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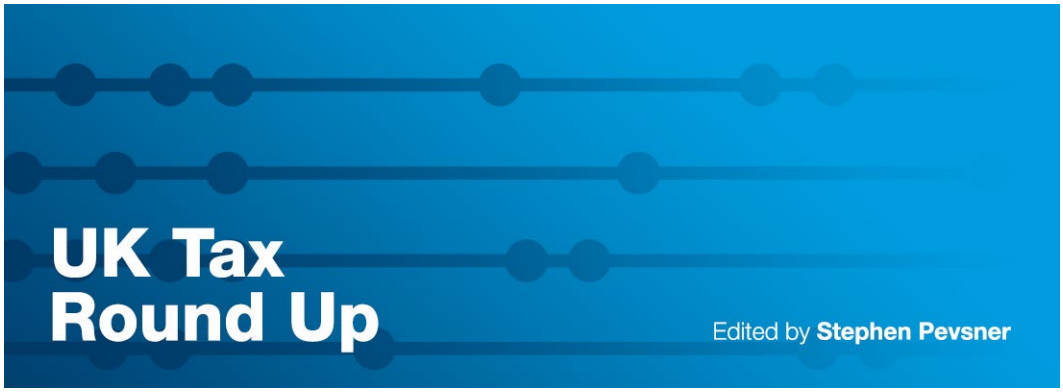

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Welcome to February's edition of the UK Tax Round Up. This month has seen a number of interesting decisions covering the unallowable purpose test in relation to cross border group relief tax losses, the application of the Canada-UK double tax treaty to the taxation of oil related payments and the application of the statutory residence test and what constitutes "exceptional circumstances", and updates from HMRC on the latest guidance on the "capital contribution" test in the salaried members rules and taxpayer return information provision related to carried interest.

HMRC Announcements

Latest HMRC guidance on "capital contribution" condition in the salaried member rules

Following wide-ranging consternation about HMRC's unexpected publication of revised guidance on the application of the salaried member "target anti avoidance rule" (TAAR) to the "capital contribution" condition in February last year, HMRC have agreed to amend their guidance, in effect reversing those changes. For our summary of the February 2024 rules please see our previous UK Tax Round Up.

Under section 863A ITTOIA 2005, members of UK limited liability partnerships (LLPs) who are treated as "salaried members" are subject to tax on their remuneration as if they were employees. Under the rules, all members of an LLP are salaried members unless they "fail" one of the three tests in sections 863B, 863C and 863D ITTOIA (so-called Conditions A, B and C). In order to fail Condition C (the "capital contribution" test), the relevant member's capital contribution to the LLP for the relevant tax year must be at least 25% or more of their expected "disguised salary" (being the amount of their total expected remuneration which is not "variable"). In addition to these conditions, the salaried member rules include a TAAR in section 863G ITTOIA which states, broadly, that no regard is to be had to any arrangement the main purpose, or one of the main purposes, of which is to secure that an LLP member is not a salaried member. It is not uncommon for LLPs which rely on certain of their members failing Condition C to have arrangements in place under which the members will make additional capital contributions to the LLP in anticipation of their remuneration increasing to ensure that the contribution is equal to at least 25% of the expected remuneration (so called "top up" contributions).

In February 2024, HMRC updated their guidance on Condition C to include an example to which they stated that the TAAR would apply involving a member who had made a "genuine" capital contribution to an LLP on becoming a member then making additional "top up" contributions as a result of an increase in expected remuneration and as required to ensure that the member continued to satisfy the 25% capital contribution in Condition C. The revised guidance stated that the additional capital contribution would be disregarded applying the TAAR if the, or any, main purpose of making the additional capital contribution was to fail Condition C. This introduced a high level of uncertainty about what sort of capital contribution arrangements HMRC considered could be disregarded for the purpose of Condition C applying the TAAR (and, indeed, how the TAAR was to be applied generally). The guidance before the changes in February 2024 had stated that "in applying the TAAR, HMRC will take into account the policy intention underlying the legislation, which is to provide a series of tests that collectively encapsulate what it means to be operating in a typical partnership. A genuine and long-term restructuring that causes an individual to fail one or more of the conditions is not contrary to this policy aim". This statement had been widely interpreted to mean that a "top up" contribution that was committed as long term capital to the LLP that was at risk for the member would be respected for the purpose of Condition C.

HMRC's latest statement to the Chartered Institute of Taxation confirms that HMRC will be reversing these changes. HMRC maintain that the TAAR will apply if the main purpose, or one of the main purposes, of the arrangements under Condition C is to secure that the salaried members rules do not apply to a member, but that in applying this test HMRC will take into account the policy intention behind the salaried members rules and have confirmed that an arrangement whereby a member makes a "genuine" contribution to an LLP, which is intended to be enduring and giving rise to real risk to the member, will not trigger the TAAR.

HMRC have not yet released any further details or drafting concerning the revisions to the guidance. While it is hoped that this revised guidance will remove the uncertainty caused by the February 2024 revisions, we wait to see whether there is any further assistance on what is required for a contribution to be "genuine" in a context where a main purpose of making such contribution might be to fail Condition C.

HMRC guidance on tax return information provision for carried interest

HMRC has published additional guidance in the *Investment Funds Manual* on the information taxpayers receiving carried interest could consider providing in or with their tax return to reduce the likelihood of HMRC launching an enquiry. Fund managers are being encouraged to include as much information as possible in partnership returns to reduce the risk of HMRC requesting more information or conducting a compliance check to verify the taxpayer's tax liability, with HMRC providing certain examples of the sort of information that they would like to see.

One of the examples relates to the difficulty that fund managers can face in providing information specific to their UK tax liability in their returns due to the information available from the funds from which the carried interest derives which often provide so-called K-1s relevant to US tax. While this is an issue that HMRC are aware of, the guidance discusses the sort of information that a fund manager should try to obtain to ensure that they have exercised "reasonable care" in preparing their UK tax returns. Where the fund manager does receive information that is not tailored to UK tax, the guidance states that HMRC would expect them "to use reasonable efforts to obtain further information, including requesting this from their firm".

Fund managers are also being encouraged to provide HMRC with "tax packs" which, while not required in order to avoid a compliance check, would provide additional useful information and could assist in minimising any checks or enquiries by helping HMRC determine the purpose of different sums in the fund manager's return. HMRC have referred to such information

assisting with determining whether sums comprising carried interest are dividends, interest or gains, or providing the details of underlying fund structures and details for any claims or elections by the funds.

Funds should consider the revised guidance and whether they could increase the information they currently provide to HMRC in relation to carried interest in order to minimise the risk of HMRC needing to conduct compliance checks and enquiries. The guidance can be found here and here.

UK Case Law Developments

Unallowable purpose rule on cross border group relief tax losses

In *Lloyds Asset Leasing Limited v HMRC,* the First-tier Tribunal (FTT) considered whether Lloyds Asset Leasing Limited (Lloyds), a UK resident company, was entitled to claim cross-border relief in the UK under section 135 CTA 2010 for losses generated by the Irish resident Bank of Scotland Ireland Limited (BOSI) which was a member of the Lloyds group. The issues under consideration were whether the qualifying loss condition in section 119 CTA 2010 and the precedence condition in section 121 were met and whether under section 127 CTA 2010 the losses should be excluded from relief in the UK because the main purpose, or one of the main purposes, of the arrangement was to secure cross-border group relief for the losses. The cross-border group relief rules were repealed in 2021 but the decision is relevant in its consideration of the "unallowable purpose" test in section 127, which provided that the non-UK amount claim as group relief would not have arisen but for arrangements the main purpose, or a main purpose, of which was to secure that the amount might be surrendered as group relief.

Applying the unallowable purpose test in section 127, the FTT found on the facts that, while the conditions for cross-border group relief for the losses in question were satisfied, one of the main purposes of the arrangements put in place was to allow the Irish losses to be surrendered as group relief in the UK and, therefore, the cross-border group relief was not available in relation to the losses.

Lloyds had acquired BOSI as part of its acquisition of the HBOS group following the financial crisis in 2008. BOSI had a large book of Irish real estate related loans that were standing at a substantial loss and had accumulated tax losses. The market in Ireland was such that it was unlikely it was going to become profitable again. Lloyds decided to exit the Irish lending market and considered a number of options to do that. Following tax advice that the BOSI Irish losses could only be used in Lloyds' UK group if, among other things, there was no possibility that the losses could be used in Ireland (or elsewhere other than the UK) and the group retained no business or permanent establishment in Ireland, it was decided in or around June 2010 that the Irish business should be wound down through a cross border merger of BOSI into a UK company in the Lloyds group, This had to be completed by the end of 31 December 2010, which was an ambitious timetable. Prior to implementing the merger into the UK company, BOSI had to be transferred from under its Dutch parent. The cross-border merger transaction was implemented by 31 December 2010 in the manner planned and Lloyds claimed the Irish losses as group relief to use against the UK profits in Lloyds. The case concerned two main issues. First, whether the losses could benefit from cross-border group relief under the necessary conditions in the UK. Second, if the losses did meet the necessary conditions, should they be excluded because the arrangements had the main purpose of attaining a tax benefit under section 127. Lloyds argued that since the group had commercial reasons for wanting to leave the Irish lending market, which was not disputed, tax was not one of the main purposes of the transaction and that after the decision to leave Ireland had been made the group could decide how to implement the exit in a tax efficient manner. Lloyds also claimed that the key decision makers would have chosen to liquidate

BOSI whether or not there was the UK tax advantage.

The FTT recited a large amount of internal communication between Lloyds' personnel that showed how the decision to implement the cross border merger of BOSI and the need to complete it by 31 December 2010 had led to a more complicated transaction than other possible transactions and that the driver behind the specifics of the transaction actually entered into had been to obtain the UK group relief. The FTT emphasised that the court can consider all of the circumstances relating to the decision taken by the taxpayer, not just the final decision or the stated principal purposes of the key decision makers, including all of the facts and advice received leading to the decision in order to determine a company's purposes. Additionally, as per prior case law, the fact that the taxpayer has a commercial purpose as a main purpose does not preclude obtaining a tax advantage also being a main purpose. The evidence also showed that Lloyds group and BOSI personnel were aware of the risk of having tax identified as a main purpose and specifically removed references to the importance of the potential tax advantage in the final approval documents and emails.

The FTT found that it was clear on the facts that Lloyds had chosen and implemented the specific method of ending BOSI's Irish lending business, being the "arrangement" that allowed the Irish losses to be surrendered to Lloyds, with a main purpose of allowing the losses to be group relieved. The group relief was, accordingly, denied applying section 127 and it was not relevant that the Lloyds group might have had other, commercial reasons for planning to bring an end to BOSI's business in Ireland.

The decision is one of several cases in recent years which have provided some clarity on the application of the unallowable purpose rule, albeit the other cases have related to loan relationships, and it serves to underline that when considering whether a company has a main purpose, or one of its main purposes, for the arrangement to obtain a tax benefit, the circumstances, evidence and intentions that the court is entitled to consider are wider than just those relating to the final decision. So, while it is accepted that tax advice will inevitably be sought in relation to a transaction, it is not sufficient that there is a commercial purpose for carrying out a general course of action and it is essential that taxpayers think carefully about just what it is that the main purpose is focused on in the particular rules that are relevant to the transaction in question.

No UK taxing rights over payments relating to oil licences under UK-Canada double tax treaty

In *Royal Bank of Canada v HMRC,* the Supreme Court (SC) considered the allocation of taxing rights between the UK and Canada under the UK-Canada Tax Treaty (the Treaty) regarding payments that were linked to oil extracted from the UK continental shelf under licence from the UK Government and whether HMRC had the right to claim UK corporation tax on the payments.

Previous decisions by the FTT and the Upper Tribunal (UT) held that under Article 6 of the Treaty and section 1313 CTA 2009, the Royal Bank of Canada (RBC) had to pay corporation tax on the payments. The Court of Appeal (CA) disagreed and held that the UK did not have the right to tax RBC for the relevant payments under the Treaty and, therefore, did not consider it necessary to determine on the application of section 1313. The SC agreed with the CA that under the Treaty the UK did not have taxing rights in relation to the relevant payments. However, the SC held that if the UK had have had taxing rights under the Treaty, the relevant payments would have fallen under the charge to UK corporation tax under section 1313 CTA 2009.

The case related to a licence to search for and extract oil granted by the UK government to a UK subsidiary (Sulpetro UK) of a Canadian company (Sulpetro Canada) set up in order to comply with the UK government's requirement that all licences be granted to UK resident

companies, with Sulpetro Canada providing all of the necessary financing and equipment in return for all of the oil which Sulpetro Canada could then sell. Under the licence, Sulpetro UK was required to make royalty payments to the UK government. Sulpetro Canada sold all of its assets, including the entire issued share capital of Sulpetro UK, to BP Petroleum Development Ltd (BP) for consideration totalling £17 million. Under the share purchase agreement, BP promised to make payments to Sulpetro Canada in respect of the Sulpetro UK's extracted oil (the Payments) as consideration for the novation of the agreement under which Sulpetro Canada had been entitled to the oil extracted by Sulpetro UK. However, the Payments would only be made if the price of a barrel of oil was more than US$20 and the Payments would be half the difference between the actual market value and US$20 per barrel.

Sulpetro Canada entered receivership and its right to receive the Payments was assigned to RBC. The Payments were considered income in RBC's hands and were subject to tax in Canada. The Payments were not made continuously due to the price of oil not always being above $20 per barrel. HMRC sent RBC notices of assessment which asserted that the Payments were subject to UK corporation tax under section 1313 CTA 2009 as being "profits from exploration or exploitation activities carried on in the UK sector of the continental shelf or from exploration or exploration rights".

RBC argued that the UK did not have taxing rights over the Payments under the Treaty because they were not "income from immovable property" which included "rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources" under Article 6(2) of the Treaty as the Payments were not consideration for the "right to work" the UK's seabed.

The FTT rejected RBC's arguments that Article 6(2) was only concerned with taxation rights in relation to the grant of the right to work by the person who owned the natural resources and not the transfer of the right to the income as such an interpretation could lead to tax avoidance. The FTT determined that RBC held rights to variable payments as consideration for the right to work under Article 6(2) and, therefore, the UK had taxing rights. In addition, since RBC had the right to the (indirect) benefit of the oil, the Payments also fell within section 1313(2)(b) CTA 2009. The UT upheld the FTT's decision, dismissing RBC's appeal that consideration should have been had to the true contractual position of the parties with the licence always remaining within Sulpetro UK, holding that Sulpetro Canada and then BP had been operating the working of the rights through Sulpetro UK under the original agreement giving Sulpetro UK its rights to exploration.

The CA disagreed, holding that Article 6(2) of the Treaty related to rights to payments held by a person who had a continuing interest in the land in question, and the rights held by Sulpetro Canada in respect of the oil extracted by Sulpetro UK did not amount to a right to work the oil, and so BP's rights to receive the Payments were not a right to work the oil in question. Therefore, the Payments were not consideration for the right to work subject to UK taxing rights under the Treaty. The CA did not then consider whether the Payments fell within the charge to UK corporation tax.

The issues for the SC were (i) whether the Sulpetro Canada's rights under the original agreement with Sulpetro UK amounted to a right to work the oil field within the meaning of Article 6(2) of the Treaty (ii) if yes, whether the Payments made by BP to RBC in consideration for those rights with regard to the novation of the agreement with Sulpetro UK from Sulpetro Canada to BP were within the scope of Article 6(2), and (iii) if yes, whether the Payments were subject to corporation tax under section 1313 CTA 2009.

On the first point, the SC agreed with the CA that the right to work was granted under licence to Sulpetro UK by the UK government and was always held by Sulpetro UK. Sulpetro Canada

never held the right to work in relation to extracting oil from the North Sea. While Sulpetro Canada provided the necessary finance to enable Sulpetro UK to discharge its obligations to the UK government, Sulpetro Canada did not itself discharge those obligations and there was no legal relationship between Sulpetro Canada and the UK government. Sulpetro Canada's right to oblige Sulpetro UK to work the North Sea shelf was legally different from having a right to work the natural resources. The SC also clarified that RBC's argument that the FTT and UT had assumed all income derived from oil in the North Sea should be taxed in the UK was an incorrect assumption to apply to the terms of the Treaty. The Treaty does not prevent entities from "avoiding" tax or determine whether income should be subject to tax or "tax-free". The purpose of the Treaty is to identify the line between Canada's right to tax specific profits of a Canadian resident company and the UK's right to tax the same profits which derive from the exploitation of the UK's natural resources. The main purpose of the Treaty being to eliminate double taxation. Article 6(2) was included to transfer certain primary taxing rights from the jurisdiction where the company is resident to the jurisdiction where the natural resources being exploited are located.

The SC agreed with the CA that when considering if the Payments amounted to consideration for the right to work, as required under Article 6(2), it was inherent in the requirement that the recipient of the payments must be the person who can confer the right to work on the payer. As neither Sulpetro Canada nor RBC, as respective recipients of the Payments, had an interest in the North Sea shelf which would enable them to confer a right to work on Sulpetro UK, the consideration received cannot have been for the right to work the North Sea shelf.

The case emphasises the intention of tax treaties is to provide for the allocation of taxing rights in certain circumstances and to assist with eliminating double taxation. A treaty does not operate to determine if an amount should be tax free and/or that amounts should be taxable applying a "flavour" to them.

"Exceptional circumstances" existed for purposes of the statutory residence test

In *A Taxpayer v HMRC*, the CA has considered whether a taxpayer avoided being resident in the UK in the tax year 2015/16 applying the statutory residence test (SRT) under Schedule 45 of FA 2013 by reason of only being in the UK because of "exceptional circumstances". The FTT had determined that the taxpayer was not resident under the statutory residence test as she was only present in the UK for some of the time in question because of "exceptional circumstances". The UT disagreed and remade the decision of the FTT holding that the FTT had erred in law in its approach to determining whether the circumstances in question were or were not "exceptional" and that they were not. The CA has held that the UT was wrong in its approach to the FTT's decision and has restored it.

The taxpayer had been tax resident in the UK until just before the commencement of the 2015/16 tax year when she relocated to Ireland, leaving her husband in the UK who was planning to retire shortly and join her in Ireland. She had a twin sister and a brother who lived in the UK. Her sister had two young children. Prior to relocating to Ireland, the taxpayer's husband had given her some shares which paid out a large dividend in the 2015/16 tax year. Under the SRT, the taxpayer could spend 45 days in the UK in the tax year before she would be treated as UK tax resident. The taxpayer agreed that she had already spent 44 days in the UK. However, she had also visited the UK twice, in December 2015 and in February 2016, for a total of six days to look after her twin sister and her children, and it was these days that were the question of the case.

The taxpayer's twin sister struggled with alcoholism and mental illness. The taxpayer provided evidence that she felt she had no option but to go to the UK in December and February in order to assess the welfare of her sister and her children and that, while she had no intention to stay at the outset, on both occasions she found a dysfunctional family household with her

sister incapable of caring for herself or her children and she could not leave until she had stabilised the situation and ensured her sister was no longer a harm to herself and that the children were being looked after.

The taxpayer relied on paragraph 22(4) in the SRT, which provides that a day does not count for the purpose of determining how many days a person has been in the UK if the person would not have been present in the UK but for "exceptional circumstances beyond their control which prevented them from leaving the UK" and that they intended to leave as soon as the circumstances permitted. The questions for the CA were whether the lower courts had correctly construed the meaning of "exceptional circumstances" and if those "prevented" the taxpayer from leaving.

"Exceptional circumstances" are not defined in the legislation, but certain illustrative examples are given of national or local emergencies such as war, civil unrest or natural disasters, and sudden or life-threatening illness or injury. The FTT found that while the taxpayer's sister did have alcohol and mental health problems, this was not an "exceptional" circumstance as there were plenty of people suffering the same. However, in the FTT's opinion, the presence and needs of the minor children who were not being looked after changed this and should be considered "exceptional circumstances" from a moral conscience perspective. The UT agreed with HMRC that the FTT erred in law in deciding that the requirement for exceptional circumstances could be satisfied by a moral or conscientious obligation, rather than a legal obligation or being physically prevented from leaving, and that the statutory test was not satisfied as the taxpayer was not prevented from leaving the UK.

The CA confirmed that when considering the SRT, the ordinary meaning should be given to the words used in it that are not defined, particularly "prevent" and "exceptional circumstances". The CA agreed with the UT that "prevent" as discussed in *Financial Conduct Authority v Arch Insurance* case meant stopping something from happening or making an intended act impossible, which is different from mere hindrance. However, the CA confirmed that this cannot be limited to specific categories such as a legal obligation to remain or being physically prevented from leaving. It is the job of the courts to distinguish between cases where there is a difference between a taxpayer compelled or obliged to stay and prevented from leaving and those cases where it is more convenient or preferable to stay. When subjective reactions and moral obligations are considered, the court should take into account whether the taxpayer's reaction is reasonable and in accordance with ordinary societal expectations.

On what is to be considered to be an "exceptional circumstance", the CA held that the UT's restrictive view that illness and death were not exceptional circumstances was incorrect. The test requires exceptional circumstances to be considered having determined the facts and circumstances as a whole and to determine whether, having regard to those circumstances, the taxpayer was prevented from leaving the UK. "Exceptional" is to be given its ordinary meaning and is a question of fact, although it must be read as a whole phrase "exceptional circumstances beyond the individual's control that prevent the individual from leaving the UK". The purpose of the examples of what is exceptional circumstances is to illustrate certain circumstances that Parliament would consider as exceptional, not to restrict exceptional circumstances to only these examples. However, the CA did hold that given the purpose of introducing this test to replace a more general test, it must have been part of Parliament's intention that the exceptional circumstances requirement would not be met too easily and courts should have proper consideration to whether, on the facts the circumstances qualify or not.

Applying this reasoning, the CA upheld and reinstated the decision of the FTT as a correct (or not unreasonable) approach to the test in the light of the taxpayer's circumstances and based

on its interpretation of the test. The CA stated that the FTT had determined on sufficient evidence that the level of neglect and consequences for the minor children were exceptional circumstances and went further than the distress and suffering generally caused by alcoholism, and prevented the taxpayer from leaving until the situation for the children was stabilised. The UT had been wrong to interfere with the FTT's decision on the basis that the FTT had applied the law incorrectly.