Slaughter and May Podcast
Tax news highlights: September 2020

Zoe Andrews	Welcome to the September 2020 edition of our tax newscast. I am Zoe Andrews, Head of Tax Knowledge.
Tanja Velling	And I am Tanja Velling, Professional Support Lawyer in the Tax department. Zoe and I will discuss speculations on how to cover the cost of the pandemic, the VAT grouping call for evidence, HMRC's change in policy on the VAT treatment of early termination fees, and the decision in the Irish Bank case on tax treaty interpretation. This podcast is recorded on 15 September 2020 and reflects the law and guidance on that date.
Zoe Andrews	Now we do not yet have dates for the comprehensive spending review and the Autumn Budget. Indeed, it has been suggested that the Chancellor that he's keeping open the option of postponing the Budget until 2021 (in the same way as was done this year because of the general election). But there has been much speculation in the press about the inevitability of tax rises in light of the huge spending on the pandemic. As the Conservative Manifesto for the general election ruled out increases in income tax, VAT and NICs, will corporation tax be raised? Corporation tax is currently at 19% and one of the rumours is a possible rise to 24%. Do you think that is a good idea, Tanja, or could that prove detrimental to economic recovery?
Tanja Velling	Well economists have warned that tax increases could undermine the recovery. Now, more than ever, we need the corporation tax rate to remain competitive. The French government, by way of contrast, had unveiled a 4-year stimulus package which will include tax cuts (not rises). That said, with a current corporation tax headline rate of 32%, France has some way to go to compete with the UK's rate of 19%. Historically, tax cuts in the UK have been shown to raise, not decrease the tax take. So, it is hoped the Chancellor will bear this in mind. Corporation tax is not as big a revenue raiser as income tax, national insurance contributions and VAT, in any event. So, the benefit may not be worth the risk. And damaging UK tax competitiveness as BREXIT looms raises other issues, too.
Zoe Andrews	Another speculation is bringing the tax treatment of dividends and capital gains tax into line with income. This would certainly have some simplification advantages and should cut down on tax planning opportunities which will make HMRC happy. But equalising the rate of CGT and income tax was proposed by Labour and opposed by the Conservatives in the general election so there will be some political hurdles to overcome here to pursue this route.
Tanja Velling	Interestingly, capital gains tax, or CGT for short, used to be charged at the same rate as income tax. This changed in April 2008 when the Labour government under Gordon Brown introduced a separate, lower CGT rate. So, aligning the rates would bring us almost full circle. I say "almost" because the introduction of the lower CGT rate in 2008 went hand-in-hand with the abolition of indexation and taper reliefs. These reliefs had previously been used to reduce chargeable gains on long-term holdings and thereby remove inflation gains from the scope of CGT. Would similar reliefs be re-introduced alongside a re-alignment of the rates?

Zoe Andrews	And this links to a crucial policy question. Especially now, in times of economic turmoil, shouldn't entrepreneurism be rewarded and encouraged? It would be a difficult time to increase tax for entrepreneurs – especially after the government only recently curtailed entrepreneur's relief. That relief was, in fact, introduced following an outcry from the business community over the abolition of indexation and taper reliefs as part of the 2008 reforms. Given this background it could appear particularly anti-entrepreneurial, if the government decided to align CGT and income tax rates without, at least, undoing their curtailment of entrepreneurs relief. Then again, if other changes are being made that will be negative for Conservative voters, it may be that some "concessions" on "taxing the rich" have to be made. But the hope is that the chancellor, having floated some ideas, will then let them all sink gracefully below the surface.
Tanja Velling	Another option that has been floated is a special online sales tax. Set at 2%, it would be expected to raise £2m a year – so, unfortunately, not a big revenue-raiser. The tax would be intended to give the High Street a slight advantage over online sellers to make up for their higher overheads. Based on recent experience with the digital services tax, it seems likely that such an online sales tax would be passed on to the consumer. I would hazard the guess that many consumers may decide that shopping from the comfort of their own homes would be worth a 2% price increase, but other, in particular more vulnerable, consumers could be driven to shop in person. The government has published a call for evidence looking at the benefits and risks of an online sales tax as part of the review of Business Rates. There will no doubt be more on this later this year.
Zoe Andrews	Yes. The Budget will certainly be an interesting one (whether it takes place in the Autumn or is delayed until next year)! What other possible changes are in the pipeline, Tanja?
Tanja Velling	The government has published a call for evidence on three aspects of the VAT grouping rules. The first includes the question whether the UK should move from "whole establishment" to "establishment only" provisions. Such a move would being the UK in line with most European countries, except Ireland and The Netherlands. So, what's the difference between the two types of provision? This goes back to the Skandia case which was decided by the Court of Justice of the European Union in September 2014. A US company had supplied IT services to its Swedish branch. The Swedish branch, but not the US head office, was part of a Swedish VAT group. This meant that the supply of IT services constituted a supply between two separate entities for VAT purposes, namely between the US company and the Swedish VAT group. Consequently, the supply was subject to Swedish VAT. Broadly, "establishment only" provisions enable the Skandia situation. Only the domestic branch, but not the foreign head office, is regarded as part of the VAT group. Therefore, supplies between the branch and the head office are treated as supplies between two different persons for VAT purposes and potentially subject to VAT. "Whole establishment" provisions, on the other hand, avoid this problem. All establishments of the foreign entity are regarded as part of the VAT group. In this way, the VAT-group would have extra-territorial reach. It would include the foreign head office as well as the domestic branch. As a result, supplies between them would be disregarded for VAT purposes.

Zoe Andrews	The second aspect is looking at making VAT grouping compulsory. Currently, whether an eligible entity is part of a VAT group is optional but the second part of the call for evidence looks at whether VAT grouping should be compulsory where eligibility criteria are met. Compulsory VAT grouping can offer administrative easements, and level the playing field for businesses who would then all operate under the same VAT treatment. But it will be quite a change for many groups which have chosen to include some but not other entities in the VAT group – and anyone selling a company with joint liability for all the group's past VAT exposures may have cause to prefer that situation had not been created.
Tanja Velling	Finally, the call for evidence looks at the grouping eligibility criteria for businesses currently not in the legislation, such as limited partnerships. The question is the following. Is it appropriate to continue to allow these to join VAT groups by extra-statutory concession or should this be put on a statutory footing? The closing date for responses is the 20th of November 2020. Zoe, while we are talking about VAT, I believe that HMRC has recently changed its policy on compensation payments. Is that correct?
Zoe Andrews	Yes, it is. HMRC published a Revenue and Customs Brief explaining its change in policy on the VAT treatment of early termination fees and compensation payments. Previously, HMRC's view was that payment of a break/termination fee provided for under a contract would not be further consideration for a taxable supply, as distinct from a separate agreement to break/terminate (outside of the original contract) where any fee would be consideration for the supply of agreeing to terminate. Now, following the CJEU case which triggered this (concerned with the early termination of a mobile phone contract) HMRC has changed its view and both are taxable. The distinction between the treatment of termination provisions/fees based solely on whether they were provided for under the original contract, or were agreed later was always thought to be suspect and so its disappearance is not particularly troubling. But what about HMRC's new approach to liquidated damages?
Tanja Velling	HMRC have gone further than required by the European case law. They now say that liquidated damages payable under a contract in respect of its early termination or breach are no longer outside-the-scope as compensation. Instead, they will be treated as further consideration under the original contract. This was a surprise and the question arises whether it means that break fees in the M&A context will now attract VAT. I think the answer is "not necessarily". Take the example where a break fee becomes payable by the seller following the termination of the share purchase agreement by the seller, for example because the seller was unable to obtain necessary shareholder approvals. The break fee would flow in the opposite direction than the consideration under the contract would have flowed if the contract had been performed. So, it cannot constitute a replacement for consideration payments. As such, it should remain outside-the-scope of VAT, provided it is compensatory in nature.
Zoe Andrews	There is a retrospective element to this policy change. For termination fees or compensation payments which were not cleared in advance by HMRC, the Brief says "Any taxable person that has failed to account for VAT to HMRC on such fees should correct the error". Those cleared by HMRC as outside the scope are fine if paid before 2 September.
Tanja Velling	Have there been any interesting cases recently?
Zoe Andrews	A case that I read with particular interest recently is the Irish Bank case which concerned the deductibility of interest payments and which turned on the

	interpretation of a double tax treaty. This case is important for two reasons. First, it contains useful points about what can be taken into account when interpreting tax treaties and second, it emphasises the distinction between the UK Parliament, as the legislature, and HMRC, as part of the executive. The Court of Appeal agreed with the Upper Tribunal that attribution of notional capital to a UK PE of an Irish bank (rather than looking at actual capital) is compatible with the UK/Republic of Ireland tax treaty. The taxpayers had argued that the UK legislation attributing notional capital to the PE was precluded by the wording of the tax treaty. If HMRC had taken into account the actual capital of the PE, the interest on the loan paid by the UK PE to the Irish bank would have been deductible. But the Court of Appeal disagreed. The business profits article of the UK/RI treaty (and the equivalent provisions of the OECD model as it varied over time) are not intended to lay down precise or exhaustive rules about allocation of profits to a PE. Contracting states have been given a measure of flexibility and the UK domestic measure requiring an attribution of notional capital was consistent with the treaty. The Court of Appeal confirmed that in the interpretation of treaties you can take into account OCED materials and foreign case law, to the extent that it is relevant. But you cannot take into account HMRC's prior practice because this is unilateral. Lord Justice Singh agreed with the lead judgment of Patten LJ but also made some interesting further observations about confusion in this area being down to insufficient attention being paid to the important distinction between the different parts of the state. The question before the Court of Appeal was what the UK Parliament, as the legislature, had done, and not what HMRC, as part of the executive had done. As is frequently the case these days, HMRC attempt to use guidance to address a perceived problem with legislation. But as Singh LJ said "Even if there is a legitimate expectation created by the past practice of HMRC it cannot prevent HMRC giving effect to the will of Parliament; indeed, it is the duty of HMRC to give effect to that will."
Tanja Velling	And now to some dates for your diary and things to look forward to. • The consultation on the Economic Crime Levy closes 13 October. The economic crime levy is a new tax to be imposed on the Anti-Money-Laundering or AML-regulated sector from 2022/23. The stated aim of the levy is to raise funds to combat economic crime such as money laundering. • We are also expecting that the OECD will soon publish the blueprints for international tax reform. These are intended to be finalised at the Inclusive Framework meeting on 8/9 October, prior to the Finance Ministers meeting on 14 October • Some interesting cases are also coming up. In October, the Upper Tribunal is due to hear the appeal in the Embiricos case concerning partial closure notices. And the Court of Appeal hearing will hear the appeal in the Development Securities case on corporate tax residence
Zoe Andrews	That leaves me to thank you for listening. If you have any questions please contact Tanja or me, or your usual Slaughter and May contact. Further insights from the Slaughter and May Tax Department can be found on the European Tax Blog - www.europeantax.blog. A recent post by Ed Milliner discusses the Revenue and Customs Brief on the VAT treatment of early termination fees and compensation payments mentioned in this podcast in further detail. You can also follow us on Twitter - @SlaughterandMayTax.