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UK TAX QUARTERLY UPDATE - MAY 2021

To Our Clients and Friends:

Spring 2021 brought two key developments to the UK tax landscape. There was the Budget announcement delivered on 3 March (together with the Finance Bill 2021 published on 11 March), setting out medium-term tax and spending plans as the UK economy emerges from the COVID-19 coronavirus. This was followed by "Tax Day" on 23 March through which more than 30 tax policies and consultations were published with the aim to modernise UK tax administration and policy development.

It is perhaps too early to comment on the long-term effects of the COVID-19 coronavirus, however the UK government appears to be alert to the need for both short-term investment incentives to businesses, as well as longer-term increases in taxes to finance a broadening UK budget deficit. With the Chancellor agreeing to hold the Conservative Party's 2019 "triple tax lock" manifesto pledge not to increase the rates of income tax, national insurance and VAT, it is not surprising then that UK corporation tax was in the spotlight for this year's Budget. The main rate is set to increase from April 2023 to 25% on profits over £250,000 (whilst the rate for small profits under £50,000 will remain at 19%, with relief for businesses with profits under £250,000 so that they pay less than the main rate). Interestingly, the threshold rate of tax for meeting the excluded territories exemption under the UK's controlled foreign company rules would rise from 14.25% to 18.75%. In line with the increase in the main rate, the UK Diverted Profits Tax rate will also rise to 31% from April 2023.

What is more surprising, however, is the absence of broader changes to the UK capital gains tax regime in the Budget this year. In May, the Office of Tax Simplification ("**OTS**") published the second report in their two-stage review of the UK capital gains regime. Following publication of the first report in November 2020, in which they recommended significant changes (see our previous Alert), the OTS' second report considers key practical, technical and administrative issues associated with the current regime. Fourteen recommendations have been made, relating to (i) the treatment of deferred consideration; (ii) the treatment of corporate bonds; and (iii) the current reporting and payment processes. Despite expectations from observers, the government has not yet implemented any recommendations from the first report and so it remains unclear whether (and to what extent) the UK government will adopt the recommendations in the future. The details of the second report will be covered in further detail in the next Quarterly Alert. "Tax Day" also came with an open consultation on the government's tax administration framework, which sought to explore ways in which the interaction of taxpayers with the tax system (from registration to payment of tax) could be updated and simplified as the UK's tax system becomes increasingly digital.

At the international level, it remains to be seen whether the OECD's Inclusive Framework's aim of reaching consensus on its Pillar I and II initiatives by mid-2021 remains achievable. US treasury secretary Janet Yellen's speech on 5 April calling for countries to agree on a global minimum corporation

tax rate for large companies, and reports earlier this year that she had dropped the former proposal under the Trump administration to allow US companies to opt in to any new system for allocating taxing rights, will however provide fresh impetus for an agreement to be reached. Agreement however among EU nations on proposals for a 21% global minimum corporate tax rate would not be easy. Although higher tax countries such as France and Germany have initially been supportive, corporate tax rates vary significantly across the continent with countries such as Ireland already making it clear it will not amend its current 12.5% corporate tax rate.

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A. UK Budget 2021

I. Amendments to the hybrid and other mismatches regime

> The Finance Bill 2021 included significant changes to the UK hybrid and other mismatches regime. It addresses many, albeit not all, of the issues raised by respondents during last year's consultation. It is expected that the new measures will serve to simplify application of the relevant rules. Groups may wish to revisit their existing structures to assess the impact of the changes and to consider whether to elect certain rules to apply retrospectively.

The UK hybrid and other mismatches regime (the "**Regime**") was introduced in 2017 to counter arrangements that give rise to hybrid mismatch outcomes and generate a tax mismatch. As discussed in our previous December 2020 Quarterly Alert, HMRC published responses to its consultation on certain aspects of the Regime in November 2020 paving the way for wider reforms and further draft legislation to follow.

The Finance Bill 2021 included key provisions making significant amendments to the Regime addressing many (if not all) of the concerns raised with HMRC by taxpayers, advisers and industry bodies. Most of these provisions reflect the announcements and draft legislation previously published by HMRC in November 2020 (see our previous Alert), although there are some changes. The following elements in particular are worth noting:

Retrospective widening of "dual inclusion income"

The previously proposed widening of the concept of "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) which was due to have mandatory

retrospective effect from when the Regime was introduced in 2017, will now have effect from Royal Assent of the Finance Bill, although companies will be able to elect to apply the changes retrospectively.

The new dual inclusion income construct widens the existing rules, by capturing income taxed in the hands of a payee in the UK, but for which there is no deduction obtained by the payer in any jurisdiction, and that non-deductibility arises from the hybridity of the UK payee. The new definition introduces the concept of inclusion/no deduction income that may be treated as dual inclusion income when determining to what extent a double deduction mismatch should be counteracted. It will be welcome news for groups that receive income that is brought into account for tax purposes in the UK without generating a tax deduction in any other jurisdiction. This should however be read alongside the extension of the targeted anti-avoidance rule under the Regime to regard steps taken to engineer something to be treated as dual inclusion income as a relevant tax advantage under the rule.

We had previously discussed potential issues with the then current application of the double deduction mismatch rules (where section 259ID did not obviously apply). In particular, 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 for an otherwise deductible expense incurred by the UK subsidiary – resulting in taxation on profits it does not economically possess. The above described changes however will now render the intra-group payment as deemed dual inclusion income. Although the wider dual inclusion income concept is to be welcomed, certain groups may continue to face double economic taxation. In particular, where the intra-group payment is instead made by a non-UK sister company to the UK subsidiary (i.e. where sister company is also wholly owned by a US parent and disregarded). As there must be no deduction obtained by the payer in any jurisdiction, the deductibility of the payment by the sister company in the jurisdiction in which it is established will prevent the intra-group payment from being treated as deemed dual inclusion income. This is disappointing given that a number of multinational group structures are arranged in this way and under the proposed rules will continue to be subject to double economic taxation. Restructuring around this issue may be costly and administratively burdensome, at a time when other jurisdictions (notably Ireland) take a more pragmatic approach to their implementation of hybrid mismatch rules by preventing a counteraction in circumstances where economic double taxation can be demonstrated.

Intra-group surrenders of "surplus" dual inclusion income

In addition to the intra-group surrender mechanism stipulated in November 2020 for "surplus" dual inclusion income where there is a shortfall in another group entity, administrative requirements for the making, withdrawing or replacing consent to such claims for "surplus" dual inclusion income to be surrendered, have now been provided. Notably, such claims will need to be submitted to HMRC. The new mechanism will nevertheless help taxpayers whose group structure results in income arising in the "wrong" entity (compared to relevant expenses). The change is effective from 1 January 2021.

Illegitimate overseas deduction

Amendments have been made to the rules regarding illegitimate overseas deductions so that they will only disallow UK tax relief where the relevant double deduction is utilised for overseas tax purposes by

an entity other than the UK corporation tax paying company or its investors. The change which takes effect from the date of Royal Assent of the Finance Bill should allow the Regime to operate more proportionately and are likely to assist US groups with disregarded UK subsidiaries.

Acting together threshold

It had been proposed in November 2020 that the definition of "acting together" should be amended to exclude any investor holding less than 10% of a partnership that is a collective investment scheme (subject to certain rules preventing partners from artificially fragmenting their interests to fall below the threshold). Instead, that proposal has been replaced with specific provisions to ensure that counteractions under the Regime are simply disapplied where they arise in respect of participants in transparent funds who hold less than a 10% interest. So although investors in a fund will be treated as acting together, a similar position is reached by ignoring interests of relevant minority investors when calculating the size of any mismatch.

Helpfully, "fund" is defined to include any collective investment scheme or alternative investment fund for UK financial services law purposes, with no requirement that it be widely held. Such funds will be transparent if they are treated as transparent for UK income tax purposes. As such, funds structured as UK limited partnerships, Luxembourg SCSps or Cayman limited partnerships should benefit. The changes will have effect from the date of Royal Assent of the Finance Bill.

In line with the proposals in November, the definition of "acting together" will be amended to exclude cases where a party has a direct or indirect equity stake in a paying entity no greater than 5%, including votes and economic entitlements.

Retrospective changes to definition of "hybrid entity"

Changes to the definition of a "hybrid entity" were originally intended to operate so that it only tests whether an entity is transparent by reference to the laws where it and its opaque investors are established/resident. The status of the potential hybrid entity under UK law would no longer be considered, unless the entity or a relevant entity in its ownership structure is in the UK.

HMRC had explained that the alteration removes the need to make the previously announced changes in relation to US LLCs. That is, where an LLC is seen as transparent under its own tax law and that of all its investors, it will no longer be a hybrid entity, thus removing the risk of counteraction under the current Regime where the UK generally views an LLC as fiscally opaque (subject to the terms of its constitutional documents) and the US regards it as fiscally transparent (unless checked close) causing it to be treated as a hybrid entity. Having made the changes as part of the initial draft of the Finance Bill 2021, the government has since identified the draft legislation as having gone too far, with certain unintended consequences resulting. The government has decided to revisit the draft legislation in order to allow it to operate solely as intended – as a result the envisaged amendments will be postponed until the next Finance Bill. The changes (when they come) will be treated as having retrospective effect from when the Regime was introduced.

The many positive changes to the Regime resolve a number of issues, but not all of the problems experienced in relation to the existing rules. Certain requests from consultation respondents last year also remain unanswered. 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).

Groups may wish to revisit their existing structures to assess the impact of the changes and to consider whether to elect certain rules to apply retrospectively.

II. Loss carry-back extension

In order to provide further aid for businesses impacted by COVID-19 coronavirus, the UK government has extended the period for which trading losses may be carried back for tax relief purposes for relevant accounting periods ending between 1 April 2020 and 31 March 2022. As a result, taxpayers will be permitted to carry-back relevant losses to set against profits incurred in the three years leading up to the period in which the loss was incurred (rather than the one year currently).

As part of the new measures, there will be a £2 million cap on the amount that may be carried back more than one year for each relevant accounting period in which a loss is made, and the cap will apply on a group basis. As a result, businesses in the two year period that the extended relief is expected to be available may be eligible for a potential cash refund. The £2 million cap will not be pro-rated for short accounting periods and the new measures do not impact the amount of trading losses that may be carried back to the immediately preceding year (which remains unlimited for companies).

Such extended relief will need to be carried back to be offset against profits from the most recent years first. By way of example, a company that incurs a loss in the year to 31 December 2020 would, under the current rules, only be able to carry this loss back to set against profits of the year to 31 December 2019. Under the new rules, after 2019 profits are fully offset, up to £2 million of such losses may be carried back to first be set against profits arising in the previous year ended 31 December 2018 and then, if necessary, 31 December 2017. As the cap applies on a per tax year basis, a separate cap of £2 million would apply on the extended carry-back of losses incurred in accounting periods ending in the period 1 April 2021 to 31 March 2022.

Claims for such carry-back relief will be required to be made on a company tax return unless the losses available to be utilised more than one year before the beginning of the relevant period are below a de minimis of £200,000. Claims up to this amount may be made outside of a return so that the benefit is obtained without waiting to submit a company tax return for the period in which the loss is incurred.

As the £2 million cap applies at group level, groups that have a member making a claim in excess of the de minimis will be required to submit an allocation statement to HMRC showing how the £2 million cap

has been allocated between group members. If no group company is able to make a claim in excess of the £200,000 de minimis, then no allocation statement will be needed.

The extension of the carry-back relief rules will be particularly useful for taxpayers in previously profitable sectors that have been heavily affected by COVID-19 coronavirus. Such businesses should consider seeking to utilise this extension as early as possible to help with cash flows, alongside other available reliefs.

III. Capital allowances "super deduction" and extension of the annual investment allowance

As part of the Spring Budget 2021 the UK government has provided for two temporary first-year capital allowances over the next two years to boost investment and productivity levels as the UK economy recovers from the COVID-19 coronavirus. These are a 130% first year capital allowance for qualifying plant and machinery assets (the "super deduction") and a 50% first-year allowance for qualifying special rate assets. In addition, the annual investment allowance of £1 million will be extended to 31 December 2021. Although the announcement was headline-grabbing at the time, the measures viewed in light of the planned increase in the rate of corporation tax may be better described as a short-term incentive to bring forward investment spending plans in lieu of longer-term increases in tax.

From 1 April 2021 until 31 March 2023, companies investing in qualifying new plant and machinery assets will be able to claim a deduction against taxable profits at the following rates:

- a 130% first year allowance on qualifying plant and machinery within the main rate pool (which under the current rules attract a writing down allowance of 18% per annum on a reducing balance basis); and

- a 50% first-year allowance for qualifying special rate assets within the special rate pool (which under the current rules attract a writing down allowance of 6% per annum on a reducing balance basis). Special rate expenditure broadly includes integral features (including electrical systems, hot and cold water systems, heating, ventilation, lifts and solar shading) and certain long-life assets.

The £1 million rate of the annual investment allowance will also be extended to 31 December 2021, although it is due to revert to the previous limit of £200,000 as of 1 January 2022. The allowance gives relief for 100% of expenditure qualifying for capital allowances, up to the threshold, in the tax year in which the expenditure is incurred.

The draft rules for the new "super deduction" and 50% allowance specify a number of qualifying conditions in order for a company to be eligible. These include the following:

- relief is only available to companies that are within the charge to UK corporation tax;

- expenditure on qualifying plant and machinery must be new (i.e. not second-hand);
- the expenditure is incurred between 1 April 2021 and 31 March 2023;
- for expenditure incurred that is associated with a contract for plant and machinery, that contract was entered into on or after 3 March 2021; and
- certain existing exclusions for first-year allowances under the current rules will continue to apply, notably this disallows connected party transactions and expenditure on assets for leasing (although following later stage amendments to the draft rules, property lessors would be able to claim the "super deduction" and 50% allowance on investments in background plant and machinery for a building).

Companies using finance to invest in plant and machinery through hire-purchase arrangements should also be able to access the "super deduction", albeit subject to separate conditions, including that payments are made to actually acquire (rather than purely lease) the asset.

Taxpayers will need to carefully consider the timing of their asset purchases, with the new measures being strictly limited to expenditure incurred on or after 1 April 2021. Under existing rules for first year allowances, capital expenditure is generally incurred "as soon as there is an unconditional obligation to pay it" (rather than deemed to be incurred on the first day a trading activity is carried out). However, the Finance Bill provisions disapply this general rule where the expenditure is incurred pursuant to a contract entered into prior to 3 March 2021 (i.e. even if the unconditional obligation to pay arises after 1 April 2021). As a result certain expenditure incurred over the following two years will not be eligible for the new "super deduction" or the 50% allowance because it was already committed to before 3 March 2021.

At the other side of the two-year window, the "super deduction" for expenditure incurred in a chargeable period ending after 31 March 2023, is proportionately reduced according to the relevant number of days in the chargeable period that extend past 31 March 2023.

As first year allowances are not pooled for capital allowances purposes, disposals of relevant qualifying assets are subject to a "balancing charge" (i.e. treated as immediately taxable income), rather than reducing the balance of the pool. To prevent abuse of the new measures, the Finance Bill provides that if assets, for which a "super deduction" was previously claimed, is disposed of on or before to 31 March 2023, an additional claw back of relief is obtained by applying a time apportioned factor of 1.3 to the calculation of the balancing charge. Similar rules apply to the 50% allowance.

Without a cap on the amount of relief available under the new "super deduction" and 50% allowance, there are clear incentives for businesses to bring forward their investment plans to take advantage. Taxpayers will be wise however to carefully consider the timing of their investments, the conditions required to qualify and the interaction of these first-year allowances with other tax reliefs.

IV. Off-payroll working rules

> Planned reforms to the off-payroll working rules (IR35) have been introduced with effect from 6 April 2021, after being postponed by 12 months owing to the COVID-19 coronavirus. The new reforms require medium and large size private sector organisations to assess whether individuals falling within the scope of IR35 and employed through an intermediary are "deemed employees", and if so, to deduct income tax and National Insurance Contributions from any fees paid. This switches the burden of the determination from the intermediary to the client who ultimately receives the services from the individual.

On 6 April 2021, the planned reforms to the off-payroll working rules came into effect. This follows a decision made by the UK government on 17 March 2020 to postpone the introduction of the reforms to the private sector due to the impact of the COVID-19 coronavirus.[1]

The off-payroll working rules ensure that individuals who are employed through their own limited company ("personal service company") or other intermediary, but who would otherwise be treated as an employee if services were provided directly to the client, are treated as "deemed employees" and will be liable to pay income tax and National Insurance Contributions ("**NICs**") as if the individual was an employee.

The former IR35 regime required the intermediary to determine whether the individual would be a "deemed employee". Making a determination of whether an individual is a "deemed employee" requires a consideration of the terms of the contract between the client and the intermediary and the working arrangements in practice. If the individual is within the scope of IR35 and a "deemed employee", the intermediary was required to operate payroll, make deductions for income tax and NICs and make employer contributions for NICs on fees received for the services.

In April 2017, similar reforms were introduced in the public sector which switched the requirement to determine whether an individual providing services through an intermediary is a "deemed employee" from the intermediary to the client.[2] The factors used to make this determination have not changed. Following the 2017 reforms, if the individual's contract fell within the scope of IR35 and a public sector organisation regarded the individual as a "deemed employee", it would then be responsible for deducting income tax and NICs.

The changes in effect from 6 April 2021 have extended the 2017 reforms to clients in medium or large size private sector organisations. Accordingly, medium or large private sector organisations that employ individuals through a limited company or other intermediary must now determine if the individual should be regarded as a "deemed employee", issuing a "Status Determination Statement" to set out and explain their decision where the rules are found to apply. There is no change for contractors working for small, private sector clients, who will still be required to make the determination themselves. If the contracted individual falls within the scope of IR35, the medium or large size private sector client will retain the obligation to account to HMRC for any employment taxes associated with the contractor's services fee (i.e. as if it was a salary payment).

Contractors engaged through an agency or umbrella company (which itself engages the contractor as its employee and pays them subject to employment taxes) should not be subject to the new rules. That is, such an agency or umbrella company should not be treated as an "intermediary" under the IR35 rules according to a clarificatory statement issued by HMRC on 15 October 2020.

Whilst applying a decision to a group of off-payroll workers with the same role, working conditions and contractual terms may be appropriate in some circumstances, HMRC guidance stresses the importance to end-clients of making determinations on a factual case-by-case basis.[3]

B. UK Consultations

I. UK asset holding company regime (second stage consultation)

In December 2020, the government published its second stage consultation on the tax treatment of asset holding companies in alternative investment funds. Interestingly, the government has opted for a new standalone regime for eligible asset holding companies (rather than individual changes to existing rules). Responding positively to many of the concerns respondents raised during the first stage last year, the proposals will be welcome news for investors and asset managers.

We previously reported on the UK government's initial stage consultation on the tax treatment of asset holding companies ("**AHCs**") in alternative investment funds, including some of the issues inherent under the existing rules, as part of our April 2020 Quarterly Alert (see here). In December 2020, HM Treasury published its response to that consultation and, recognising there is a strong case for change in this area, sought views on more detailed design features for a more internationally competitive tax regime for AHCs. The consultation response, although positive, is the first in a number of expected consultations on potential changes to the tax treatment of UK funds and fund structures.

Most respondents to the March 2020 consultation agreed that a key aim of such funds is to ensure that its investors do not achieve a significantly worse tax outcome (including timing and administrative requirements) than if they had invested in the underlying investment directly. Identifying that a closely defined concept of an AHC would, in any event, be required if individual changes to existing rules were implemented, the government has instead opted for a new standalone tax regime for AHCs. The key features of the proposed regime are described below:

Eligibility

According to the response paper, the bespoke regime is intended to apply to the use of AHCs "*in structures where capital from diverse or institutional investors is pooled and managed by an independent, regulated or authorised asset manager in which the AHC plays an intermediate, facilitative role*". Accordingly, eligibility criteria will need to identify: (i) criteria for investors making investments via an AHC, (ii) how investors should be identified, (iii) criteria to identify the asset manager, and (iv) the character and activities of the AHC, with the government seeking feedback on how best to achieve

the relevant aims. In respect of criteria (iv) above, the government wants to restrict the regime to entities that serve to facilitate flows of capital, income and gains between investors and investment assets. It should not apply to funds that otherwise meet the above criteria but carries on activities that form part of the trade of a portfolio company.

It is anticipated that a company would need to elect into the AHC regime as part of its company tax return.

AHC taxation

The government has proposed that any taxable profit of an AHC should be proportionate to its intermediary role. The proposed AHC regime does not propose a fully tax exempt AHC, which may be helpful to funds seeking to access benefits under the UK's double tax treaty network.

In respect of deductions against taxable profits at the AHC level, provided the AHC practices the return of its profits to its investors, it is proposed that the AHC should be able to obtain relief against its taxable income (albeit, limited in accordance with transfer pricing principles). On the other hand, given the additional deductions available to an AHC under the regime, it is proposed that an AHC should not be able to surrender or claim losses as group relief.

The response paper provides little in the way of detail in respect of transfer pricing approaches, instead requesting feedback from respondents. Given the need of funds to accurately predict their taxable margins, this will be an important development.

Disposals of investment assets by an AHC would be subject to a new relief (instead of the existing substantial shareholding exemption) from taxation at the AHC level. An exception to the relief would be for UK land and assets that derive 75% or more of their value from UK land in accordance with existing rules. The government anticipates that gains not reinvested will be taxed when returned to UK investors (or on those investors when they dispose of their interest in the AHC), with the intention that the AHC regime should not be used to artificially defer tax on capital gains.

The government is also considering a specific exemption under the AHC regime from withholding tax on interest paid by an AHC to its investors, unusually, by reference to a purpose test to disapply the exemption where a main purpose is the escaping of tax imposed by any jurisdiction.

Taxation of investors

Under the proposals, the AHC rules should operate so that for investors within the scope of UK tax:

- amounts deductible from taxable income of an AHC and paid to investors are treated as taxable income in the hands of those investors; and
- amounts returned to investors that are attributable to capital gains realised by an AHC are treated as gains in the hands of those investors.

For income purposes, UK investors would be taxed on returns as if they were of the form from which the AHC had itself derived such income from its investments (e.g. interest income received from a portfolio company that is then distributed to the UK investor).

For capital gains purposes, the proposal is for amounts returned to investors that are attributable to capital gains realised by an AHC to be treated as capital gains in the hands of the investors. Given the complexity of certain funds and the variety of ways in which an AHC might return gains to investors, complex rules may follow to allow for the tracking of gains through fund structures. The government has also made clear this is an area where anti-avoidance rules will be needed.

More broadly, there will also be consideration of whether there is scope for a more simplified exemption from stamp duty and stamp duty reserve tax on some or all transfers of shares and loan capital in an AHC.

Real estate considerations

Under existing UK rules, investors are required to pay tax on rental income and capital gains on UK real estate even if those investors are resident outside the UK. The response paper is therefore careful to explain that any new AHC regime should not create risks of loss of UK tax on UK property income and gains for the government.

The initial proposed solution to this however is somewhat disappointing: that AHCs under the regime be prevented from owning UK land or UK property-rich assets. Helpfully, this approach is subject to further consultation, and the response paper also considers situations where an AHC would be permitted to hold UK real estate indirectly through a separate corporate vehicle.

The government received feedback on a number of areas where the UK real estate investment trust (“**REIT**”) regime could be improved. In particular, a relaxation of the current listing requirements for certain investors, as well as providing increased flexibility under the balance of business eligibility criteria, are currently being considered by the UK government. Whilst a more fulsome review of the REIT regime is intended to form part of a separate funds review, the government is considering a number of changes that could be made alongside the AHC rules that would make the UK a more competitive location for holding real estate assets.

The second stage consultation on a new AHC regime will be welcomed by investors and asset managers alike. A key comment from respondents however is that any new UK AHC regime will necessarily be compared to other domestic investment structures (such as those with AHCs in Luxembourg), and it is not clear to what extent (if any) a UK regime would need to provide benefits above and beyond those in other jurisdictions. Any such benefits would also need to be considered carefully, in light of the value attributed by investors to tax regimes that provide certainty and rules that are straightforward to follow.

II. UK funds review consultation

In January 2021, the government published a call for tax, regulatory and other input as part of its broader review of the UK funds regime. The paper sets out the scope and objectives of the review, and invites stakeholders to provide views on which reforms should be prioritised and taken forward. The wider aim being to make the UK a more attractive location to establish, administer and manage funds, and to support a wider range of more efficient investment vehicles better suited to investor needs.

The call for input follows last year's Spring Budget announcement (see our April 2020 Alert here) and sits alongside other areas of consultation (see second stage AHC consultation section above). It covers the areas that will be particularly relevant to UK asset managers and fund administrators, including tax, regulatory and other aspects of the regime. The government appears to have taken on the message that any new UK funds regime will need to compete directly with existing preferential regimes within established hubs (such as those in Ireland and Luxembourg). In addition to enhancing the UK's reputation as a location for new funds, any new regime should also consider the incentives provided for existing funds to move to the UK given the costs of re-domiciliation and speculated changes to the UK's capital gains tax and carried interest rules.

From a tax perspective, the call for input covers the following areas:

- Tax neutrality principle (that is, to ensure investors achieve a tax neutral treatment irrespective of whether they invest in an asset directly or through a fund vehicle) – recognising that as a practical matter the existing regime does not always achieve such tax neutrality for investors in funds (e.g. certain balanced funds that invest in both equity and debt instruments are not always entitled to tax deductions for distributions at the fund level giving rise to tax leakage), the consultation seeks views on ways in which the regime may be improved.

- Barriers within the existing REIT rules – recognising that the rules for REITs can be complex, the government will consider simplifying measures including the relaxation of the listing requirement, changes to how the close company test is applied, the application of the holders of excessive rights rules and how the "balance of business" test should operate.

- Issues with the UK approach to VAT on fund management services – the review paper only seeks initial responses to the issues at this stage (with separate actions to follow later this year). Nevertheless, the recoverability of VAT on management fee costs at fund level, and that the position of asset managers is not adversely affected by their incurring of irrecoverable VAT that would not arise had they provided management services to a fund established outside the UK, will be important to the success of any UK funds regime.

- Declining use of UK limited partnerships and tax-elected funds – the call for evidence seeks views as to why the use of UK limited partnerships has declined in recent years and take up of the tax-elected fund regime, introduced to facilitate onshore multi-asset funds, has been so

limited. The perceived complexity of each of the regimes compared to those in other jurisdictions which adopt more straightforward tax exemption models will likely be a factor. If so, the wider funds review provides an opportunity for more substantive (rather than incremental) changes to the taxation of these vehicles.

The consultation closed on 20 April 2021. The British Private Equity and Venture Capital Association ("**BVCA**") published its response on the same date, noting the importance of the UK limited partnership regime (English and Scottish) to the UK private funds industry and the relative ease with which legal and tax enhancements may be made without the need for an entirely new regime for unauthorised fund structures. The BVCA response also reiterated the importance of preserving the UK's capital gains tax and carried interest rules in an increasingly competitive global marketplace and in order to attract asset managers to the UK.

The scope of the review and range of proposals will be welcome news. Given the trend within the funds industry to accumulate holding vehicles in a single jurisdiction (in order to satisfy even more stringent international substance requirements for tax purposes), it is helpful that the UK funds review comes alongside coordinated consultations on the UK asset holding company regime. More details of the proposals and the ways in which they would operate are to follow, however funds and asset managers will be keen to assess whether any new UK funds regime is straightforward to access and is competitive with those of other key EU and non-EU fund domiciles.

III. Uncertain tax treatment consultation

On 23 March 2021, the government published its second consultation on proposals to require large businesses to notify HMRC in advance if they have taken a tax position contrary to HMRC's. Whilst certain aspects of the proposal have changed for the better (such as a series of more objective triggers for when an uncertain tax treatment occurs), the requirement and administrative burden for large businesses to provide HMRC with information to help them identify and resolve potential disagreements at an earlier stage remains.

We previously reported on the delay (until April 2022) of a new obligation for businesses to notify HMRC of uncertain tax positions taken in their tax returns (see our see our previous Alert). As part of its Tax Day announcements in March this year, the government has published its second consultation on uncertain tax treatment that will broadly require large businesses to notify HMRC in advance if they have taken a tax position contrary to HMRC's.

The first consultation last year received widespread criticism from respondents that the proposal was too subjective and difficult for businesses to assess. HMRC appears to have taken note, with the new consultation aiming to obtain feedback on a series of more objective triggers for determining when an uncertain tax treatment occurs. It is proposed that these will be scenarios where the tax treatment:

- results from an interpretation that is different from HMRC's known position;

- was arrived at other than in accordance with known and established industry practice;
- differs from how an equivalent transaction was treated in a previous return;
- is in some way novel, so that it cannot reasonably be regarded as certain;
- is the subject of a provision in the company's accounts;
- results in a deduction greater than the related economic loss; or
- has been the subject of professional advice that either contradicts other advice received or has not been followed.

Whilst more helpful than the proposal as part of the first consultation, a number of the new triggers are still likely to be viewed as too subjective (with significant scope for further HMRC guidance). The second consultation requests views from stakeholders on the threshold for notification, exclusions from the requirement to notify and input on a new penalty regime. Helpfully, the second consultation provides that the new measure would only apply to VAT, income tax (including PAYE) and corporation tax (rather than all taxes envisaged under the first consultation). The previous materiality threshold of £1 million has instead been replaced with a figure of £5 million, as a means of reducing the administrative burden for businesses. In addition, there will now only be one penalty for failure to notify a tax uncertainty, which would fall on the entity rather than on any individual (with slightly different rules applying to large partnerships). Despite these positive changes, the underlying policy rationale for the new regime has still not been fully explained. As a result, taxpayers may be concerned that the proposals are a disproportionate response to the issues HMRC has identified and hopes to solve.

Other aspects are yet to be explained, such as the position of taxpayers that do not have a HMRC Customer Compliance Manager, and the expected actions where a tax position becomes uncertain after a report has been made (e.g. following subsequent updates to HMRC manuals). Whilst certain aspects of the proposal have changed for the better, the requirement for large businesses to provide HMRC with information to help them identify and resolve potential disagreements at an earlier stage remains.

IV. Transfer pricing documentation consultation

On 23 March 2021, the government published a new consultation to seek views on the clarifying and strengthening of UK transfer pricing documentation requirements. The consultation aims to explore potential changes to: (i) transfer pricing record keeping requirements for the largest businesses, and (ii) the introduction of a new tax filing requirement for all businesses affected by transfer pricing regulations.

The current transfer pricing documentation requirements are governed by relatively generic record keeping requirements for businesses to keep sufficient records to deliver complete and accurate tax returns. The new proposals as part of the consultation may require certain businesses to keep additional

transfer pricing information in a standardised format in order to be promptly provided to HMRC upon request, and to provide further details in their annual tax return about material cross border transactions with associated entities.

The government is seeking feedback on the introduction of a new requirement for multinational enterprises within country-by-country reporting groups to provide HMRC with a copy of the master file and local file within 30 days of request. In addition, the benefits of requiring the local file to be supported by some form of evidence log is being explored

The consultation also seeks to align the UK with the approach taken by a number of other jurisdictions, which require businesses to file an annual schedule reporting data about intra-group cross-border transactions. Such an international dealings schedule is proposed to be in addition to any requirement for a master and local file. It would apply to those businesses within the scope of the UK transfer pricing rules (that is, other than small and medium sized businesses that are generally exempt), and UK-to-UK transactions would be excluded.

C. Other UK Developments

I. Deferral of HMRC's VAT treatment of compensation and termination payments and VAT grouping consultation update

VAT Treatment of Compensation and Termination Payments

HMRC has updated its guidance on the VAT treatment of compensation payments and termination charges by withdrawing previously published amendments stipulating that such payments will generally be subject to VAT having retrospective application. Instead, the revised VAT treatment will take effect from a "future date" (still to be determined at the time of writing), and HMRC will issue revised guidance to assist businesses with the new approach.

In our previous Alert, we discussed Revenue and Customs Brief 12/20 which concluded that, in HMRC's view, payments by a customer for early termination or cancellation of a contract constitutes consideration for the original supply that the customer had contracted for. That is, such payments will generally be subject to VAT including with retrospective effect. Previously, payments, including compensation or early termination payments, were regarded as outside the scope of VAT.

When Revenue and Customs Brief 12/20 was first published in September 2020, the amendments were not well received by industry, which raised concerns about the negative effects to the principle of legal certainty arising from the retrospective application.

On 25 January 2021, HMRC decided that the VAT treatment set out in Brief 12/20 would no longer have retrospective application, but that it would apply from a "*future date*".[4] Although the particular date is currently unclear, HMRC has provided welcome clarification that businesses have two choices about how to treat payments until further guidance is issued. This includes: (i) treating payments as

consideration for a supply and therefore liable to VAT, or (ii) regard the payments as outside the scope of VAT (if that is how they were treated before the HMRC Brief) until further guidance is published. Until this time, it may be prudent for taxpayers to review any termination and compensation payments within new or existing contracts that may fall within the scope of the revised guidance, to enable swift action once further guidance is published.

VAT Grouping

Following last year's call for evidence to review VAT grouping provisions in the UK, the UK government announced plans within the Spring Consultation to publish the responses in summer 2021, although the government would not take the issue any further.

In August 2020, HMRC issued a call for evidence to examine the operation of VAT grouping provisions in the UK, and determine how the provisions impact businesses and the wider business environment in order to inform future policy.[5] The call for evidence sought information on the establishment provisions; compulsory VAT grouping; and the eligibility criteria for limited partnerships who are not within the current legislation, which is discussed further in our previous Alert.

In the 2021 Spring Consultation, it was announced that whilst the responses to the call for evidence would be published by summer 2021, the government would not take the issue further.

As discussed further in our previous Alert, we identified concerns raised in relation to the additional administrative burden of the "establishment only" approach, the inflexibility of compulsory VAT grouping and an increase in compliance costs for funds that may not be recoverable. Given that the proposals in the call for evidence may have increased VAT costs for UK taxpayers, the decision by the government to take no further action may be welcomed, particularly by fund structures and financial services groups.

II. Brexit developments: EU/UK social security co-ordination and repeal of UK's implementation of the EU Interest and Royalties Directive

EU / UK Social Security Coordination

Following the UK's exit from the European Union on 31 December 2020, the EU-UK Trade and Cooperation Agreement has introduced a Social Security Protocol which seeks to replicate the former social security coordination between the UK and the EU under the EU's Social Security Regulations.

Prior to 1 January 2021, the EU's Social Security Regulations[6] provided that an individual is only subject to the social security rules of one member state at any time, and typically contributions will be payable to the state where the work is done. Limited exceptions to the basic principle included: (i)

individuals working in two or more member states, and (ii) those who worked in the UK on a short term assignment. In effect, the Social Security Regulations prevented an individual from paying social security contributions in multiple member states and protected against the risk of double taxation.

The EU–UK Trade and Cooperation Agreement includes a Social Security Protocol, which has largely replicated the existing social security coordination between the UK and EU. As before, an individual to whom the Social Security Protocol applies shall be subject to the legislation of one state only – namely, the state where the employment activities are performed. Two exceptions however remain for: (i) detached workers; and (ii) employees working in two or more member states.

Detached workers who are seconded by UK employers to work in an EU member state on a temporary basis for a maximum period of 24 months will remain within the scope of UK National Insurance contributions. Unlike under the Social Security Regulations, there will be no prospect to extend the 24 month period. Notably, and in contrast to the Social Security Regulations, this was an "*opt in*" provision, but by 1 February 2021, all EU member states had opted in, and agreed to apply the provisions. However, each EU member state can opt out of the rules in the future with only one month's notice.

The Social Security Protocol maintains that where an employee works in the UK, as well as one or more EU jurisdictions, the employee will be subject to contributions in the jurisdiction where the employee resides, provided that at least 25% of their working time or remuneration is pursued there. Otherwise, a number of tests (depending in part on how many employers the employee has) is applied to determine whether contributions are payable in the UK or the EU.

The Social Security Protocol is applicable to both UK and EU nationals, and to third-country nationals who are or have been subject to the social security system of either the UK or an EU country, but not to individuals working in EEA countries (Iceland, Norway, Lichtenstein or Switzerland) who may be required to obtain further documentation to permit payment of National Insurance contributions in the UK.[7] It will cover new assignments, or employees starting work in multiple locations on or after 1 January 2021. Any arrangements in effect prior to this date will continue to be governed by the Social Security Regulations for so long as the existing arrangements continue unchanged and without interruption.

Repeal of the Interest and Royalties Directive

The Finance Bill 2021 has repealed UK law that gave effect to the EU Interest and Royalties Directive, effective from 1 June 2021. As a result, UK companies will no longer be able to rely on the withholding tax reliefs for interest and royalty payments between connected companies. Such companies are instead advised to deduct tax at the respective double tax treaty rate, which may be nil, although not necessarily in all cases.

The EU Interest and Royalties Directive[8] was implemented into UK law in 2004. It ensured that intra-group interest and royalty payments between connected companies in different EU member states were

not treated less favourably than such payments between connected companies within the same member state.

Where each of the following conditions were satisfied: (i) the payee is a company resident in an EU member state other than the UK; (ii) the payer is a UK tax resident company or a UK permanent establishment of an EU company; and (iii) the payer owns at least 25% of the payee (or vice versa) or a third company owns at least 25% each of the payer and payee, the EU Interest and Royalties Directive aimed to remove, wherever possible, withholding taxes on payments of interest and royalties between such connected companies.

When the Brexit transition period ended on 31 December 2020, the EU Interest and Royalties Directive was no longer applicable to the UK. The UK implementing laws were however still in force and so its provisions still apply to payments of interest and royalties paid from the UK to EU member states. The Finance Bill 2021 repealed the UK implementing laws, with effect from 1 June 2021. The effect of this is that interest and royalty payments made from UK resident companies to eligible connected companies resident in the EU will no longer be exempt from withholding tax.

- Instead, from 1 June 2021, withholding tax obligations will be governed "*solely by the reciprocal obligations in double taxation agreements*".[9] In many cases, the double taxation agreements may, subject to relief application to HMRC, reduce or eliminate withholding tax obligations, reducing the impact on tax liabilities . However, UK resident companies should carefully consider the applicable rate and conditions under the relevant double taxation agreement between the UK and relevant EU member state where a connected company is expected to receive such interest or royalty payments.

III. UK property-rich collective investment vehicles – limited portfolio exemption for offshore CIVs

In 2020, the UK government consulted on new legislation relating to "UK property-rich" collective investment vehicles ("CIVs") and their investors for UK capital gains tax purposes. New legislation has been introduced so that specified investors in UK property-rich CIVs are (provided certain conditions are satisfied) treated as not having a substantial indirect interest in UK land at the time of a relevant disposal for capital gains tax purposes.

New UK regulations came into effect on 24 March 2021 amending the tax treatment of non-UK investors in UK property-rich CIVs. This follows consultations that took place late in 2020.[10]

The Finance Bill 2019 first introduced the ability to tax gains made by non-UK residents on UK property, including specific rules for 'UK property-rich' CIVs and their investors. The effect of the legislation was that offshore CIVs that are not partnerships were by default treated as companies for the purpose of chargeable gains, and disposals of interests in offshore CIVs by non-UK resident investors would also be subject to UK tax.

Under the 2019 rules, CIVs were treated separately to the treatment of UK property-rich assets (i.e. assets that derive at least 75% of their value from UK land). Non-UK resident investors were liable to pay tax on any gain arising from a disposal of a UK property-rich asset where they owned at least a 25% interest (directly or indirectly) in that entity (a substantial indirect interest). Non-UK resident investors in CIVs however did not have the benefit of the substantial indirect investment test and did not have to satisfy the 25% ownership threshold before tax was payable.

The new CIV regulations seek to redress this imbalance. Under the new rules, an offshore CIV disposing of a UK property-rich company will be deemed not to have a substantial indirect interest if the CIV:

- meets the non-UK real estate and genuine diversity of ownership conditions;
- is not a UK feeder vehicle (i.e. where at least 85% of the market value of the assets of the vehicle at that time derives from units in a single CIV that is UK property-rich) immediately before the disposal; and
- immediately before disposal, the offshore CIV did not have a 10% interest in the UK property-rich company.

The effect of this is that non-UK resident investors in offshore CIVs that dispose of an interest in a UK property-rich company will not be treated as having a substantial indirect interest in UK land at the time of the relevant disposal. Accordingly, non-UK resident investors will not be liable to pay capital gains tax on the disposal, provided that the conditions listed above are met. This will be welcome news to non-UK resident investors in UK land and helps to prevent potential situations of double taxation where non-UK resident investors dispose of their interests in a CIV vehicle.

IV. Draft regulations to implement OECD Mandatory Disclosure Rules

The UK government plans to begin consultations to implement the OECD Mandatory Disclosure Rules after the scope of mandatory reporting under DAC 6 was significantly narrowed shortly before the end of the Brexit transition period.

As noted in our January DAC 6 update, the UK government narrowed the scope of mandatory reporting under the EU Mandatory Disclosure Regime, (“**DAC 6**”), in the UK with effect from 11 pm on 31 December 2020. As a result, only cross-border arrangements (i.e. those concerning the UK or an EU member state) falling within the Category D hallmark of DAC 6 (broadly, those that (a) have the effect of circumventing the OECD’s Common Reporting Standard, or (b) obscure beneficial ownership) will be reportable.

As part of the Finance Bill 2021, the UK government confirmed that it will begin consultations on, and the implementation of, mandatory reporting under the OECD Mandatory Disclosure Rules. No specified time frame has been provided for the consultation, but HMRC explained that it will be “*as soon as*

practicable" in order to transition from European to international rules. It is also likely that the existing legislation which implements DAC 6 in the UK will be repealed.

V. Possible changes to UK stamp duty procedures

During the COVID-19 pandemic, HMRC relaxed procedures for the stamping of instruments subject to UK stamp duty. Updates to HMRC's guidance suggest that these processes may be permanent.

The "stamping" of instruments subject to UK stamp duty is an analogue process: it requires the instrument of transfer to be posted to HMRC, a physical stamp affixed to the instrument (once HMRC is satisfied that the duty had been paid), and the stamped instrument posted back to the taxpayer or its advisers. The process typically takes approximately 6 to 8 weeks. Procedures were, however, relaxed as a result of the COVID-19 pandemic. Since March 2020, HMRC has: (a) accepted, via email, pdf copies of instruments of transfer and instruments signed electronically; and (b) instead of physically stamping the instrument, (once satisfied that stamp duty has been paid) provided taxpayers with a letter of acknowledgment directing registrars that the register of the company transferred can be updated to reflect the change of shareholder. While the process still generally takes 4 to 6 weeks, the changes have been widely welcomed, and HMRC issued a consultation in the summer of 2020 about modernising the stamping process. In April 2021, guidance (first published in March 2020) to explain the above-mentioned changes was updated, to remove references to "temporary measures" in place "during the pandemic", and instead refer to "new measures". While HMRC has yet to make an announcement, the updates suggest that the processes currently in place may be permanent.

D. International Developments

I. EU consultation on VAT rules for financial and insurance services

On 8 February, the European Commission ("**EC**") launched a public consultation on the VAT rules applying to the supply of financial and insurance services, with a view to updating and rationalising existing rules. The consultation closes on 3 May, with the EC proposing to introduce a new directive in the last quarter of 2021.

Supplies of financial and insurance services are generally exempt for VAT purposes. While this makes the cost of the supplies more competitive to customers, it restricts the ability of financial and insurance businesses to recover their input VAT. The consultation identifies a number of concerns about the VAT rules in this area:

- The law has developed over the years through fact-specific case-law, rather than coherent policy decisions. Supplies of fund management services to defined benefit pension schemes are taxable, for example, while those provided to defined contribution pension schemes are generally exempt.

- The rules are often applied inconsistently across member states, jeopardising neutrality and creating uncertainty.
- The exemption for financial services may not adequately address the increasingly sophisticated types of financial and insurance services developed in the interim.

A number of alternatives for addressing the above concerns have been put forward – each involving a trade-off between the benefit of greater simplicity, and policy concerns about increasing costs for consumers. Proposals include the possibility of: (a) removing the VAT exemption entirely for financial and insurance supplies, with VAT charged at the standard rate, or alternatively, reduced rates; (b) limiting the scope of exempt financial and insurance supplies; (c) granting businesses the option to tax financial and insurance supplies and (d) reinstating financial and insurance businesses' flexibility to address irrecoverability through VAT group and cost-sharing groups (mechanisms which have, in recent years, been curtailed[11] or removed for financial services providers[12], respectively).

The consultation comes at an interesting time. Since the end of the Brexit transitional period, UK suppliers of financial and insurance services have been able to recover input VAT on exempt supplies made to recipients in the EU. The potential competitive advantage for the UK financial industry may serve as a catalyst for EU reform. Further, with the end of the Brexit transitional period last year, the UK is no longer obliged to keep in step with EU VAT developments. The UK Treasury's own consultation on the VAT treatment of financial services (which was widely expected to open on Tax Day) has yet to be published. If there is clarity on the proposed changes to EU VAT rules by the time the UK consultation concludes, this delay may prove wise: a consultation on the future of UK VAT rules is likely to produce the most considered outcomes when it is informed by the wider VAT landscape in which those rules sit.

II. EU public country-by-country reporting

EU proposals for so-called "public country-by-country reporting", first mooted in 2016, are gaining traction. Broadly, EU jurisdictions (and many others) currently require parent companies of large multinational groups to annually report (generally to their home tax authority) key financial information for each jurisdiction in which the group operates. New EU proposals would, if implemented, require large groups with EU operations to publicise such information.

BEPS Action 13 standards (which have been adopted in over 90 jurisdictions) require parent companies of multinational businesses with annual global revenues of over €750 million to provide tax authorities with an annual breakdown, for each jurisdiction in which the group operates, of revenue, (pre-tax) profits/losses and tax paid and accrued. In February, 16 EU member states (the minimum necessary for the proposal to advance) agreed to support a draft directive for public reporting of (broadly similar) information - albeit on a slightly less granular basis (with information on non-EU jurisdictions generally being aggregated).

The draft directive currently contemplates that the reporting obligation would apply to groups meeting the above-mentioned €750 million threshold whose parent company is incorporated in an EU member

state, while those with an EU subsidiary or branch (other than a small-sized enterprise) would also need to "comply or explain". Businesses subject to the EU's Capital Requirements Directive IV would be exempt.

The EC will now negotiate with the European Parliament (who favour more onerous requirements) on the draft directive, with a view to reaching agreement by the end of June. If the proposals are implemented, it would likely be a watershed moment for tax transparency. However, the costs are likely to be felt not only in the form of additional compliance burdens, but also in the potential chilling effect on legitimate tax planning (which non-tax professionals may view with suspicion).

III. New OECD COVID-19-related guidance

The OECD has published specific guidance on the application of: (i) transfer pricing principles[13]; and (ii) double tax treaties[14], in the context of the COVID-19 pandemic.

As discussed in our April and July 2020 Quarterly Alerts, there has been uncertainty over the last year as to how transfer pricing principles and double tax treaties should be applied in the novel context of the COVID-19 pandemic. The OECD has now published new guidance on these subjects, which (while expressly not intended to displace existing OECD guidance) is intended to provide greater clarity.

Transfer pricing guidance: The new transfer pricing guidance addresses: (i) comparability analysis; (ii) losses and the allocation of COVID-19-specific costs; (iii) government assistance programmes; and (iv) advance pricing agreements. Highlights include practical suggestions for addressing the absence of contemporaneous comparability data, such as providing flexibility in related party contracts for terms to be retrospectively updated to reflect contemporaneous comparability data when it becomes available). The guidance also confirms that (while each advance pricing agreement should be assessed on a case-by-case basis) changes in economic and market conditions arising from the COVID-19 pandemic are likely to qualify as a breach of the critical assumptions under the OECD's advance pricing agreement guidelines.[15]As discussed in our April and July 2020 Quarterly Alerts, there has been uncertainty over the last year as to how transfer pricing principles and double tax treaties should be applied in the novel context of the COVID-19 pandemic. The OECD has now published new guidance on these subjects, which (while expressly not intended to displace existing OECD guidance) is intended to provide greater clarity.

Tax treaty guidance: The guidance addresses (amongst other things) concerns relating to: (i) residence and the creation of permanent establishments; (ii) agency and construction site permanent establishments; (iii) changes to an individual's residence status; and (iv) income from employment. In particular, the guidance confirms that (in the OECD's view): (A) neither "*the exceptional and temporary change of the location where employees exercise their employment*" nor "*the temporary conclusion of contracts in the home of employees or agents because of the COVID-19 pandemic*" should create a permanent establishment for businesses; and (B) "*a temporary change in location of board members or other senior executives is an extraordinary and temporary situation due to the COVID-19 pandemic and such change of location should not trigger*

a change in treaty residence." In an employment tax context, however, the guidance notes that "an exceptional level of coordination between jurisdictions is needed to mitigate the compliance and administrative costs for employees and employers associated with an involuntary and temporary change of the place where employment is performed", and (where relevant) recommends recourse to mutual agreement procedures.

The decision as to how these topics will be dealt with ultimately rests with local tax authorities. Unfortunately, (unless the tax authority has issued guidance on its intentions), whether they will choose to follow the OECD's pragmatic approach is only like to become apparent once the crisis has abated.

E. Notable Cases

I. Danske Bank A/S v Skatteverket (C-812/19) and The Commissioners for Her Majesty's Revenue & Customs v Wellcome Trust Ltd (C-459/19)

Two key VAT decisions were handed down by the Court of Justice of the European Union ("**CJEU**") in March 2021: *Danske Bank*[16] and *Wellcome Trust.*[17]

Danske Bank A/S v Skatteverket (C-812/19)

Background

Danske Bank's head office was located in Denmark and was part of a Denmark VAT group. The company carried on activities in Sweden through a branch which did not form part of any VAT group. The head office provided a computer platform to the branch for the purposes of its activities in Sweden and re-charged a portion of the costs to the branch. A question arose as to whether the supply of the platform by the head office to the branch was a supply for VAT purposes and subject to a VAT reverse charge in Sweden.

Drawing on the principle set out in *Skandia,* the CJEU found in favour of the Swedish authorities, and held that by joining the Danish VAT group, the head office became a taxable person for VAT purposes, separate from the branch. Accordingly, VAT applied under the reverse charge mechanism on the services provided to the Swedish branch.

Observations

The *Danske* decision is likely to have implications for cross-border businesses operating through branches in the EU and third countries. Not only will this decision increase VAT compliance and administrative obligations for these businesses, exempt or partially exempt groups that had previously relied on the decision in *FCE Bank*[18] (which held that services between a head office and a branch could be ignored for VAT purposes) will now be subject to VAT, such VAT being, in whole, or in part, irrecoverable - representing an actual cost. For those solely making 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.

While financial institutions are hopeful that the EC's review of the VAT rules[19] (currently subject to public consultation (as noted above)), will lead to the removal of the VAT exemption on supplies of financial and insurance services (allowing recovery of any input VAT incurred on the relevant supplies) it is not yet clear whether this indeed will be the outcome, or when a new VAT directive would take effect. Accordingly, the *Danske* decision will likely force businesses to review their intra-group supplies, in the interim.

The CJEU noted that EU VAT grouping rules should be limited territorially, meaning that overseas branches should not belong to a domestic VAT group (i.e. supporting an 'establishment only' approach). It will be interesting to see whether member states that apply a 'whole establishment'[20] approach to VAT grouping, like Ireland and the Netherlands, will be forced to revise their rules as a result.

As the decision in *Dankse* was delivered following the end of the transition period, the UK is not bound by this decision. The UK currently applies a 'whole establishment' approach to VAT grouping, accordingly, UK VAT groups are not subject to this territorial limit and overseas branches may be treated as part of a UK VAT group (subject to the treatment of the branch under the VAT grouping rules in the other jurisdiction).

***Wellcome Trust Ltd* (C-459/19)**

Background

The CJEU upheld the Attorney-General's decision[21] (reported in our July 2020 Quarterly Alert) determining that a UK trustee receiving services from an overseas supplier in connection with its non-economic activities must account for VAT under the reverse charge mechanism (with potential irrecoverable VAT suffered) where those services are used in a business, and not a private capacity.

Observations

The CJEU rejected the argument that a taxable person receiving services in connection with its non-economic activities was not a 'taxable person acting as such' for the purposes of Article 44. The CJEU distinguished between a taxable person carrying out non-economic activities in a business capacity and non-economic activities in a private capacity, noting that the latter would not fall to be treated as a "taxable person acting as such" under Article 44. Consequently, the Court noted that for the purposes of determining the place of supply for VAT purposes in this instance, the purpose of the non-economic activities should be clearly documented.

II. HMRC v Development Securities PLC and Others [2020] EWCA Civ 1705

The Court of Appeal ("**CoA**") allowed HMRC's appeal that certain Jersey-incorporated subsidiaries of a UK parent were centrally managed and controlled in the UK by the directors of

the UK parent, and consequently, UK tax resident. Whilst the judgement expressed 'considerable reservations' about the First Tier Tribunal's ("**FTT**") conclusions on residency, the CoA ultimately overturned the Upper Tribunal's ("**UT**") subsequent decision on technical grounds.

Background

Jersey resident subsidiaries ("**Jersey Companies**") of a UK-resident company ("**DS Plc**") purchased UK real estate (the "**Assets**"), above value (the "**Acquisition**"). Immediately following the Acquisition, the Jersey Companies migrated to the UK (by replacing Jersey directors with UK resident directors) and transferred the Assets to other UK group members with an aim to maximise capital losses available to the UK group. Following advice from DS Plc regarding the arrangement, the directors of the Jersey Companies met in Jersey to approve the arrangement.

To maximise the capital loss position, the Jersey Companies had to be Jersey tax resident at the time of the Acquisition. This was contested by HMRC.

A company is resident in the UK if it is either (i) incorporated in the UK; or (ii) centrally managed and controlled in the UK. The latter is ultimately a question of fact. *De Beers Consolidated Mines Ltd v Howe*[22] is the leading authority on (ii), establishing the principle that a company resides where its real business is carried on and where decisions are in substance made.

The CoA decision

The CoA upheld the FTT's decision that central management and control had been exercised by the directors of DS Plc. The FTT determined that, while the directors of the Jersey Companies met in person, were made aware and had understood the arrangement, they were merely agreeing to implement transactions on the instruction of the directors of DS Plc, "*without any engagement with the substantive decision albeit having checked (in tandem with DS Plc) that there was no legal bar to them carrying out the instruction*".[23]

The CoA had restored the FTT's decision on the basis that the reasons for the UT overturning the FTT's decision, were flawed. It is interesting to note that the CoA did not necessarily agree with the FTT's decision. Lord Justice Nugee noted that he had 'considerable reservations' about the FTT's conclusions on residency and agreed with the taxpayers comment that "*the [First-Tier Tax Tribunal's] decision was the first time in any case where the local board of directors of a company had actually met, had understood what they were being asked to do, had understood why they were being asked to do it, had decided it was lawful, had reviewed for itself the transactional documents, had been found not to have acted mindlessly, but had nevertheless been found not to have exercised [central management and control]*."[24]

Observations

The CoA's decision is yet another example of the difficulties faced in applying the corporate residency test in practice. The CoA reiterates the importance of documentation and note-taking at board meetings however, falls short of clarifying the application of the residency test where an offshore company acts on instruction from a parent. It remains to be seen whether DS Plc will rely on Lord Nugee's reservations as support for an appeal to the Supreme Court.

III. Odey Asset Management LLP v HMRC [2021] UKFTT 31 (TC)

The FTT found that profits allocated to a corporate member as part of a deferral mechanism were subject to income tax (as miscellaneous income)[25] in the year amounts were ultimately received by the individual members.

Background

Odey Asset Management Limited ("**Odey**") was a UK partnership carrying on an investment fund management business. Under a special capital arrangement, individual members' right to receive partnership profits (an "**Individual Share**") were deferred until certain performance conditions were satisfied. Each year, Odey paid the Individual Shares to a corporate member of Odey ("**PSCL**") (the "**year of allocation**"). PSCL would contribute these amounts to Odey subsequently reallocate these profits (subject to the satisfaction of certain conditions) at which time, the individuals could withdraw their Individual Share (the "**year of receipt**"). Odey held that the individual members were not subject to income tax on their Individual Share in the year of allocation or of receipt.

HMRC disagreed, arguing that each individual member is subject to tax:

- on their Individual Share in the year of allocation under section 850 of the Income Tax (Trading and Other Income) Act 2005 ("**ITTOIA**");
- in the alternative, in the year of receipt under section 687 of ITTOIA (relating to miscellaneous income), or
- if section 687 ITTOIA did not apply, under sections 773 to 778 of chapter 4 of part 13 of the Income Tax Act 2007 ("**ITA**") (relating to the sale of occupation income).

HMRC lost on (1) but won on (2). The FTT noted that (3) would not apply in this case.

(1) Section 850 of ITTOIA

Section 850 provides that the share of partnership's trading profits treated as arising to a partner is by reference to the current "profit-sharing arrangements" defined as, "rights of the partners to share in the profits of the trade and the liabilities of the partners to share in the losses of the trade". The FTT held

that a "right" referred to an immediate legal entitlement to receive profits. While the profits had been 'ear-marked' for particular individuals in the year of allocation, receipt of those amounts was conditional on meeting certain performance criteria. The FTT accordingly held that the Members had no such "right" in the year of allocation and that section 850 did not apply.

(2) Section 687 of ITTOIA

The FTT held that the amounts received in the year of receipt were subject to tax under section 687 - which operates as a 'sweep up' provision, applying to income 'from any source'. The FTT held that:

- sums received were analogous to employment income (in effect, as a deferred bonus);
- the "source" of the amounts is the individual members employment ; and
- drawing on the Upper Tier Tribunal's decision in Spritebeam[26], there was a 'sufficient connection' between the individuals employment and the amounts received, notwithstanding the absence of any contractual obligation on Odey to pay these amounts.

(3) Section 773 to 778 of chapter 4 of part 13 of ITA

Broadly, a tax arises under these provisions where: (i) an individual carries on an occupation; (ii) an individuals earning capacity is exploited by putting another person in a position to enjoy all or part of the income derived from the individuals activities; and (iii) a capital amount is received by the individual in connection with (ii).

The FTT determined that condition (ii) was not met as PSCL was not put 'in a position to enjoy all or part of the income derived from the individuals activities' - it received those amounts in its own right. Interestingly, the FTT reached a different conclusion in *HFFX LLP & Ors v HMRC*[27] finding that amounts allocated to the corporate member (in lieu of being paid to individual members) were subject to tax under these provisions.

Observations

It is interesting that HMRC relied on the operative income tax provisions and did not bring a claim under the targeted anti-avoidance rules despite, as the FTT noted, the clear tax motives behind the arrangement. Given the broad scope of section 687 of ITTOIA, we may see HMRC increasingly seek to tax individual members receiving 'capital' amounts (calculated with reference to employment activities), as income. Over the years, HMRC has introduced a myriad of rules (for example, the disguised investment management fee rules and the income-based carried interest rules) that tax investment managers' performance-based fees, as income, and the *Odey* decision arguably now provides HMRC with yet another avenue through which this could be achieved.

[1] https://www.gov.uk/government/publications/off-payroll-working-rules-communication-resources/know-the-facts-for-contractors-off-payroll-working-rules-ir35

[2] https://www.gov.uk/government/publications/off-payroll-working-in-the-public-sector-changes-to-the-intermediaries-legislation/off-payroll-working-in-the-public-sector-changes-to-the-intermediaries-legislation

[3] https://www.gov.uk/government/publications/off-payroll-working-rules-communication-resources/know-the-facts-for-contractors-off-payroll-working-rules-ir35

[4] https://www.gov.uk/government/publications/revenue-and-customs-brief-12-2020-vat-early-termination-fees-and-compensation-payments

[5] https://www.gov.uk/government/publications/vat-grouping-establishment-eligibility-and-registration-call-for-evidence

[6] Comprised of Regulation (EC) 883/2004 on the co-ordination of social security systems and Regulation (EC) 987/2009, the implementing regulations.

[7] https://www.gov.uk/guidance/national-insurance-for-workers-from-the-uk-working-in-the-eea-or-switzerland

[8] EU Council Directive 2003/49/EC.

[9] https://www.gov.uk/government/publications/repeal-of-provisions-relating-to-the-interest-and-royalties-directive/repeal-of-provisions-relating-to-the-interest-and-royalties-directive

[10] https://www.gov.uk/government/consultations/draft-regulations-the-uk-property-rich-collective-investment-vehicles-amendment-of-the-taxation-of-chargeable-gains-act-1992-regulations-2021

[11] See for example, *Skandia* (Case C-7/13) and *Danske Bank* (Case C-812/19), discussed in section E below.

[12] As to which, see *DNB Bank* (Case C-326/15), *Minister Finansów v Aviva* (Case C-605/15) and *EC v Germany* (Case C-616/15).

[13] Guidance on the transfer pricing implications of the COVID-19 pandemic: https://www.oecd-ilibrary.org/social-issues-migration-health/guidance-on-the-transfer-pricing-implications-of-the-covid-19-pandemic_731a59b0-en

[14] Updated guidance on tax treaties and the impact of the COVID-19 pandemic, OECD, 21 January: https://www.oecd.org/coronavirus/policy-responses/updated-guidance-on-tax-treaties-and-the-impact-of-the-covid-19-pandemic-df42be07/

[15] Guidelines for Conducting Advance Pricing Arrangements under the Mutual Agreement Procedure, 2017: https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-

multinational-enterprises-and-tax-administrations-2017/annex-ii-to-chapter-iv-guidelines-for-conducting-advance-pricing-arrangements-under-the-mutual-agreement-procedure-map-apas_tpg-2017-20-en#page1

[16] *Danske Bank A/S, Danmark*, *Sverige Filial v Skatteverket* (Case C-812/19) EU:C:2021:196 (11 March 2021) (Advocate General: E. Tanchev).

[17] *The Commissioners for Her Majesty's Revenue & Customs v Wellcome Trust Ltd* (C-459/19) EU:C:2021:209 (17 March 2021) (Advocate General: G. Hogan).

[18] *Ministero dell'Economia e delle Finanze and Agenzia delle Entrate v FCE Bank plc* (C-210/04) EU:C:2006:196 (23 March 2006) (Advocate General: P. Léger).

[19] Launched as part of the EU's tax action plan for fair and simple taxation to support the EU's recovery (published 15 July 2020).

[20] This means that overseas branches of eligible persons, can be treated as part of a domestic VAT group.

[21] *Wellcome Trust Ltd* (C-459/19) (25 June 2020).

[22] (1906) 5 TC 198.

[23] *Development Securities (No. 9) Ltd & Ors* [2017] TC 0600 [430].

[24] *HMRC v Development Securities PLC and Others* [2020] EWCA Civ 1705 [101].

[25] Section 687, Income Tax (Trading and Other Income) Act 2005.

[26] *Spritebeam v HMRC* [2015] STC 1222.

[27] *HFFX LLP & Ors v HMRC* [2021] TC8023.

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