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CLIENT BRIEFING

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TAX AND THE CITY REVIEW FOR JULY

The UK joins other jurisdictions in delaying by six months the reporting deadlines for the new mandatory disclosure rules under DAC6 which come into force on 1 July (although they apply retrospectively from 25 June 2018). HMRC confirms that, exceptionally, claims for carry back loss relief can be made on the basis of anticipated losses if adequate evidence is provided. The OECD continues to facilitate work on the reform of the international tax rules even though an agreement including the US on Pillar One will not now be possible until after the US election. US Treasury guidance provides that from 1 July when the USMCA replaced the NAFTA, any reference to the NAFTA in a US tax treaty should be interpreted as a reference to the USMCA, but there is no such helpful guidance extending the meaning of "equivalent beneficiary" under US treaties to include UK residents.

DAC6

Delay to reporting deadlines

The news that the UK reporting deadlines for DAC6 have been delayed by six months will be welcomed by intermediaries such as lawyers, accountants and financial institutions and (in some cases) taxpayers, currently grappling with a review of cross-border transactions between 25 June 2018 and 30 June 2020 to determine what is reportable for this look-back period. Such reports are now due by 28 February 2021 instead of by 31 August 2020.

From 1 July 2020, the focus should be on real-time evaluation of transactions, although the start of the 30-day period for reporting of arrangements whose reporting trigger is activated between 1 July 2020 and 31 December 2020 is also postponed until 1 January 2021. This is fortunate, not least because the IT system for reporting to HMRC that was due to be available from 1 July is not yet up and running. It also gives everyone more time to make sure they understand the rules and the HMRC guidance published on 30 June in *its International Exchange of Information Manual* (at IEIM60000 onwards) and to ensure appropriate procedures are in place to identify reportable cross-border arrangements.

The delay is made possible by the agreement at EU level to amend the DAC to permit member states (which includes the UK during the Brexit transition period) to delay reporting by up to six months if they wish to do so. The UK regulations implementing DAC6 – the International Tax Enforcement (Disclosable Arrangements) Regulations, SI 2020/25 - will be amended to reflect the delay and HMRC guidance states that no action will be taken for non-reporting between the period of 1 July and the date on which the amendment is eventually made.

HMRC's guidance on the delay (IEIM80010) does not mention a delay to:

- the commencement of the requirement under regulation 7(2) that a UK intermediary unable to report because of privilege should notify another intermediary, or if none, the relevant taxpayer, as soon as reasonably practicable of the reporting obligations under regulations 3 or 4; or
- the reporting required by a UK intermediary or UK taxpayer under regulations 3(b) or 4(b) respectively - which are to be made within the period of 30 days beginning on the date that notification is received.

This has been drawn to HMRC's attention and it is hoped that the amending regulations will deal with this.

Privilege

The UK regulations include an exception from reporting for information which is covered by legal professional privilege (LPP). There had been some confusion, however, about the scope of this exception following HMRC's consultation in July 2019 on draft guidance which suggested lawyers should still be able to provide some "factual information" such as the names of relevant taxpayers and other intermediaries and a description of the transaction, notwithstanding the privilege exception. This approach to LPP was inconsistent with case law, however, as many respondents explained to HMRC.

Such 'factual' information can, and in most cases will, be subject to LPP because it forms part of, or would otherwise reveal, the substance or subject matter of confidential communications that have passed between the lawyer and the client for the dominant purpose of obtaining and giving legal advice. The final HMRC guidance (IEIM621130) avoids delving into what LPP actually is and applies to, so it is helpful that the Law Society has published a set of FAQs titled *DAC6 and LPP* which clarify the scope of the exception and help lawyers to identify the circumstances in which they would need to report. While not endorsed by HMRC, it is our understanding that HMRC received the FAQs in advance and had no objections to their publication.

Impact on financial institutions

Financial institutions will need to consider whether they are intermediaries for the purposes of DAC6, either as a promoter, or, (where there is sufficient knowledge), as a service provider. In some cases, they may be relevant taxpayers. The final HMRC guidance explains that a bank involved in simply providing finance might not have knowledge of the wider arrangements, and crucially whether the arrangement triggered any hallmarks. In such a case, the bank is not expected to make a report, because it did not know, and could not reasonably be expected to know, that it was involved in a reportable arrangement at the time that the arrangement was entered into (IEIM621050).

AFME/ISDA have published a paper proposing a common approach to the application of DAC6 to financial products and services, looking in particular at the application of the hallmarks to financial products and the level of knowledge that a financial institution will typically have of the wider arrangements. The AFME/ISDA paper explains:

- It is important that financial institutions have reasonable and proportionate procedures built in to their existing tax risk governance framework to identify scenarios where they may be acting as an intermediary to a reportable cross-border arrangement. Where these tax risk controls are not triggered, or do not result in escalation, it would then be reasonable for financial institutions to conclude they did not know or have reason to know they are acting as a service provider for a reportable arrangement and that consequently they do not have a reporting obligation under DAC6.

- The provision of ordinary financial products and services is unlikely to give financial institutions reason to know they are providing services in respect of a wider, reportable cross-border arrangement implemented by a client. But where a financial institution specifically designs or markets a product for tax reasons or tailors a transaction based on tax attributes, it can be expected the financial institution would have knowledge of the arrangement as a whole and should consider application of the hallmarks.

Some of the hallmarks relevant to financial products are subject to the main benefit test. The UK legislation provides that this test is met only if the main benefit is a tax advantage which is contrary to the principles and policy objectives of the tax provisions relevant to the arrangement in question. It is our understanding, however, that not all member states limit the meaning of tax advantage in this way. Nevertheless, the AFME/ISDA paper attempts to align the interpretation of tax advantage between tax authorities by drawing on the preamble to DAC6 which makes it clear that the purpose of the legislation is to ensure that tax authorities are informed of potentially aggressive tax arrangements. The paper proposes that where an arrangement produces a tax advantage that is consistent with the law and policy, it should not be regarded as either aggressive or beyond the knowledge of tax authorities. If other tax authorities endorse this view which is already written in to the UK legislation, it will be very welcome!

Early corporation tax repayments based on anticipated losses

HMRC has updated its *Company Taxation Manual* (paragraphs CTM92090 and CTM92650) to confirm that companies may bring a claim to recover corporation tax in exceptional circumstances where the claim depends on events in a subsequent accounting period that has not ended at the time of the claim. This applies to both instalment payers and non-instalment payers and permits them to carry back losses of accounting period 2 (AP2) and reclaim corporation tax paid in the prior accounting period (AP1) even before AP2 has ended. Normally, until AP2 is ended, no allowable tax loss has crystalised because the loss would have to be set against the AP2 profits before determining the amount left for carrying back to AP1.

As a result of the pandemic, there are many companies who anticipate that the expected losses in AP2 are likely to comfortably exceed any relevant income in AP2 and the amount of taxable profits of AP1 that relate to the repayment claim. In order to make a claim before the end of AP2, companies will be expected to provide HMRC with full supporting evidence such as management accounts, forward looking reports to the company's board of directors and any relevant public statements. The level of evidence required will depend on the particular fact pattern of the company, including at what stage in AP2 the claim is made and how firm the projections for AP2 are as a whole at that time.

This change will provide welcome assistance with cash flow for businesses hit hardest by the pandemic.

International tax reform

Pillar One

There were some attention-grabbing headlines in the news last month following a letter from US Treasury Secretary Steven Mnuchin to the OECD requesting a pause of the work on international tax reform until later in the year. One such headline was 'US upends global digital tax plans after pulling out of talks' (Financial Times, 17 June 2020). Pascal Saint-Amans set the record straight, however, in a subsequent podcast. The US is not pulling out of the talks but has had to park the possibility of agreement on Pillar One (the new nexus and allocation rules) until after the US election because it will not be possible to reach agreement before the election.

The priority for the US right now is the trillions of dollars of damage that the pandemic is doing to the US economy, not the billions of dollars at stake under the international tax reform proposals. As Saint-Amans explained, however, for the EU it is a matter of principle and fairness and there is the political will to continue the work. Accordingly, the OECD has made a statement that it will maintain its schedule of meetings to offer all members of the Inclusive Framework a place in the design of a multilateral approach.

We were expecting more technical papers from the OECD this summer but it sounds like the focus is now on sharing something later in the year. In the meantime, Saint-Amans said the time could be used to simplify and streamline the Pillar One proposal to demonstrate in October that there is a good solution which could then be finalised after the US election.

In the meantime, it is inevitable that trade tensions will continue between the US and those jurisdictions which have implemented a unilateral digital services tax (DST) rather than waiting for a global solution. This includes the UK whose 2% DST is currently going through the legislative process but will apply from 1 April 2020, although no tax is due to be paid until 2021.

The US concluded in December 2019 that the French DST is discriminatory against US companies and President Trump announced the US would impose tariffs on imported French goods. A compromise was reached that France would not collect the tax until the end of 2020 and the US agreed not to impose tariffs while the OECD seeks to agree a global measure. Now that global consensus will not be possible by the end of the year, where does this leave the US/France compromise? And the US has not stopped there. In June, the UK and a number of other countries with DSTs (and even the EU itself) have been added to US trade investigation hit list. The US does not want to rush the global solution – but is not happy about the unilateral measures or even an EU measure in the interim, which it perceives unfairly target US tech companies.

Pillar Two

There is still the possibility of political agreement on Pillar Two (a global minimum rate of tax) by the end of 2020, however. Saint-Amans explained progress here has advanced more quickly as there has not been the same problem settling the scope as with Pillar One. It could technically be agreed in October except some countries (including the UK) see it as a package with Pillar One.

There is, however, nothing to stop the countries who want to adopt Pillar Two going ahead as a coalition without those who do not because, as the US has shown with GILTI, it is not necessary to amend tax treaties to bring in a minimum rate of tax. Saint-Amans warns that any countries with reservations about Pillar Two, such as low-tax countries, would still be better off being part of the consensus to shape the minimum tax, including getting carve outs and other protections which would benefit them.

US tax treaties and Brexit

US tax treaties were understandably drafted on the assumption that the UK would continue to be a member of the EU. In order to obtain the benefit of many of the treaties between the US and EU member states, a UK holding company's non-UK subsidiaries must be owned by an 'equivalent beneficiary' which is generally defined as 'a resident of a Member State of the European Community or of a European Economic Area state or of a party to the North American Free Trade Agreement'. Clearly no one saw the need, even in the US/UK treaty (which is intended to apply to people in the UK) to add the UK to the list: it was covered by the EU wording. Post-Brexit, however, the UK company no longer qualifies as an equivalent beneficiary and its non-UK subsidiaries may be denied treaty benefits. Where necessary, most groups have reorganised pre-Brexit to avoid non-resident companies losing treaty benefits, but it is hoped that there will, in time, be a fix for this.

The US Treasury recently issued guidance confirming that from 1 July when USMCA replaced NAFTA, any reference to NAFTA in a US bilateral income tax treaty should be interpreted as a reference to USMCA. This was necessary to correct an oversight in USMCA's implementing language which would have caused problems for companies relying on benefits in the relevant treaties which continue to refer to NAFTA.

It is a shame the US Treasury did not also add to this guidance that UK residents would continue to be treated as 'equivalent beneficiaries' notwithstanding Brexit. But the US is understandably not feeling that helpful towards the UK at present with the introduction of the UK's digital services tax which it sees as targeting US tech companies. So we will have to wait a while yet, perhaps for wider UK/US trade discussions, before this treaty issue is resolved.

What to look out for:

- The Finance Bill is progressing through its legislative stages with Royal Assent likely before the summer recess.
- The next Inclusive Framework meeting on the tax challenges from the digitalisation of the economy is scheduled to take place remotely in July so there may be an update on progress made.
- Regulations will be enacted amending the UK regulations implementing DAC6 (SI 2020/25) to delay the reporting deadlines by six months.
- Draft legislation to tighten existing legislation against those who promote and market tax avoidance schemes is to be published in July, for inclusion in Finance Bill 2021.

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