Proskauer

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Welcome to the October edition of the Proskauer UK Tax Round Up. It has been a reasonably busy month, with a number of interesting UK cases being reported as well as further clarity from the CJEU in relation to VAT. The Autumn Budget will be presented later today and the Finance Bill 2019 will be published on 7 November.

General UK Tax Developments

CIOT responds to the draft profit fragmentation provisions in the Finance Bill 2019

The Chartered Institute of Taxation (CIOT) has published its response to the profit fragmentation rules published on 6 July 2018 in Clause 10 and Schedule 6 of the draft Finance Bill 2019.

The CIOT considers that the rules as currently drafted would contravene EU law, in particular the freedom of establishment, as they would potentially create a different tax treatment where there were multiple jurisdictions involved in a transaction compared to a purely domestic situation. Whilst conceding that restriction of fundamental freedoms is possible where there is justification, the CIOT notes that the conditions for the new rules to apply are significantly wider than what EU case law indicates is justifiable.

The CIOT notes that the freedom of establishment under EU law is likely to remain relevant as any transitional arrangement agreed in relation to Brexit is likely to ensure that the fundamental freedoms will continue to apply in the UK beyond 29 March 2019. Having said that, it might be assumed that the government considers that the draft rules would not contravene EU law.

Government proposal for SDLT surcharge for non-UK residents

The government has announced a proposal to increase the stamp duty land tax (SDLT) liability for non-UK resident individuals and companies. The proposal is for a 1% or 3% surcharge to the existing SDLT rates. The government claims that the proposal could raise as much as £120 million of additional tax which it states would be used to tackle homelessness.

The government intends to provide further detail and consult on the proposal but no indication has been given as to when any increase could come into force.

HMRC to introduce bilateral advance pricing agreements for financial transactions

HMRC has announced that it intends to begin a programme of bilateral advance pricing agreements (APAs) for financial transactions and finance companies. It is inviting expressions of interest from UK taxpayers who might see benefit in entering into such bilateral APAs in relation to their financing arrangements with HMRC and the other relevant tax authority.

HMRC has indicated that the proposal is in response to the rapid changes in the international tax landscape applicable to financial transactions transfer pricing and a desire to offer greater certainty for all parties in line with the aims of the OECD's base erosion and profit shifting (BEPS) project.

An APA allows the tax authority and the taxpayer to enter into an agreement relating to the taxpayer's transfer pricing. The agreement would generally cover a period of at least five years and would offer a reduced risk of tax audits and investigations during that period of time.

UK Case Law Developments

Business asset holdover relief available where non-UK resident family members had no interest in transferee company

In *William Reeves v HMRC*, the Upper Tribunal (UT) has considered the availability of business asset holdover relief on a disposal of assets to a company whose sole shareholder had a spouse and children who were non-UK resident. The UT has reversed the First-Tier Tribunal's (FTT's) decision and allowed the relief.

Mr Reeves gifted assets to a UK resident company of which he was the sole shareholder. Mr Reeves claimed business asset holdover relief but HMRC considered the claim to be invalid due to Mr Reeves' wife and children being non-UK resident at the time of disposal. Under the provisions, the relief is not available where the transferee company is controlled by non-UK resident persons who are connected with the person making the disposal. As Mr Reeves' wife and children are connected with him as sole shareholder, his shareholding was attributable to them and they were considered to have control of the company. The key issue was whether the mere fact that Mr Reeves' wife and children, none of whom had any actual interest in the transferee company, were non-UK resident should result in his loss of the relief. The FTT had agreed with HMRC that it did.

Mr Reeves argued that applying the words of the legislation strictly would create an absurd result. The UT agreed with Mr Reeves and held that the relief was available since it could not have been Parliament's intention that relief would be denied simply because a connected person of the transferor exists who is non-UK resident even if they have no actual interest in the transferee company. The UT limited the effect of the connected person language to apply only to persons who control the transferee by actually holding interests in it or another company.

Additionally, Mr Reeves argued that, even if the literal wording of the provision could not be ignored, he could rely on provisions of the European Convention on Human Rights (ECHR) and the prohibition of discrimination and the protection of property.

The UT considered whether the holdover relief provisions are discriminatory because they treat Mr Reeves, his wife and children differently due to the fact that they are not all UK resident. In concluding that the provisions did create discrimination in relation to Mr Reeves' status as a person with a non-UK resident wife and children and that the treatment was not justified and proportionate, the UT showed that there is potential for bringing human rights claims as a challenge against tax legislation which may create arbitrary results due to a person's tax residency.

This is a rare example of both a purposive application of an anti-avoidance provision in favour of the taxpayer and a successful use of the ECHR to avoid unreasonable taxation.

No treaty protection available against a transfer of assets abroad tax liability

In *Davies, McAteer, Evans-Jones v HMRC,* the FTT has denied treaty protection to taxpayers against a charge under the transfer of assets abroad (TOAA) rules relating to a Mauritian company's trading income.

A Mauritian company which was 100% owned by an insurance company acquired a UK property. The taxpayers purchased life insurance policies from the insurance company to give them access to the proceeds in the Mauritian company. HMRC issued assessments on the basis that the taxpayers were liable to income tax on the Mauritian company's trading income under the TOAA rules.

The taxpayers argued both that the motive defence was available and the double tax treaty between the UK and Mauritius applied to prevent the UK from taxing the income arising to the Mauritian company.

The FTT rejected the taxpayers' appeal on the basis that:

- although taking out the insurance policies was not itself tax avoidance, the overall set of arrangements was designed to avoid tax; and
- the taxpayers were not able to claim double tax treaty protection under the UK-Mauritius treaty as, under the TOAA rules, the company's income was deemed to be the taxpayers' income and the taxpayers could only claim any reliefs which would have been available to them if the income had in fact arisen to them. As the taxpayers were not resident in Mauritius, treaty protection was not available to them.

It is the unavailability of treaty relief that is of interest in the context of the TOAA rules and other rules which treat the income or gains of non-residents as arising to UK taxpayers. For instance, it is HMRC's longstanding view that UK taxpayers are protected from an attribution of a non-resident close company's capital gains tax charge under section 13 TCGA if the non-resident is in a double tax treaty jurisdiction with a suitable capital gains tax article (such as Luxembourg). This decision (albeit of the FTT) might raise questions about that, although it might well be that the specific terms of section 13 and the relevant double tax treaty article would retain the treaty protection.

Subscription price paid for shares subject to transfer pricing

In *The Union Castle Mail Steamship Company Limited v HMRC*, the UT held that, although the derecognition of derivative contracts did result in a "loss" for accounting purposes, that loss had not arisen from the derivatives themselves and so no tax deduction was available. In addition, it stated that the availability of the loss should be determined by reference to the loss that would have arisen had market value been paid for shares issued by the taxpayer to its parent as part of the transaction.

In order to avoid a tax charge arising to the taxpayer (Union Castle) on transferring some options to its parent, a publicly quoted investment trust company, Union Castle issued new "A shares" to its parent which carried a right to receive a dividend equal to 95% of the cash flows from the derivative contracts. Union Castle accounted for, and claimed a tax deduction for, a loss equal to the 95% of the derivative contracts in its accounts. HMRC disallowed the deduction.

The UT disagreed with the FTT that there had been no loss, stating that a loss arose for accounting purposes on the derecognition of the options because economic value had been lost to Union Castle. However, the UT refused Union Castle's appeal as it concluded that the loss had not arisen from the derivatives. The loss had arisen from the disposal of rights under the derivative contracts by Union Castle to Caledonia through the issue of the new shares.

Possibly more interestingly, although not necessary for the determination of the case, the UT considered whether the issue of shares from subsidiary to parent could fall within the transfer pricing rules as a "provision". The UT concluded that an issue of shares could amount to a provision for the purposes of the transfer pricing rules as there was nothing which operated to exclude capital transactions generally from the rules. This conclusion, although not binding as it was not determinative in the appeal, suggests that a wider number of connected party transactions might fall under the transfer pricing rules than has been considered the case to date.

European Case Law Developments

Input VAT recovery on hire purchase contracts

We referred in the May UK Tax Round Up to the opinion of the Attorney General (AG) of the Court of Justice of the European Union (CJEU) in the *Volkswagen Financial Services* case relating to Volkswagen's permitted recovery of input VAT costs relating to the sale of cars under hire purchase contracts. The CJEU has now delivered its verdict.

In the case, Volkswagen sought to recover its general input VAT costs incurred for the hire purchase arrangements in which all of its profit was realised under the finance credit element, rather than the sale of cars element, of the arrangements with its customers. The CJEU held that input VAT on general overheads should be considered as a separate cost component of the taxable supplies of a partially exempt business, even where the costs in question were not incorporated into the price paid by the customers for the taxable supply (here, the supply of cars). Furthermore, the CJEU held that Member States cannot apply a method of apportionment of VAT for such partially exempt businesses which does not take into consideration the initial value of goods. Such decision, in confirming a level of input tax recovery in relation to overheads, rejects HMRC's claim that such tax relating to overheads should not be recoverable at all.

Input VAT recovery on costs associated with failed takeover

We referred in the May UK Tax Round Up to the opinion of the AG in another European VAT case (*Ryanair v HMRC*). On 17 October, the CJEU followed the opinion of the AG and held that it was possible to deduct input VAT on costs incurred in relation to an unsuccessful takeover bid.

The CJEU held that this was possible when the company intended to acquire the target company in order to pursue an economic activity subject to VAT as part of its existing business (e.g. the provision of management services to the target for a fee). The CJEU held that the deduction of input VAT was possible even if the economic activity was not carried on provided that the exclusive reason for the expenditure in question was the intended economic activity.

The CJEU's decision confirms the extension of the scope of recoverability into the area of aborted M&A deals and helps to provide further clarity in this evolving area of VAT law.

BEPS and the Multilateral Instrument

Synthesised texts for double tax treaties with Serbia and Slovenia published

Following the UK's ratification of the OECD's Multilateral Instrument (MLI), effective from 1 October 2018, HMRC has published synthesised texts of the existing treaties with Serbia and Slovenia, which have been amended by the MLI. The texts set out the terms of the treaties as amended by the MLI. HMRC has promised to produce such synthesised documents for all treaties that are affected by the MLI in due course.

Although these texts will be useful to taxpayers in determining the impact on particular existing treaties, the synthesised texts do not possess any legal force and so do not take precedence over the original treaties and how they are amended by the MLI and its application to the treaty in question and care should be taken in relying on them.