

## UK TAX QUARTERLY UPDATE – DECEMBER 2020

The UK, and the international economy, have faced momentous challenges in the past year. The UK economy shrank 11 per cent - the largest drop in over 300 years - and, according to last month's figures from the UK's Office for Budget Responsibility, its debt level is set to balloon to £394 billion in 2020 - the highest recorded level of borrowing in the UK since 1944 and equivalent to 19% of GDP. Conversely, however, interest rates on government debt are at a historic low and are expected to remain so for some time.

The Chancellor vowed in October to make "hard choices" that are needed to "balance the books" and to address the high levels of national debt incurred during the COVID-19 coronavirus pandemic. However, the International Monetary Fund warned the Chancellor that now is not the appropriate time to balance the books. The economic outlook for the UK remains highly uncertain and its success depends upon a multitude of factors, including the effectiveness and timing of vaccines, the outcome of the Brexit negotiations and the response of businesses and households to these events. Whilst the UK Government does expect relatively rapid economic recovery in the UK, the costs of COVID-19 combined with the head wind pressures from a post-Brexit world undoubtedly will put pressure on the UK economy, at least in the near term. Another tension is the desire to attract investment (by way of illustration, see the two consultations mentioned below). It is inevitable that revenues will need to be raised, though not necessarily as soon as 2021. As the Autumn Statement was cancelled this year, it remains to be seen how UK tax policy may change in response.

In the meantime, however, there have been plenty of incremental proposed (and actual) changes to the UK, and the international, tax landscape. Following a positive reception to an initial consultation on the UK asset holding company ("AHC") regime, the UK government recently launched a second stage consultation on more detailed design features of a new AHC regime (including targeted changes to the UK real estate investment trust regime). The government is also currently consulting on new legislation relating to "UK property rich" collective investment vehicles and their investors for UK capital gains tax purposes, broadly designed to address administrative burdens borne by specified investors under existing rules. We will cover these topics and address any published outcomes of these consultations in our next Quarterly Alert (together with the recent OECD publications on transfer pricing and the impact of COVID-19).

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<b>A. International and UK developments</b>	
<b>I. BEPS 2.0 - OECD Blueprints</b>	

In October, the OECD’s Inclusive Framework (the “IF”) released blue-prints for its Pillar I and Pillar II initiatives - addressing respectively, (a) new nexus rules for the digital economy and (b) “top-up tax” mechanics to secure an international minimum tax rate. The blueprints focus on technical aspects of the proposals and illustrate that the proposals are becoming increasingly complex. They also acknowledge that there are many points on which political agreement has yet to be reached. It remains to be seen whether the IF’s aim of reaching consensus on both Pillar I and II by mid-2021 remains achievable.

### **Pillar I<sup>1</sup>**

Pillar I focuses on the *allocation* of taxing rights (rather than the tax base itself) and seeks to redistribute taxing rights to so-called “market jurisdictions” (i.e. jurisdictions into which a group’s “in scope” services and products are supplied and/or its users are located). The blueprint does not seek to fit this new “nexus” rule into the existing international tax framework, but rather, layers it *over* the framework.

Though much remains to be agreed politically, the blueprint sets out the direction of travel for many technical aspects of the proposals:

- *Scope*: The proposals will apply to: (a) “automated digital services” businesses, including social media platforms, online search engines and cloud computing businesses and (b) “consumer facing businesses” (i.e. retail businesses). Some IF members favour a staggered introduction of the rules, with delayed implementation for consumer facing businesses.
- *Thresholds*: It is proposed that the new nexus rules would only apply to global businesses with revenue from “in-scope” activities above certain (yet to be politically agreed) thresholds both: (a) globally and (b) in jurisdictions that don’t currently tax the relevant income (on

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<sup>1</sup> The Pillar 1 blueprint is available here: <https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-one-blueprint.pdf>

existing residence / permanent establishment principles). The former threshold is expected to be set at c.€750 million.

- *Exclusions*: Blanket carve-outs are proposed for the financial industry (asset managers, insurers, pension funds, and banks), the extractives and natural resources industries, and international airlines and shipping.
- *Calculation of tax base*: The amount of income available to be allocated to market jurisdictions (so called “Amount A”) is not determined on the basis of principles. Rather, (once a political decision is reached on the various thresholds) its calculation is intended to be a highly mechanical exercise. In high level terms:
  - Amount A is intended to represent the group’s global “excess profit” from in-scope activities - i.e. income exceeding an agreed level of profitability, which would be calculated using agreed formulae (that would vary by industry). Determining the level at which “excess profit” is set is likely to be highly contentious.
  - The starting point for the calculation would be the group’s consolidated accounts, with the various formulae (to calculate the tax base, and the allocations) being applied to figures set out therein. Where a group has both in-scope and out-of-scope activities, it is proposed that taxpayers prepare additional “segmented” accounts (but that losses from out-of-scope activities could not be set against profits from in-scope activities). This raises the prospect that businesses could be subject to additional tax in multiple jurisdictions, even if they are loss-making overall.
- *Nexus*: It is proposed that Amount A would only be shared between market jurisdictions in which the group has an “active and sustained participation”. This would be tested by reference to revenue generated in that jurisdiction over a certain number of (yet to be decided) years. It is contemplated that, for consumer facing businesses, market jurisdictions may need to meet higher thresholds (of revenue and/or other qualitative factors) to meet this test.
- *Novel “dispute prevention” mechanisms*: In expanding the pool of jurisdictions to which taxing rights are awarded, the proposals materially increase the scope for double taxation. The blueprint recognises this - and that existing dispute resolution processes (such as mutual agreement procedures, discussed further below) may be ill-equipped to resolve disputes between tax authorities regarding their rights to tax “in scope” income. The blueprint therefore focuses on novel “dispute prevention processes”. In particular, the blueprint contemplates that many aspects of the proposals (including the amount of income to be allocated to market jurisdictions generally, and to specific jurisdictions in particular) would, for each in-scope taxpayer, be subject to advance review both by (a) the tax authorities of interested jurisdictions and (b) if there is disagreement, panel(s) of representatives from tax administrations in IF member states. Such innovation is to be welcomed. Nevertheless, concerns have been raised about the practicality of such measures. In the absence of willingness and (perhaps more significantly) means on the part of tax authorities to allocate resources to the proposals, demand for pre-agreement is likely to outstrip capacity, with taxpayers potentially suffering the cost of double taxation whilst they wait.
- *Implementation*: The blueprint contemplates that the proposals would be implemented via a multi-lateral instrument (an “MLI”). Past experience with 2018’s MLI (giving effect to BEPS 1.0 initiatives) illustrates that, in practice, implementation of MLIs is highly staggered. To

prevent businesses facing significant double taxation risks during such a transitional period, it is hoped that streamlined implementation can be achieved.

- *Matters for political decision:* In addition to the points raised above, swathes of the proposal remain subject to political agreement - not least: (a) whether Pillar A will be introduced on a mandatory or (as the US proposes) optional basis (as to which, see our [July Tax Quarterly Alert](#)) and (b) the various thresholds and percentages inherent in the proposed calculations.

The complexity of the new rules is apparent, even at this relatively early stage of the process. With such an ambitious project, some degree of complexity (and additional compliance burden) was unavoidable. Nevertheless, it seems likely that this has been exacerbated by the early choice not to fit Pillar I proposals within existing tax frameworks (e.g. by expanding the traditional concept of a physical “permanent establishment” to accommodate digital presences). Moreover, the significant risk of double taxation inherent in the project’s aims has led the IF to favour a model based on formulae (offering certainty) over principles (offering flexibility). While such certainty may be welcome in the short term, it is not without challenges. Though not acknowledged by the blueprint, it seems likely, for example, that the various thresholds and percentages intrinsic to the rules would need to be refreshed every 5-10 years in response to inflation, the changing fortunes of particular industries, and human ingenuity as to the various means by which value can be created. As such, even if consensus can be reached next year, it is unlikely to be the end of the multinational political decision making on which the rules rely.

## **Pillar II<sup>2</sup>**

In contrast to Pillar I, Pillar II expressly *aims* to increase the amount of tax paid by certain multinational groups. It would do so by introducing an international minimum effective tax rate. The level at which this would be set has yet to be agreed between IF members.

The blueprint gives significant shape to the proposal:

- *Scope:* The blueprint contemplates that Pillar II would, in any given year, only apply to groups with a consolidated gross revenue in excess of €750 million (in the immediately preceding fiscal year).
- *Exclusions:* In good news for the investment management industry, it is proposed that certain types of entities heading multinational groups (such as investment entities, sovereign wealth funds and pension funds) would be exempt - although the proposals could apply to entities lower down the ownership chain. However, (in contrast to Pillar I) it appears that there is limited political will for including a broader carve out.
- The blueprint largely focuses on two proposed “top-up” tools:
  - *The income inclusion rule (the “IIR”):* The IIR gives the jurisdiction in which the group’s parent is resident the power to levy a “top-up” income tax, on the parent, in respect of the difference between the group’s effective tax rate and the (yet to be

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<sup>2</sup> The Pillar II blueprint is available here: <https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint.pdf>

agreed) minimum rate. The proposal is supported by a “switch-over rule” which would effectively disapply obstacles to such taxing rights in double tax treaties.

- *The “undertaxed payments rule” (the “UTPR”)*: Broadly, the UTPR empowers source jurisdictions to apply withholding tax to, or deny a deduction for, related party payments which are not taxed (or are subject to low tax) on receipt. This proposal is supported by the “subject to tax rule”, which would amend treaties to give effect to source countries’ new taxing rights.
- A key element of both proposals is the manner in which the group’s effective tax rate (the “ETR”) is calculated:
  - *Blending*: The IF appears to have rejected an approach based on “global blending”, which would have calculated the ETR at group level. Instead, the IIR favours “jurisdictional blending” – which requires groups to calculate the ETR for each jurisdiction in which they have a taxable presence. While the blueprint moots the possibility of certain simplification processes (such as a safe harbour where the ETR (calculated for county-by-country reporting purposes) is a certain level above the minimum tax rate) it acknowledges that such proposals are in their infancy. Indeed, even with simplification methods, a jurisdiction-focused approach is likely to result in a significant compliance burden (particularly when compared to the simplicity offered by global blending).
  - *Financial accounts as a starting point*: Interestingly, notwithstanding the preference for jurisdictional blending, the blueprint proposes that the ETR be calculated using the parent’s consolidated accounts. Many taxpayers had favoured simpler alternatives, including: (a) a “proxy” ETR calculation, based on consolidated accounts only (which, while divorced from the tax actually paid, would minimise the compliance burden) or (b) an ETR calculation based on the tax *actually paid* in each jurisdiction (which would align the proposals with the economic reality, and use information that taxpayers are already required to prepare at a local level). The proposed approach creates particular difficulties for many businesses in the financial industry, for whom there are often material mismatches between the consolidated accounting, and tax, position. Examples include insurers (who are often taxed on a fundamentally different basis than ordinary corporate income taxpayers) and issuers of additional tier 1 capital instruments and other hybrid instruments. Under the proposals, such businesses could be subject to additional tax in circumstances where their *actual* ETR is above the minimum level.
  - *Measures to address tax volatility*: The IF recognise “*the principle that Pillar II proposals should not seek to impose additional tax where a low ETR is merely a product of timing differences in the recognition of income or the imposition of taxes*”. The blueprint therefore proposes certain mechanics to address these points, such as the right to carry forward “excess” ETR (over the minimum rate) and off-set it against a low ETR in subsequent years. However, it is contemplated that this carry-forward right may be limited to seven years.
  - *IIR substance carve outs*: Similar to another notable erosion rule, the US’ “global intangible low-taxed income rule (“GILTI”), the blueprint contemplates that certain types of income would be carved out of the ETR calculation. These include payroll taxes, and (a fixed amount of) income from fixed assets. This is, the blueprint notes,

because Pillar II “focuses on excess income, such as intangible-related income, which is most susceptible to base erosion”. Nevertheless, the narrow scope of the exclusion omits many additional sources of income which are not “mobile”, including income from traditional non-digital businesses which rely on a fixed establishment and a local consumer base.

- Other matters addressed in the blueprint include:
  - *Interaction between IIR and UTPR:* The blueprint notes the IF’s intention that the UTPR operate as a “backstop” to the IIR, applying only where the parent’s jurisdiction of residence has not implemented the IIR. However, the blueprint’s proposals do not quite achieve this stated aim. In particular, the blueprint contemplates that the UTPR could apply to payments made to a parent entity that is subject to the IIR, if the ETR in its jurisdiction of residence is below the minimum rate. This raises the prospect that parent entities could be subject to both the IIR and the UTPR, creating the potential for multiple layers of tax, and a heavy compliance burden.
  - *Implementation:* The blueprint proposes that treaty changes needed to implement the switch-over-rule and the subject-to-tax rule would be implemented via an MLI signed and ratified by IF members. As regards the IIR and the UTPR, it is contemplated that the OECD would produce draft legislation for implementation by IF member states. While the latter approach is designed to limit the difficulties that would be created by mismatches in implementation (such as increased compliance costs and an enhanced risk of double taxation) such differences are likely unavoidable. As regards the risk of double tax in particular, (in contrast to Pillar I) the blueprint signals an intent to rely solely on existing dispute resolution procedures. The weaknesses in these processes (discussed further below) have raised concerns as to whether this goes far enough.
  - *Matters for political decision:* Key elements, however, remain subject to political agreement. These include (a) the rate at which the minimum tax will be set and (b) the interaction between Pillar II proposals and (broadly equivalent) base erosion taxes (such as the US’ GILTI and the base erosion anti-abuse tax). On the latter point in particular, it is hoped that a sensible agreement can be reached to minimise double tax risk.

The IF has been subject to intense pressure to reach a consensus on the proposals - not least from the EU, who have threatened to introduce equivalent measures if the IF cannot reach agreement - and possibly even if they do (see further our [July Tax Quarterly Alert](#)). Nevertheless, given the significant, once-in a-generation, changes contemplated by the blueprints, the short period of public consultation (which ran for two months to 14 December) is notable. It is hoped that the IF can resist pressure to hurry these significant projects, increase taxpayer engagement and take the time needed to develop proposals that best achieve the aims of: (a) imposing tax only where there is economic under-taxation and (b) minimising the compliance burden on taxpayers.

## II. OECD consultation on dispute resolution mechanics

In November, the OECD published a consultation document on mechanisms to make double tax treaty dispute resolution procedures more effective. Proposals include implementing a requirement for tax authorities to submit to binding arbitration where they cannot otherwise reach agreement within two years (so called “MAP arbitration”). The effectiveness of treaty dispute resolution mechanisms is set to take on increased significance for certain UK taxpayers. Earlier this month, the UK government announced the repeal of two EU directives which provide for MAP arbitration where tax authorities from EU member states cannot reach agreement on tax treaty disputes. The process will therefore no longer apply to disputes under the UK’s treaties with 11 EU jurisdictions (including Italy, Denmark, Poland and Romania).

Double tax treaty disputes arise where a taxpayer has been taxed by two states, each of whom believes that the treaty between them entitles them to do so. Such disputes are currently resolved through “mutual agreement procedures” (so called “MAP”) - a process by which the relevant tax authorities, through discussion, attempt to resolve disagreements about the effect of the relevant treaty. Though the outcome of the dispute will determine the amount of tax the taxpayer must pay, and to whom, the taxpayer is not party to the discussions.

MAP’s weaknesses are well known. For example:

- *It relies on tax authorities reaching agreement:* The process can be inherently uncertain. Though treaty provisions require tax authorities to “endeavour to resolve” the dispute, the taxpayer bears the risk that they will not, and that the relevant double tax will not be relieved.
- *It is time consuming:* Recent figures from the OECD indicate that on average, transfer pricing cases take 30.5 months to resolve via MAP, while other cases take 22 months<sup>3</sup>. Interestingly, in 2019, the UK was the jurisdiction with the fastest resolution of cases via MAP (taking an average of 21 months for transfer pricing cases and 6 months for other cases). These figures are likely to increase going forward, with taxpayer requests for MAP having doubled since 2016.

### *The Consultation*

The consultation asks stakeholders to “*share any general comments on their experiences with, and views on, the status of dispute resolution and suggestions for improvement*”. However, in contrast to the approach to Pillar I dispute resolution processes (described above), it does not seek to challenge the primacy of MAP, or to address its weaknesses with significant reforms. Some key issues with MAP, such as the above-mentioned delays, are not addressed at all.

Rather, narrow changes to existing systems and procedures are proposed. These centre around possible steps to strengthen the minimum standards that IF members have (since 2016) committed to adhere to on the subject (the “Minimum Standards”), and include mandatory:

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<sup>3</sup> <https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics.htm> and <https://www.oecd.org/tax/dispute/mutual-agreement-procedure-2019-awards.htm>

- (a) Programmes for bilateral advance transfer pricing agreements, pursuant to which taxpayers seek advance clearance from tax authorities that their arrangements will be treated as arm's length. Interestingly, the consultation acknowledges that many jurisdictions already have such programmes in place. Moreover, those that do not would be exempt if they have only a minimal number of transfer pricing MAP cases.
- (b) Training on international tax issues for tax authorities' auditors and examination personnel (with a view to preventing excessive adjustments likely to give rise to disputes).
- (c) Suspension of tax collection while MAP is on-going (if/to the extent that such measures apply to domestic challenges).
- (d) Rules enabling MAP agreements to be implemented, notwithstanding domestic time limits (where the matter is not addressed in the terms of the treaty itself).
- (e) MAP arbitration.

Importantly, the proposals put forward in the consultation do not represent IF consensus, and therefore function as mere discussion points. Some proposals are, accordingly, disappointingly modest in their aims (e.g. (a) and (b) above). Others (such as those at (c) and (d) above) do not seek to fix dispute resolution *mechanisms* themselves, but instead seek to accommodate MAP's weaknesses (perhaps recognising that support for an effective alternative remains quite a way off). While this is helpful in the short-term, it does not represent a long term solution.

In particular, the consultation strikes a pessimistic note on the likelihood of achieving consensus on mandatory MAP arbitration, noting that "*a number of [IF members] have clearly indicated that MAP arbitration raises several issues around constitutional and sovereignty concerns, [and] practical issues including cost, capacity and resource constraints, which is why they do not support its inclusion into the Minimum Standard and consider it very difficult to move away from such position*". The statement is informed, no doubt, by the less than enthusiastic response to such provisions in the 2018 MLI, with all but 33 of the signatories opting out.

Nevertheless, as tax laws become ever more complicated, the scope for disagreement grows. Tax treaties will increasingly fail in their objective of preventing double tax if tax authorities have the option of merely "agreeing to disagree". Indeed, this problem will be amplified if/when Pillar I and II proposals take effect. It is therefore hoped that, once BEPS 2.0 processes wind down, the OECD will refocus its attention (and its resources) on this fundamental issue.

### ***Brexit***

Unfortunately, global reluctance to embrace MAP arbitration is likely to gain increasing significance for certain UK taxpayers. Earlier this month, the UK government announced that it would repeal UK laws that give effect to two EU directives that provide for MAP arbitration in disputes between EU tax authorities<sup>4</sup>. From 1 January 2021, applications for MAP thereunder will not be accepted. Many EU jurisdictions have, like the UK, opted into the MLI's MAP arbitration provisions, or otherwise have bilateral treaties with the UK that include such provisions. The repeal will not impact taxpayers' positions under those double tax treaties. However the UK's treaties with Italy, Poland, Denmark, Romania, Czech Republic, Croatia,

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<sup>4</sup> Directive (EEC) 90/463 on the elimination of double taxation in connection with the adjustment of associated enterprises (the so-called "Union Arbitration Convention") and Directive (EU) 2017/1852 on tax dispute mechanisms in the EU (the so-called "Arbitration Directive")



Slovakia, Bulgaria, Estonia, Latvia and Lithuania do not provide for MAP arbitration, and these jurisdictions have not opted into the MLI's arbitration provisions. If a taxpayer is subject to double tax in the UK and any one of these jurisdictions, they will face an increased risk that any MAP proceedings, if initiated, will not be resolved. It remains to be seen whether the UK will seek to renegotiate the relevant bilateral treaties.

### **III. Updates to the Directive on Administrative Cooperation (DAC)**

#### **(i) DAC 6 update**

See our Gibson Dunn presentation on DAC 6 [here](#).

The first UK DAC 6 reporting deadline, on 30 January 2021, is fast approaching. As a result, parties to cross border arrangements are increasingly focusing their thinking on the practical implications of mandatory reporting obligations, with DAC 6 provisions starting to feature in contractual arrangements. Other recent developments include the publication of further guidance from HMRC on the application of the DAC 6 in the UK, and the removal of the Cayman Islands from the EU's non-cooperative tax jurisdictions list (though unanswered questions remain with respect to whether certain payments to the Cayman Islands will be subject to DAC 6 reporting obligations in the UK).

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 certain cross-border tax arrangements with an EU nexus. Due to the COVID-19 coronavirus pandemic, the implementation of DAC 6 was deferred (on an optional basis). Certain jurisdictions, such as Germany and Finland, chose to proceed as planned, with mandatory reporting beginning in July. The UK opted to defer, and the first UK reporting deadlines, beginning on 30 January 2021, are now fast approaching (for further detail, see our July 2020 Quarterly Update [here](#)). (It's worth noting in particular that DAC 6 obligations will be unaffected by, and will remain in force following, the end of the Brexit transition period).

In the meantime, DAC 6 developments continue. Of particular note has been the recent (widely anticipated) removal of the Cayman Islands from the EU list of non-cooperative jurisdictions, which might be short-lived as its removal provoked further discussions and even calls for it to be re-added to the list (primarily on the basis of the secrecy laws of the jurisdiction and the scale of offshore financial activities taking place there). One of the many adverse tax implications of being on the list is that a DAC 6 reporting obligation can be triggered if the recipient of a deductible cross-border payment, between associated enterprises, is resident in a jurisdiction on the list. Unfortunately, it is not yet clear how this development interacts with the deferral of reporting in the UK – in particular whether such payments to a Cayman recipient while Cayman was on the list (between 18 February 2020 and 6 October 2020) are required to be reported to HMRC. The point will be particularly relevant to those sectors which regularly use Cayman vehicles in investment structuring and it is hoped that HMRC will clarify the point before the reporting deadline for transactions in the period (being 30 January 2021 for reportable transactions after 30 June 2020, and 28 February 2021, for transactions on or before 30 June 2020 where the first step in implementation was taken on or after 25 June 2018).

HMRC has, however, published updated guidance on other aspects of the rules. The revised guidance:

- Confirms that an arrangement that otherwise concerns only one jurisdiction will not be considered “cross-border” solely because an intermediary involved in that arrangement is located in a different jurisdiction.
- Confirms that a non-UK, non-EU branch of a UK resident company, that provides aid, assistance or advice in respect of a reportable arrangement, will be subject to UK reporting obligations. However, HMRC would therefore not usually expect a DAC 6 report to be made where local data laws would restrict the ability to report, unless transactions were being actively routed through a branch in order to avoid DAC 6 reporting obligations.
- Addresses, in particular, the triggers for reporting (the so called “hallmarks”) which incorporate transfer pricing concepts. For example, as regards the hallmark for arrangements involving:
  - the use of unilateral safe harbour rules, HMRC has confirmed that (a) safe harbour rules agreed by jurisdictions on a bilateral or multilateral basis (such as OECD agreements) and (b) arrangements that have been properly priced on an arm’s length basis (even if they also happen to fall within a safe harbour rule) should not be in scope;
  - the transfer, between associated enterprises, of “*hard-to-value intangibles*” (i.e. those for which no reliable comparables exist and projections of future cash flows or income therefrom are “*highly uncertain*”), HMRC has confirmed that the degree of uncertainty must be higher than a normal level of uncertainty. While helpful, unfortunately, the subjective nature of the clarification leaves residual uncertainties as to how this is to be applied in practice; and
  - intragroup cross-border transfers of functions, risks or assets (where the earnings before interest and taxes (“EBIT”) of the transferor, are decreased by 50%), HMRC has provided additional guidance on the calculation of EBIT.

Given the impending reporting deadline, attention is now being focused toward the more practical aspects of mandatory reporting obligations. For example, trends are developing toward addressing reporting obligations in relevant contractual arrangements (including fund investor side letters and tax deeds in an M&A context). In addition, there continue to be substantive differences in how key aspects of DAC 6 have been implemented in different jurisdictions, including the applicability of hallmarks and the operation of legal professional privilege.

## (ii) DAC 7 update

Consensus has been reached on DAC 7, paving the way for the bolstering of information-gathering powers of tax administrations regarding income generated via the digital platform economy. The main aim is to provide better cooperation across tax administrations, whilst keeping business compliance costs to a minimum through providing a common EU reporting standard.

EU member states recently “reached consensus” on the proposed amendment (published on 15 July 2020) to Council directive 2011/16/EU (“DAC 7”) which requires the automatic exchange of information on revenues generated by sellers on digital platforms. In a departure from previous iterations, which focused on direct taxes, DAC 7 will also cover VAT. (For further information on its scope, see our [April Tax Quarterly Alert](#). This update was tweeted by Benjamin Angel, Director of Direct Taxation at the European Commission’s Directorate-General for Taxation and Customs Union: “Consensus reached on DAC 7...DAC 7 will ensure that tax administrations get information from platforms on transactions done by users in Member States, be the platforms located within the EU or outside.”<sup>5</sup> It is unclear when DAC 7 will become law, but it is expected in the very near term, as work has already begun on the next amendments to Council Directive 2011/16/EU - DAC 8 (see below).

## (iii) DAC 8: proposal for the automatic exchange of information relating to crypto-assets

Work has begun on “DAC 8” - the next version of the European Council Directive on Administrative Cooperation in the Field of Taxation (Council Directive 2011/16/EU). The proposals form part of EU efforts to create a framework for the (regulatory and tax) automatic exchange of information mechanics of crypto-assets. Feedback on the EU’s proposals is requested by 21 December 2020. Following a public consultation period (anticipated in the first quarter of 2021), the European Commission expects to publish legislation in the third quarter of 2021.

Last year, European Commission President, Ursula von der Leyen, emphasized the need for “a common approach with Member States on cryptocurrencies to ensure we understand how to make the most of the opportunities they create and address the new risks they may pose.”<sup>6</sup> The European Commission elaborated on that plan in mid-November, publishing a roadmap for bringing crypto-assets and e-money within the scope of existing automatic exchange of information mechanics. It is proposed that this would be achieved via a further amendment to the Directive on Administrative Cooperation in the field of taxation (a proposed “DAC 8”). If implemented, current information reporting and exchange regimes (such as the exchange of information on financial accounts reported by financial institutions) would extend to crypto-assets (as well as intermediaries for these assets, such as crypto-exchanges and brokers).

<sup>5</sup> <https://twitter.com/benjaminangeleEU/status/1330223479300497410>

<sup>6</sup> Mission letter of President-elect Von der Leyen to Vice-President Dombrovskis, 10 September 2019. [https://ec.europa.eu/commission/sites/beta-political/files/mission-letter-valdis-dombrovskis-2019\\_en.pdf](https://ec.europa.eu/commission/sites/beta-political/files/mission-letter-valdis-dombrovskis-2019_en.pdf)

Crypto assets are digital assets based on distributed ledger technology (“*DLT*”) and cryptography. DLT is a decentralised database used to record, share and synchronise the transaction of assets. The European Commission roadmap acknowledges that income derived from crypto-assets could be subject to taxation - a view widely held by tax authorities internationally. HMRC, for example, first published (non-binding) guidance on how it considers UK tax law applies to arrangements involving crypto-assets back in 2014. This guidance was subsequently updated, and supplemented, with guidance for businesses on the taxation of crypto-assets in 2019. Indeed last month, HMRC announced (at the OECD’s virtual Global Blockchain Policy Forum) its plans to soon release an entire manual of guidance on the subject.

However, the ability of tax authorities to ensure the appropriate application, and proper enforcement, of tax legislation to (and to transactions in) crypto-assets is hindered by two key issues which DAC 8 aims to tackle:

- First, the lack of information at national tax authority levels about the use of crypto-assets and e-money: As crypto-assets and e-money (and relevant intermediaries such as crypto-exchanges and brokers) are not fully covered by the existing provisions of DAC, tax authorities: (a) have to rely on taxpayers’ ordinary course self-assessment obligations and (b) (notwithstanding the international reach of crypto-asset technology) have limited tools to exchange any information which is reported between them. Moreover, there are inherent difficulties in identifying and taxing these new assets in the same way as more traditional assets, including (as identified by the Commission) “[t]he lack of centralised control for crypto assets, its pseudo-anonymity, valuation difficulties, hybrid characteristics and the rapid evolution of the underlying technology as well as their form...”<sup>7</sup>
- Second, the exclusion of crypto-assets and e-money from the scope of existing EU legislation, resulting in ‘*disparity in sanctions applied*’ thereunder to crypto-assets and e-money on one hand, and more traditional assets and currencies on the other.

The above concerns reflect that lack of information on crypto-assets and e-money is a major stumbling block for tax authorities and that, unless addressed, this will likely undermine the integrity of other information exchange initiatives in place to tackle tax evasion, such as the exchange of information from financial institutions on financial accounts set up by DAC 2 in 2014. Among other measures, the proposals would address this gap by extending DAC2 obligations to crypto-assets, and those who facilitate the holding of, and transactions in, them (e.g. exchanges and brokers). Feedback on the proposals was sought by 21 December 2020, to be followed by a public consultation in the first quarter of 2021, and the publication of an amending Directive in the third quarter.

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<sup>7</sup> European Commission Inception Impact Assessment. Ref. Ares(2020)7030524 - 23/11/2020  
<https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12632-Tax-fraud-evasion-strengthening-rules-on-administrative-cooperation-and-expanding-the-exchange-of-information>

## IV. UK developments

### (i) Fundamental changes to UK capital gains tax proposed in report published by Office of Tax Simplification

In November 2020, the Office of Tax Simplification (“OTS”) published the first of two reports on their review of the UK capital gains tax (“CGT”) regime, recommending significant changes. If implemented, the changes could potentially result in material changes to liabilities for UK taxpayers. Any recommendations adopted could be implemented as early as March 2021, when the Spring Budget is expected.

The OTS is the independent adviser to the government on simplifying the UK tax system. In response to a request from the Chancellor in July 2020, the OTS carried out a review of UK CGT, with the aim of identifying the policy design of, and the principals underpinning, CGT and then exploring opportunities to address any areas where the present rules distort behavior or do not meet their policy intent. The first report addressing the policy design and principles underpinning CGT was published in November (the "Report") and a second, technical report, is expected in early 2021. Whilst there has been a lot of media coverage of certain aspects of the OTS review (and certain areas that it highlights for review), it is important to note that the objective of the OTS is to set out a framework of policy choice about the design of tax.

The OTS formulated their Report by reference to four policy areas: (1) rates and boundaries; (2) the Annual Exempt Amount; (3) capital transfers, and (4) business reliefs.

The proposals focus on the liabilities of individuals, but cover neither the attribution of offshore gains to UK resident individuals, nor the CGT implications of an individual’s arrival or departure from the UK. The CGT treatment of trusts was also not addressed.

Eleven recommendations were made, with the most fundamental proposals related to addressing the disparity between the current rates of CGT (generally 20%) and income tax (from 20% to 45% for higher income earners). This discrepancy is correctly highlighted as one of the main sources of complexity in the area of individual taxation. Given that CGT rates are lower, individuals can be incentivised to arrange their affairs so as to re-characterise income as capital gains. There is, accordingly, a raft of complex UK anti-avoidance legislation targeting such re-characterisation techniques, such as the “transactions in securities rules” (which operate to tax a profit as income, rather than as a chargeable gain subject to CGT) and the “transactions in UK land” provisions (which seek, broadly, to ensure that profit arising in the context of trading transactions involving certain disposals of interests in UK real estate will be taxed as income, rather than chargeable gains). The areas that the Report indicates would most notably benefit from a greater convergence of the income tax and CGT rates are: (a) share-based remuneration, and (b) the accumulation of retained earnings in smaller owner-managed companies.

The Report does, however, also highlight the many arguments against raising CGT - in particular: (i) the inappropriateness of taxing an increase in value that is due simply to inflation, and (ii) a CGT rate increase may incentivise taxpayers to hold assets or otherwise alter commercial strategies in relation to in-scope assets.

The Report notes that, if the government did increase CGT rates, further knock-on amendments would be required in other aspects of the relevant tax legislation, including the anti-avoidance provisions referred to above, and there would be a case for considering a greater degree of flexibility in the use of capital losses.

Other proposals of interest in the OTS report include:

- a lowering of the annual exempt amount (£12,300 in tax year 2020-21) to a de minimis amount (on the basis that it is an ineffective means to achieve its stated objective of compensating for inflation, because it does not take holding periods or asset values into account). Instead, the OTS propose a broader exemption for personal effects (with only specific categories of assets being taxable).
- the replacement of Business Asset Disposal Relief (formerly Entrepreneurs' Relief - which, by way of reminder, reduces the CGT rate to 10% on the disposal of assets and shares meeting certain conditions) with a relief more focused on retirement.

It is not clear whether (and if so, to what extent) the UK government will adopt the recommendations from this Report or the OTS.

## **(ii) Finance Bill 2021 – updates following consultation responses**

The UK government has published draft legislation for the Finance Bill 2021, alongside explanatory notes, responses to consultations and other supporting documents (see our previous July 2020 Quarterly Update for list of tax policy consultations). Certain draft provisions for the Finance Bill 2021 were published in July 2020, at which point there was intended to be an Autumn Budget later in 2020. This was however cancelled as a result of the COVID-19 pandemic, and on 12 November, the government instead published further draft legislation, (without a budget). Consultation on the draft legislation will close on 7 January 2021, with the Finance Bill 2021 expected to be introduced to Parliament in spring 2021 and to receive royal assent in summer 2021. Notably, the publication of further legislation in spring 2021 raises the possibility that further new legislation will be introduced in 2021 with a very short consultation window.

### **(a) LIBOR withdrawal**

Following its consultation, over the summer, on the potential tax implications of the withdrawal of the London Interbank Offered Rate (“LIBOR”), HMRC has published its response, together with updated guidance for businesses and new draft guidance for individuals. The guidance, which should provide UK taxpayers with a path to circumvent potential adverse tax impacts of the withdrawal, will be welcomed by affected parties.

The publication of LIBOR is expected to cease after the end of 2021, such that parties to financial instruments, with a term beyond 2021, that reference LIBOR (so called “legacy contracts”) will need to be amended to refer to (or replaced with contracts that refer to) one of several alternate reference rates.

The consultation aimed: (i) to seek views on how the several UK statutory references to LIBOR should be amended as a result of the LIBOR withdrawal and (ii) to identify the tax impacts that could arise from the reform of LIBOR (and other benchmark rates). With only a few references

to LIBOR in the tax legislation (dealing with treatment of certain leases), on 12 November 2020, HMRC published draft legislation for inclusion in the Finance Bill 2020/21 to ensure the leasing provisions continue to function as intended. Helpfully, the draft legislation also introduces a power to allow any unintended tax consequences arising from the transition away from LIBOR (and other benchmark rates) to be addressed separately in secondary legislation.

HMRC has also produced guidance (updated on 12 November 2020 following responses to the consultation) that explains its view on the tax implications of amending financial instruments to respond to the benchmark reform. As discussed in our previous [Alert](#), the guidance (published in draft form in March):

- confirms that any amounts recognised in taxpayers' profit and loss statements as a result of such amendments will generally be taxed / relieved in the usual way; and
- addresses other potential tax implications, confirming, among other things that (a) amendments to legacy contracts would not generally be treated as giving rise to a new contract - provided amendments are on (broadly) economically equivalent terms, and (b) in such circumstances, provisions requiring taxpayers to test the economic reasonableness of the contracts' terms (such as transfer pricing, distributions and stamp duty relief, provisions) would not generally need to be revisited.

The guidance has now additionally been updated to:

- provide comfort that HMRC would generally treat amendments to financial contracts pursuant to (or on terms which mirror) market standard documentation (such as ISDA's IBOR Fallbacks Protocol) as constituting amendments on economically equivalent terms, (and hence as not generally giving rise to a new contract) - irrespective of whether amendments were booked as a new trade in internal systems;
- confirm that amendments to financial contracts via (or on terms which mirror) such market standard documents should generally be considered arm's length for transfer pricing purposes;
- confirm that the VAT treatment of one-off additional payments, made in connection with transition-related amendments, will follow the treatment of the underlying supply (and hence will generally be exempt for most financial transactions); and
- confirm that relief can be sought, under existing provisions of the hybrid mismatch rules, if differences in the tax treatment of the transition across relevant jurisdictions gives rise to timing mismatches.

In addition, HMRC published guidance for individuals, mirroring the position set out in the business guidance and additionally confirming that amendments to financial instruments would not generally give rise to a disposal for capital gains tax purposes.

It is worth noting that the tax treatment described above, and in the guidance, would not generally apply where taxpayers respond to LIBOR's withdrawal by replacing, rather than amending, legacy contracts. Nevertheless, for those taxpayers that opt to amend legacy contracts (on economically equivalent terms), the guidance should provide a path to minimising the tax implications of transition, and will be welcome relief for affected parties.

## **(b) Amendments to the hybrid and other mismatches regime**

On 12 November 2020, HMRC published its response to its consultation on certain aspects of the UK hybrid and other mismatches regime, together with some draft legislation to amend the rules, explanatory notes and a policy paper summarising other proposed legislative changes to be included in the Finance Bill 2021. The majority of measures will be welcomed by businesses. However, certain aspects of the regime continue to represent a missed opportunity to address certain instances where tax deductions are disallowed even in the absence of an economic mismatch.

The UK hybrid and other mismatches regime was introduced in 2017 to counter arrangements that give rise to hybrid mismatch outcomes and generate a tax mismatch. As mentioned in our previous [April](#) and [July](#) Tax Quarterly Alerts, HMRC consulted on certain aspects of the regime over the summer, particularly:

- the rules applying to “double deductions”, and the application of section 259ID income (a provision introduced in 2018 which broadly takes account of certain taxable income where there is no corresponding deduction);
- the definition of “acting together” (for the purposes of rules which broadly, aggregate the interests of persons acting together when testing whether parties to arrangements are under sufficient “commonality of ownership” to fall within the scope of the regime); and
- the application of the regime to certain categories of exempt investors in hybrid entities.

On 12 November 2020, HMRC published its response to the consultation, draft legislation and a policy paper summarising proposed new legislation to be included in the Finance Bill 2021. As the consultation process welcomed broader views on the UK hybrid regime, the scope of the policy paper details wider reforms and further draft legislation can be expected at some point in the future. Certain measures (noted with an asterisk\* below) are proposed to take effect retrospectively from 1 January 2017.

Whilst the majority of measures are intended to be helpful, some aspects continue to represent a missed opportunity to address certain instances where tax deductions are disallowed in the absence of an economic mismatch. A non-exhaustive list of key proposed measures is set out below:

- Changes will be made to provide reliefs to certain categories of taxpayer:
  - The definition of “acting together” will be amended to exclude cases where: (i) a party has a direct or indirect equity stake in a paying entity no greater than 5%, including votes and economic entitlements\*, and (ii) any investor holds less than 10% of a partnership that is a collective investment scheme (not dissimilar to Luxembourg’s implementation of anti-hybrid mismatch rules), which will take effect from the date of Royal Assent of the Finance Bill 2021. The changes, will be welcome news to investment managers, and funds, focusing on portfolio interests.
  - Counteractions will be prevented under certain parts of the rules where the recipient of a relevant payment is a tax exempt investor (akin to a qualifying institutional investor within the UK substantial shareholding exemption rules). It is intended that this will apply from the date of Royal Assent of the Finance Bill 2021.



- Counteractions will be prevented where payments are made to and from entities taxed as securitisation vehicles under the UK securitisation regulations\*.
- Amendments will be made to address the application of reliefs where there is dual inclusion income (broadly a single amount of ordinary income that is recognised twice for tax purposes where the relevant entities and jurisdictions involved correspond to those that benefit from a double deduction)
  - Section 259ID will be repealed\*. Instead, the definition of dual inclusion income will be widened to include income that is brought into account for tax purposes in the UK without generating a tax deduction in any other jurisdiction (e.g. payments from a US parent to a UK subsidiary that is disregarded for US federal income tax purposes). This treatment will only apply where that outcome would not have arisen but for the hybridity of the UK recipient which gives rise to a counteraction under the UK hybrid rules\*.
  - A new surrender mechanism for “surplus” dual inclusion income is to be introduced. This will allow entities within a group relief group to surrender dual inclusion income, for set-off against doubly deductible amounts elsewhere in the group. It is intended that this will apply from 1 January 2021.
  - In our [April Tax Quarterly Alert](#), we discussed potential issues with the current application of the double deduction mismatch rules (where section 259ID does not obviously apply). In particular, we considered a scenario where an intra-group payment by a US parent company to a UK subsidiary (that is disregarded for US federal income tax purposes) may give rise to a disallowance, under the UK hybrid rules, for an otherwise deductible expense incurred by the UK subsidiary - resulting in taxation on profits it does not economically possess. The example highlighted a broader issue with HMRC’s previous “fix” introduced in 2018 by section 259ID, which is highly narrow in its application. The above changes address the issues raised in the example, albeit with one caveat – that this treatment will only be available where the inclusion/no deduction treatment was created by the same element of hybridity as the double deduction under consideration. So, where a US parent makes a payment to its disregarded UK subsidiary, the new treatment will be available (i.e. it would have been the disregarded status of the UK subsidiary which gives rise to the inclusion/no deduction mismatch). Whilst the widened definition of dual inclusion income will be helpful for certain taxpayers, for others it will not. Common structures where UK subsidiaries that have been checked open incur costs from third parties, whilst only receiving reimbursement from another subsidiary or sister company that is also checked open, but resident in neither the US nor the UK, continue to face economic double taxation. That is unfortunate, particularly given that other countries (such as Ireland) have adopted a more pragmatic approach to the implementation of their hybrid regimes to prevent such an outcome occurring for taxpayers (and consistent with the OECD principle that double taxation should be avoided).

- More generally:
  - The carry forward treatment of illegitimate overseas deductions (amounts for which it is reasonable to suppose that (part of) a hybrid entity's double deduction amount is deducted under non-UK law for a taxable period from the income of any person, excluding the investor) under the hybrid rules is to be amended, so that where a relief is used by a multinational or dual resident company to set against its own single inclusion income, the relief will not be permanently denied in the subsidiary or branch. The amendments will take effect from the date of Royal Assent of the Finance Bill 2021.
  - Acknowledging that the interaction of the US Dual Consolidated Loss rules with Part 6A of the hybrid rules should not operate to deny loss relief in both jurisdictions, HMRC in its response to the consultation has indicated that the new surrender mechanism and changes to the definition of illegitimate overseas deductions above should simplify the economic effects of the US rules. HMRC guidance is also expected to be published in the future to clarify the interaction. The imported mismatch rule, will be amended so that: (i) condition E (which previously required the overseas regime to apply similar provisions to the relevant part of the UK rules) will instead test whether an overseas regime seen as a whole is equivalent to the UK hybrid rules and prevents any counteraction if it is (to apply from the date of Royal Assent of the Finance Bill 2021); and (ii) condition F (which provided taxpayers with a degree of protection against a counteraction by allowing consideration of UK tax attributes to mitigate against a foreign mismatch payment) will be repealed\*.

The draft legislation published to date only relates to the double deduction rules, and the application of section 259ID income. Although a timeline was not provided by HMRC, further draft legislation can be expected at some point in the future to address the remaining measures in the policy paper. HMRC has also indicated it will provide further clarification of certain points in forthcoming updates of its guidance on the hybrid regime.

Despite the many proposed changes, certain requests from consultation respondents have been explicitly rejected. These include the addition of a tax avoidance motive to the regime, an exclusion for small and medium-sized enterprises and the treatment of the US global intangible low-taxed income (GILTI) rules as an equivalent regime (so as to prevent a UK counteraction where a GILTI charge applies).

Given the scale of the hybrid and other mismatches rules and respective HMRC guidance, there has understandably been criticism of the UK's overly mechanical approach (as opposed to a more principles based approach taken by certain other EU jurisdictions).

### **(c) Delay in the implementation - uncertain tax treatment rules**

A proposed new obligation for businesses to notify HMRC of uncertain tax positions taken in their tax returns has been delayed until April 2022.

HMRC consulted, over the summer, on a proposed new requirement for large businesses to notify HMRC where they have adopted an uncertain tax treatment (an uncertain tax treatment being one where the business believes that HMRC may not agree with their interpretation of the legislation, case law or guidance). The proposals are designed to improve HMRC's ability

to identify tax treatments adopted by large businesses that do not stand up to legal scrutiny. In part, this is intended to aid HMRC's efforts to open an inquiry into relevant tax positions before the statutory deadlines have passed.

The consultation concluded on 27 August 2020, and attracted strong criticism from respondents for the level of ambiguity inherent in the proposed reporting requirement (in effect requiring a judgement as to what action HMRC might take in relation to any tax position – across the full range of UK taxes). The proposals were originally due to apply to tax returns filed after April 2021, but have now been delayed until April 2022. Helpfully, HMRC appears to have now accepted the original proposal was perhaps too subjective and difficult for businesses to assess. Consequently, it is looking at ways to make the definition more objective and straightforward to comply with, whilst minimising the administrative impact on businesses.

Businesses will understandably be relieved that HMRC is revisiting the proposals in light of critical responses to the consultation. In addition, the delay provides respite from a potentially costly administrative burden at an uncertain time for many businesses.

#### **(d) Extension of the annual investment allowance**

The UK government has announced an extension, until 1 January 2022, to the £1 million annual investment allowance for capital allowances purposes. The allowance gives relief for 100% of expenditure qualifying for capital allowances, up to the threshold, in the tax year the expenditure is incurred. The allowance was previously increased to a maximum of £1 million (from £200,000) for a 2-year period, but was due to expire at the end of 2020. The announcement will be welcome news for businesses, who may be incentivised to increase capital investment at a time where managing short-term liabilities may have otherwise been more in focus.

### **V. UK and EU VAT updates**

#### **(i) UK VAT grouping – Establishment, Eligibility and Registration Call for Evidence**

In August, HM Treasury published a call for evidence (“CfE”) to gather stakeholders’ views on certain elements of the UK VAT grouping rules. Feedback has been sought, in particular, on (a) the interaction of the UK’s establishment rules with other EU Member States’ and the application of the rules to overseas branches; (b) possible compulsory VAT grouping; and (c) grouping eligibility criteria for limited partnerships and Scottish limited partnerships.

#### ***VAT Grouping***

Broadly, VAT grouping rules enable “eligible entities”<sup>8</sup> under common control to register for VAT as a group, and be treated as a single taxable entity for VAT purposes. A VAT group files one VAT return through the group’s representative member and supplies made between VAT group members are disregarded for UK VAT purposes. The purpose of VAT grouping is to allow administrative efficiency and while the purpose of the mechanism is not to achieve VAT savings, in practice, in some circumstances, VAT grouping supports this result.

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<sup>8</sup> “Eligible entities” are generally bodies corporate, but can also include individuals, partnerships and Scottish partnerships, in certain circumstances.

### ***Establishment provisions***

The UK applies a “whole establishment” approach to VAT grouping. This means that “fixed establishments” (broadly akin to branches) of eligible persons, whether in the UK or abroad, are treated as part of the UK VAT group. This contrasts with other EU countries’ “establishment only” provisions, which the UK does not utilise. The “establishment only” rules provide that where an entity has “fixed establishments”<sup>9</sup> (or “branches”) in multiple jurisdictions, it is only the establishment in the country in which the VAT group is based that can be included in that VAT group.

Differences in VAT grouping rules have led to additional administrative and operational complexities for businesses. The document therefore calls for feedback on the benefits of adopting the “establishment only” provisions.

If the UK adopted the “establishment only” approach, only UK fixed establishments of foreign companies could be within a UK VAT group. This means that overseas branches of that foreign company could not join the UK VAT group – with the effect that supplies from foreign headquarters to a UK branch or a UK branch to foreign headquarters would be subject to VAT.

For entities/groups making exempt or partially exempt supplies, any input VAT incurred in connection with supplies from non-UK branches of the head-office (or other members of the group) would be irrecoverable (or partially irrecoverable), representing an actual cost for these groups. For those making solely taxable supplies, any input VAT incurred in connection with those supplies will be recoverable - albeit, that there may be a cash flow impact if periods of account are not aligned.

The CfE notes that an “establishment only” approach may reduce the administrative burden as groups will only then have to account for a reverse charge for VAT, and would not have to engage with anti-avoidance provisions introduced to prevent abuse of the existing rules (which the CfE contemplates would be repealed if the UK moved toward an “establishment only” approach). It is arguable whether the benefit of removing the anti-avoidance provisions will outweigh the additional administrative requirements that will come from adopting an “establishment only” approach - particularly for groups heavily reliant on internal supplies. Under the latter approach, compliance burdens may equally arise from the requirement to charge and account for VAT on certain recharges of staff costs, and any other supplies made between branches that are currently part of a UK VAT group.

### ***Implications of Skandia<sup>10</sup>***

As a result of the Court of Justice of the European Union’s (“CJEU’s”) judgment in Skandia, the UK introduced an exception to the “whole establishment” approach, effective 1 January 2016. Under this exception, if the overseas branch is a member of a VAT group in its local jurisdiction (which applies an “establishment only” approach to VAT grouping), then the UK head office and the overseas branch cannot be treated as the same taxable person, and VAT is applied to supplies made between them.

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<sup>9</sup> For UK VAT purposes, a “fixed establishment” is an ‘establishment other than the business establishment, which has the human and technical resources necessary for providing or receiving services permanently present’ (HMRC VAT Notice 741A).

<sup>10</sup> *Skandia America Incorporation (USA), filial Sverige v Skatteverket* (Case C-7/13) EU:C:2014:2225 (17 September 2014) (Advocate General: M. Wathelet).

The call for evidence seeks feedback on the potential reversal of the UK's changes to the VAT grouping rules following *Skandia*, acknowledging that the application of *Skandia* is administratively onerous for businesses. While this reversal would alleviate some VAT costs and compliance burdens for taxpayers, these benefits would be significantly outweighed by the costs associated with the introduction of any of the other proposals suggested in the CfE.

### ***Compulsory VAT grouping***

VAT grouping in the UK is currently optional for entities that meet the relevant control and establishment conditions. In particular, corporate groups can choose: (a) whether or not to form a VAT group and (b) which eligible entities in a corporate group should be a part of that VAT group.

In certain jurisdictions, however, VAT is compulsory for specific sectors. The government states that compulsory VAT grouping can offer administrative benefits, and level the playing field for businesses who would then all operate under the same VAT treatment.<sup>11</sup> The CfE seeks feedback on the introduction of compulsory VAT grouping into the UK.

Concerns have been raised, in particular, that compulsory VAT grouping is an “inflexible” approach, which will have significant adverse commercial consequences because of enforced joint and several liability that attaches to membership. It is notable that the recent introduction of compulsory grouping in Luxembourg is widely considered to have been unsuccessful, as a result of inflexibilities and resultant commercial difficulties.

### ***Eligibility criteria***

For VAT purposes, in a UK fund context (where the fund vehicle is typically either a limited partner (“LP”) or a Scottish limited partnership (“SLP”)):

- (a) The activities of the general partner (the “GP”) of the LP / SLP are treated as the activities of the fund vehicle (i.e. the LP / SLP, as applicable). The fund vehicle is therefore generally able to form a VAT group with the investment manager for the fund (as the GP will usually be part of the same investment management group as, and eligible to be grouped for VAT purposes with, the investment manager) allowing investment management supplies to be made to the fund free from VAT.
- (b) Since last year, LPs and SLPs have been entitled (but not required) to join a VAT group if the LP / SLP controls all the entities in the VAT group. “Control”, in this context, is tested by reference to whether the LP / SLP would, if it was a body corporate, be the holding company of the entities - a test which is itself determined by reference to voting rights / ability to appoint directors. Generally, this enables the fund LP / SLP (acting through the GP) and accordingly, the investment manager, to also be part of a VAT group with the fund's portfolio companies.

The CfE acknowledges the position described in paragraph (a) above, noting that the current VAT grouping rules enable LPs / SLPs to receive supplies from entities other than the GP free of VAT - notwithstanding that the GP typically has limited rights to the profits / assets of the funds - which are held, by fund investors, outside of the VAT group. The CfE therefore: (a)

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<sup>11</sup> <https://www.gov.uk/government/publications/vat-grouping-establishment-eligibility-and-registration-call-for-evidence>

contemplates limiting LPs' / SLPs' ability to join VAT groups, by imposing a requirement for common *beneficial ownership* and control, and (b) asks for stakeholders' views on the impact of such changes.

It was the combination of the rules in (a) and (b) above that led to the decision in *Melford*<sup>12</sup> (discussed in our [April Tax Quarterly Alert](#)). By way of recap, in *Melford*: (a) the fund's investment manager was grouped with the fund vehicle but (b) the parties had chosen not to include the underlying portfolio entities in the VAT group. As a result, (a) the investment manager was able to provide taxable supplies to the portfolio companies (thereby improving its recovery position) but (b) the fund was able to receive investment management services from the investment manager free from VAT (as those supplies were between members of the same VAT group, and hence disregarded). It is therefore possible that the result in *Melford* may have been the trigger for the CfE - with HMRC possibly seeking to (a) gauge whether/how to change existing rules to prevent the outcome achieved by the taxpayers in *Melford*, and (b) collect information regarding the collateral damage of the alternative approaches.

If this is indeed the case, it seems likely that restricting current fund grouping arrangements would cause material harm. In a funds context (or where an LP / SLP otherwise serves as a collective investment vehicle), if the proposals in the CfE were implemented, the fund vehicle LP / SLP would no longer be eligible to join a VAT group with:

- its GP and investment manager, with the effect that VAT would be payable by the LP / SLP on investment management services received from the investment manager; or
- the fund's portfolio companies, with the effect that VAT would be payable by the portfolio companies on any investment management services received from the LP / SLP.

This would increase compliance costs, and it's possible that at least some of the VAT payable by the fund LP / SLP, and/or the portfolio entities, may be irrecoverable. The proposals would, therefore, increase the cost of using UK fund structures. For existing funds in particular, these costs would not have been assumed at the time the fund was set up, or reflected in economic modelling (and accordingly, may distort results).

### *Next steps*

It is expected that the proposals mooted in the CfE would, if implemented, give rise to an increase in VAT costs for many UK taxpayers, in particular, for fund structures and financial services groups. UK VAT groups should continue to monitor this consultation process. We would expect further dialogue from HMRC in respect of this CfE over the coming months.

### **(iii) Input VAT recovery for financial services provided to customers outside the UK**

The Chancellor has announced that from 1 January 2021 (following the end of the Brexit-transition period), the VAT recovery position of UK financial and insurance service providers will not be restricted as a result of their making supplies to persons belonging outside the UK. Legislation to give effect to the proposals has not yet been published.

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<sup>12</sup> *Melford Capital General Partner v Revenue and Customs Commissions* [2020] UKFTT 6 (TC)

In order to obtain full recovery of input VAT incurred on costs, either: (a) the relevant costs must be directly related to the provision of taxable supplies or (b) the costs must form part of general overheads (and may be only partially recoverable to the extent the taxpayer makes exempt supplies). Financial services are generally exempt for UK VAT purposes. Accordingly, input VAT incurred in connection with the provision of financial services is currently generally irrecoverable.

In November, HMRC announced proposals which, broadly (if implemented), would mean that UK providers of financial services and insurance (including intermediary) services would be able to recover input VAT incurred on: (i) financial and insurance services supplied to customers belonging outside the UK (including to persons belonging in the EU) or directly related to an export of goods; or (ii) the making of arrangements for these supplies.

Supplies to UK customers will remain exempt for UK VAT purposes. Accordingly, UK financial and insurance businesses that make supplies to both UK and non-UK customers will need to calculate input VAT recovery in accordance with the partial exemption method.

As a result of the announcement, financial and insurance groups may wish to reconsider their intragroup VAT planning, particularly where the UK VAT group includes entities with EU branches (to whom the UK VAT group currently makes non-taxable supplies). Depending on their particular circumstances, it may be the case that the UK VAT group's recovery position could be improved by de-grouping such UK entities, with a view to recognising the supplies made to its EU branch for VAT purposes.

From a documentation perspective, it is important that suppliers maintain evidence to support the input VAT claimed, including invoices and any relevant correspondence establishing the connection between the input VAT claimed and supplies made to EU. Given the potential benefits of the proposed changes (if they are implemented), maintaining documentation and monitoring internal processes will become increasingly important.

#### **(iv) VAT treatment of termination fees – HMRC issues revised guidance**

HMRC has changed its position on the VAT treatment of termination charges and compensation payments, following the CJEU's judgements in *Meo* and *Vodafone Portugal*. HMRC's new position, set out in HMRC's Revenue and Customs Brief 12/20<sup>13</sup>, states that charges arising from early contract termination will generally be subject to VAT. Notably, this includes payments described as compensation or liquidated damages.

Prior to Brief 12/20, which was published in September, payments arising out of early contract termination were generally treated as outside the scope of VAT. In particular, payments would only be outside the scope of VAT to the extent that the termination payment, or the payment of liquidated damages, was contemplated in the relevant contract between the parties.

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<sup>13</sup> <https://www.gov.uk/government/publications/revenue-and-customs-brief-12-2020-vat-early-termination-fees-and-compensation-payments/revenue-and-customs-brief-12-2020-vat-early-termination-fees-and-compensation-payments>

Following the CJEU's decision in *Meo*<sup>14</sup> and *Vodafone Portugal*,<sup>15</sup>, HMRC has revised this position, now concluding that payments by a customer for early termination or cancellation of a contract in fact constitutes consideration for the original supply that the customer had contracted for. The new position applies to cases where the original contract contemplates such a payment, as well as cases where a separate agreement (outside of the original contract) is reached.

In *Meo*, the CJEU held that early termination charges (in the case at issue, under a telecom contract) reflect consideration for the supply of the original services, regardless of whether the customer uses that supply or not. More recently, in *Vodafone Portugal*, the CJEU confirmed that this would be the case even where the payment is not calculated by reference to the value of the services that would have been provided under the contract (but for the termination). HMRC's guidance confirms that, for the payment to be subject to VAT, there just needs to be a "direct link" between the termination payment and a taxable supply.

### ***Rate of VAT***

While we would expect the VAT treatment of termination payments to match the VAT treatment of the underlying supplies, it is not entirely clear whether this will be the case or whether such payments will be standard-rated. Further clarification is expected on this point.

### ***Retrospective effect***

Brief 12/20 states that any taxable person that has failed to account for VAT to HMRC on such termination payments should correct the error. This implies that HMRC intends the guidance to apply retrospectively. While it is not mentioned, we would expect the general VAT time limits for correcting past errors to apply. Consequently, termination payments received in accounting periods that ended within the past four years should be reviewed. If an adjustment is required, the supplier will need to pay the VAT due to HMRC and amend their VAT returns. (HMRC has not stated whether it intends to charge interest and/or penalties on any late-paid VAT where an adjustment is required. However, we would expect further clarification from HMRC on this point).

Suppliers should, in such circumstances, consider whether the contractual terms underlying the supply would enable them to pass the VAT cost on to their counterparty. However, even if counterparties are required, under such contracts, to bear the cost of such VAT, given the passage of time, there may be practical difficulties in recovering these amounts, particularly given the current economic climate. Looking forward, early termination and compensation clauses should be drafted to account for VAT costs and potential VAT adjustments.

### ***Particular applications***

#### ***Property-related transactions***

The revised guidance will likely have a significant impact on property-related contracts. The VAT position of landlords, property managers and developers should be reviewed where

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<sup>14</sup> *MEO - Serviços de Comunicações e Multimédia SA v Autoridade Tributária e Aduaneira* (Case C-295/17) EU:C:2018:942 (22 November 2018) (Advocate General: J. Kokott).

<sup>15</sup> *Vodafone Portugal – Comunicações Pessoais, SA v Autoridade Tributária e Aduaneira* (Case C-43/19)EU:C:2020:465 (11 June 2020) (Advocate General: G. Pitruzzella)



termination payments have been charged. Past and future payments for breaking a commercial lease will likely be subject to UK VAT, where the landlord has opted to tax the property. Similarly, for residential developers, termination payments incurred in connection with certain construction-related services (e.g. architect fees, surveyor costs, supervisory services), where these services do not constitute a single “design and build” contract, may attract UK VAT at the standard rate. It is expected that payments for breach of contract, such as dilapidation payments, will remain outside the scope of VAT.

### *M&A break-up fees*

There is a question as to whether the guidance extends to “break-fees” - a common compensatory clause in an M&A context, which requires one party to compensate the other if the agreement does not complete. This so-called “break-fee” is typically calculated as a percentage of the consideration that would have been payable had completion occurred. We consider it likely that:

- Where the contract provides for the seller (or the target) to pay the break-fee, the fee should not be subject to VAT. This is on the basis that the payment is disconnected from the consideration for the supply (that would otherwise have been made) under the contract - as that consideration would have come from the buyer, rather than the seller.
- If the break-fee is payable by the buyer, it is *possible* that the payment may be subject to VAT. However, the circumstances do differ from those contemplated in HMRC’s updated guidance - which describes the early termination of a supply that has (to some extent at least) taken place. A break fee, in contrast, is payable in circumstances where completion never occurred, and no supply was ever made from the seller to the buyer. On that basis, HMRC may take the view that break fees are outside the scope of VAT, even if payable by the buyer. In any event, if the contract was for the sale of shares, that supply would have been exempt from VAT, and the same treatment should extend to the break-fee.

## **Brexit**

On 31 December 2020, the Brexit transition period will come to an end and the legal consequences of the UK’s decision to leave the EU will take effect. This will have implications from a tax perspective - irrespective of whether a no-deal Brexit can be avoided. While the UK direct tax, and transfer tax, consequences are expected to be minimal, there will be some changes to national insurance contribution and VAT rules. Most significantly, customs duties may apply on the importation of a range of goods into the UK from the EU customs market (and vice versa). Indeed, the consequences are not limited to UK tax: leakage may be suffered on investment structures involving the UK and any of Germany, Italy and / or Portugal and certain EU resident subsidiaries of UK resident companies may face obstacles in accessing US double tax treaties.

Although the UK left the EU on 31 January 2020, from a tax perspective at least, the effect will not be felt until the end of the transition period, at 11pm on 31 December 2020. A non-exhaustive list of the key changes that will then take effect are set out below.

## ***UK direct tax***

The legal effects of Brexit will be minimised by the European Union Withdrawal Act 2018 (the “Withdrawal Act”). Broadly, the Withdrawal Act provides: (a) for EU law to be retained as a part of UK domestic law (except to the extent specifically repealed by the UK parliament) and (b) for EU case law, handed down prior to the end of the transition period, to remain binding for UK legal (and tax) purposes - to the extent not overruled by a decision of the UK Supreme Court or (as is proposed) High Court<sup>16</sup>. As a result, significant changes to UK direct taxes are not expected on 31 December.<sup>17</sup>

Nevertheless, there will be changes (and practical difficulties too). While it seems likely that the UK parliament may be keen to exercise these new powers, the enthusiasm of the UK courts remains to be seen. In the recent *Volkerrail*<sup>18</sup> case, the First Tier Tribunal opted to disapply certain UK tax provisions (restricting the surrender of losses between UK resident, and UK branches of EU resident, taxpayers) on grounds of incompatibility with EU law. Should HMRC appeal, it may present one of the first opportunities to test the High Court’s interest in exercising their freedom to depart from the CJEU. Moreover, following the end of the transition period, UK courts will no longer be able to refer questions about the application of EU law to the CJEU. Last week’s referral from the Upper Tribunal to the CJEU in *Gallagher*<sup>19</sup> (regarding the compatibility with EU law of territorial limitations on UK relief for intra-group transfers) is likely to be the last of its kind. Thus, even if retained EU laws remain on UK statute books, there is scope for conflicting applications in the EU and the UK– bringing an inherent risk of double taxation and enhanced compliance costs.

## ***UK transfer taxes***

Certain provisions of EU law prevent a 1.5% stamp duty / stamp duty reserve tax charge applying: (a) on issuances of securities into a clearing system or depositary receipt system in connection with the raising of capital or (b) on transfers of securities into such systems which are integral to such capital raising. The UK government has confirmed that these reliefs, which are frequently relied upon in capital markets transactions, will be retained.

## ***Social security contributions***

EU regulations<sup>20</sup>, which prevent internationally mobile workers from paying social security contributions in more than one EU member state, will cease to apply from 31 December. (For existing arrangements, a slight extension has been provided for “so long as the [arrangements]

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<sup>16</sup> Although the UK government has announced that it intends for the UK High Court to also have such power, legislation is not yet in place. Cases decided by the CJEU after 31 December 2020 will be merely persuasive authorities in UK proceedings.

<sup>17</sup> Following the end of the transition period, UK courts will no longer be able to refer questions about the application of EU law to the CJEU. In what may well be the last such referral for UK tax purposes, the UK’s Upper Tribunal this week referred questions to the CJEU about the compatibility of certain UK tax provisions (relating to reliefs for intra-group transfers) with EU law. The responses of the CJEU will only be relevant for transfers taking place prior to 31 December 2020.

<sup>18</sup> *Volkerrail Plant Ltd and others v HMRC* [2020] UKFTT 476 (TC)

<sup>19</sup> *Gallagher Ltd v HMRC* [2020] UKUT 354 (TCC). The responses of the CJEU will only be relevant for transfers taking place prior to 31 December 2020.

<sup>20</sup> Regulations (EC) No. 883/2004 and 987/2009

continue without interruption”). The UK has introduced legislation which (broadly) attempts to replicate the position under the regulations. However, as (most) EU member states have not reciprocated, the risk of double tax continues. The UK has, however, secured a bilateral agreement with Ireland, and intends to pursue similar agreements with other member states.

## **VAT**

Under current rules, goods imported into the UK from the EU (and vice versa) are generally subject to acquisition VAT - which the importer accounts for by way of reverse charge (if registered for VAT purposes). From the end of the transition period, such imports will instead be subject to import VAT (which under current rules, must be accounted for immediately). The UK government has introduced legislation, to take effect from 31 December, to ensure that this change does not accelerate the time at which importers must account for VAT. Equivalent treatment will be extended to imports from non-EU jurisdictions as well.

## **Customs duties**

The cost of the UK’s departure from the EU is likely to be most apparent in the context of customs duties. From 31 December 2020, (except to the extent otherwise agreed) customs duties, at rates determined by applicable World Trade Organisation (“WTO”) trading terms, will apply on goods imported into the UK from the EU (and vice versa). The UK published its WTO trading terms (the so-called “UK Global Tariff”) in May<sup>21</sup>. That contemplates that approximately 60% of items will be tariff-free, with the remaining 40% attracting duties at an average rate of approximately 6%. The EU, meanwhile, will apply its “Common External Tariff” (which imposes duties at an average rate of approximately 7%) to imports from the UK. Even if a “no-deal Brexit” can be avoided, any agreement under consideration at the moment is unlikely to be sufficiently expansive to materially improve this position. As the EU is the UK’s largest global trading partner, the economic impact is expected to be significant.

## **European tax**

The UK’s departure from the EU may also impact taxpayers’ position under the laws of EU member states. In particular, taxpayers will need to consider whether they can continue to access reliefs available under (a) the EU Interest and Royalties Directive<sup>22</sup> (the “IRD”), which generally prevents withholding tax arising on intra-group payments of interest and royalties and (b) the EU Parent / Subsidiary Directive<sup>23</sup>, which generally prevents withholding tax and direct tax applying on dividend payments (in each case, between EU-resident companies). Interestingly, the UK Withdrawal Act operates to preserve the benefit of these EU tax reliefs for *EU taxpayers* transacting with UK taxpayers. Unfortunately, this position has not been reciprocated by EU member states. As a result, even if treaty relief is available, (a) dividends paid from German entities to UK entities will now be subject to German withholding tax of at least 5%, (b) intra-group interest and royalties paid between UK- and Italian- resident companies will generally be subject to withholding tax of at least 10% and 8%, respectively and (ii) intra-group interest and royalties paid between UK- and Portuguese- resident

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<sup>21</sup> For further information see <https://www.gov.uk/guidance/uk-tariffs-from-1-january-2021>

<sup>22</sup> Council Directive 2003/49/EC

<sup>23</sup> Council Directive 2011/96/EU

companies will generally be subject to withholding tax of at least 10% and 5%, respectively (in each case subject to any domestic reliefs).

Finally, for EU-resident subsidiaries of UK-resident companies, access to treaty relief under their residence jurisdiction's treaty with the US may be impeded. This is because their parent would no longer be a resident of an EC / EEA member state for the purposes of the "derivative benefits" exemption to the limitation of benefits article in the treaty. For further information, see our [Client Alert](#) on the subject.

### ***Going forward***

The Withdrawal Agreement's retention of EU retained law will, to some extent, smooth the end of the transition period. However, significant portions of retained EU law cannot fully maintain the status quo, because this would require reciprocity from EU member states. It is therefore hoped that the UK government will continue to engage with EU member states (bilaterally if necessary) to remove (or at least reduce) leakage on EU/UK transactions.

More generally, from the end of the transition period, it can be expected that EU and UK tax law will begin to diverge. The extent of this divergence, and the substantive areas in which UK policy and legislation will depart from the EU, remain to be seen. Nevertheless, (particularly in the administratively-heavy field of VAT) it seems likely that the mere *fact* of such divergence will generate increased compliance costs for pan-European businesses.

## **B. Notable Cases**

### ***I. Blackrock HoldCo 5 LLC v HMRC [2020] UKFTT 443 (TC)***

HMRC sought to disallow UK tax deductions for all of the interest payable on \$4 billion worth of loans pursuant to UK and international transfer pricing rules and the unallowable purpose rule contained in the Corporation Tax Act 2009. The First-tier Tribunal rejected HMRC's arguments and found for the taxpayer in respect of both issues. However, it is likely that HMRC will appeal the decision.

This case arose following HMRC's decision to disallow the deduction by BlackRock Holdco 5 LLC ("LLC5") of loan relationship debits in respect of interest payable on \$4 billion worth of loan notes issued by LLC5 to its parent company, Blackrock Holdco 4 LLC ("LLC4"), under each of the unallowable purpose and transfer pricing rules.

### ***Background***

LLC5 appealed HMRC's decision in the First-tier Tribunal ("FTT") and the following issues were identified in the appeal:

- 1) Was a / one of the main purpose[s] of LLC5 being a party to the loan relationships with LLC4 to secure a tax advantage for LLC5 or any other person?
- 2) What amount of any debit is attributable to the main purpose of securing a tax advantage (if any) on a just and reasonable apportionment? (issues 1 and 2 being the "Unallowable Purpose Issue")

- 3) Do the loans between the LLC5 and LLC4 differ from those which would have been made between independent enterprises? (the “Transfer Pricing Issue”)

The dispute with HMRC arose from the acquisition structure of the US part of Barclays Global Investors business (“BGI US”) in December 2009. Blackrock Holdco 6 LLC, (“LLC6”), LLC4 and LLC5 were incorporated on 16 September 2009 and LLC 4 elected to be a disregarded entity for US tax purposes and as such interest accruing to it from the acquisition would not be taxed in the US.

On 31 March 2012, LLC5 entered into a loan agreement with LLC6, pursuant to which LLC6 loaned \$92,640,000 to LLC5. . LLC5 used these funds to make the interest payments due on certain tranches of the loan notes. On 30 September 2012, LLC5 entered into a loan agreement with LLC6, pursuant to which LLC6 loaned \$92,728,008 to LLC5. LLC5 used these funds to make the interest payments due to LLC4 in September 2012 on certain tranches of the loan notes.

LLC5 filed company tax returns for accounting periods ending 30 November 2010 to 31 December 2015 and claimed deductions on its interest expenses under the loan notes for the relevant accounting periods.

For each of the returns, HMRC concluded that “*no amount of the interest payable or the finance charges/or the payment to vary the terms of loan notes/or the other finance costs [by LLC5 in respect of the Loan Notes in the return period] is deductible for UK tax purposes and no amount may be included within the non-trade deficits arising on loan relationships as recorded on the company tax return for the period.*”

#### Unallowable Purpose Issue

The relevant provisions of the Corporation Taxes Act 2009 as applicable at the time of the transaction provided are contained in sections 441 and 442. In summary, Section 441 provided that a company may not bring into account any debits which on a “just and reasonable apportionment” is attributable to an unallowable purpose. Section 442 provided that a loan relationship of a company has an unallowable purpose if a party to the relevant loan relationship entered into a transaction which included a purpose (“the unallowable purpose”) which is not amongst the business or other commercial purposes of the company. Section 442 further provided that a tax avoidance purpose is only regarded as a business or other commercial purpose of the company if it is not “(a) the main purpose for which the company is a party to the loan relationship or, as the case may be, enters into the related transaction, or (b) one of the main purposes for which it is or does so”. References to a tax avoidance purpose are references to any purpose which consists of securing a tax advantage for the company or any other person.

Tax advantage is construed widely under the Corporation Tax Act 2010 as “*a relief from tax or increased relief from tax...*”

The FTT quoted a number of cases in relation to the identification of the “purpose” of a company.<sup>24</sup> The FTT went on to state that it was common ground that the deduction of loan

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<sup>24</sup> House of Lords case of *Inland Revenue Commissioners v Brebner* 1967 2 AC 18 as authority that it is the company’s subjective purposes that mattered. The case of *Mallalieu v Drummond (Inspector of Taxes)* 1983

relationship debits in respect of interest is a tax advantage and that it is *the subjective purpose of LLC5 that is to be considered in order to determine whether securing a tax advantage was the “main purpose” or “one of the main purposes” of its loan relationship with LLC4*. The FTT considered the evidence of a board member of LLC5 who stated that he had not taken account of any UK tax advantage in the decision to proceed with the relevant transaction. The FTT adopted the reasoning of the House of Lords in *Mallalieu v Drummond*, and stated that it was necessary to look beyond the conscious motives of LLC5 and take into account the inevitable consequences of entering into the loan relationship with LLC4 – one of which was the securing of a tax advantage. The FTT concluded that there was both a commercial and tax purpose in entering into the relevant loans and as such it was necessary to consider a “just and reasonable apportionment”. The FTT followed the obiter comments of Judge Beare in *Oxford Instruments UK 2013 Limited v HMRC* and concluded that as the tax advantage purpose had not increased the debits, on a “just and reasonable basis”, all of the relevant debits arising in respect of the relevant loans should be apportioned to the commercial main purpose rather than the tax advantage main purpose.

### The Transfer Pricing Issue

The FTT considered whether the terms of the loans entered into between LLC5 and LLC4 differ from those which would have been made between independent enterprises, taking account of all relevant information, including:

- (a) Would the parties have entered into the loans on the same terms and in the same amounts if they had been independent enterprises?
- (b) If the answer to question (a) is negative, would they, as independent enterprises, have entered into the loans at all, and if so, in what amounts, at what rate(s) of interest, and on what other terms?

The FTT took into account the analysis of expert witnesses on behalf of LLC5 (the “Joint Statement”) and HMRC (the “Gaysford Statement”) relating to transfer pricing. Both the Joint Statement and the Gaysford Statement agreed that it would have been possible for LLC5 to execute a \$4 billion debt transaction in December 2009 with an independent enterprise at similar interest rates to the actual transaction that took place between LLC5 and LLC4, but subject to different terms and conditions that independent lenders would have required to manage the credit risks appropriately.

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2 AC 861 as authority that when identifying a “subjective purpose”, such purpose can be wider than the conscious motive of the person concerned. In the case of *Oxford Instruments UK 2013 Limited v HMRC* 2019 UKFTT 254 (TC), Judge Beare considered the extent to which on a “just and reasonable apportionment” how much of any debit is attributable to an unallowable purpose whereby there are one or more commercial main purposes. Judge Beare stated that “*as long as the company can show that it had one or more commercial main purposes unrelated to any tax advantage in entering into, and remaining party to, that loan relationship, and that the relevant debits would have been incurred in any event, even in the absence of the company's tax advantage main purpose in so doing, then none of the relevant debits should be apportioned to the tax advantage main purpose*”. Judge Beare’s comments on this issue did not form part of the court’s conclusion on the facts of that particular case but provides a helpful analysis.

The FTT stated that although paragraph 1.42 of the Organisation for Economic Co-operation and Development (OECD) Guidelines<sup>25</sup> recognises that, “it may be helpful to understand the structure and organisation of the group and how they influence the context in which the taxpayer operates”, it is clear from the OECD Guidelines that a separate entity approach should be adopted. This approach is outlined in paragraph 1.6 of the OECD Guidelines as follows: *By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances (i.e. in “comparable uncontrolled transactions”), the arm's length principle follows the approach of treating the members of an MNE [multinational enterprise] group as operating as separate entities rather than as inseparable parts of a single unified business.* The FTT noted that such an approach is also consistent with the UK tax legislation, namely section 147(1)(a) Taxation (International and Other Provisions) Act 2010, which concerns the transaction or series of transactions made or imposed between “any two persons”. Accordingly, the FTT stated that the transactions to be compared are the actual transaction, a \$4 billion loan by LLC4 to LLC5 and the hypothetical transaction, a \$4 billion loan by an independent lender to LLC5 having regard to the covenants which such an independent lender would have required. The FTT concluded that, given the expert evidence, even though an independent enterprise would not have entered into the relevant loan on the same terms as the actual transaction it would, subject to various covenants, have entered into the relevant loans on the same terms as the parties in the actual transaction.

**II.** *Dunsby v HMRC [2020] UKFTT 0271 (TC) and Bostan Khan v HMRC [2020] UKUT 168 (TCC) (2 June)*

The First Tier Tribunal and the Upper Tribunal (“UT”) recently considered and applied the Ramsay principle of statutory interpretation in two separate cases: *Dunsby v Revenue and Customs Commissioners [2020] UKFTT 271 (TC)* and *B Khan v HMRC [2020] UKUT 168 (TCC) (2 June)*, respectively. Its application in these cases sheds some light on limitations of the principle, including that the UK courts will not recharacterise a composite transaction if the purposive interpretation of relevant tax legislation does not require it.

Briefly, the facts in *Dunsby* were as follows: the appellant (“D”) was the sole original shareholder and director of a company (the “Company”). D and the Company implemented a tax avoidance scheme (sold to them by a promoter) that was, in the words of the FTT, designed to allow shareholders in trading companies with distributable profits to receive those profits free of income tax. Broadly, the scheme involved the Company issuing a single share in a new class (the “S share”) to a non-UK resident, unconnected recipient (“G”). In exchange for a small subscription amount (£100), the holder of the S share had the right to receive income profits and distributions, but had no voting rights. The return of capital of the S share was limited to its nominal value. G created a Jersey trust (the “Trust”) and transferred the S share to the trustee. The terms of the trust essentially provided a de minimis hurdle payment for a charity; a de minimis hurdle payment for G and the majority of any further income (98%) would be received on trust for the benefit of D (0.5% and 1.5% of the further income would go to a charity and G, respectively). The Company declared a single dividend payment in

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<sup>25</sup> Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations approved by the OECD on 22 July 2010

respect of the S Share. D did not pay income tax on the amount received. HMRC (by way of a closure notice) amended D's self-assessment tax return - D appealed. The FTT dismissed the appeal, finding that the payment from the Company would be treated as income (and therefore taxable as income) received by D (either under the settlements anti-avoidance legislation, or - if that was the incorrect basis - under the transfer of assets abroad legislation). HMRC successfully argued that the receipt was to be treated as income to D under the settlements legislation.

What is particularly interesting about the judgment, however, is the FTT's application of Ramsay to arguments proposed by HMRC. The FTT (in dismissing one of HMRC's arguments) set out that it would be an incorrect interpretation of the Ramsay principle to, when applying tax legislation to a factual scenario, simply disregard transactions or elements of transactions which had no commercial purpose. Such an approach was dismissed by the FTT as "going too far". In Dunsby, HMRC had tried to argue an interpretation that ignored the true facts of the arrangement. The payments from the Company were in accordance with company law treatment of the transactions. When applying tax legislation to a set of facts, two steps are required: (i) determine on a purposive basis the precise transaction the provisions are to apply to; and (ii) apply that tax legislation to the transaction identified. The Ramsay principle was whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically (*Collector of Stamp Revenue v Arrowtown Assets Ltd* [2003] HKCFA 46 at [35]). Whilst the taxpayer was unsuccessful in this case, Dunsby serves as a reminder as to some of the limits of the Ramsay principle, frequently used by HMRC in defending its position.

The UT in *B Khan*<sup>26</sup> considered - and dismissed - arguments put forward by HMRC based on the Ramsay principle. The case concerned the tax treatment of the sale of a target company (the "Company") to an individual ("K") and of subsequent payments made from the Company. K acquired 100% of the Company for £1.95 million plus the net asset value of the Company. Immediately following the acquisition, the Company bought back 98 of the total 99 shares for consideration of £1.95 million. HMRC issued a closure notice, amending K's tax return by increasing the income tax due (on the basis that the buy-back of the 98 shares was a taxable distribution and subject to income tax).

K's (unsuccessful) appeal to the UT was based on the grounds that the FTT erred in failing to recognise the "true substance" of the transaction, which K asserted was that it was a composite transaction pursuant to which K, in return for entering into the various transactions, received the remaining share in the Company without £1.95 million distributable reserves. On this basis K (unsuccessfully) asserted that his income tax liability should have been calculated on his net receipt of the single share (rather than the single share, plus £1.95 million).

Of note with respect to the Ramsay principle, the FTT considered whether the construction of a tax statute, using a purposive statutory interpretation, required the court to consider solely one element of a composition transaction or, on the other hand, the whole of the transactions viewed together as a composite. The UT considered a line of case law that sets out what it considers to be the modern approach to the interpretation of taxing statutes (*Barclays Mercantile Business Finance Ltd v Mawson* [2005] STC 1; *UBS AG and DB Group Services v HMRC* [2016] UKSC 13; *Inland Revenue Commissioners v Wesleyan and General Assurance Society* (1946) 30 TC 11). The UT found that, whilst the process of statutory construction may

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<sup>26</sup> *B Khan v HMRC* [2020] UKUT 168 (TCC) (2 June)



reveal the relevance or otherwise of the economic effect of transactions, it should not be assumed that economically equivalent transactions should be taxed in the same way. The UK courts will not re-characterise a composite transaction if the purposive interpretation of relevant tax legislation does not require it.

### III. *Bluejay Mining plc* [2020] UKFTT 473 (TC)

HMRC denied Bluejay Mining plc (“Bluejay”) credit for input VAT incurred for the relevant VAT accounting period on the basis that Bluejay, a holding company, was not making taxable supplies to its subsidiaries for consideration and/or that there was no economic activity being carried on by Bluejay. The FTT instead found that Bluejay was carrying on an economic activity and allowed the appeal.

Bluejay is a UK incorporated holding company which is listed on the Alternative Investment Market. It operates in the mineral exploration and mining industry. Bluejay’s business model broadly consisted of Bluejay identifying a possible mining project following which the necessary exploration licence would be acquired by a locally resident subsidiary. Bluejay would provide technical services to the local subsidiary and would loans the funds to pay for such services to the local subsidiary. If and when the project is successful or the licences and relevant assets are sold to another company which is willing and able to take the project to exploitation, the intracompany debt is repaid.

As explained by the FTT, HMRC’s position was that Bluejay's central activity is to make a return through investing by buying shares in foreign mining companies. It also supplies technical services to its foreign subsidiaries. HMRC contended that in order to be able to claim input tax in relation to supplies of the services to the subsidiaries, Bluejay needed to be able to show that those services are supplied in return for a consideration. It also needed to show that those services are provided for the purpose of generating income on a continuing basis from the provision of those services, i.e., that it is carrying on an economic activity. Accordingly, HMRC’s position was that the purpose of the provision of the services was not to generate income on a continuing basis but to enhance the value of Bluejay’s investment in the subsidiary, and, as such, the services did not amount to an economic activity. The FTT noted that HMRC’s position required a re-characterisation of the contracts between Bluejay and its subsidiaries as HMRC were arguing that the “contracts as drafted do not represent the economic and commercial reality of the situation”.

The FTT concluded that the contracts do reflect the underlying economic and commercial reality of the transactions. The FTT stated that it was important that “the contract for services provides that invoices are to be settled within 30 days of the invoice being submitted and I cannot see this as anything other than consideration for the services rendered”.

In relation to the question as to whether Bluejay was carrying on an economic activity, the FTT considered the case of *Polysar Investments Netherlands v Inspecteur der Invoerrechten en Accijnzen C-60/90*<sup>27</sup> in the Court of Justice of the European Union (“CJEU”) and concluded that it is necessary to examine the actual services provided to a subsidiary in order to establish if the holding company is carrying on an economic activity. The FTT concluded that Bluejay was carrying on an activity when supplying technical services to its subsidiaries. It remains to be seen whether HMRC will appeal the decision.

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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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<sup>27</sup> In *Polysar*, the CJEU stated as follows: “*It does not follow from that judgment, however, that the mere acquisition and holding of shares in a company is to be regarded as an economic activity, within the meaning of the Sixth Directive, conferring on the holder the status of a taxable person... It is otherwise where the holding is accompanied by direct or indirect involvement in the management of the companies in which the holding has been acquired, without prejudice to the rights held by the holding company as shareholder*”.