option. The transactions comprised a set of steps specifically designed to operate as a composite whole and to give rise to the legal effects that would (usually) attract allowances but which lacked any enduring commercial consequences. Although the

taxpayer had given up ownership of the assets, with all of the legal and commercial effects that entailed, it did so only to generate the desired allowances and for the bare minimum of time considered necessary to achieve that result.

The scheme in this case is of mainly historical interest because legislation was introduced in 2011 to counteract it. However, the case has wider value because of the insightful analysis of the current state of the *Ramsay* principle of statutory interpretation.

V. *Vermilion Holdings Ltd v. HMRC*[15]

In *Vermilion Holdings*, the Upper Tribunal ("UT") found that in considering whether an option was granted to a director "by reason of employment" for the purposes of UK employment-related securities rules, it was not necessary that the employment was the *sole* (or dominant) reason for granting the option; it was sufficient that employment was a condition of the option being granted.

In *Vermilion*, an individual ("X") provided consultancy services to Vermilion Holdings Ltd ("Vermilion"). Instead of paying fees for those services, Vermilion granted an option over its shares to X's consultancy company in 2006 (the "2006 option"). Vermilion subsequently fell into financial distress and X was appointed as a director of Vermilion as part of a broader rescue funding proposal that included an injection of new capital. During the restructuring, the now valueless 2006 option was replaced with a new option in 2007, on amended terms including a precondition that X would be the option holder instead of X's own consultancy company (the "2007 option").

HMRC argued that the 2007 option was an employment-related securities option as it was granted by Vermilion as X's employer (the holding of a directorship being treated as an employment under the relevant rules). The question at issue was whether the option to acquire the shares was made available "by reason of employment" and would be treated as an "employment-related securities option".[16] If it was, the profit on exercise of the 2007 option would be chargeable to income tax and NICs. If not, the exercise would not be taxable, with only the gain on a subsequent disposal of the shares chargeable to capital gains tax.

The FTT had previously ruled that the 2007 option was not an employment related securities option, on the basis that (as a matter of fact) the share option was granted solely as a replacement to the 2006 option. The FTT acknowledged however that the option was "made available" by Vermilion, so that a particular provision, which deems an option granted to a person by a corporate employer to be made available by reason of employment,[17] was in point. Nevertheless, the FTT considered that the deeming provision led to an anomalous and unjust result, so its application should be limited in this instance.

The UT reversed this decision finding that the 2007 option was granted by reason of employment. It was held that the 2007 option had been granted to X both:

- to replace the 2006 option (which could no longer continue in existing form); and

- as part of a package of measures conditional on the employment of X.

In applying existing case law,[18] the UT held it was not necessary that the employment was the *sole* (or dominant) reason for granting the option; it was sufficient that employment was a condition of the option being granted. Consequently, the 2007 option was an employment-related securities option.

Although the background facts of the case are unique, the FTT had found, perhaps surprisingly, that the 2007 option was not granted by reason of employment. Despite not considering the FTT's approach to limiting the scope of the above-mentioned deeming provision, the UT, in reversing that decision, provides clear insight and greater certainty for taxpayers in how these provisions operate.

VI. *Blackrock Investment Management (UK) Limited v. United Kingdom*[19]

The ECJ *Blackrock* judgment will be of interest to fund managers managing a mixture of special investment funds and other funds, as it confirmed that a single supply of management services to a fund manager (making such mixed supplies) will be subject to a single rate of VAT and will not benefit from the management exemption from VAT.

The ECJ judgment in *Blackrock* will be of relevance to fund managers providing mixed supplies when monitoring and planning their VAT position. The judgment confirmed the AG's opinion (reported in our last Quarterly Client Alert) that a single supply of management services, provided by a third-party software platform for the benefit of a fund manager of both special investment funds ("SIFs") and non-SIFs, cannot fall within the management exemption from VAT. The entire supply was subject to standard rate VAT in this case.

To briefly recap the facts of this case: the taxpayer ("Blackrock") provided investment advisory services to both SIFs and non-SIFs. There is a specific VAT exemption for the management of SIFs whilst the management of non-SIFs is subject to standard rate VAT. A related US entity ("Blackrock US") provided investment management services to Blackrock in the form of an AI platform known as "Aladdin". As Blackrock US is not established in the UK, Blackrock had to account for VAT under the reverse charge mechanism. In doing so, Blackrock considered that the Aladdin services it used for the management of SIFs should be exempt from VAT under the fund management exemption. Blackrock therefore accounted only for the tax on services used in its management of non-SIFs, apportioning the value of those services in accordance with the value of the non-SIFs under management.

The ECJ ruled that the approach taken by Blackrock was incorrect on the basis that a uniform VAT rate applied to the Aladdin services. All parties agreed that the Aladdin services constituted a single supply and the ECJ considered that this supply could not be bifurcated.

The decision highlights three key points:

1. There are limited circumstances in which a single supply of services may be viewed as distinct and separate services. The Aladdin services comprised of multiple elements which were found

to be equally necessary to allow investment transactions to be made under good conditions. These elements were so closely linked that they formed, objectively, a single indivisible economic supply and so they could not be artificially separated. Consequently, the Aladdin services could not be regarded as specifically for the management of SIFs.

2. The fact that Blackrock predominantly made VAT-able supplies to non-SIFs was not a determinative factor for identifying the applicable VAT rate. Had Blackrock predominantly made VAT exempt supplies to SIFs, for example, that would not have rendered the Aladdin services exempt from VAT.

3. The management exemption from VAT cannot be applied by apportioning consideration for a single supply of services which are used for different purposes. The exemption is defined by the nature of the services provided and not with respect to the person supplying or receiving the services.

The consequences for taxpayers will vary depending on their VAT position and the arrangements that they have in place with third party suppliers. The decision will be of particular interest to fund managers providing mixed supplies and receiving supplies used in the management of a variety of fund types. Practically, fund managers should consider if, from a VAT perspective, their third party supplier arrangements are accurately reflected in contractual arrangements. Any contractual separation that is not artificial could avoid inadvertently missing out on the management exemption.

VII. *HMRC v. Wellcome Trust Ltd (Case C-459/19)*

The Advocate General *in HMRC v Wellcome Trust* has opined that services provided to a UK taxable person for the purposes of its non-economic activity were, for VAT purposes, provided in the place where the recipient belonged.

In HMRC v Wellcome Trust, the taxpayer was a legal company which was the trustee of a charitable trust. The trust (acting through the taxpayer) predominantly earned income from the holding of investments, but also made a small number of taxable supplies, which required the taxpayer (in its capacity as trustee) to be registered for VAT purposes. The AG was asked to consider the place of supply of investment management services procured by the taxpayer from investment managers based outside the EU in respect of the above-mentioned investments.

The taxpayer's argument was a technical one, based on the wording of Directive 2006/112/EC (the "VAT Directive").

The Directive provides that VAT applies to "the supply of services for consideration within [an EU member state] by a taxable person acting as such". A "taxable person" is, broadly, a person carrying on an economic activity. Although the taxpayer was (as a result of the few taxable supplies it made) a

taxable person, the ECJ had previously specifically ruled that the taxpayer's activity in holding investments was not an economic activity[20].

Generally, (subject to exceptions for specific supplies), the place of supply for a supply of services to:

- a "taxable person acting as such" is the place where the recipient is established; and
- a "non-taxable person" is the place where the supplier is established.

The Directive, however, also includes a deeming rule, which specifies that '[f]or the purpose of applying the rules concerning the place of supply of services (a) a taxable person who also carries out activities or transactions that are not considered to be taxable supplies….shall be regarded as a taxable person in respect of all services rendered to him and (b) a non-taxable legal person who is identified for VAT purposes shall be regarded as a taxable person".

The taxpayer considered that, as the place of supply rule for supplies for taxable persons referred to a supply to the taxpayer "acting as such", regard must be had to whether the taxpayer received the supply in its capacity as a taxable person or a non-taxable person (i.e. whether the supply received would be used in making taxable or non-taxable supplies). The above mentioned deeming provision did not deem a taxpayer carrying on mixed activities to always be "a taxpayer acting as a taxable person", and so did not override this requirement.

The Advocate General ("AG") disagreed, considering that the words "acting as such" could not be considered in isolation from the purpose of the place of supply rules. Ignoring express deviations, the rules were intended to set out exhaustive rules for determining the place of supply for supplies to a taxable person (except those intended for private use). The fact that the taxpayer was a non-taxable person in relation to supplies it made did not mean that, for this purpose, it was not a taxable person in relation to supplies it received. The reverse charge mechanism did, therefore, apply.

Looking at the wording of the place of supply rules in isolation, it is possible to have some sympathy with the taxpayer's argument. However, the case highlights that purposive interpretation has as important a role to play in a VAT context as any other – particularly in the application and meaning of key legislation such as the VAT Directive. Ironically, it is VAT's formulaic order which necessitates recourse to a purposive interpretation: in considering whether VAT applies to a supply, one of the first steps a taxpayer must take is to determine (by reference to the self-contained place of supply rules) where the supply is made. To adopt the taxpayer's argument would have undermined this process, by drawing a category of supplies outside the scope of VAT without even needing to consider where the supplies have been made.

VIII. *Sonaecom SGPS SA v. Autoridade Tributária e Aduaneira*[21]

The AG in *Sonaecom* opined that the actual, rather than the intended, use of taxable supplies is determinative when considering whether input VAT is deductible.

The case concerned a holding company, Sonaecom SGPS SA ("Sonaecom"), that both passively held shares in certain companies and supplied taxable services to other companies, i.e. a "mixed holding company". Sonaecom intended to acquire shares in a telecommunications provider and it incurred output VAT in relation to the proposed acquisition, namely (a) consultancy services in respect of a market study and (b) commission paid to an investment bank in respect of the issuance of bonds.

Sonaecom asserted that it planned to use the capital obtained from the bond issuance to acquire the target shares and following acquisition, to provide taxable technical support and management services to the target. However, the acquisition failed to materialise, and Sonaecom used the funds from the bond issuance to make a loan to the parent company of its group. The funds were subsequently repaid by the parent, and used by Sonaecom to purchase shares in other companies.

Generally, for a taxpayer to obtain full input VAT recovery in respect of costs it incurs, the costs must be directly attributable to the provision of taxable supplies by the taxpayer. In the case of a mixed holding company, a partial deduction may be available if the costs are not directly linked to the provision of services by the taxpayer, and are instead a part of its general overheads.

The question at issue here was whether the deductibility rules in the Sixth VAT Directive[22] permitted Sonaecom to deduct VAT paid in respect of the consultancy and bond placement services on the basis of the use to which the taxpayer intended (at the time of receipt) to put the supplies received (i.e. the provision of the taxable services to the target), rather than the subsequent actual use (i.e. the exempt supply of the loan to the parent). As regards the bond expenses, in the alternative, Sonaecom argued that the expenses were part of its general overheads and that the funds from the issuance had merely been "parked" with the parent, before being returned to enable Sonaecom to continue with its general activities.

Following previous judgments of the ECJ[23], the AG opined that (a) Sonaecom had the right to full input VAT deduction in respect of expenditure incurred for the acquisition of shares in a company to which it intended to supply taxable services and (b) that this right to deduct persists, even if the acquisition does not ultimately happen.

However, crucially, the AG also opined that, where the taxpayer's intended use is superseded by a different actual use within the relevant tax period, the latter takes priority. There was a direct and immediate link between the bond expenses (the input transaction) and the exempt loan to the parent (the output transaction). The latter precluded Sonaecom from making an input VAT deduction in respect of the bond expenses incurred on the basis of the aborted intended use. Moreover, expenses can only be considered part of general overheads in the absence of a direct and immediate link with any supply; here, there was a direct and immediate link to the exempt supply of the loan.

The case illustrates that where costs are incurred for the purposes of making taxable supplies which do not materialise, taxable persons who want to maintain their right to deduct input VAT should carefully consider the VAT impact of any subsequent use to which the funds are put. A subsequent exempt output transaction (even if only intended to be temporary) may eliminate their right to deduct VAT.

[1] https://www.gov.uk/hmrc-internal-manuals/international-exchange-of-information/ieim800010

[2] https://www.gov.uk/hmrc-internal-manuals/international-exchange-of-information/ieim800000

[3]] *See* link here.

[4] Taxes (Base Erosion and Profit Shifting) (Country-by-Country Reporting) Regulations 2016

[5] As to which, see the letter of 9 April from the Chancellor to the Chair of the Treasury Committee.

[6] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD

Publishing, Paris at paragraph 3.47

[7] *Ibid*, at paragraph 1.129

[8] *Gordon & Blair Ltd v IR Commrs* (1962) 40 TC 358

[9] *Kirk & Randall Ltd v Dunn* (1924) 8 TC 663

[10] *Fowler v HMRC* [2020] UKSC 22

[11] Specifically, section 6(5) ITEPA provides that "*employment income is not charged to tax [as employment income] if it is within the charge to tax under Part 2 of the Income Tax (Trading and Other Income) Act 2005 (trading income) by virtue of section 15 of that Act (divers and diving supervisors)*". Section 15(2) provides that "*the performance of the duties of employment is instead treated for income tax purposes as the carrying on of a trade in the United Kingdom*".

[12] *Investec Asset Finance Plc and another v HMRC* [2020] EWCA Civ 579

[13] *Centrica Overseas Holdings Ltd v HMRC* [2020] UKFTT 197 (TC)

[14] *Cape Industrial Services Limited & Robert Wiseman and Sons Limited v HMRC* TC/2015/01817 TC/2015/01791

[15] *Vermilion Holdings Ltd v HMRC* [2020] UKUT 162 (TCC)

[16] Under section 471 ITEPA 2003

[17] Under in section 471(3) ITEPA 2003

[18] *Wicks v Firth* 56 TC 318

[19] *Blackrock Investment Management (UK) Ltd v United Kingdom* (C-231/19)

[20] *Wellcome Trust (C-155/94)*

[21] *Sonaecom SGPS SA v Autoridade Tributária e Aduaneira* (Case C-42/19) EU:C:2020:378 (14 May 2020) (Advocate General Kokott).

[22] Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes. Specifically Articles 4(1) and (2) and 17(1), (2) and (5) of the Sixth VAT Directive were at issue.

[23] *Cibo Participations SA* (Case C-16/00), *Floridienne* (Case C-142/99) and *Ryanair* (C-249/17).

Gibson Dunn's lawyers are available to assist with any questions you may have regarding these developments. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the Tax Practice Group or the authors:

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