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CLIENT BRIEFING

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TAX AND THE CITY REVIEW

The review of the UK funds regime continues with the publication of the wider review, following publication of a second consultation on the proposed new asset holding company regime and priority changes to the REITs regime. In *Wilmslow*, the FTT finds an attempt by a loan broking company to avoid irrecoverable input tax on advertising services is distinguishable from *Newey* and fails. There are changes ahead for the hybrid and other mismatches rules with legislation expected in Finance Bill 2021 to make the rules more workable and proportionate. As COVID-19 continues to impact business operations, the OECD publishes transfer pricing guidance and revised treaty guidance.

Review of UK funds regime

There is a lot on the table when it comes to the review of the UK funds regime announced at Budget 2020 to enhance the UK's attractiveness as a location for asset management. Different strands of the review are at different stages with the proposed new asset holding company (AHC) regime and certain priority changes to the REITs regime being the most advanced and expected to be covered in draft legislation for technical consultation later this year for inclusion in the Finance Bill that will become FA 2022. The closing date for comments on the priority REITs changes and views on the design of the AHC regime is 23 February.

New AHC regime

One effect of BEPS, particularly Action 6 on treaty abuse, is that it is advisable to locate fund management activity and AHCs in the same place. Given the scale of asset management activity currently in the UK, the UK has the potential to become the location of choice for new AHCs if tax-related barriers are removed.

The key objective of fund structures is to leave the investor in no worse position from the perspective of tax paid on investment income and gains, than if they had invested directly in the underlying assets. AHCs are therefore generally located in jurisdictions where they will pay no more tax than is commensurate with their intermediate role in the fund structure, facilitating the flow of capital, income and gains between investors and underlying investments. At present, some European jurisdictions have more favourable regimes to attract AHCs and the government seeks to redress this by delivering an effective, proportionate and internationally competitive tax policy for AHCs that will remove barriers to the establishment of these companies in the UK.

Priority REITs changes

A comprehensive review of the REIT rules is intended to form part of the wider funds review, but four changes have been prioritised to be made alongside the introduction of the AHC rules, in advance of the wider funds review, to make the UK a more competitive location for holding real estate assets. The four priority areas for change are: relaxing the listing requirement; further changes to the close company requirement; relaxing the holders of excessive rights rule for distributions to recipients not subject to withholding tax; and reforming the balance of business test.

Wider review

A wide-ranging call for input has been published, requesting responses by 20 April 2021. The goal is to make improvements to the tax and regulation of the UK funds regime to make the UK a more attractive location to set up, manage and administer funds. The new regime should enable a wider range of efficient investments better suited to investors' needs, unleash investment into productive and green technologies and grow the number of funds located in the UK to level up the economy by supporting jobs outside London. The call for input notes that it will not be possible to make all of the changes under consideration and seeks views on which reforms should be taken forward and how these should be prioritised.

Any reforms must be compatible with the government's robust approach on avoidance and evasion and with the UK's international commitments and must ensure the

UK can effectively exercise taxing rights over UK source income. The government remains committed to supporting portfolio delegation from and to the UK as a means to promote market efficiency, investor choice and to reflect the global nature of financial markets.

To ensure any proposed reforms are fit for purpose, the government is keen for feedback on the effectiveness of prior reforms and why the take up of particular entities (such as Tax-elected Funds) has been limited. The government is also keen to understand the barriers to the use of UK-domiciled limited partnership funds and the Private Fund Limited Partnership which was introduced in 2017 and whether tax changes could improve their use. It is acknowledged that stakeholder input is vital to creating a regime and fund vehicles that work for the industry.

Review of VAT treatment of fund management fees

A review of the VAT treatment of fund management fees is also on the cards for this year. The UK's approach to VAT on fund management services can create incentives for the domicile of funds outside of the UK and assessing the correct VAT treatment is currently complex, leading to high administrative burdens and significant volumes of litigation. Leaving the EU presents an opportunity to deliver simplifications and other potential reforms in this area. The government is looking to take initial views and is currently conducting research, ahead of potentially conducting a separate formal consultation on the options at a later stage.

Wilmslow

Wilmslow Financial Services PLC (In Administration) v HMRC [2020] UKFTT 516 (TC) concerns tax planning arrangements of a UK company, Wilmslow, relating to its loan broking activities, which are exempt services for the purposes of VAT. Wilmslow adopted a business structure involving a Gibraltar entity in an attempt to avoid irrecoverable input tax on advertising services.

This case has some similarities with *HMRC v Newey T/A Ocean Finance* [2018] EWCA Civ 791 (and indeed the delay in this case being heard arises from the appeal being stayed pending the outcome of the Court of Appeal's judgment in *Newey*). A key difference, however, is that in *Wilmslow* all the marketing, processing and provision of vetted applications for loans was provided by Wilmslow in the UK, bypassing the directors of the Gibraltar entity. On the facts, the First-tier Tax Tribunal (FTT) found the arrangements were highly uncommercial, did not reflect the economic or commercial reality and were contrived to result in a tax advantage. The FTT held the essential aim was to avoid irrecoverable VAT and that the structure of the arrangements was contrary to the purpose of VAT by its artificiality.

In order to eliminate the abusive advantage, the FTT found the appropriate re-definition was to treat Wilmslow as the supplier of loan broking services and as the recipient of advertising services at all material times. This meant that Wilmslow made exempt supplies of loan broking and the associated input tax on the advertising services it was treated as receiving was therefore irrecoverable.

Hybrids rules - Finance Bill 2021 changes

The hybrid and other mismatch rules (hybrids rules) have been in force since 1 January 2017 and are complex, mechanical rules implementing the recommendations of the OECD report on BEPS Action 2. The UK introduced its hybrids rules in advance of similar rules in other jurisdictions and HMRC has acknowledged that the real world has proved even more complicated than the draftsman could anticipate, however, and changes to the rules are proposed in order to improve their practical workability and to make their impact more proportionate. No 'I told you so's', please!

A consultation ran from 19 March 2020 until 28 August 2020 on the revision of three main areas: the double deduction rules, the acting together definition and exempt investors in hybrid entities. In many cases stakeholder feedback went beyond these three issues and the summary of responses published on 12 November 2020 confirmed a number of other changes will be made concerning: the interaction of TIOPA 2010 Chapter 11 with transfer pricing, securitisation vehicles, investment trusts, US GILTI, illegitimate overseas deductions, issues with Chapter 11 conditions E and F, sections 259GB(3) and (4A) and Chapter 3 relevant debt relief provisions. A number of these changes will have retrospective effect from 1 January, 2017, to ensure the regime operates proportionately and as intended.

In many respects they reflect a softening of the original "blunt club" approach. Before the rules were first introduced, many commentators pointed out that they would lead to economic double taxation because of the lack of a motive test and the narrow focus on simply counteracting gross hybrid benefits rather than any net hybrid benefit derived by the group. The original response from HMRC was, in effect, 'good, that will encourage people to get rid of hybrids in their structures which is the behavioural response we are looking for'.

But the Government now acknowledges both that the 2017 US tax reforms have actually created a strong incentive for US owned groups to check foreign subsidiaries open, thereby creating more hybrid entities, in order to greatly simplify compliance and that unchecking UK companies to get rid of their hybrid status can be prohibitively expensive where that

triggers a deemed US tax disposal. So some hybridity is here to stay, and the rules are to be made more proportionate though it is not possible to reach a perfect answer in all cases and an 'element of compromise is unavoidable'.

Two pieces of draft legislation were published in November to address this situation where the hybrids rules are operating disproportionately. The first is a retrospective change to the double deduction rules dealing with deemed dual inclusion income, proposing to treat income that is fully taxed but not subject to any corresponding deduction in any territory as dual inclusion income if, absent the hybridity of the UK company, there would not have been an inclusion/non-deduction mismatch. The result of being treated as dual inclusion income is that the receipt may then be used to mitigate the impact of the hybrids counteraction of the double deduction amounts. Section 259ID, which was intended to alleviate a disadvantageous mismatch in the form of an inclusion/no deduction outcome arising as an intrinsic feature of a commercial structure but which did not go far enough, will no longer be required and will be repealed.

The typical situation this is there to deal with is a UK subsidiary checked into its US parent. For US tax purposes, payments between them do not exist. So this means that any deductible payment made by the UK subsidiary to the US parent necessarily gives rise to a hybrid deduction/non-inclusion outcome and can only be used against dual inclusion income. But, as things stand, the hybrid disbenefit - namely that any payment from the US parent to the UK subsidiary which is taxable in the UK will not be deductible in the US - is not taken into account.

The second permits the allocation of dual inclusion income within a group. It will allow companies within group relief groups to match dual inclusion income arising in one company with doubly deductible amounts in another with effect from 1 January 2021.

So, at the moment, if a US parent has two UK subsidiaries, both checked open, one of which receives third party income, pays it to the other which uses it to make a payment to a third party, the group is subject to counteraction - losing the UK tax deduction on the payment to the third party - despite having obtained no advantage. This is on the basis that there would otherwise be a double deduction for that payment (once in the UK for the payor, once in the US for the US parent) and whilst the third party income is also taxed twice (once in the hands of the payee, once in the US for the US parent), it arises in the "wrong" entity.

The technical consultation on both items of draft legislation closed on 7 January and legislation making these changes and the other proposed changes will be included in Finance Bill 2021.

HMRC guidance will also be updated to clarify the interaction between the US dual consolidated loss rules with Part 6A and the interaction of the R&D regime with the hybrids regime. A future iteration of HMRC's guidance will also confirm that the reference to profits available for distribution is intended to carry its corporate legal meaning and so refers only to amounts which could lawfully be distributed under the Companies Acts. It is not intended to encompass payments which would be deemed to be distributions for tax purposes even though as a legal matter they are not the entitlements of creditors qua creditors on windings up.

The hybrids rules will still be very technical and complicated, but should be a bit more workable and proportionate in practice after these changes are made.

COVID-19 - OECD guidance on transfer pricing and on tax treaties

Transfer pricing

The disruption caused to business operations by COVID-19 has caused challenges for many businesses' transfer pricing models. The OECD has published guidance on a number of issues giving a clear message that the arm's length principle and the OECD Transfer Pricing Guidelines 2017 are 'fit for purpose' in dealing with the transfer pricing implications of COVID-19, and there is no need to adopt a different approach. Transfer pricing is one area, at least, where the 'new normal' looks very similar to the pre-pandemic position. The guidance does, however, provide clarification and support for taxpayers and tax administrations in four priority areas: comparability analysis; government assistance programmes; losses and the allocation of COVID-19 specific costs; and advance pricing agreements, (APAs). The last two of these are explored in more detail below.

Businesses seeking to make limited-risk entities bear a share of the group-wide losses (including due to "exceptional", "non-recurring" or "extraordinary" COVID-19 related costs) should heed the warning of the OECD that tax authorities should be sceptical of arguments that an entity which has historically been limited-risk should now bear a share of pandemic risk. Such an argument, if successful, may additionally expose taxpayers to the prospect of higher arm's length profits for that entity in the future, and for any open years in the past.

On APAs, the guidance encourages businesses and tax administrations to continue negotiating APAs through the pandemic. COVID-19 should not affect existing APAs

unless a condition leading to the cancellation or revision of the APA (for example, a breach of critical assumptions) has occurred. Where a business is concerned that an APA is no longer appropriate, it should approach the relevant tax administration in a timely and transparent manner. The OECD recommends that tax administrations, on the other hand, should consider waiting for a reasonable period until data and information on the magnitude and longevity of the economic impact of COVID-19 are available before determining how to respond to a breach.

Tax treaties

COVID-19 has caused travel disruption and a change in working practices which businesses and advisors have worried could affect tax residence and/or create new permanent establishments (PEs) or affect an existing PE determination. The OECD has issued updated guidance on tax treaties and the impact of the COVID-19 pandemic which adopts broadly similar views on questions around the creation of PEs and changes in tax residence as the guidance issued in April 2020.

The revised guidance includes further sample guidance issued by tax authorities in a number of jurisdictions including Australia, Germany, the UK and the US. The OECD has also added a note of caution that companies' tax positions may be affected when temporary changes to working practices take on a more permanent character. Although many businesses may be looking to embrace the flexibility of remote-working even after restrictions are lifted, more permanent working practices may have tax implications for the business.

The revised guidance maintains the view expressed in the April version that 'the exceptional and temporary change of the location where employees exercise their employment' should not create new PEs for the employer. The previous assertion that 'it is unlikely that the COVID-19 situation will create any changes to a PE determination' has been deleted, however, which is an indication that some tax authorities may take a stricter view in this respect than others.

Whilst HMRC has agreed to take a 'holistic view of the facts and circumstances of each case' on the question of tax residence, the revised guidance reveals some tax authorities (those in Australia, Canada, Greece, Ireland, and New Zealand) have issued firmer guidance stating that the presence of board meetings or members of key management (for example) outside a company's normal place of residence as a result of COVID-19 restrictions, will be disregarded for the purposes of a tax residence determination.

But for how long can the OECD (and tax authorities more generally) maintain the position that the COVID-19 restrictions (and resulting business practices) are 'temporary'? One year in, do business practices begin to look more 'normal' than temporary or extraordinary? Businesses should take care to review their practices as COVID-19 restrictions continue and as they gradually transition out of COVID-19 working conditions.

In terms of practical steps for ensuring board meetings do not cause a problem with tax residence, if a meeting is to be held remotely, it is advisable that the board minutes and other ancillary documents explain the COVID-19 situation and its impact on travel. Where appropriate, non-resident directors could attend board meetings as observers and not exercise their voting rights, or alternate directors present in the relevant jurisdiction could be appointed.

What to look out for:

- **The Supreme Court is scheduled to hear the appeal in *HMRC v Tooth* on 2-3 March concerning the conditions for a discovery assessment under Taxes Management Act 1970 s 29.**
- **The Budget will be held on 3 March and Finance Bill 2021 is expected to be introduced shortly thereafter.**
- **5 March is the closing date for comments in the consultation of extending Making Tax Digital (MTD) to corporation tax. This project could bring changes beyond a mere digitisation of current processes. For instance, the government is inviting views as to whether a nominated company should be enabled to undertake all MTD filings on behalf of its group members. It is also considering the alignment of the filing dates for company law and tax purposes by bringing forward the time limit for filing company tax returns. This might mean that, whereas all companies currently have 12 months after the end of the accounting period to submit a company tax return, this would be reduced to 6 months for public limited companies and 9 months for private limited companies.**

- The Court of Appeal is scheduled to hear *Ingenious Games LLP and others v HMRC* on 11 March 2021, on whether the LLPs that took part in an avoidance scheme intended to provide enhanced tax reliefs to investors by incurring expenditure on the production of films and video games were trading.

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CONTACT

Mike Lane
PARTNER
T: +44 (0)20 7090 5358
E: mike.lane@slaughterandmay.com

Zoe Andrews
PSL COUNSEL & HEAD OF TAX KNOWLEDGE
T: +44 (0)20 7090 5017
E: zoe.andrews@slaughterandmay.com

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For further information, please speak to your usual Slaughter and May contact.