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UK TAX QUARTERLY UPDATE - FEBRUARY 2022

In this client alert, we outline a number of significant UK and international tax developments of recent weeks and months, many of which will continue to take shape as we move forward into 2022.

In the UK, domestic tax policy looks set to play as important a role as ever as the government continues to walk the tightrope of seeking to stimulate economic activity and investment, whilst raising much needed revenue. Forecasters have predicted strong economic growth over 2022, but this is against the backdrop of record pandemic borrowing, a drop in tax revenue figures for 2020/2021, high inflation and expected interest rate rises (of course exacerbating the government's cost of borrowing). Many will find themselves wondering if the current government will be able to hold out on all aspects of the "triple tax lock" pledge to not raise income tax, National Insurance contributions or VAT until 2024 – of course already side-lined in relation to National Insurance contributions which are due to increase by 1.25% from April 2022.

In the international tax arena, 2022 promises to be a seminal, perhaps "make or break", year. The OECD's BEPS 2.0 project is in full motion, at least as regards Pillar II in relation to which model rules were published in a flurry of activity in December 2021. With a scheduled 2023 effective date, some degree of turmoil looks inevitable as numerous stakeholders get to grips with the finer details of local implementation – and that's before we even begin to understand the interplay with US domestic tax policy and reform. Pillar I proposals on the other hand would appear to be considerably less advanced and so far less certain to succeed, although model rules for domestic implementation are still expected in early 2022.

In any event, we expect to see the UK government continue to stake the UK's claim to be "open for business", with significant measures in the asset management and investment funds sector in particular which seek to enable the UK to compete with other jurisdictions and bolster the financial services components of the UK economy – as analysed further below.

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

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A. Domestic developments

I. Specific Regimes

a. Qualifying Asset Holding Companies

> The UK government has published draft legislation for a new UK tax regime applicable to 'Qualifying Asset Holding Companies' ("**QAHCs**"). As expected, the draft legislation, which is expected to come into force in April this year, introduces a separate regime for QAHCs rather than amending existing tax rules. Many of the benefits of QAHCs are obtainable under existing rules, although the QAHC regime should make it easier to avail of them. The QAHC regime also offers some of the benefits which previously required structuring through Luxembourg holding companies.

We previously reported on the UK government's initial stage consultation on the tax treatment of asset holding companies (see here) and its second stage consultation on the same topic (see here). Draft legislation was first published in July and further amended in November 2021 (when it was published in the Finance Bill 2021-2022) and December 2021. Now that we have draft legislation, it is clearer what the benefits (and limitations) of the QAHC regime are. The conditions and benefits of the QAHC regime are summarised below. The key area where we see the QAHC being useful is for clients without substance in other flexible jurisdictions (such as Luxembourg) requiring a holding company which permits repatriation of profits at different times during the life of an investment.

The Benefits

a. *Generous exemption from tax on gains and certain income*. Disposals of shares by a QAHC (subject to an exception for shares in UK land-rich companies) benefit from an exemption from tax on chargeable gains. While this position can often be achieved using the existing substantial shareholdings exemption, it will be much simpler for a QAHC to achieve this position with its broader exemption, and this avoids the need to perform an analysis of the trading status of the company being disposed of. The exemption also applies to gains on disposals of non-UK land and there is a separate exemption from tax on income from an overseas property business (including where the income is derived from debt and derivatives related to that overseas property business). In practice, a number of territories have introduced real estate tax regimes which will mean that it is nonetheless most efficient to structure investments in land in a particular country through a corporate vehicle in the same country but this benefit may still be useful in certain circumstances. The exemption is not intended to shelter gains on sales of UK land and does not apply to direct or indirect disposals of UK land.
b. *Enhanced deductibility*. Results dependent interest (for example on profit participating loans) is not generally deductible for UK tax purposes either because the loan will constitute a hybrid instrument or because the interest will be recharacterised as a distribution. These rules are disapplied in order to allow a QAHC to pay results dependent interest while recognising a tax deduction. This may increase the utility of shareholder debt funding of investments through a QAHC and be a feature of particular interest to credit funds.
c. *Withholding tax exemption*. The usual obligation to withhold income tax from payments of interest by a UK company will not apply to a QAHC. This should allow debt to be raised outside the UK treaty network without incurring the administrative and cost burden of listing the debt.
d. *Enhanced tax treatment on share buy-backs*. The usual stamp duty charge on a repurchase of a UK incorporated company's shares is disapplied. However, the bigger benefit is likely to be that the rules which would ordinarily treat a share buy back as an income distribution to UK shareholders are disapplied. While it is currently possible to achieve capital treatment (with lower tax rates) on a liquidation of a UK company (for example, following a complete exit of an investment) this should allow for capital returns during the life of an investment (for example on a partial exit via a sale of one of the QAHC's investments). The ability to do this is currently one of

the key benefits of a Luxembourg structure where classes of 'Alphabet' shares can be liquidated to allow for capital returns during the life of an investment.

The Conditions

a. *QAHCs must decide to be QAHCs.* The regime is not automatic and a would-be QAHC needs to decide to enter the regime and notify HMRC of its decision.
b. *QAHCs cannot also be UK REITs.* As discussed above in relation to the benefits of the QAHC regime, it is not intended to apply preferential tax treatment to investments in UK land. That is the purpose of the REIT regime and, for that reason, a QAHC may not be a UK REIT.
c. *QAHCs must be UK tax resident.* This should be a straightforward condition for most would-be QAHCs to meet.
d. *QAHCs must be unlisted.* This requirement relates to the equity interests in the QAHC which may not be listed on any public market or recognised stock exchange.
e. *The activity condition.* QAHCs are not intended to be used for the purposes of an operating business. Accordingly, it is a condition of the regime that the main activity of the QAHC is to carry on an investment business. Non-substantial operating business will not disqualify a QAHC from the regime.
f. *Investment strategy condition.* A QAHC's investment strategy must not involve the acquisition of listed securities (although an exception designed to allow for public-to-private transactions is included). The rationale for this condition is that dealings in listed securities and associated dividend returns are expected to give rise to income-like returns to investors and the QAHC regime should not be used to facilitate turning these returns into capital by having them flow through a QAHC.
g. *Ownership condition.* This condition is likely to be the one requiring the most analysis before choosing to adopt the QAHC regime. To analyse the condition, the first step is to identify the QAHC's 'relevant interests'. These are broadly equity interests and include any right to vote, profits available for distribution or assets on a winding up. Having identified the 'relevant interests' the condition will not be met if 30% or more of the relevant interests are held by non-'Category A Investors'. The second step is accordingly to identify the Category A investors. For a fund to be a Category A Investor it needs to be a collective investment scheme or an alternative investment fund (both of these are regulatory concepts). These are effectively institutional investors (such as insurers, pension funds and charities) and certain funds. In addition, the fund needs to be either widely held (specifically this means not 'close' or, in the case of a collective investment scheme only, having genuine diversity of ownership) or 70% controlled by other Category A investors. Detailed provisions are included to test whether a fund formed as a partnership is 'close' or not. For example, a general partner's voting entitlement can be ignored and provisions are included to ensure that carried interest does not artificially distort the profit entitlement when applying this test.

When will the QAHC be useful?

It is perhaps easiest to answer this in the negative and demonstrate how many of the benefits of a QAHC can be achieved under current law. Take, as an example, an investment by a private equity fund with UK tax resident individuals (e.g. carried interest holders) as partners in an unlisted trading company. This is a fairly common fact pattern. A simple UK acquiring company may achieve many of the benefits of a QAHC: the existing substantial shareholdings exemption should exempt any gain on exit; and a liquidation of the acquiring company should allow for capital treatment for the UK individual partners. If the acquiring company needs to raise debt from non-treaty eligible lenders (e.g. many US credit funds) then, subject to marketing restrictions, it can simply list the debt on a recognised stock exchange to mitigate any UK withholding tax on interest. If there is a need to repatriate funds to investors in capital form to investors before exit, the structure can be amended such that a Luxembourg company is interposed between the fund and the UK acquiring company allowing for partial liquidations of a class of Luxembourg shares and (subject to anti-avoidance provisions) capital returns.

In that example, the QAHC regime does not offer much in the way of 'new' tax incentives. But what if marketing restrictions mean that debt held by non-treaty eligible lenders cannot be listed? Or what if (for example due to the effect of ATAD 3 (discussed below)) the Luxembourg company cannot establish sufficient substance and it is not viable to include it in the structure? And what if the target holds a substantial investment property such that it may be substantially non-trading for the purposes of the substantial shareholdings exemption? In all of these scenarios, the QAHC regime may present a desirable alternative to the traditional Luxembourg/UK holding structure. Even if the QAHC regime is not strictly 'needed' to address these kinds of concerns, it may offer a simple alternative (doing away with requirements to list debt or engage corporate service providers in multiple jurisdictions for example) to existing structuring options.

b. **Real Estate Investment Trusts**

The UK government has published draft legislation amending the UK's Real Estate Investment Trust ("**REIT**") regime. The draft legislation (due to come into force in April 2022) contains a number of amendments to the existing regime which should be welcomed by affected taxpayers. These are summarised below.

We previously reported (see here) that consultations were underway (as part of the broader review of the UK's tax treatment of investment funds) to establish whether reforms should be made to the UK's REIT regime in conjunction with the introduction of the QAHC regime. The draft legislation was first published in July and further amended in November, when it was included in Finance Bill 2021-2022. The result of these consultations and the ensuing draft legislation mean that the benefits of the REIT regime will be more accessible. As discussed above, the QAHC regime is not intended to benefit investments in UK land so the relaxation of the REIT regime is a welcome development.

The main change is a relaxation of the requirement that the ordinary shares of a REIT are listed on a recognised stock exchange. Although REITs were originally intended to be widely held listed vehicles, this principle has been eroded over the years such that, since 2012, certain institutional investors may (alone or with other such investors) hold all of the shares in a REIT without it losing its tax-favoured status by virtue of becoming a 'close company' (broadly a company controlled by 5 or fewer shareholders), although note that other requirements would need to be navigated in this scenario. However, prior to the changes due to come into force in April 2022, the listing requirement still applies even where the REIT is a 'close company' which has maintained its tax status on account of being owned by institutional investors. In other words, even though the REIT is not widely held, it must (currently) still be listed. The draft amendments fix for this slightly odd result by removing the listing requirement where 70% of the REIT's ordinary share capital is held by certain institutional investors.

Linked to the above change, there is also a relaxation of the rules for determining which investors count as institutional investors for the purposes of the rules described above in relation to close company status and (from April 2022) the relaxed listing requirement. UK REITs and Non-UK equivalents of UK REITs qualify as institutional investors for these purposes. However the 'Non-UK equivalent of a UK REIT' category is currently very narrow. It requires the REIT law of the relevant non-UK jurisdiction to be compared with UK law to determine whether they are equivalent: if they are not (for example because the non-UK jurisdiction permits close companies to be REITs) then the non-UK REIT will not fall into this category (even if it would satisfy the requirements of the UK REIT regime). This position is changing such that the test is effectively whether the non-UK REIT would meet the conditions to be a UK REIT (it becoming irrelevant whether the law in the UK and the other jurisdiction contain the same conditions for REIT status).

A key feature of REITs is the imposition of withholding tax on distributions of property income (this is the quid pro quo to the exemption from direct tax on property income in the hands of the REIT). In order to ensure that investors in REITs could not get the dual benefit of receiving distributions of untaxed profits without withholding tax by relying on double tax treaties, a 'holder of excessive rights charge' is imposed. A holder of excessive rights is a shareholder in the REIT who has greater than 10% voting or economic rights. The 10% figure is intended to track the shareholding required under many tax treaties in order to benefit from an exemption from dividend withholding tax. Where there is a holder of excessive rights, the benefit of the exemption from tax on property income is effectively disapplied (by imposing a charge on the REIT) such that, while a distribution may be made clear of withholding tax by virtue of a treaty, the underlying profits are effectively taxed. The oddity of the current position is that, where a shareholder in the REIT is entitled to be paid a distribution of property income gross for reasons other than a double tax treaty (for example because the shareholder is itself a UK company), the holder of excessive rights charge still applies. This is fixed in the draft legislation such that a shareholder which can be paid gross (for reasons other than the application of a double tax treaty) will not be a holder of excessive rights.

The final change worth noting is intended to reduce the compliance burden for REITs. In essence the change will allow for REITs to assess whether 80% of their profits and assets derive from their property business (which is a requirement for the tax favourable treatment applicable to REITs) based on consolidated accounts. Currently REITs are required to assess this on a company by company basis.

Overall these changes are a welcome development but should be seen more as 'fixes' to some odd results inherent in the current regime rather than a wholesale change to the benefits of or eligibility for the regime.

II. Compliance

a. Notification of Uncertain Tax Treatment

Proposals to require certain (large) businesses to notify HMRC of uncertain tax positions that they are taking were first mooted in March 2020. In November 2021, draft legislation was included in the Finance Bill 2021-2022 to implement the new notification requirements (with effect from April 2022). In a welcome development for taxpayers, the circumstances in which a notification will be required have been significantly reduced.

We previously reported on the original proposals for the notification requirement (see here). We also reported that, after widespread criticism of the subjective nature of the tests for a notification requirement, the second consultation proposed seven triggers for a notification requirement and reduced the number of taxes within the scope of the rules (see here). These triggers attracted further criticism and were reduced down to three triggers in the draft legislation published in July 2021 and two triggers in the Finance Bill 2021-2022 (published in November 2021).

Under the Finance Bill 2021-2022 proposals, the triggers for a notification requirement are:

- where provision has been recognised in the accounts of the company or partnership to reflect the probability that a different tax treatment will be applied to a transaction to which the amount relates; and
- if the tax treatment applied in arriving at the amount relies (wholly or in part) on an interpretation or application of the law that is not in accordance with the way in which it is known that HMRC would interpret or apply the law.

While the latter trigger above still involves some uncertainty and a judgement as to how HMRC would interpret the law, these triggers should be far easier for taxpayers to navigate.

As previously reported, the measures only affect 'large businesses' (broadly those with a balance sheet of over £2 billion and turnover of over £200 million) and only apply to PAYE, income tax, VAT and corporation tax.

An exception to the notification requirement applies where HMRC already have all of the information (e.g. because it was notified an applicable disclosure regime) which would have been provided in the notification.

b. **Basis Periods**

> Under proposals in Finance Bill 2021-2022 for tax years 2024-2025 onwards, trading profits (on which individuals pay income tax) are to be calculated based on the profits for the tax year rather than the profits for the accounting period of the underlying business.

Under current law, self-employed traders and members of trading partnerships are (subject to special rules applicable to the early years of trade) chargeable to income tax based on the profits of the trade shown in the accounts for any accounting period which ends in the April to April tax year. Accordingly, by way of example, if an accounting period of a trading partnership ends on 1 May 2022, no tax is payable by an individual partner for the tax year ending April 2022 in respect of profits earned from May 2021 to May 2022 (because May 2022 is not within the tax year which runs from April 2021 to April 2022). In that example, income tax is effectively deferred for (almost) a year.

Under the new rules published in the Finance Bill 2021-2022 (in November 2021), profits for an accounting period will need to be apportioned to the tax year such that the deferral is no longer possible. The measures are due to come into effect for the 2024-2025 tax year with a transitional period occurring in the 2023-2024 tax year. This presents a number of compliance difficulties including the possibility that the accounts of the business will not have been finalised at the point that the individual is required to pay tax on the profits which will ultimately appear in those accounts.

The solution to most of the compliance issues with the proposal is to have the accounting reference date of the business match the end of the tax year such that, going forwards, the profits for the accounting period and the tax year are one and the same thing. Indeed, this appears to be the intention behind the proposals: to simplify the position such that accounting and tax years match with a view to facilitating the introduction of 'Making Tax Digital' for income tax.

However, this solution will not be available to all businesses (some cannot easily change their accounting reference date).

Partners in businesses which change their accounting reference date (or in businesses which do not change it and so are effectively required to calculate their tax as if they had changed it) face an acceleration of tax liabilities (subject to spreading provisions for the transitional period) and associated cashflow costs.

c. **Transfer Pricing**

> In November 2021, HMRC published a summary of responses to its consultation on changes to the UK's transfer pricing documentation requirements. The government has decided to proceed only with limited aspects of the measures originally contemplated. Draft legislation to implement the proposals is expected later this year.

We previously reported (see here) that the UK government was consulting on clarifying and strengthening the UK's transfer pricing documentation requirements. A summary of the responses to that consultation was published on 30 November 2021.

In publishing the summary responses, the government also confirmed that it intends to proceed with the measures we previously reported on by introducing a requirement to keep a master file and a local file. However, the government is not planning to introduce a requirement to maintain an International Dealings Schedule following concerns being raised in response to the consultation over the cost and administrative difficulties associated with it.

Draft legislation for the new requirements is expected during this year.

III. Autumn Budget 2021

a. Residential Property Developer Tax

From 1 April 2022, the Residential Property Developer Tax (**"RPDT"**) will impose a new 4% tax on profits from UK residential property development (in excess of an annual £25 million allowance for each corporate group).

As part of the government's Building Safety Package aiming to bring an end to unsafe cladding, the government believes it is right to seek a fair contribution from the largest developers in the residential property development sector to help fund it. Accordingly, the RPDT was initially announced on 10 February 2021.

Legislation for the RPDT was published in the Finance Bill 2021-2022 (the updated draft legislation to reflect the technical consultation was released at the Autumn Budget 2021) and will apply from 1 April 2022 to profits arising from UK residential property development recognised in accounting periods ending on or after that date. In particular, RPDT will be a 4% tax imposed on profits arising from UK residential property development.

However, each group (being companies that are 75% subsidiaries of a common parent) will be provided with a £25 million annual allowance (the "**Allowance**") for the group to use against their profits arising from UK residential property development. The group will be required to nominate an allocating member. The allocating member will allocate the Allowance amongst the group companies as it deems fit. The draft legislation does not yet indicate the process to nominate a group company as the allocating member. However, where an allocating member has not been nominated, the Allowance will be split equally between the members of the group.

Where the Allowance is not exceeded, there will be no need to report residential property development profits. However, any profits from residential property development that is over the Allowance must be reported, and any tax due will be paid as part of the company's Corporation Tax return. This has the effect that only large residential property developers (i.e. those with profits of over £25 million per year from residential property development) will be liable to pay the tax, meeting the government's intention for RPDT.

Consideration of RPDT will be required when engaging in joint ventures that are likely to give rise to profits arising from UK residential property development. It must first be determined which group the joint venture will fall within. A minority holder in a joint venture may then require assurances from the majority holder of the joint venture that a suitable level of the Allowance will be allocated to such joint venture each year so that an excessive level of RPDT is not paid by the joint venture.

b. Corporate re-domiciliation

As part of the Autumn Budget 2021, the UK government launched a consultation on proposals to allow non-UK incorporated companies to move their corporate domicile to the UK. The consultation closed on 7 January 2022.

While a non-UK company may, under current law, become UK tax resident if its central management and control occurs in the UK, it is not currently possible for a non-UK company to fully redomicile (effectively moving its place of incorporation) to the UK. The proposals, if enacted, would change this and the stated intention behind them is to improve the attractiveness of the UK as a holding jurisdiction. Specifically, they aim to reduce the tax and legal complexity of migrating a business to the UK through a transfer of assets or shares to a new UK holding company.

A re-domiciliation regime already exists in a number of jurisdictions (Luxembourg and Delaware in particular) but it is important to note that the usefulness of the proposals only extends to companies considering re-domiciliation from a country which allows them to 'leave' their existing domicile ('outward re-domiciliation'). Most (but not all) countries which allow for the migration of corporate domicile into the country ('inward re-domiciliation') also allow outward re-domiciliation and the consultation requests views on whether the UK should also allow both outward and inward re-domiciliation. Any proposals for the UK to allow outward re-domiciliation are likely to be accompanied by stringent solvency requirements and exit fees.

The conditions for inward re-domiciliation are expected to allow any non-UK body corporate to re-domicile to the UK provided they have directors of good standing, are not a risk to national security or the public interest, are not in their first accounting period and submit a report explaining the impacts of re-domiciliation. A registration fee is also likely to apply on inward re-domiciliation.

It is not yet clear what impact inward re-domiciliation to the UK will have on tax residence with the consultation keeping all options open. From a tax perspective, it will be interesting to see how the proposals progress with regard to becoming (either automatically on inward re-domiciliation or only if central management and control shifts to the UK) or ceasing (either automatically on outward re-domiciliation or only pursuant to a double tax treaty) to be UK tax resident.

Other tax issues should the proposal come into effect and considered by the consultation include: whether the UK tax base could be eroded by importing non-UK losses, whether assets held by the re-domiciling company should be stepped up to market value base cost at the point of re-domiciliation, stamp duty on inward our outward re-domiciliation and VAT. The consultation does not contain much detail on these tax issues and asks for views on each of them rather than expressing a proposal so it will be interesting to monitor how the detailed proposals develop.

B. International developments

I. European Commission Communication on Business Taxation for the 21st Century

In May 2021, the European Commission (the "**EC**") published its Communication on Business Taxation for the 21st Century (the "**Communication**"). The cornerstone of the Communication was a proposal for measures to tackle the use of abusive shell companies, and in December, the EC published a draft directive on the subject (so-called "**ATAD 3**" or the "**draft Directive**"). Broadly, the draft Directive (which remains subject to Member State negotiation) proposed that passive EU-resident companies: (a) must report to tax authorities on whether they meet certain minimum substance requirements; and (b) would (amongst other measures) be denied treaty benefits if they lack sufficient substance. Other high-level proposals mooted in the Communication include: (i) an obligation for large companies with EU operations to publish their effective tax rate; (ii) an intention to address a perceived bias towards debt-funding over equity; (iii) a recommendation that Member States extend their loss carry back rules; and (iv) an EU common tax base, replacing stalled proposals for the common consolidated corporate tax base with a very similar alternative ("Business in Europe: A Framework for Income Taxation, or "**BEFIT**".)

Measures to tackle abusive shell companies

Broadly, the draft Directive seeks to: (a) identify shell companies by imposing "substance" reporting obligations on certain undertakings; and (b) penalise their use by: (i) denying the shell company treaty benefits; and (ii) ignoring its existence for the purposes of taxing its shareholders (again, without the benefit of treaty reliefs). The effect is that shareholders will generally be in a worse tax position for having sought to impose a shell company.

Scope: The draft Directive, which is proposed to take effect from 1 January 2024, applies to undertakings that are tax-resident in a Member State and have, for the preceding two years, met the following conditions:

a. The undertaking was passive, in that more than 75% of its: (i) revenues were from "relevant income" (broadly passive income, such as interest, dividends, royalties, income from crypto-assets and certain types of finance income); or (ii) total assets were immoveable and moveable property;
b. The undertaking was engaged in cross-border activities in the sense that: (a) more than 60% of its moveable and immoveable assets (by book value) are located outside its jurisdiction of residence; or (ii) at least 60% of its relevant income is earned or paid out via cross border transactions; and
c. The undertaking outsourced the administration of its day-to-day operations and decision making on significant functions. (Interestingly, the draft Directive does not elaborate further on what this means in practice, in the context of inherently passive activities.)

Broadly, the obligations would not apply to: (a) listed companies; (b) certain regulated financial undertakings; (c) undertakings with at least five full-time staff (working exclusively to generate relevant income); or (d) holding companies tax-resident in the same jurisdiction as their: (i) shareholder(s) or (ii) subsidiaries (if those subsidiaries are mainly operational companies).

Obligations: These "in scope" undertakings must report to their tax authority annually on whether they meet specified minimum substance requirements, and provide related supporting information. Although the presumption can be rebutted in certain instances, an undertaking will be presumed to be a shell company unless it has:

a. premises available for its exclusive use in its jurisdiction of tax residence;
b. at least one active bank account in the EU; and
c. either: (i) at least one director that is resident in the same jurisdiction as the undertaking, is not a director or employee of an unconnected undertaking and is authorised to take (and in fact regularly does take) decisions in relation to activities/assets generating relevant income or (ii) a majority of full-time employees resident in same jurisdiction as the undertaking (that are qualified to generate relevant income).

Reported information is automatically shared between tax authorities periodically. There is scope for an undertaking to request exemption from reporting if, broadly, it can demonstrate that its existence doesn't lead to a tax saving. However, in the absence of such exemption, undertakings that fail to report will be subject to a penalty, which must be at least 5% of its turnover in the relevant year.

Impact: If an undertaking fails to meet minimum substance requirements (and is, accordingly, characterised as a "shell company"):

a. It will be denied access to treaty benefits in its jurisdiction of tax residence and will be unable to obtain a certificate of tax residency (or will be provided with a certificate indicating that it is not entitled to treaty relief).
b. If its shareholders are resident: (i) in a Member State, they will be taxed as though the undertaking's relevant income accrued directly to them (after deducting tax paid by the undertaking on the same income, but ignoring the effect of any double tax treaty); and (ii) in a third country, a payer of relevant income (resident in a Member State) must apply any local withholding tax, without taking into account the effect of any double tax treaty between its jurisdiction of tax resident and the shareholder's.

Consequences:

a. *Structuring*: Many taxpayers bolstered their European substance in the wake of the Danish "beneficial ownership" cases (when the Court of Justice of the European Union denied "beneficial owner" status, and accordingly, relief under European directives, due to a lack of substance). This has generally led to the consolidation of group holding companies in particular jurisdictions, such as Luxembourg or the Netherlands. The draft Directive, however, appears to move the needle on what constitutes substance, by indicating that the use of (suitably qualified, experienced) corporate service providers as local directors will no longer be sufficient. It remains to be seen whether this will work in favour of, or against, UK efforts to attract asset holding companies (through its "qualified asset holding company regime", discussed above). In particular, if the draft Directive is implemented in its current form, taxpayers will need to assess whether to commit to EU holding companies (by bolstering substance) or retreat in favour of non-EU holding companies.
b. *Compliance*: The proposals will add to taxpayers' compliance burden and costs, and further increase the information at tax authorities' disposal.
c. *International tax agenda*: The EC's proposals are restricted in their territorial scope, which will limit the ability to penalise shareholders for their attempt to make use of shell companies. In this respect, the EC appears to have taken on a mantle perhaps better suited to the OECD (whose agenda has, in recent years, been monopolized by BEPS 2.0, described below). As the BEPS 2.0 project moves toward completion, it will be interesting to see if the OECD may take over the baton, with a view to creating a harmonised international standard.

Other proposals mooted in the Communication

Tax transparency proposals: The Communication contemplates a requirement for large companies/groups with operations in the EU to publish their effective tax rate annually. The effective tax rate would be calculated using the methodologically employed under BEPS Pillar II proposals, discussed below. No further details have been published, although the Communication contemplates that a legislative proposal would be tabled in 2022. Until recently, EU tax disclosure rules had focused on the provision of information to, and the exchange of information between, tax authorities. However, this proposal is part of an increasing trend toward tax transparency. In November, for example, the EC finalised legislation requiring public country-by-country reporting (discussed in our alert from May 2021). Under the latter proposals, broadly, EU-headquartered groups (and groups with EU operations) having an annual turnover exceeding €750 million must, for financial periods beginning on or after 22 June 2024, publish their effective tax rate on a jurisdiction-by-jurisdiction basis (including, in some instances, for non-EU jurisdictions). Given its similarities to public country-by-country reporting requirements, it is unclear whether the EC will pursue the proposal in the Communication further. Either way, the push toward public disclosure suggests that tax may increasingly become a reputational, as well as an operational, matter for taxpayers, as they consider how their tax position will be viewed by tax authorities, investors and the general public. In particular, it remains to be seen whether taxpayers will move toward voluntary disclosure of tax information to provide greater context to public disclosures.

Possible tax relief for equity funding: The Communication proposes a possible "allowance system for equity financing" (the "Debt Equity Bias Reduction Allowance", or "DEBRA"). The proposal is intended to address EC concerns about a "consistent "pro-debt" bias" which it considers can contribute to an "excessive accumulation of debts"…and the potential for "high waves of insolvency". An Impact Assessment was published in June and a public consultation ran from July to October 2021. The Impact Assessment clarified that, while the EC was considering allowances for (new and/or existing) equity in the form of deductions for "notional" interest, it was also contemplating additional measures for the disallowance of actual interest deductions. Further details are not expected until Q1 2022, so the precise scope and mechanics of the proposals remain to be seen. However, the Communication makes clear that any allowance would be subject to an anti-avoidance rule. The introduction of allowances for equity funding (if introduced) could potentially give jurisdictions such as Luxembourg and the Netherlands an advantage over the UK as a holding-company jurisdiction. Nevertheless, tax regimes already include an abundance of interest restriction regimes (including, notably, transfer pricing rules which already deny deductions for excessive debt funding costs). Accordingly, it is hoped that the EC will avoid the complications of adding an additional one to the tax landscape.

Recommendation on loss rules: Alongside the Communication, the EC published a recommendation to Member States on the domestic treatment of tax losses. This is intended to address EC concerns (set out in the Communication) about the impact of the COVID-19 pandemic on small and medium enterprises, which the EC notes are "often less able to absorb or finance losses than larger companies". Noting that "the "treatment of tax losses in Member States is still very different", the EC recommends that Member States introduce a mechanism enabling small and medium businesses to carry back losses (of up €3 million) for up to three years. Perhaps recognising the difficulties involved in passing binding legislation (which, as mentioned above, would require unanimous Member State consent), it is notable that this measure took the form of a non-binding recommendation. In particular, this may serve to highlight the gulf between the EC's ambitious BEFIT proposal (below) and Member State enthusiasm for harmonisation of substantive tax rules.

Common corporate tax base: The Communication restates the EC's ambitions for a "single corporate tax rulebook for the EU" – replacing proposals for a "Common Consolidated Corporate Tax Base" (first mooted in 2011) with BEFIT. BEFIT proposals contemplate a common tax base (based on Pillar II proposals, discussed below), which would be allocated between Member States on the basis of a common formula. Such allocations would be taxed at national rates and would, the Communication notes, remove the need for transfer pricing between Member States. A detailed BEFIT proposal is expected to be tabled in 2023. However, given the need for unanimous Member State support, it remains to be seen whether BEFIT will become a reality. In particular, the Communication frames the rebranded proposal as building on the work done, in the intervening years, by the OECD on the BEPS 2.0 project. However, given concerns about the practicability of certain aspects of Pillars I and II (discussed further below) it would seem prudent to give Member States an opportunity to implement and road-test those proposals before considering whether to apply them on a broader scale.

II. Political agreement on Pillar I and Pillar II proposals

In July 2021, after years of negotiation, 130 jurisdictions from the OECD's Inclusive Framework on Base Erosion and Profit Sharing (the "**IF**") reached agreement on international tax reform. Additional jurisdictions (including Ireland, Hungary and Estonia) subsequently signed up, bringing the number to 141 jurisdictions. The agreement, which seeks to address tax challenges arising from the digital economy, comprises "Pillar I" (creating new rules for the allocation of taxing rights between jurisdictions) and "Pillar II" (providing for a global minimum tax rate). After years of doubt, the agreement signals that Pillar I and II proposals are likely to become a reality. Indeed, for Pillar II in particular, thought has turned toward implementation, with the publication of: (a) Model Rules by the OECD (the "**Model Rules**"); (b) a draft implementing directive by the EC (the "**Pillar II Directive**"); and (iii) a consultation on UK implementation (which closes on 4 April 2022) by the UK Treasury (the

"**UK Consultation**"). However, despite these developments, concerns remain as to whether material aspects of the proposals are practicable.

Pillar I

The description of the agreement reached on Pillar I, from IF statements in July and October (together the "**Statements**"), largely tracks the consultation "blueprint" published in late 2020 (as to which, see our alert from December 2020 and the comparison table below). That said, there are notable departures in the rules for determining "in scope" multinationals. True to the project's intention to address the digital economy, original proposals targeted a limited category of digital businesses (although this was, in 2020, expanded to include all customer facing businesses). Some evidence of mission creep is to be found, then, in the absence of any entry-conditions by reference to the nature of a multinational's activities (with the exception of limited carve-outs for certain industries). As against that, however, taxpayers will welcome the material increase in financial thresholds (with entry-level turnover thresholds more than 25 times greater than suggestions mooted in the blueprint).

	Blueprint proposal/suggestion	**Statements**
	In-scope taxpayers	
Sector	Multinational groups with consumer facing business.	Multinational groups. (No sectoral limit referred to.)
Financial Threshold	Global turnover of €750 million.	◦ Global turnover above €20 billion (to be lowered, in time, to €10 billion); and ◦ Profitability (i.e. profit before tax/revenue) of 10%.
Regime Exclusions	◦ Extractive and natural resources industries; ◦ Financial industry (asset managers, insurers, pension funds, and banks) ◦ Airlines and shipping; ◦ Construction; and ◦ Sale and leasing of residential property.	◦ Extractives; and ◦ Regulated financial services (FAQs published by the OECD in October 2021 also refer to exclusions for shipping and pensions, suggesting that omissions from the Announcements may not reflect a substantive change.)
	Application	
Summary	For in-scope taxpayers, Pillar I "nexus" rules will apply (instead of traditional nexus rules based on residence or permanent establishment) to a portion of their profits known as "Amount A". Taxing rights over Amount A will be allocated between certain "market jurisdictions".	
Calculation of Amount A	Income exceeding an agreed level of profitability, which would be calculated using agreed formulae (that would vary by industry).	20-30% of "residual profits" (i.e. profits exceeding 10% of revenue, based on financial accounts with minor adjustments and with the right to carry forward losses).
"Market jurisdiction"	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.	Jurisdictions in which: ◦ The end product is used or consumed (within the meaning of yet to be determined industry-specific rules); and ◦ The group derives at least €1 million of revenue in the relevant year. (The threshold is €250,000 for small jurisdictions with a GDP of less than €40 billion.)

Allocation between market jurisdictions	Based on revenue-based allocation key. Where residual profits are already taxed in a market jurisdiction, there will be a "safe harbour" to cap the market jurisdiction's allocation of Amount A.	
	Other	
Double tax	Residence jurisdiction would relieve double tax via exemptions and credits.	Double tax to be relieved via exemptions and credits
Dispute prevention /implementation	Advance review of certain matters (e.g. allocation of Amount A between market jurisdictions) 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.	No detail provided, beyond saying that disputes will be solved in a "mandatory and binding way".
Implementation	Via multi-lateral instrument ("**MLI**") (to be available for signature in mid-2022). Proposals to take effect in 2023.	

It is unclear whether omissions from the Statements are intended to indicate a substantive absence of agreement, or merely reflect the role of the Statements as high-level political statements directed toward a broad audience. The scant detail on the dispute prevention mechanics (a key detail, given the scope for conflict, and ultimately, double taxation) is particularly concerning, and may serve to illustrate the (yet to be bridged) gulf between a political agreement and a practicable proposal. The former represents a momentous achievement, but with the timeline for implementation fast approaching, attention must move swiftly to the latter. To that end, Model Rules for Pillar I are expected to be published in Q1 this year. It is hoped that the Model Rules will shed colour on gaps in the Statements, but it remains to be seen whether they will make good on the Accouchements' promise to keep compliance costs "at a minimum".

Pillar II

The principal Pillar II development reflected in the Statements is an agreed minimum rate (15%) – the crux of the proposal, which had long been a source of political discord. Though there are tweaks to other aspects of the proposals, the substance of the Pillar II agreement reflected in the Statements remains very close to the "blueprint" published for consultation in late 2020 (as to which, see our alert from December 2020 and the comparison table below). However, one feature of the Model Rules published by the OECD in December seems poised to reignite political debate: the Model Rules contemplate that a group's effective tax rate in a particular jurisdiction would be increased (and accordingly, the top-up tax levied by the home jurisdiction of the group's parent would be reduced) if the local jurisdiction introduced domestic minimum tax rules and levied a top-up tax thereunder first. Though Pillar II was originally conceived as a revenue-generating measure for the home jurisdiction of the group's parent, it now seems likely that governments will act on the suggestion in the Model Rules, so as to retain tax generated from Pillar II in their own jurisdictions. In the UK Consultation, for example, views are sought on a UK domestic minimum tax.

	Blueprint proposal/suggestion	**Materials**
	In scope taxpayers	
Financial threshold	Global turnover of €750 million (in the immediately preceding year).	Global turnover of €750 million (in 2 of the last 4 preceding years) - although Statements note IF members are free to set at lower rate.
Excluded entities	Government entities (including sovereign wealth funds), international and non-profit organisations, pension funds and investment funds that are (in each case) parents of	

	an “in-scope” group. Exclusion doesn’t apply to entities controlled by the foregoing (other than pure holding companies 95% controlled by excluded entities).	
“GloBE” Application		
Summary	Pillar II proposals contemplate two key rules (together, the so-called “**GloBE**”) to impose a minimum tax on “in-scope” groups: 1. Income inclusion rule (the “**IIR**”): The parent of in-scope multinational groups will be subject to a “top-up” tax on the income of its 80% subsidiaries/group permanent establishments (so called “**constituent entities**”), to the extent that such income isn’t taxed at a minimum rate. 2. A fallback, “undertaxed payments rule” (the “**UTPR**”): Broadly, if the IIR doesn’t apply (e.g. because a group does not have a parent resident in a jurisdiction that implemented the IIR), liability for the “top-up” tax is allocated between constituent entities in jurisdictions that did implement the GloBE.	
Min tax rate	TBD	15%
UTPR exemption	N/A	Groups (meeting turnover threshold) beginning international expansion (i.e. having overseas: (i) tangible assets not exceeding €50 million; and (ii) operations in no more than 5 other jurisdictions). Exemption cannot apply for >5 years.
Calculation of top-up tax		
Summary	° For each jurisdiction in which the group has constituent entities, the top-up tax will apply to the extent that the effective tax rate of the local constituent entities (the “**ETR**”) falls below the minimum tax rate. ° An ETR above the minimum rate in one jurisdiction cannot be off-set against an ETR below the minimum rate in another jurisdiction. ° The amount of top-up tax payable by a parent in respect of a jurisdiction is reduced by the amount of any domestic top-up tax imposed by the latter jurisdiction.	
ETR calculation (per jurisdiction)	Total tax liability for “covered taxes (i.e. taxes on income/profit) (as adjusted) Income from financial accounts (less fixed carve-out) (as adjusted)	
Excluded jurisdictions	TBD (as a “de minimis exemption” was one of a number of potential simplification measures mooted).	Jurisdiction is excluded where group has revenues <€10 million and profits <€1 million.
Fixed “substance carve-out”	Unspecified percentage of payroll and book value of tangible assets.	° 10% of payroll (moving to 5% within 10 years); and ° 8% of book value of tangible assets (moving to 5% within 10 years).
Other		
GILTI co-existence	TBD	
Implementation	° OECD to produce model draft legislation for implementation by IF member states. ° Treaty changes could be by way of bilateral agreement or MLI.	° Each jurisdiction to legislate for GloBE (guided by the OECD Model Rules). Legislation to be implemented in 2022, take effect in 2023 and provide for UTPR to come into effect in 2024. ° Bilateral treaty amendment for switch-over rule.

IF members that have joined the agreement are not required to implement GloBE (although they must respect the taxing rights of IF members that have). For those that intend to, however, two key aspects of the proposals may give pause:

- *Unilateral implementation*: BEPS 2.0 was envisaged as a mechanism to prevent disjointed domestic responses to matters of global concern. However, in contrast to Pillar I (whose subject matter more obviously lends itself to a multi-lateral approach), Pillar II will be implemented by IF members separately, guided by a set of common rules. A similar approach was taken with the OECD's Common Reporting Standard, and has proved fertile ground for mismatches in approach (and related compliance costs). Early evidence suggests that implementation of the GloBE will fare no better. In contrast to the Model Rules, the Pillar II Directive applies the IIR to purely domestic groups (in order to comply with freedom of establishment requirements), and the UK Consultation notes that while "*the UK will implement the [Pillar II] rules in the UK as closely to the [Model Rules] as possible…there may be limited areas where the rules need to be adapted, for example to reflect concepts in UK law*". Where, as here, the subject matter relates to substantive taxing rights, the risk of divergence carries potential for double taxation. Further consideration from IF members as to whether there is scope for a multilateral approach may be warranted.

- *Complexity*: Even if every jurisdiction implemented the GloBE uniformly, the complexity inherent in the underlying proposals creates an impractical compliance burden. This will only be exacerbated if jurisdictions introduce domestic minimum taxes as well. As described in a letter from "Business at OECD" (an international business network) to the OECD, "the Model Rules may prove such an administrative and compliance struggle for many tax authorities….as well as for taxpayers given less than 12 months to implement as yet unwritten, detailed laws, [that] 2023 (and possibly 2024) could be years of significantly increased uncertainty and instability".

C. Notable Cases

I. Hargreaves Property Holdings Limited v HMRC [2021] UKFTT 390 (TC)

The First-Tier Tribunal ("**FTT**") reiterated that when assessing where the source of income is, the "underlying commercial reality" must be considered from a "practical, or realistic, point of view".

Background

Hargreaves Property Holdings Limited ("**HPH**") was the ultimate parent of a group of companies engaged in property investment, development and construction (and, at the relevant time, all such properties were located in the UK). The group acquired property primarily for investment purposes, and accordingly did not intend to carry on a trade of dealing in property. HPH sought funding from a number of trusts controlled by the founders and directors of the group to finance its property investment business.

These loans were documented with a view to preventing the interest under the relevant loan having a UK source - all payments under the relevant loan were to be made outside of the UK, the relevant loan would be governed by the laws of a jurisdiction other than the UK and that alternative jurisdiction would have sole and exclusive jurisdiction in relation to the relevant loan. The lender would also assign: (a) the right to the interest under the relevant loan to a Guernsey resident company shortly before the interest was paid; and (b) the principal of the relevant loan to a group company. The lender would then arrange for the borrower to repay the interest and principal very shortly after the assignments, and advance an amount to the borrower to fund that repayment.

The question arose as to whether HPH, when it paid interest on the loans, should have withheld UK income tax from the payments of interest and accounted for that income tax to HMRC.

The FTT held that HPH should have withheld UK income tax from the payments of interest and accounted for that income tax to HMRC. This was on the basis that the underlying commercial reality was that the interest paid on the relevant loans arose in the UK (applying *Ardmore Construction Limited v HMRC)*, and that, despite the fact that the Lender could call for repayment of the loans on short notice, and that each loan had in fact lasted for less than, or only a little over, a year, the interest was yearly interest.

Observations

While the *Hargreaves* decision does not introduce any new concepts in relation to the withholding of UK income tax on interest payments, it demonstrates that the courts will apply particular focus on the residence of the debtor and the situs of the assets used to fund the payments when determining the source of income - as opposed to an intended "smokescreen" used to argue that the interest is not UK source. When reaching this decision, the FTT relied on Arden LJ in *Ardmore*, noting the need to consider the "underlying commercial reality" and to ask "which was the source from a practical, or realistic, point of view". Accordingly, it appears that it would be extremely difficult for any UK resident companies that carry on business exclusively in the UK to argue that any interest payments they make are not funded out of assets situated in, and the profits of activities conducted in, the UK.

Similarly, the *Hargreaves* decision demonstrates that the obligation to withhold tax on interest payments cannot be avoided by deliberately structuring loans as short-term loans to avoid the "yearly interest" requirement of withholding tax from interest payments. The courts will look at the reality of the loans' purpose, and may consider that they are actually intended to provide long-term financing.

This case may also prompt HMRC to look at cross-border loan arrangements more closely moving forward. Accordingly, when arranging cross-border financing, companies should carefully consider whether or not to withhold tax on interest payments that may be at risk of having a UK-source.

II. **Kwik-Fit Group Limited and Others v HMRC [2021] UKFTT 283 (TC)**

The FTT held that: (a) in determining whether a loan was transferred for tax avoidance purposes, it is the main purpose of the transfer (and not the main purpose of the underlying loan) that will be considered and (b) merely increasing the interest on a loan borrowed for commercial purposes could be an "unallowable purpose" (with the result that deductions for the increased interest could be denied).

Background

Following the acquisition of the Kwik-Fit Group by Itochu Corporation, a number of intra-group receivables were assigned to an intermediate holding company within the Kwik-Fit Group, Speedy 1 Limited ("**Speedy 1**"). Speedy 1 had a carried forward non-trading loan relationship debit ("**NTD**") of £48 million, against which the interest income owed to it under the intra-group loans could be sheltered. The interest rate charged on such loans was increased. As a result of the reorganisation, the NTDs in Speedy 1 were used in under three years, rather than the c. 25 years originally estimated by the Group Tax Manager.

HMRC stated that the unallowable purposes rule (at section 441 of Corporation Tax Act 2009) applied to disallow the debits arising to borrowers paying interest to Speedy 1 under the intra-group loan relationships. Specifically, where a debtor did not have a pre-existing loan relationship with Speedy 1, HMRC disallowed the whole of the interest debit, and where the debtor had a pre-existing loan relationship with Speedy 1, HMRC disallowed the interest debit to the extent that it had been increased following the reorganisation.

The borrowers challenged the disallowance on two grounds: firstly that they were not party to the loan relationships for an unallowable purpose, and secondly, that there wasn't an unallowable purpose in increasing the interest as the increase was to comply with the transfer pricing rules.

Whilst the FTT acknowledged that the purpose of the loan and the purpose of being a party to the transaction at issue were two separate issues, in this case, the FTT concluded that the main purpose for both in relation to the new loans was the securing of the tax advantage for the group. While the existing loans had a commercial purpose, the increased interest rate applied to the loans provided a new additional, main purpose, being the utilisation of the NTDs and thereby securing a tax advantage for the group (an unallowable purpose).

Further, the argument in respect of transfer pricing was not accepted on the basis that the arm's length rate only needs to be applied when calculating the tax due; there is no requirement to alter the actual rate on the loan, and furthermore, the increase was only applied to loans where Speedy 1 was the lender, meaning that the transfer pricing rules were only selectively applied.

Observations

In *Kwik-Fit*, the FTT made a clear distinction between the original purpose for the loan, and the new purpose for the loan upon being assigned. There was no dispute that the original purpose for the loans (being to provide financing amongst the group companies) was not for an unallowable purpose, but due to the nature of the assignment of the intra-group loans during the reorganisation, it was the purpose of such assignment and increase in interest rate that was under scrutiny here.

Due to the drastic change in the business environment over the past 2 years, significantly more corporate groups are undertaking reorganisations in order to streamline their business and shift focus to different aspects of businesses moving forward. When transferring intra-group loans amongst group companies, businesses must ensure that the purpose for transferring the loan to a particular entity is not mainly for the purpose of utilising losses existing in that entity. More generally, taxpayers should be careful in increasing interest rates on such loans for tax purposes (subject, of course, to the requirements of transfer pricing) without any commercial or business purpose for doing so.

III. Centrica Overseas Holdings Limited v HMRC [2021] UKUT 200 (TCC)

Overturning the FTT's decision, the Upper Tribunal ("**UT**") held that a subsidiary's expenses in respect of a sale could be deducted for tax purposes, notwithstanding that the decision to sell was taken by its parent. The UT stated that there is no reason why the investment business of an intermediate holding company may not be managed by individuals employed by the ultimate parent company of the group.

Background

The FTT had held that adviser's fees incurred by Centrica Overseas Holdings Limited ("**COHL**", an intermediate holding company within the Centrica Plc group) in connection with the sale of a part of its business to a third party were not deductible expenses of COHL's management. This was on the basis that the management decision to sell was made by the ultimate parent company of the group, Centrica Plc. Specifically, the FTT found that COHL had not taken any relevant management decisions itself (albeit that COHL's directors had participated in their other capacity as heads of group functions) and in particular that there was no formal documentation of its decision (e.g. board minutes of COHL).

The FTT's decision was overturned by the UT. The UT stated that there is no reason why the investment business of an intermediate holding company may not be managed by individuals employed by the ultimate parent company, especially when those individuals are also directors of the intermediate company and have fully participated in the decision-making process. Accordingly, the FTT was incorrect in stating that it was necessary for COHL to document such decision making before the expenses could be treated as deductible expenses of COH's management.

Observations

While in many corporate transactions, board minutes are produced for the majority of, if not all, entities involved, the development in *Centrica* shows that even if documentation is not put in place for decisions made by a subsidiary, such decisions may still be found to have been made by the relevant subsidiary. Of course, in *Centrica*, the fact that the directors of COHL were also directors of Centrica Plc will have impacted the UT's decision making, but as these circumstances arise commonly in corporate structures, this principle may extend quite widely.

This decision appears to slightly blur the lines between the decision making process of companies in a corporate group. In particular, the UT confirmed that directors do not need to formally 'change hats' to distinguish when they are acting for each company within a group that they are a director of. This creates an idea that a director can, in a sense, act in the role of a director of the group when making decisions, as opposed to for specific companies.

Notwithstanding this judgement, we would nevertheless recommend that: (i) the decision making process of each entity involved in a transaction should be formally recorded; and (ii) directors clearly distinguish between their roles in a group when making decisions.

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 in London:

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