Corporate Tax

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Sandy Bhogal

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PREFACE

This is the eighth edition of *Global Legal Insights – Corporate Tax*. It represents the views of a group of leading tax practitioners from around the world.

One consistent trend across each jurisdiction is the evolving nature of tax rules which impact cross-border arrangements, and the ongoing uncertainty that this creates. BEPS implementation is now well into the domestic implementation phase and transfer pricing is now a mainstream aspect of tax planning.

We also see renewed effort to reach an international consensus on taxation of the digital economy, with increasing concern that further delay will prompt unilateral domestic action across the OECD. This has prompted reaction from the US government in particular, and it was recently announced that the US would not be taking part in negotiations relating to 'Pillar One' – which broadly 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. The US stated that they were stepping away from talks as the OECD was not making headway on a multilateral deal on digital services taxation. In addition, tax compliance and information reporting are entering a new phase, as DAC 6 will be implemented across the EU.

The impact of COVID-19 will inevitably add to the complex international tax landscape. The long-term impact of the lockdown restrictions and the fiscal measures taken by governments worldwide remains to be seen; however, it is likely that tax policy will play an important role in revitalising the economy.

Authors were invited to offer their own perspective on the tax topics of interest in their own jurisdictions, explaining technical developments as well as any trends in tax policy. The aim is to provide tax directors, advisers and revenue authorities with analysis and comment on the chosen jurisdictions. I would like to thank each of the authors for their excellent contributions.

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United Kingdom

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Gibson, Dunn & Crutcher UK LLP

Overview of corporate tax work over last year

Significant deals and themes

The following statistics are accurate as at July 2020.

*Mergers & Acquisitions ("**M&A**")*

The value of outward M&A in 2019 was £20.9 billion, which is lower than the total outward M&A value in 2018 (£23.8 billion) and the lowest recorded since 2016 (£17.3 billion) and significantly lower than the £77.5 billion value recorded in 2017. The total value of inward M&A in 2019 was £53.8 billion compared to £78.8 billion in 2018. The lower values of outward and inward M&A transactions can be explained by fewer higher value acquisitions compared to recent years.

The total value for domestic M&A during 2019 was £8.7 billion, a significant decrease compared to 2018 (£27.7 billion). Again, the decrease is as a result of a reduction in higher value domestic M&A transactions. Year-on-year comparison also shows that the value of completed domestic M&A during 2019 was the lowest recorded since 2015, when the value was £6.9 billion. One notable domestic M&A transaction that took place in 2019 was Ensco Plc of the UK, which acquired Rowan Companies Plc of the UK. The majority (206) of the outward M&A deals in 2019 (250) came from the Americas (100) and Europe (106). This is consistent with the area analysis reported in 2018. The majority (503) of total inward M&A deals in 2019 (575) came from the Americas (269) and Europe (234), which is comparable with 2018.[1]

Financing

London IPO proceeds were £5.9 billion in 2019, which is lower than in 2018 where £9.6 billion was raised. Network International Holdings plc was the largest IPO to list in 2019, raising £1,218 million of capital. This was followed by Trainline plc which raised £1,093 million.[2]

Real estate transactions

2019 was a noticeably slow year for commercial real estate ("**CRE**") transactions in the UK. The first nine months of the year saw £32 billion invested in UK CRE – the slowest nine-month period since 2013.[3] However, overseas investors continued their dominance of the real estate investment market and increased their market share to 49% (up from 44% in 2018). However, the geographical source of capital changed in 2019 as Far Eastern investors decreased capital deployed to £4.93 billion, whereas North American investors increased to £8.42 billion.[4]

*Transfer pricing and diverted profits tax ("**DPT**")*

HM Revenue & Customs ("**HMRC**") approximated that the annual amount of additional actual tax secured from transfer pricing challenges decreased from £1,774 million in

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2017/2018 to £1,169 million in 2018/2019.[5] In addition, the DPT yield figures published by HMRC have decreased from 2017/2018 (£219 million) to 2018/2019 (£12 million).[6] HMRC stated that the figures reflect the net amount received as a result of HMRC issuing DPT charging notices which are not repaid. HMRC also noted that in previous years, an amount was included in the DPT yield equating to additional corporation tax arising from transfer pricing enquiries as a result of behavioural change relating to the DPT. Due to the close association between DPT and transfer pricing enquiries, HMRC stated that they now "*no longer consider this subdivision of transfer pricing yield to be appropriate*" and will report on the additional corporation tax relating to behavioural change in the wider figure for transfer pricing yield.

Key developments affecting corporate tax law and practice

The below section on UK tax law developments reflects a summary of the key developments in 2019, but it is not a comprehensive or detailed discussion of all tax measures in the past year. The legislation, case law and information stated below is accurate as at July 2020.

<u>Domestic legislation</u>

COVID-19 tax implications

The coronavirus ("**COVID-19**") pandemic has had a significant impact on the UK economy and all sectors have been affected by the restrictions imposed in order to control the disease. The tax implications of the COVID-19 pandemic are constantly evolving as the Government response to dealing with the virus develops. The longer-term impact of COVID-19 for UK tax policy remains to be seen but the short-term measures adopted by the Government are summarised below.

Legislative measures and updated HMRC guidance

- Tax residence for individuals and corporates

The COVID-19 pandemic has resulted in the introduction of the most severe international travel restrictions in modern times. This is relevant for corporate taxpayers and individuals as the application of numerous tax provisions is dependent on where an individual or an organisation's employees and directors are physically located. The UK statutory residence test considers the number of days an individual spends in the UK in determining their tax residency (amongst other factors). HMRC released a statement confirming that certain situations arising from the COVID-19 pandemic would constitute "exceptional circumstances" for the purposes of the statutory residence test for individuals. There are still a number of areas that require clarification, namely, (i) individuals at risk of losing UK tax residency status due to being unable to enter the UK as a result of the travel restrictions, and (ii) existing rules require that no more than 60 days in the UK can be ignored due to "exceptional circumstances" but it is not clear when the current travel restrictions will be completely lifted.

In relation to corporates, HMRC published COVID-19 guidance in the International Tax Manual, stating that HMRC considers that the "*existing legislation and guidance in relation to company residence already provides flexibility to deal with changes in business activities necessitated by the response to the COVID-19 pandemic*". In addition, in respect to permanent establishment, the relevant HMRC guidance similarly stated 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*". HMRC did note 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,

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or because some decisions are taken in the UK over a *short period of time*. Likewise, the HMRC guidance also stated that a non-resident company will not have a UK fixed place of business permanent establishment after a *short period of time* as a degree of permanence is required. It is not clear what HMRC will consider a short period of time, particularly as the duration of the travel restrictions is unknown. As the migration of company residence and creation of a permanent establishment may have serious consequences, it will be important for companies to identify if they will be affected and to consider how to mitigate the risk if the crisis continues for an extended period.

- Tax treatment of the Coronavirus Job Retention Scheme Grant ("**JRS**")

The JRS provides qualifying employers with a subsidy of 80% of the gross salary of furloughed employees, subject to a cap of £2,500 per month, backdated to 1 March 2020. The JRS is available for the period to the end of October 2020 (extended from its end date of June 2020). To be eligible for JRS, employers must have created and started a pay-as-you-earn ("**PAYE**") payroll scheme on or before 19 March 2020. The receipt of the grant is treated as taxable income for businesses "in accordance with normal principles" (typically, this will mean it is treated as trading income), but the corresponding wage costs will continue to be deductible as normal. In the Summer Economic Update 2020, the Government announced that it will introduce a one-off payment of £1,000 to UK employers for every furloughed employee who remains continuously employed through to the end of January 2021.

Extensions to deadlines and other procedural measures

There are a number of extensions to consultation and tax filing deadlines as well as new procedures adopted to deal with the restrictions caused by the COVID-19 pandemic. A summary of the current measures as at July 2020 are outlined below.

Stamp duty on share transfers: New procedures have been put in place so that the process for stamping stock transfer forms following share transfers is carried out by email (and not by post). Company secretaries will be able to update company shareholder registers upon receipt of an electronic verification letter from HMRC (rather than on receipt of duly stamped stock transfer forms). Stamp duty relief applications must be sent by email.

Off-payroll working rules (IR35): New rules designed to mitigate tax avoidance by workers, and the companies hiring them, who supply their services via intermediary companies (but who would be employees if the intermediary was not used) have been deferred for 12 months until April 2021.

Extension to Spring Budget 2020 consultation deadlines: On 28 April 2020, the Government announced a three-month extension to a number of the consultations published as part of the Spring Budget 2020 as a result of the COVID-19 pandemic. The extension applies to a number of consultations including (i) the tax impact of the withdrawal of the London interbank offered rate ("**LIBOR**"), (ii) notification of uncertain tax treatment by large businesses, (iii) hybrid mismatches, (iv) tackling construction industry scheme abuse, (v) tax treatment of asset holding companies in alternative fund structures, and (vi) the call for evidence on raising standards in the tax advice market.

EU Directive on Administrative Cooperation: The European Commission had, as a result of COVID-19, initially proposed to defer the reporting deadlines under DAC6 by three months, whilst affirming that the initial date of application of the rules will remain until 1 July 2020. However, political agreement has been reached by EU 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;

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- 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; and
  - 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.

Depending on the evolution of the pandemic, the amended directive also provides for the possibility to extend the deferral period once, for a maximum of three further months.

HMRC updated guidance on "reasonable excuse": HMRC updated its general guidance on how it would apply the concept of reasonable excuse where COVID-19 has impacted on a person's ability to meet their tax obligations. The updated guidance states that HMRC will consider COVID-19 as a reasonable excuse for missing some tax obligations (such as payments or filing dates). Taxpayers are expected to explain how they were affected by COVID-19 and they must still make the return or payment "as soon as [they] can".

Conduct of tax tribunals and courts: All proceedings before the First-Tier Tax Tribunal were stayed for 28 days from 24 March 2020 with all time limits for complying with directions extended by the same period. With effect from 21 April 2020, this general stay has been extended until 30 June 2020 for all cases categorised as standard or complex, with the hearing windows for those cases and the deadlines pushed back by a further 70 days. The Upper Tribunal Tax and Chancery Chamber stated that its administrative functions are greatly reduced at the present time. However, the judges (both the tribunal judges and the high court judges) will be working remotely and during the period of the current pandemic, substantive hearings will take place remotely until further notice in accordance with the relevant Practice Direction.

Digital taxation

The Finance Bill 2019–21 has introduced, with effect from 1 April 2020, a 2% digital services tax ("**DST**") levied on the revenues of search engines, social media services and online marketplaces which derive value from UK users.

The DST will be levied on any revenue earned by a group connected to "digital services activity", namely (a) social media services, (b) internet search engines, or (c) online marketplaces which are attributable to UK users. A social media service is defined as an online service where the main purpose (or one of its main purposes) is to promote interaction between users and make content generated by users available to others. The rules helpfully state that an internet search engine does not include a facility on a website designed to search material on such website or closely related websites. An online marketplace is defined as an online service the main purpose of which is to facilitate the sale by users and enables users to sell or advertise things to other users.

A UK user is defined as an individual who, it is reasonable to assume, is normally located in the UK or a business that is established in the UK. The DST focuses on the participation and engagement of users as an important aspect of attribution of value. Generally, revenues are attributable to UK users if the revenue arises by virtue of a UK user using or paying for the service. However, advertising revenues are derived from UK users when the advertisement is intended to be viewed or consumed by a UK user. The provision of associated online

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services by a social media service, internet search engine or online marketplace may also give rise to the DST. An associated online service is one that is operated by an online platform and derives significant benefit from its association with the social media service, internet search engine or online marketplace. A significant exemption from the online marketplace definition is for financial and payment services providers with more than half their relevant revenues arising from the trading of financial instruments. The DST will only be payable by businesses whose global revenues from the in-scope activities are at least £500 million. Tax will not be levied on the first £25 million of revenue from in-scope business activities linked to the participation of UK users. Groups will be able to elect to calculate their DST liability under an alternative method which deducts a proportion of relevant operating expenses attributable to UK digital services revenues applicable to the group.

Various jurisdictions have also been implementing unilateral national measures relating to the tax challenges arising from the digitalisation of the economy (including France, Austria, Hungary, Italy and Turkey). It is difficult to envisage how multiple domestic minimum tax rules would interact on a global level. Issues relating to sovereignty over tax affairs are likely to arise, as well as the matter of how to determine tax allocation rights. A move towards a global minimum tax, as suggested in pillar two of the Organisation for Economic Co-operation and Development ("**OECD**")'s proposal (discussed below), may unify the various domestic rules. However, it would be highly complicated to achieve this from a technical and administrative perspective. The DST does contain provisions allowing relief for certain cross-border transactions. This is in recognition that transactions concluded on a marketplace may be cross-border in nature, so that the revenues are linked to both a UK user and a foreign user. Normally, all the revenues from the transaction will be UK digital services revenues; however, subject to a valid claim being made, UK digital services revenues from qualifying cross-border transactions may be reduced by 50%. In order to qualify, the cross-border transactions should be:

- a marketplace transaction where a foreign user is a party; and
- where all or part of the revenues arising in connection with the transaction are, or would be, subject to a foreign digital services tax charge.

A foreign digital services tax need not be identical to the UK DST, but the legislation provides that it should be "similar". It is not clear exactly what will constitute a foreign digital services tax and as there is no further legislative interpretation, HMRC guidance on the matter will be important in practice.

There are a number of other international considerations regarding the operation of the UK DST, particularly in relation to state aid concerns and the interaction of the UK DST with the UK's double tax treaty obligations.

The Government has committed to reviewing the position by the end of 2025 in order to better align UK tax policy with the international consensus.

<u>International Tax Enforcement (Disclosable Arrangements) Regulations 2020 ("**DAC6**")</u>

Final regulations implementing DAC6 in the UK were published on 13 January 2020. DAC6 is the most recent EU reporting regime and requires promoters and service provider intermediaries to report details of certain cross-border tax arrangements that feature one or more "hallmarks". The hallmarks are widely drawn and leave a lot of room for debate as to whether many ordinary commercial transactions and structures will be reportable. HMRC has published guidance to the UK DAC6 regulations as there are key points that have not been dealt with in the DAC6 regulations.

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The UK DAC6 regulations implement Directive (EU) 2018/822 (the "**EU Directive**"). Even though the UK has officially left the EU, it is still legally obliged to implement the EU Directive properly so the scope of the UK rules closely follows that of the EU Directive. Any deviation from this would mean the UK would not meet its international obligations and could also lead to potential differences in the approaches of the UK and other countries.

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

Corporation tax on non-UK resident companies with UK property income

As previously announced, from 6 April 2020, non-UK resident companies that carry on a UK property business, or have other UK property income, will be charged to corporation tax, rather than being charged to income tax. Accordingly, UK property income profits chargeable to corporation tax will be calculated in accordance with ordinary corporation tax principles as set out in the relevant legislation.

A non-UK resident company that carries on a UK property business is also chargeable to corporation tax in respect of its profits that arise from loan relationships or derivative contracts that the company is a party to for the purpose of that business. Existing income tax withholding provisions under the non-resident landlord scheme will continue to apply, unless the non-UK resident company has permission to be paid gross (notwithstanding that amounts withheld will be within the corporation tax regime).

There are adverse consequences of the changes, including: (i) restrictions on the deduction of interest and other finance costs under the hybrid mismatch rules (if applicable) or the corporate interest restriction (which broadly limits deductions in excess of £2 million per group to 30% of EBITDA as a default position, subject to available exemptions and elections); and (ii) restrictions on the use of carried-forward income and capital losses (which cannot be set-off against more than 50% of profits exceeding £5 million in any year). However, pre-6 April 2020, property rental losses can still be carried forward for use against future profits without restriction.

UK real estate – non-resident capital gains tax

The significant changes for non-resident investors in UK real estate were enacted in the Finance Act 2019 and came into effect on 6 April 2019. Historically, non-resident investors were not subject to UK capital gains tax ("**CGT**") on UK real estate sales, but the new rules mean that CGT is levied on UK real estate sales by non-UK resident investors. Broadly, all non-UK residents will now be taxable on gains on disposals of directly held interests in any type of UK land. Non-UK residents will also be taxed on any gains made on the disposals of significant interests in entities that directly or indirectly own interests in UK land. For tax to be imposed, generally the entity being disposed of must be "property rich" (where at least 75% of the gross market value of the entity's qualifying assets at the time of disposal is derived from UK land), and the non-UK resident must be a "substantial investor" (where, at the date of disposal or at any time within two years prior to disposal, the non-UK resident holds, or has held directly or indirectly, at least a 25% interest in a property-rich entity).

There are three broad tax treatments that may apply for offshore collective investment vehicles ("**CIVs**") falling within these new rules:

a) Default position: The default position for CIVs will be that they are treated for capital gains purposes as if they were companies. An investment in such a fund will be treated

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as if the interests of the investors were shares in a company, so that where the fund is UK property rich, a disposal of an interest in it by a non-UK resident investor will be chargeable to UK tax under the new rules. CIVs may therefore be subject to corporation tax from April 2020 as a result of being treated as companies.

b) Transparency election: The fund manager of a CIV may make a transparency election provided the relevant entity meets certain conditions. The effect of the election is to treat the CIV as a partnership for UK capital gains purposes such that any gains arising at CIV level would be chargeable on its investors.

c) Exemption election: Eligible CIVs can instead apply for an exemption election. The effect of this election is to provide entity-level exemption from tax on direct and indirect disposals of UK land. Investors will become chargeable on investment gains on distribution of realised gains by the fund or when investors sell their interest in the CIV.

The UK Property Rich Collective Investment Vehicles (Amendment of the Taxation of Chargeable Gains Act 1992) Regulations came into force on 10 April 2020 and make amendments to the above-mentioned legislation in the Finance Act 2019. The main purpose of the amendments is to ensure that exempt investors such as pension funds will not lose the benefit of the exemption when investing in UK property-rich CIVs.

Changes to entrepreneurs' relief lifetime limit for CGT

A number of changes were introduced in the Finance Act 2019 relating to entrepreneur's relief ("**ER**"), namely: (i) an increase in qualifying holding period; (ii) dilution; and (iii) amendments to the 5% shareholding test. Further changes were announced in the Spring Budget 2020. For disposals taking place on or after 11 March 2020, there will be an immediate reduction in the lifetime limit available for ER from £10 million to £1 million. The changes will result in a reduction of the maximum relief available from £1 million to £100,000 for individuals who realise gains that qualify for ER. As a general rule, the time of disposal for capital gains purposes is the time when the contract for sale becomes unconditional (rather than the time of completion). Parties to an uncompleted pre-11 March 2020 sale contract will be subject to the £1 million lifetime limit unless they can demonstrate (a) that the purpose of entering into the contract was not to take advantage of this timing rule (in order to circumvent the widely reported narrowing of ER), and (b) in the case of connected parties, that the contract was also entered into for wholly commercial reasons. In addition, where shares have been exchanged for those in another company in the period from 6 April 2019 to (and including) 10 March 2020, and an election to crystallise the gain on the exchange (rather than adopt roll-over treatment) is made on or after 11 March 2020, the new lifetime limit will apply if, broadly, either:

- the companies whose shares are exchanged are under common control; or
- the consequence of the exchange is that the exchanging shareholders' proportionate shareholding is increased, and qualifies for ER.

Stamp duty

Legislation was published in the Finance Bill 2019–21 in relation to changes to the calculation of stamp duty and stamp duty reserve tax for certain connected company transactions. The legislation extends the market value rule at sections 47 and 48 Finance Act 2019 (which applies in respect of transfers of listed shares or securities to connected companies) to transfers of unlisted securities to connected companies. Such transfers will be caught by the extended market value rule where there is an issue of shares by way of (part) consideration for the transfer.

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Prior to the proposed extension, the stamp duty payable on the transfer of UK shares in a share-for-share exchange would be calculated by reference to the value of shares issued in consideration. The extension of the market value rule to transfers of unlisted securities to connected companies is intended to discourage "swamping", i.e. tax planning whereby the value of newly-issued consideration shares is low in the context of share-for-share exchanges.

Structures and Buildings Allowance ("**SBA**")

Businesses that incur qualifying expenditure on the construction, renovation or conversion of non-residential structures and buildings on or after 29 October 2018 may claim SBA. The annual rate of SBA will increase from 2% to 3% from 1 April 2020 for corporation tax purposes, and 6 April 2020 for income tax purposes.

Hybrid Capital Instrument ("**HCI**") regime

A new HCI regime came into force in place of the regulatory capital securities regime from 1 January 2019. Prior to 1 January 2019, the taxation of regulatory capital instruments issued by banks and insurers was governed by the Taxation of Regulatory Capital Securities Regulations, SI 2013/3209 as amended (the "**RCS Regulations**"). The analysis under the RCS Regulations broadly required a determination that the instrument met the regulatory capital requirements and that a targeted anti-avoidance rule was not applicable.

Pursuant to the new HCI regime, the terms and conditions of each HCI will need to be analysed to ensure that it meets the definition of HCI for tax purposes. The definition of HCI is detailed in the new section 475C of the Corporation Tax Act 2009. This provision states that a loan relationship is an HCI if:

- it makes a provision under which the debtor can defer or cancel a payment of interest;
- it has no other significant equity features; and
- the debtor has made an election in respect of the loan relationship that has effect for the period. This election is ineffective where there are arrangements of which the main purpose, or one of the main purposes, is to obtain a tax advantage for any person.

Group financing exemption in the UK CFC regime

The Finance Act 2019 contained changes to the UK taxation of controlled foreign companies ("**CFC**") taking effect from 1 January 2019. The CFC regime introduced in 2012 operates by reference to gateways, through which CFC income must pass if it is potentially to be subject to a CFC charge. For non-trading lending activity in low-taxed CFCs, income can pass through a relevant "sub-gateway", either if the capital being deployed has been sourced from the UK part of the group, or if the "significant people functions" ("**SPFs**") in respect of the lending activity are located in the UK. Formerly, the so-called "group financing exemption" could prevent income on certain loans (broadly, loans to other non-UK members of the relevant group) from passing through either sub-gateway. Accordingly, from 1 January 2019, the exemption only protects against the UK capital sub-gateway, and not the UK SPFs one.

Capital loss carry-forward restriction

The corporate income loss restriction was introduced with effect from 1 April 2017. Under the relevant rules, only 50% of a company's profits or gains in an accounting period can be offset by carried-forward income losses, subject to the application of a £5 million deductions allowance.

Capital losses were exempted from these rules. However, from 1 April 2020, legislation contained in the Finance Bill 2019–21 restricts companies' use of carried-forward capital losses to 50% of the capital gains arising in an accounting period, subject to the existing £5 million deductions allowance which a group will now have to allocate between capital

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as well as income losses. It will apply to gains arising on or after 1 April 2020, but the restriction will apply to all carried-forward capital losses, whenever arising. Current-year losses can be utilised without restriction.

Anti-forestalling measures have been put in place to stop companies from incurring capital gains before 1 April 2020. The anti-forestalling provision states that if a company has an accounting period ending before 1 April 2020, a deduction in respect of a chargeable gain will not be allowed if the main purpose or one of the main purposes of the relevant arrangements (entered into on or after 29 October 2018) is to secure a tax advantage by reason of the capital loss restriction not having yet come into effect.

Profit fragmentation

Schedule 4 of the Finance Act 2019 enacted new rules to target arrangements through which a UK resident carrying on a business transfers a disproportionate part of their profits to offshore persons or entities in low-tax jurisdictions and whereby a related individual receives, or could receive, some kind of benefit from the value transferred. Broadly, these rules apply where: (i) there is a provision between a UK-resident person or entity and an overseas person or entity; (ii) as a result of the provision, value is transferred from the UK-resident person or entity to the overseas person or entity which derives from the profits of a business chargeable to UK income tax or corporation tax; (iii) the value transferred exceeds what would be agreed between independent parties acting at arm's length; (iv) a related individual is able to enjoy the profits that have been diverted; and (v) there is a tax mismatch (very broadly, the tax payable overseas is less than 80% of the reduction in UK tax) and it is reasonable to conclude that the main purpose, or one of the main purposes, for which the arrangements were entered into was to obtain a tax advantage. These new rules came into effect in respect of value transferred on or after 1 or 6 April 2019 for corporation tax and income tax purposes, respectively.

Offshore receipts in respect of intangible property

The Finance Act 2019 also introduced new "offshore receipts in respect of intangible property" ("**ORIP**") rules which took effect from 6 April 2019. The new rules are designed so that a charge to UK income tax will arise to certain non-UK residents (broadly those resident in jurisdictions that do not have a double tax treaty which contains a non-discrimination article) in respect of income from intangible property that is referable to sales of goods or services in the UK, where the intangible property (or rights over that property) are held in a no- or low-tax jurisdiction.

A tax exemption applies where the tax payable by the non-UK resident in relation to income that is referable to the sale of goods or services in the UK is at least 50% of the UK income tax charge that would otherwise arise. In addition, there is a £10 million *de minimis* UK sales threshold. Targeted anti-avoidance rules have effect for arrangements entered into on or after 29 October 2018.

Consultation on UK hybrid mismatch rules

International hybrid mismatches and related tax arbitrage are among the primary areas identified in the OECD's 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**"), 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.

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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. However, the mechanical operation of these rules has resulted in unexpected material disallowances for some taxpayers. A consultation on certain technical aspects of the hybrid rules has been launched. The consultation on the UK hybrid mismatch rules focuses on three areas, namely:

- **Double deduction mismatches**: Expenses deducted twice (either in two jurisdictions or by more than one taxpayer) in relation to arrangements where a hybrid entity is involved may trigger a counteraction under the UK hybrid mismatch rules, such that a UK tax deduction would be denied to a relevant UK entity within scope of the rules. However, no counteraction is required to the extent that the expenses are deducted from so-called "dual inclusion income". This is intended to refer to the same amounts of income brought into the charge to tax for different taxpayers. However, there are strict limits as to when amounts so brought into account would qualify. Despite changes made in 2018 to the UK hybrid rules to address double deduction mismatches, it is generally recognised that the double deduction rules can often apply more widely than they should, targeting genuinely commercial arrangements where there is no economic mismatch.
- **Connected parties – "acting together"**: In the absence of "structured arrangements", the hybrid rules will only apply where parties to the arrangements are connected. In applying this test, parties who are "acting together" will be deemed to be connected. The purpose is to prevent otherwise unconnected parties from working together or being used to circumvent the effect of the rules. Nevertheless, the consultation acknowledges that the test can throw up practical difficulties (e.g. as a result of difficulties in obtaining sufficient information about counterparties' structures to assess whether the deeming provisions apply). HMRC has therefore called for evidence of circumstances where taxpayers feel the impact of the deeming provisions should be modified.
- **Exempt investors in hybrid entities**: An expense in a UK company would not typically be disallowed if the payment is made directly to an exempt investor (e.g. a pension fund or sovereign wealth fund). However, where the payment is indirectly made to such exempt investors via a hybrid entity, there is no equivalent general dispensation. This goes against the overarching intention of the UK tax system to achieve tax neutrality for collective investment. HMRC states in its consultation that it is willing to contemplate the case of amending the hybrid rules to improve the operation of the rules, e.g. a "white list" of entities which would not give rise to a counteraction.

The consultation deadline was originally May 2020 but has been extended to August 2020 in response to the COVID-19 pandemic.

<u>Consultation on the tax treatment of asset holding companies in alternative investment fund structures</u>

In the course of 2020, the UK Government has committed to undertake a review of the UK's funds regime. This will include a review of the value-added tax ("**VAT**") treatment of fund management fees and a consultation regarding the tax treatment of asset holding companies. The aim of the consultation is to "*gather evidence and explore the attractiveness of the UK as a location for intermediate entities through which alternative funds hold assets*". Some of the issues cited in the consultation are specific to particular kinds of funds as follows:

- *Credit funds*: Distribution treatment for results-dependent interest and the relative narrowness of the UK's securitisation regime.
- *Real estate funds*: The trading condition to the substantial shareholding exemption and relatively stringent conditions to accessing the UK REIT regime.

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- *Private equity*: Income treatment on the distribution by intermediate holding companies to funds of disposal proceeds from the sale of underlying assets (in particular in the context of share buybacks).

The consultation also discusses general issues that would be relevant to most asset holding companies, namely: (i) administrative burdens in qualifying for exemption from interest withholding tax; and (ii) the application of hybrid mismatch rules to exempt fund investors, and difficulties arising from investors being treated as "acting together" for the purposes of the rules.

The Government has confirmed that it is prepared to make comprehensive legislative changes in response to the consultation. However, the consultation noted that (i) the Government is not willing to make changes that would take income or gains outside the scope of UK tax in a manner which is "*inconsistent with the overall principles of the UK tax system*", and (ii) any such changes must be compatible with the UK's international obligations under the OECD BEPS project and the UK's obligations in respect of state aid.

The consultation deadline was originally May 2020 but has been extended to August 2020 in response to the COVID-19 pandemic.

<u>Notification of uncertain tax treatments for large businesses</u>

The Government announced its intention to require large businesses to notify HMRC where they have adopted an uncertain tax treatment. A consultation document entitled "*Notification of uncertain tax treatment for large businesses*" sets out the framework for that requirement and seeks views on a range of implementation issues. The notification requirement will be legislated in the Finance Bill 2020–21 and will apply to uncertain tax treatments in returns filed after April 2021.

The proposal is designed to improve HMRC's ability to identify issues where businesses have adopted a different "legal interpretation" to HMRC's view. This includes the interpretation of legislation, case law and guidance. Taxes covered by the proposal include corporation tax, income tax (including PAYE), VAT, excise and customs duties, insurance premium tax, stamp duty land tax, stamp duty reserve tax, bank levy and petroleum revenue tax. The intention is to catch all "uncertain tax positions", irrespective of whether they derive from genuine uncertainty or "*with the deliberate intention of pushing the boundaries of the law to their advantage*". However, only "large" businesses (broadly expected to be those with a turnover above £200 million and/or a balance sheet total above £2 billion) will be within scope. Notification will not be necessary where (a) a transaction is disclosed under the Disclosure of Tax Avoidance Schemes rules or under DAC6, or (b) the uncertainty is the subject of formal discussion with HMRC, or HMRC confirms that it already has sufficient information regarding the uncertainty. Similarly (although not a formal exemption), HMRC would not consider the rules to apply where they have previously provided clearance and there is no change in facts or circumstances. It is also proposed that uncertain tax treatments which amount to a maximum of less than £1 million in the tax outcome will not be notifiable.

The consultation deadline was originally May 2020 but has been extended to August 2020 in response to the COVID-19 pandemic.

<u>IR35 and off-payroll working</u>

The "intermediaries legislation" ("**IR35**") is designed to ensure that an individual who works like an employee, but through their own personal service company ("**PSC**") is liable to employment income tax and national insurance contributions in cases where such individual would have been an employee if they were directly engaged by an organisation.

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Draft legislation was published in July 2019 which, if enacted, would extend the changes to the IR35 rules imposed upon the public sector to large- and medium-sized private sector businesses. The proposed changes will impose significant compliance burdens on businesses as it will shift the responsibility of operating the off-payroll working rules from the individual's PSC to the business to which the individual is supplying their services. Accordingly, under the new rules, businesses will be required to determine for each worker whether or not that worker would be an employee if he or she was engaged directly by the business and ensure that income tax and national insurance contributions are deducted from payments in cases where the IR35 rules apply.

The changes to the off-payroll rules were due to come into effect on 6 April 2020. This has now been delayed until April 2021 because of the COVID-19 pandemic.

Joint and several liability of directors on corporate insolvency

On 11 April 2018, the Government published a discussion document entitled "*Tax Abuse and Insolvency*". Following consultation in respect of the discussion document, a new cross-tax provision has been included in the Finance Bill 2019–21. The draft legislation allows HMRC to make directors and other persons involved in tax avoidance or evasion jointly and severally liable for a company's tax liabilities, if there is a risk that the company may enter insolvency.

Domestic case law

The below cases are a sample of significant recent tax cases. *Hancock and another v HMRC* sets out the circumstances in which roll-over relief is applicable in the conversion of both qualifying corporate bonds ("**QCBs**") and non-QCBs. The case of *Christa Ackroyd Media Ltd v HMRC* considers when an employer exercises control in the context of the intermediaries legislation. The Supreme Court in *Fowler v HMRC* examined the interaction of UK national law and the double tax treaty between the UK and South Africa. The case of *Gallaher Ltd v HMRC* considered the compatibility with EU law of the limitation to UK corporation taxpayers of the relief in the "no gain no loss" provisions and led to an amendment to the legislation in Finance Bill 2019–21. *R (on the application of Aozora GMAC Investment) v HMRC* is a significant case as it is a reminder on the limits of establishing legitimate expectation when relying on HMRC guidance. In *United Biscuits (Pension Trustees) Ltd and another v HMRC*, the long dispute concerning the classification of VAT for services supplied to the United Biscuits occupational pension scheme was referred to the European Court of Justice and it opined that the such supplies were not VAT-exempt. Finally, the case of *Union Castle Mail Steamship Co Ltd v HMRC* concerned the taxation of derivatives held in an investment fund and the Court of Appeal concluded that a statutory requirement can override computational accounting principles.

Hancock and another v HMRC [2019] UKSC 24

Mr and Mrs Hancock exchanged shares in their company for redeemable loan notes. They structured the disposal of their shares in three stages. Stage 1 was the exchange of the shares for notes which, being convertible into foreign currency, were not QCBs. At stage 2, the terms of some of those notes were varied so that they became QCBs. At stage 3, both sets of notes (QCBs and non-QCBs) were, together and without distinction, converted into one series of secured discounted loan notes ("**SLNs**"), which were QCBs. The SLNs were subsequently redeemed for cash. The taxpayers sought to show that the redemption of the loan notes fell outside the charge to CGT by virtue of the exemption in section 115 of the Taxation of Chargeable Gains Act 1992 ("**TCGA**") for disposals of QCBs.

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Roll-over relief is available for reorganisations, resulting in the issue of securities such as shares. The issue was whether roll-over relief (pursuant to section 127 TCGA) applied on the original disposal of their shares by the taxpayers. The Supreme Court stated that (1) a conversion as defined is to receive the same relief as a reorganisation, i.e. roll-over relief, even if it involves QCBs whose disposal is otherwise outside the charge to CGT, and (2) emphasis is given to the "*aggregation of the securities into a single asset*". Accordingly, the applicability of roll-over relief depended on whether the conversion of securities at the third stage comprised separate transactions or if it was only one conversion of the QCBs and non-QCBs. The appeal would fail if it was concluded that the third stage had involved separate transactions.

Section 116(1) TCGA provides as follows:

> "*This section shall have effect in any case where a transaction occurs of such a description that, apart from the provisions of this section—*
>
> *(a) sections 127 to 130 would apply by virtue of any provision of Chapter II of this Part; and*
>
> *(b) either the original shares would consist of or include a qualifying corporate bond and the new holding would not, or the original shares would not and the new holding would consist of or include such a bond.*"

The Supreme Court stated that section 116(1)(b) TCGA contemplates the possibility of a single transaction which involves a pre-conversion holding of both QCBs and non-QCBs, and also acknowledged that, coupled with the fact that the Court of Appeal's interpretation renders the words "*or include*" appearing in section 116(1)(b) idle, these are powerful arguments in support of the appellants' construction.

However, the Supreme Court also observed that there would be nothing to prevent taxpayers from using the occasion of a minimal conversion (e.g. £1 nominal QCB) following a reorganisation and obtaining relief from CGT, which was stated to be "*plainly contrary to and inconsistent with that which was intended to apply to a conversion connected to a reorganisation*".

The Supreme Court added that the word "include" in section 116(1)(b) made it clear that "*the intention of Parliament was that each security converted into a QCB should be viewed as a separate conversion*". Accordingly, it was held that there had been two conversions: one of QCBs; and one of non-QCBs. The potential gain within the non-QCBs was frozen on conversion and did not qualify for roll-over relief pursuant to section 127 TCGA.

Christa Ackroyd Media Ltd v HMRC [2019] UKUT 326

In *Christa Ackroyd*, the Upper Tribunal upheld the decision of the First-Tier Tribunal ("**FTT**") that the BBC had sufficient control of a presenter that, had the services been supplied directly by the presenter rather than through her personal services company, an employment relationship would have subsisted.

Ms Ackroyd is a television journalist and presenter who presented "Look North" on BBC 1 between 2001 and 2013. The appeal before the FTT related to a fixed-term contract dated 4 May 2006 between the BBC and Christa Ackroyd Media, which was terminated by the BBC in June 2013 (the "**Contract**"). Between March 2013 and October 2014, HMRC issued to Christa Ackroyd Media determinations in respect of income tax and notices of decision in respect of national insurance contributions under the intermediaries legislation contained in sections 48 to 61 of the Income Tax (Earnings and Pensions) Act 2003 ("**ITEPA**") and the relevant national insurance contribution legislation. For the period covered by the Contract, the legislation required the FTT to determine a direct contract between the BBC

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and Ms Ackroyd for the services under that contract (the "**hypothetical contract**") and to determine whether the circumstances are such that it would be a contract of employment.

The Upper Tribunal stated that in determining employment status, the starting point is the conditions set out in *Ready Mixed Concrete (South East) Limited v Minister of Pensions and National Insurance* [1968] 2QB 497, namely: (i) mutuality of obligation; (ii) control; and (iii) taking into account other relevant factors (a negative condition that looks at the provisions of the contract as a whole). It was determined by the FTT that the necessary mutuality of obligation existed and that condition was not the subject of appeal. The issue in the appeal turned to whether the FTT erred in law in concluding that, on the basis of the facts found, under the hypothetical contract, the BBC would have had sufficient control of Ms Ackroyd to establish a relationship of employment.

The Upper Tribunal held that the FTT correctly determined that under the Contract, the BBC had explicit control over Ms Ackroyd in a number of important respects, and that it should be implied that it had "ultimate authority" in the sense referred to in the relevant case law including statements from MacKenna J in *Ready Mixed Concrete*, whereby it was stated that:

> "*The question is not whether in practice the work was in fact done subject to a direction and control exercised by any actual supervision or whether any actual supervision was possible but whether ultimate authority over the man in the performance of his work resided in the employer so that he was subject to the latter's order and directions*."

The determination by the Upper Tribunal was very fact-specific to this case but the issues raised will become increasingly relevant to corporate businesses as the intermediaries legislation is extended to the private sector in April 2021.

Fowler v HMRC [2020] UKSC 22

Mr Martin Fowler is a qualified diver, resident in the Republic of South Africa. During the 2011/2012 and 2012/2013 tax years he undertook diving engagements in the waters of the UK Continental Shelf.

HMRC claimed that the income he earned from those diving engagements is subject to UK taxation. The double taxation treaty between the UK and South Africa (the "**Treaty**") had to be applied in order to determine the taxation of Mr Fowler. The Treaty provides for employment income to be taxed in the place where it is earned, i.e. in the UK, but for the earnings of self-employed persons to be taxed only where they are resident, i.e. in South Africa.

The Supreme Court noted that there were two primary complications: (a) under UK tax law, employed divers such as Mr Fowler are to be treated as if they were self-employed for income tax purposes; and (b) under article 3(2) of the Treaty, any terms that are not defined in the Treaty itself are to be given the meaning that 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).

The Treaty identifies specific categories of income (or profits) and provides that each are taxable in one or other contracting States of the Treaty. Accordingly, pursuant to article 14, employment income is taxed where it is earned, whereas pursuant to article 7, business profits are (subject to the rules about permanent establishment) taxable where the relevant business enterprise is resident.

The relevant UK legislation is as follows: (i) tax on employment income is regulated by the ITEPA; and (ii) tax on trading profits is regulated by the Income Tax (Trading and Other Income) Act 2005 ("**ITTOIA 2005**"). Section 6(5) ITEPA provides that "*employment income is not charged to tax under this Part if it is within the charge to tax under Part 2 of ITTOIA 2005 (trading income) by virtue of section 15 of that Act (divers and diving*

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supervisors)". Section 15(2) ITTOIA 2005 provides that where section 15 applies, "*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*".

The Supreme Court then considered how the deeming provision contained in section 15(2) ITTOIA 2005 should be applied in respect to the Treaty provisions. The Supreme Court held that the taxation of Mr Fowler's remuneration as trading income under section 15 of ITTOIA 2005 did not affect its classification under the Treaty. This reversed the Court of Appeal's decision. The Supreme Court stated 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 that relevant terms of the Treaty would otherwise have. In this case, there was "no doubt" that article 14 would apply without section 15 (if the taxpayer was employed, rather than self-employed, on general principles, which was assumed in this judgment). This case highlights that taxpayers should carefully analyse the ambit of national deeming provisions to determine whether they affect their position under double tax treaties.

Gallaher Ltd v HMRC [2019] UKFTT 207 (TC)

In *Gallaher*, the FTT considered the compatibility with EU law of the limitation to UK corporation taxpayers of the relief in the "no gain no loss" provisions contained in section 171 of the TCGA 1992. The FTT held that the difference in treatment between a purely domestic transfer, and one to a group company in a different EU or EEA State, was a restriction of the Netherlands parent company's right to freedom of establishment which could not be justified, unless the UK company was given the option to pay the extra tax over five years. In the absence of such an option, the FTT concluded that the transfer to the Netherlands company should be treated in the same way as a domestic transfer.

From 11 July 2019, companies may apply, with immediate effect, to defer payment of up to the amount of corporation tax on profits or gains attributable to affected group asset transfers. The Finance Bill 2019–21 introduces draft legislation to allow companies to defer payment of tax which arises on certain transactions with group companies in the EEA. This is intended to provide certainty for UK business following the FTT decision in *Gallaher*.

R (on the application of Aozora GMAC Investment) v HMRC [2019] EWCA Civ 1643

In *Aozora*, the Court of Appeal concluded that a statement in HMRC's International Manual could, in theory, establish a legitimate expectation, but that the taxpayer had failed to show that HMRC departing from its published guidance would be "*so unfair as to amount to an abuse of power*".

The principal issue that arose before the FTT was whether the relevant HMRC manual gave rise to a legitimate expectation on the part of a taxpayer to rely on the contents of such manual as an interpretation of the relevant legislation. Aozora UK was the wholly owned subsidiary of a Japanese company, Aozora Japan. Aozora UK owned a subsidiary in the USA, Aozora US. Aozora UK had made loans to Aozora US and received interest payments. The USA had imposed a 30% withholding tax on the interest received and Aozora UK was liable to corporation tax in the UK on such interest. It was denied relief under the relevant legislation. Aozora UK argued that HMRC's International Manual contained a representation by HMRC that gave rise to a legitimate expectation that it would be taxed in accordance with the manual, whether or not the terms of the manual were accurate. The FTT concluded that the relevant HMRC guidance was a representation that may give rise to legitimate expectation. However, the FTT examined whether the taxpayer relied on

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the relevant representation and concluded that Aozora Japan's tax adviser relied on their own analysis, and Aozora UK was unable to demonstrate that it had suffered substantial detriment by means of "putative reliance" on the relevant representation. The taxpayer appealed the FTT's decision.

The Court of Appeal clarified that a legitimate expectation can arise from a statement made by HMRC in its published guidance. However, in this case, the Court of Appeal held that the kind of representation relied on by Aozora UK, although clear, unambiguous and unqualified, is "*weak in the sense that it is only a representation as to HMRC's opinion as to the law*". In addition, Aozora Japan obtained advice from specialist tax advisers who were not at any great disadvantage compared to HMRC when coming to their own view of the law, and it is that view on which Aozora Japan relied. Accordingly, Aozora UK has not shown that it has suffered a serious detriment as a result of any reliance on the representation. Given the increased publication of HMRC guidance, this case is an important reminder on the limits of establishing legitimate expectation when relying on said guidance. However, it should be noted that each case will be examined on its own facts and circumstances.

United Biscuits (Pension Trustees) Ltd and another v HMRC Case C-235/19

The dispute before the Court of Appeal between the trustees of an occupational pension scheme of United Biscuits (UK) Ltd and HMRC concerned the classification for VAT purposes of the investment management services supplied to the trustees of United Biscuits occupational pension scheme for the purposes of the administration of its pension scheme.

The Court of Appeal referred the case to the European Court of Justice and the principal question was whether investment management services supplied to United Biscuits occupational pension scheme were exempt "insurance transactions" within article 135(1)(a) of Council Directive 2006/112/EC (the "**VAT Directive**") and its predecessor provisions. Advocate General Pikamäe ("**AG**") opined that supplies of pension fund management services to United Biscuits occupational pension scheme between 1978 and 2013, by trustees who were not approved as insurers (i.e. non-insurers), were not VAT-exempt.

The VAT Directive provides that the supply of services for consideration within the territory of a Member State by a taxable person acting as such is to be subject to VAT. However, Member States shall exempt from VAT "*insurance and reinsurance transactions, including related services performed by insurance brokers and insurance agents*". The AG stated that it was apparent that in accordance with the relevant UK legislation on the authorisation of insurance companies, the provision of pension fund management services, including to defined benefit occupational pension funds, was a class of "insurance business" when effected and carried out by an insurer carrying on an insurance business.

During the period from 1 January 1978 to 30 September 2013, as regards supplies of pension fund management services to defined benefit occupational pension funds, HMRC distinguished between those provided by insurers, which were exempt, and those provided by non-insurers, which were not exempt, pursuant to the relevant UK legislative provisions in place at the time. The dispute concerns whether the supply of pension fund management services by trustees who are not approved as insurers may be classified as an "insurance transaction" and thus be exempt from VAT.

The AG stated that although insurance transactions were not defined by the VAT Directive, the exemption must be interpreted in context. The essentials of insurance transactions are "*that the insurer undertakes, in return for prior payment of a premium, to provide the insured, in the event of materialization of the risk covered, with the service agreed when the contract was concluded… it is the assumption of risk for consideration that allows*

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an activity to be classified as an insurance transaction". In addition, the AG stated that the concept of "insurance transactions" must be understood in a strict sense and not to the management of insurance policies. Furthermore, insurance transactions necessarily imply the existence of a contractual relationship between the provider of the insurance service and the person whose risks are covered by the insurance, namely, the insured. Accordingly, it is the nature of the relationship, not the status of the parties, that determines whether something is an insurance transaction.

The AG stated that in this case, the investment managers did not contract with the trustees to provide any form of indemnification against the materialisation of risk, so that the pension fund management services at issue do not entail any assumption of a risk by the investment managers for consideration. The AG opined that it follows that such an activity is not an "insurance transaction" and is not exempt from VAT. The AG also rejected arguments on fiscal neutrality, noting that the discrepancy in the treatment of services provided by insurers and non-insurers arose from the UK treatment, not EU law.

Union Castle Mail Steamship Co Ltd v HMRC [2020] EWCA Civ 547

In *Union Castle Mail Steamship Co Ltd v HMRC*, the Court of Appeal dismissed the taxpayers' appeals against the Upper Tribunal's decision which disallowed corporation tax deductions for purported losses arising from a marketed derivatives "derecognition" scheme.

The issue was whether the "derecognition" in the accounts of the taxpayers' companies of 95% in one case, and 100% in the other, of the value of derivative contracts held by them respectively gave rise to an allowable loss for the purposes of corporation tax. This issue turns on the proper construction and application of schedule 26 to the Finance Act 2002, which contains an exhaustive code for the taxation of profits arising from derivative contracts.

Union Castle Mail Steamship Company Limited ("**Union Castle**") made a bonus issue to their parent company of 5020 "A Shares". The A Shares carried a right to receive a dividend equal to 95% of the cash flows arising on the close-out of certain derivative contracts, such dividend to be paid within five business days following receipt by Union Castle of the cash flows. As a consequence of issuing the A Shares, Union Castle was required to "derecognise" 95% of the value of the derivative contracts for accounting purposes, amounting to £39,149,128. HMRC disallowed a deduction of £39,149,128 made by Union Castle in its corporation tax return for the year to 31 March 2009, claimed as a result of a derecognition of 95% of derivative contracts held by it.

The relevant paragraphs of schedule 26 to the Finance Act 2002 (as they applied in the tax year 2008/2009) are as follows:

> "*Paragraph 15:*
>
> *(1) The credits and debits to be bought into account in the case of any company in respect of its derivative contracts shall be the sums which, when taken together, fairly represent, for the accounting period in question –*
>
> *(a) all profits and losses of the company which (disregarding any charges or expenses) arise to the company from its derivative contracts and related transactions; and*
>
> *(b) all charges and expenses incurred by the company under or for the purposes of its derivative contracts and related transactions.*"

The key issue in this case was in relation to the "fairly represented" requirement. The Court of Appeal held that this requirement was a freestanding criterion which was not bound by the accounting treatment of profits and losses and it could override such treatment. While it was long-established that the computation of the profits and losses of a business for tax purposes was to be undertaken in accordance with generally accepted accounting

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principles, that general principle had to give way to any express or implied statutory rule. The Court of Appeal held that the "fairly represented" requirement was such a rule. In this case, the accounting debit did not fairly represent a loss to Union Castle for the purposes of paragraph 15(1) of schedule 26. It had lost no asset nor incurred any liability other than a liability to pay a dividend on shares, such shares being issued for no consideration to its parent company. The payment of a dividend was in fact a distribution of profits. Accordingly, an obligation to pay a dividend could not be a loss.

European – EU law developments

The below section on EU tax law developments reflects a summary of the key developments in 2019, but it is not a comprehensive or detailed discussion of all measures in the past year. The law and information stated below is accurate as at July 2020.

Brexit update

On 31 January 2020, the UK left the EU and the UK-EU withdrawal agreement came into force. Section 1 of the European Union (Withdrawal) Act ("**EUWA**") repealed the European Communities Act 1972 ("**ECA 1972**"), which had previously enabled EU law to apply to the UK. However, the EUWA saved most of the provisions contained in the ECA 1972 (in modified form) for the duration of the transition period, i.e. until 31 December 2020, as well as any UK legislation that implemented EU requirements, i.e. "EU-derived domestic legislation". The new body of retained EU law by the EUWA will provide a basis for continuity, but will require amendment to reflect the change in the UK's relationship with the EU.

Digital Taxation – OECD and EU updates

As part of the OECD/G20 BEPS project, and in the context of Action 1, the Task Force on the Digital Economy considered the tax challenges raised by the digital economy. The 2015 Action 1 BEPS Final Report and the 2018 Action 1 BEPS Interim Report noted that highly digitalised business models are characterised by an unparalleled reliance on intangibles, along with the importance of data, user participation and their synergies with intangible assets.

Following the publication of the Action 1 BEPS Reports, the potential tax challenges were debated – particularly in relation to the remaining BEPS risks and the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among jurisdictions. No consensus was reached regarding how to address these issues but there was a commitment to deliver a final report in 2020, aimed at providing a consensus-based, long-term solution. Further to the analysis included in the Action 1 BEPS Reports, members of the OECD/G20 Inclusive Framework on BEPS suggested that a consensus-based solution to the taxation of the digital economy should be focused on: (i) the allocation of taxing rights by modifying the rules on profit allocation and nexus; and (ii) unresolved BEPS issues. On 31 May 2019, the OECD published a consensus document entitled "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy" (the "**Programme Report**"). The Programme Report emphasises that the way multinational corporations are taxed will need to be reshaped in order to effectively deal with the tax challenges arising from digitalisation.

The Programme Report focuses on two pillars, namely:

Pillar One – Allocation of taxing rights: This pillar details the different technical issues that need to be resolved to undertake a coherent and concurrent revision of profit allocation.

Pillar Two – Remaining BEPS issues: This pillar describes the work to be undertaken in the development of a global anti-base erosion ("**GloBE**") proposal that would, through changes to domestic law and tax treaties, provide jurisdictions with a right to "tax back" where other

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jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.

The development of the GloBE proposal under pillar two contemplates radical new principles of international taxation which would extend beyond the sphere of purely digitally-focused businesses by way of:

- an income inclusion rule that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate;
- an undertaxed payments rule that would operate by way of a denial of a deduction for a payment to a related party if that payment was not subject to tax at or above a minimum rate;
- a switch-over rule to be introduced into tax treaties, which would permit a residence jurisdiction to switch from an exemption to a credit method where the profits attributable to a permanent establishment or derived from immovable property are subject to an effective rate below the minimum rate; and
- a subject-to-tax rule that would complement the undertaxed payment rule by subjecting a payment to withholding or other taxes at source.

These developments represent a significant moving of the international tax goalposts. The European Commission also proposed in March 2018 its own turnover tax on digital businesses, pending reform of its common corporate tax rules for digital activities. However, such proposals have been laid aside due to opposition from several EU Member States. Despite ongoing negotiations, a growing list of countries (including the UK, France, Austria, Hungary, Italy and Turkey) have decided to move ahead with unilateral measures to tax the digital economy.

ATAD II

On 12 July 2016, the Anti-Tax Avoidance Directive ("**ATAD I**") 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**") was subsequently implemented, which amended ATAD I and required that EU Member States introduce comprehensive hybrid mismatch rules under a prescriptive set of principles. ATAD II contains complex measures in relation to hybrid mismatches (to be implemented from January 2020) and reverse hybrids (to be implemented from January 2022). The principal additions compared to ATAD I are that (i) hybrid mismatch situations are targeted in a global context, and (ii) ATAD II also applies to hybrid permanent establishments, imported mismatches and reverse hybrids.

Non-cooperative jurisdictions

There are certain countries that the EU considers as having sub-par tax governance standards. Such countries are included in the list of "non-cooperative jurisdictions". On 18 February 2020, it was announced that the EU's Economic and Financial Affairs Council had added the Cayman Islands to the list of non-cooperative jurisdictions. It should be noted that some jurisdictions are taking counteractive measures in respect to the non-cooperative jurisdictions. For example, on 31 March 2020, Luxembourg released a bill aimed at disallowing the deduction of interest and royalty expenses paid to companies set up in blacklisted countries. The purpose of the proposed measures is to fight aggressive tax planning that results in interest and royalty payments made by Luxembourg companies that are tax-exempt or taxed

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at a very low tax rate in such jurisdictions. Other Member States, such as the Netherlands, France and Belgium are also enacting tax measures against non-cooperative jurisdictions.

BEPS update

In 2019, the UK continued its implementation of the BEPS measures. An update on the implementation status of certain key BEPS measures is outlined below:

- *Action 1 – Addressing the tax challenges of the digital economy*: The Finance Bill 2019–21 has introduced, with effect from 1 April 2020, a 2% DST levied on the revenues of search engines, social media services and online marketplaces which derive value from UK users.
- *Action 2 – Hybrids*: A consultation on certain technical aspects of the UK hybrid rules has been launched, focusing primarily on (a) double deduction mismatches, (b) connected parties "acting together", and (c) exempt investors in hybrid entities.
- *Action 4 – Interest deductions*: The restriction on tax deductibility of corporate interest expense consistent with OECD recommendations was introduced in the UK on 1 April 2017. Schedule 11 to the Finance Act 2019 made a number of changes to the corporate interest restriction legislation that is contained in TIOPA. Most of the changes made by schedule 11 have been made to ensure that the legislation works as it was intended.
- *Action 13 – Transfer pricing documentation and country-by-country reporting*: The UK is party to the automatic exchange of country-by-country reports, and as of January 2020, has activated 64 exchange relationships.
- *Action 15 – Multilateral Instrument ("**MLI**")*: The MLI has now been implemented in the UK, the effect of which is to enable countries to implement the recommendations contained in the relevant BEPS actions into double tax treaties. Other countries are now also ratifying the instrument and thereby enacting amendments into bilateral tax treaties.

Developments affecting attractiveness of the UK for holding companies

Tax climate in the UK

The UK has had to use extraordinary economic measures to deal with the impact of the COVID-19 pandemic. It will remain to be seen how tax policy will be shaped in the coming years in order to recover the economy and revitalise UK industry. Aside from COVID-19, Brexit will have a significant and long-term impact on EU-wide tax planning, particularly in relation to the loss of EU Directives. It will be interesting to examine the impact of the newly introduced DST in the UK and also how it will interact with similar measures on an EU-wide and global level. Many service providers and companies will have to grapple with the new UK DAC6 regulations aimed at promoting cross-border tax transparency, but there are still unanswered questions as to its practical application.

Industry sector focus

Overseas property investors

The UK continues to be one of the most mature and diverse real estate markets in the world. However, it has undergone numerous changes to the real estate tax provisions in recent years and the impact of such measures on the economic return for overseas investors is still unclear.

Finance

The Government has recently committed to undertake a review of the UK's funds regime. In addition to various financial regulatory matters, the indirect and direct taxes of funds will be considered with a view to examining the case for policy changes. This will include a review of the VAT treatment of fund management fees and a consultation regarding the

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tax treatment of asset holding companies in alternative fund structures. In addition, it is expected that, from the end of 2021, LIBORs, which are used as reference rates in the loan, bond and derivatives markets, will cease to be published. Instead, these rates are to be replaced with "nearly risk-free" benchmark rates. Similar processes are occurring with other benchmark rates, e.g. EONIA. The UK Government has launched a consultation calling for information from taxpayers regarding the tax issues that arise from the reform of LIBOR and other benchmark rates.

Oil and gas

On 20 March 2017, the Government published a discussion paper identifying tax issues that may be discouraging new investment in older UK continental shelf oil and gas fields and assets and which may, therefore, result in the decommissioning of late-life assets before maximising their economic value. The paper focuses on the impact of decommissioning costs on sales, particularly asset sales. The discussion paper primarily focused on the feasibility of introducing a transferable tax history. This led to provisions in the Finance Act 2019 to enable a seller's tax history to be transferred on the sale of an interest in a UK oil licence, thereby enabling the buyer to set the decommissioning costs of the field against the transferable tax history. The petroleum revenue tax rules will also be amended to allow a deduction for decommissioning costs.

The year ahead

The impact of COVID-19 on UK businesses is multifaceted, from the disruptions to daily working routines to changes in consumer demand dependent on industry. From an economic perspective, the forecasts announced in the Spring Budget 2020 did not take into account the full impact of COVID-19 and it is apparent that the UK economy will suffer, but the extent of any recession is unpredictable at this stage. The current climate will mean that companies will have to consider many issues, particularly in relation to their workforce and maintaining production. In addition, on 31 January 2020, the UK left the EU and the impact of this on UK industry will be determined by the outcome of ongoing negotiations during the transition period.

Despite the challenging circumstances, businesses must be cognisant of the evolving tax climate nationally and on a global level. UK tax authorities are continuing to use extensive powers to counteract perceived tax avoidance and compliance with the various reporting obligations, particularly DAC6, which may become increasingly burdensome. In addition, the OECD's attempt to craft a "consensus-based solution" to the taxation of the digital economy by the end of 2020 – embodied by the two pillar approach set out in its Programme Report – marks a potentially ground-breaking shift in the way taxation will apply to multinational businesses.

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Endnotes

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