Tax and the City Review

March 2020

Budget 2020 announcements of interest to financial services include a new economic crime levy and a change to bank surcharge. A review is underway of the taxation of UK investment funds and a consultation on the hybrid mismatch rules is expected shortly. HMRC loses for the third time in *Smith & Nephew* as the Court of Appeal holds that the exchange losses were losses for the purposes of the loan relationships rules and dismissed HMRC's latest argument that the losses did not represent 'real world' losses. The OECD's much-anticipated Transfer Pricing Guidance on Financial Transactions was published in February and is an improvement on the 2018 discussion draft.

Budget 2020: measures affecting financial services

As usual, the devil was in the detail of the documents released when the Chancellor sat down, rather than in the sound bites during the Budget speech itself.

Economic crime levy

Another budget, another new tax, or this time an economic crime levy. This levy is intended to be paid by firms subject to the Money Laundering Regulations to help fund new government action to tackle money laundering. A consultation document on the levy is promised later this spring.

Bank surcharge

Since 2016 banks have had to pay an 8% surcharge on (broadly) all their chargeable profits. The current surcharge legislation disregards carried-forward allowable losses transferred in from non-banking companies to a bank where they are used to reduce future chargeable gains but does not disregard such transferred in carried-forward losses used against in year gains. Finance Bill 2020 (to be published on 19 March) will amend the bank surcharge rules from 11 March to correct this and make sure banks cannot reduce their surcharge liability using allowable losses suffered in non-banking parts of their group. The reason this flaw in the current rules has only come to light now, 4 years after the surcharge was introduced, is likely a result of Brexit planning. Most of the time banking companies' transactions are on trading account and so they have a lot of carried-forward capital losses which they do not tend to use. But, as part of the Brexit contingency planning, valuable assets (such as goodwill) of UK trading entities will have been transferred outside the UK, realising capital gains which they would have sought to shelter with capital losses – including in-year losses transferred from other group companies that are not banking companies.

Consultation on hybrids rules

Usually when there is a consultation on the hybrids rules there is a worry it will make the rules worse for taxpayers. The consultation on hybrid mismatch rules announced in the Budget, however, suggests good news as the intention is to ensure the rules work proportionately as intended. The government is likely to try to fix some circumstances where you can get odd results. For example, a deduction non-inclusion outcome where the person you could tax is exempt (e.g. charity), but they happen to hold a stake through a limited partnership.

VAT on financial services

We welcome the announcement that the government will set up an industry group to review how financial services are treated for VAT purposes. The competitiveness of the financial services industry will be increasingly important after the transition period.

Review of taxation of UK investment funds

The government is reviewing the case for policy changes to the UK's funds regime, looking at regulation as well as tax, to remove barriers to the establishment of UK holding companies within certain investment fund structures. The review will consider the VAT treatment of fund management fees and other aspects of the UK's funds regime.

The consultation published on Budget day is the first part of this review and looks at whether there are changes to be made that could ensure the UK is a more attractive location for companies used by funds to hold assets. Through this consultation, the government seeks to improve its understanding of fund structures, the commercial drivers for their location and the fiscal and economic benefits they bring to the jurisdiction in which they are located. The consultation document makes it clear, however, that changes will only be made if there is evidence they will bring clear benefits and will not create unprotected risks of abuse and avoidance, or decrease the UK tax take in a way inconsistent with the principles of the UK tax system.

***Smith & Nephew*: exchange losses were losses arising from loan relationships**

In *Smith & Nephew Overseas Ltd and others v HMRC* [2020] EWCA Civ 299, the Court of Appeal unanimously dismissed HMRC's appeal, although Sir Geoffrey Vos did not agree with part of the majority's reasoning. This case has not been easy to determine because, in the words of Sir Geoffrey Vos, it "has stood on somewhat shifting sands", both parties having changed their positions as the case progressed.

The three taxpayers were UK companies in the Smith & Nephew group. The ultimate parent of the group was Smith & Nephew plc which used US dollars as its functional currency. Each of the taxpayers was owed an intercompany receivable by its immediate parent company. Although the loans were not interest bearing, the taxpayers, which were otherwise dormant, had to prepare annual tax returns reporting notional interest income on the loans. It was decided that the loans should be released/waived.

When HMRC agreed that the release of the inter-company debts would not give rise to taxable credits or debits but refused to give assurance that the waivers would be disregarded for capital gains purposes, a group restructuring, including a change of functional currency, was devised which would more or less eliminate the intercompany receivables in a tax efficient manner.

The effect of the restructuring was that the taxpayers became direct or indirect subsidiaries of Smith & Nephew plc and were obliged to change their functional currency from sterling to US dollars at a time when the only asset on their balance sheets was a substantial inter-company debt owed to them by their parent company. The intercompany receivables were then substantially eliminated as consideration for the share transfers in the reorganisation. The accounting method chosen triggered exchange losses of around £675m as a result of revaluations in the accounts. The losses were said to arise as a result of the fall in the value of sterling against the US dollar although the taxpayers had no underlying foreign exchange exposure and suffered no real economic loss. HMRC did not accept the losses arose for corporation tax purposes.

Both the First-tier Tribunal (FTT) and the Upper Tribunal (UT) had agreed that the accounts were GAAP compliant (the taxpayers being entitled to

adopt the accounting method they chose) and that the exchange differences gave rise to "exchange losses". HMRC did not challenge either of these conclusions before the Court of Appeal but appealed against the UT's decision that the exchange losses did "fairly represent" losses of the taxpayers for the purposes of Finance Act 1996 s84(1). In particular, HMRC raised a new argument that the exchange losses did not reflect a "real world" detriment and so could not "fairly represent" the losses of the taxpayers. The taxpayers responded with a new argument that the "fairly represent" test is not relevant to the particular exchange losses in this case on construction of the relevant legislation.

Lady Justice Rose gave judgment on behalf of the majority of the Court of Appeal that the "fairly represent" test is not even engaged in this case (because the interaction of regulation 13 of the Exchange Gains and Losses (Bringing into Account Gains and Losses) Regulations, SI 2002/1970 and the loan relationship regime is such that the "fairly represent" test is bypassed). But even if this conclusion were wrong and the "fairly represent" test does apply, Rose LJ went on to say it would be satisfied in this case because the way that section 84A(1) interpolates exchange gains and losses means that the question posed by s84(1) in the context of exchange gains and losses is "do the credits and debits to be brought into account fairly represent the exchange gains and losses arising to the company as a result of its loan relationships?" and not "do the exchange gains and losses fairly represent the profits, gains and losses of the company?". This means all you have to show is that the debits are the same amount as the exchange losses.

The Court of Appeal unanimously agreed that the "fairly represent" test cannot and should not lead to an investigation into the reality of the exchange losses. The majority went further and said even if it did, there are in this case sufficient real-world consequences (the impact of the currency fluctuations on the consideration paid for the intra-group transfer of the shares in the taxpayers as part of the reorganisation and the need for a capital reduction to ensure distributable profits to fund a dividend as part of the restructuring).

Sir Geoffrey Vos preferring not to decide on the regulation 13 point (leaving this to await a case in which a decision cannot otherwise be reached) would dismiss the appeal on the basis that the "fairly represent" test applies and is satisfied in this case. He agreed with Rose LJ that the "fairly represent" test has no real substance to it in the context of exchange losses as it simply requires the GAAP compliant debits to be brought into account. Once HMRC gave up its argument that the debits in question did not accord with GAAP, it had little left in its armoury. Sir Geoffrey Vos expressed the view that exchange gains and losses are different from other gains and losses arising from a company's loan relationship as an exchange loss is a fact dependant only on the times at which a comparison is made. There was no place for a "real world" overlay here as there had been in *GDF Suez Teesside v HMRC [2018] EWCA Civ 2075* which was not concerned with exchange losses.

HMRC has accepted all along that the restructuring of the Smith & Nephew group was undertaken for commercial reasons and not for avoidance reasons. This is so despite the fact that the restructuring, including the change of functional currency, was devised by the taxpayers' advisers to achieve the purpose they could not be certain to achieve by simply releasing the inter-company debts. From the start, however, HMRC has not pursued a tax avoidance argument in this case, perhaps because it wanted to obtain a strong decision on "fairly represent" in a non-tax avoidance scenario. This may prove to be a costly decision!

Although the "fairly represent" test is no longer a part of the loan relationships rules (having been replaced in 2015 with a regime targeted anti-avoidance rule (TAAR)), this case is an important

decision for the other cases waiting behind it. It also highlights the inconsistency of HMRC's application of the test in recent years. The regime TAAR and the certainty it brings are a welcome improvement on the old "fairly represent" test and the judicial activism required to make sense of it.

Transfer pricing guidelines

The OECD's much-anticipated Transfer Pricing Guidance on Financial Transactions was published in February. The guidance, which applies the arm's length principle to financial transactions of associated enterprises, is intended to aid consistency in the application of transfer pricing which will reduce transfer pricing disputes and double taxation. It will form a new Chapter X of the Transfer Pricing Guidelines and will add a new section to Chapter I on risk-free and risk-adjusted rates of return.

The guidance on financial transactions has been a long time coming as the OECD has found it challenging to get consensus on some aspects. Compromises have inevitably been made along the way. For example, delineation under Chapter I is not mandated as the only approach for determining whether purported debt should be respected as debt. The guidance clarifies that countries may use domestic legislation to address issues of capital structure and interest deductibility.

Improvements since the 2018 discussion draft include:

- **Group credit rating and implicit support**: moving away from having a rebuttable presumption that the group's credit rating should apply to every member of the group. The final guidance recognises that there will be some cases where it might be appropriate to apply the group's credit rating to an individual MNE, but in others it will be more appropriate to use the MNE's stand-alone credit rating and adjust for implicit support (the incidental benefit an MNE is assumed to receive solely by virtue of group affiliation).

- **Cash pooling** (either physically or notionally bringing together the balances on a number of separate bank accounts): noting that there is no "one size fits all" approach. Instead, the accurate delineation of cash pooling transactions will depend on the facts and circumstances of each case. The economically significant risks (including liquidity risk and credit risk) associated with the cash pooling arrangement must be examined under Chapter I guidance. The short-term nature of the credit and debit positions within the cash pool arrangement must be taken into account.

- **Captive insurance**: recognising the possibility of internal risk diversification, although noting this may generate lower capital efficiencies than those achieved through external risk diversification.

What to look out for:

- On 18 or 19 March, the Court of Appeal is scheduled to begin hearing HMRC's appeal in *HMRC v 1) NCL Investments Limited, 2) Smith & Williamson Corporate Services Limited*.

- The Finance Bill is expected to be published on 19 March alongside some of the consultations promised in the Budget.

On 24 March the Supreme Court is scheduled to hear HMRC's appeal in *Fowler v HMRC* on whether Article 7 (on business profits) or Article 14 (on income from employment) of the UK-South Africa Double Taxation Treaty applies for the purpose of allocating taxing rights in respect of remuneration for services provided by a diver in the UK under a contract of employment.

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

Zoe Andrews
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.

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