Proskauer

March 2019

For more information, please contact:

Stephen Pevsner
Partner
t: +44.20.7280.2041
spevsner@proskauer.com

Robert E. Gaut
Partner
t: +44.20.7280.2064
rgaut@proskauer.com

Catherine Sear
Partner
t: +44.20.7280.2061
csear@proskauer.com

Welcome to the March edition of Proskauer's UK Tax Round Up. As expected, in light of the UK Government's preoccupation with the Brexit process, no new tax measures were announced by the Chancellor in the Spring Statement earlier this month. However, there have been two interesting EU cases on availability of withholding tax relief and the compatibility of domestic anti-avoidance regimes with the EU's fundamental freedoms.

EU developments

European Court rules that withholding tax exemptions under EU Directives can be denied by abuse of rights principle

At the end of February, the Court of Justice of the European Union (CJEU) issued two judgments addressing the circumstances in which withholding tax exemptions under the EU's Interest and Royalties Directive (IRD) and Parent/Subsidiary Directive (PSD) can be denied on grounds of the recipient not being the "beneficial owner" of the payment (in relation to the IRD) and of abuse of rights (in relation to both Directives). The judgments related to cases referred by the Danish national court. The cases involved payments of interest and dividends by Danish companies to Luxembourg companies that were owned by private equity funds.

For private equity funds, the question of holding company eligibility for double tax treaty benefits in relation to withholding taxes has been brought into sharper focus in recent years with the OECD's work on BEPS and the consequent introduction of a principal purpose test (PPT) in covered double tax treaties. These cases are a reminder that a holding company's eligibility for reliefs under these EU Directives can be restricted and the CJEU stated that the application of the Directives is restricted by the EU's general principle of abuse of rights in all cases. More surprisingly, the Court decided not to follow the Advocate General's opinion published in March last year on who was the "beneficial owner" of the interest is the IRD case and suggested a test based on actual ability to determine how the interest is used rather than a more formative test of who is entitled to sue for the interest.

In addition, the cases provide a useful indicator of how EU jurisdictions might seek to apply the PPT, since the basis conditions for there to be an abuse of rights under EU law are very similar to the conditions for the PPT to apply.

According to the CJEU, a number of indicators could suggest such an abuse of rights. Although not a bright line test, the following factors are among those which might point to abuse: arrangements which do not reflect economic reality, the structure of which is purely one of form and the principal objective or one of its principal objectives of which is to obtain a tax advantage running counter to the aim or purpose of the applicable tax law; a company the sole activity of which is the receipt of the payments and their transmission to the beneficial owner or to other conduit companies; situations where the evidence of the management of the company, its balance sheet, the structure of its costs and expenditure actually incurred, the staff that it employs and the premises and equipment that it has point to an absence of economic reality; legal arrangements being such that the company does not have the right to use and enjoy the payment in question; the simultaneity or closeness in time of, on the one hand, the entry into force of major new tax legislation creating withholding tax leakage and, on the other hand, the setting up of complex financial transactions and the grant of intragroup loans.

In addition, the Court provided guidance on the meaning of "beneficial owner", a requirement for the IRD withholding tax exemption to apply. This was stated to be the entity which actually benefits from the interest economically and has the power freely to determine the use to which it is put.

The CJEU also suggested that when determining if there has been an abuse of rights it is not determinative that some investors in the recipient are resident in jurisdictions which have a double tax treaty with the jurisdiction of the payer. The Court stressed that a tax authority only has to show that the recipient of the payment is not its beneficial owner, without needing to identify who the beneficial owners are and whether they are themselves eligible for any relief. In the context of private equity holding structures, these are potentially concerning developments as funds might have wanted to place weight on the treaty eligible status of investors to get tax authorities to accept that – looked at in the round from a tax perspective – the holding company is primarily an administrative convenience and not part of an abusive arrangement.

European court considers whether CFC rules constitute a justifiable restriction on free movement of capital

On 26 February, the CJEU handed down its judgment in the case of *X GmbH* (C-135/17), which considered, amongst other things, the German controlled foreign company (CFC) rules and their compatibility with EU fundamental freedoms. The taxpayer, a German company, held a 30 per cent shareholding in a Swiss subsidiary company. The subsidiary qualified as a CFC under the German rules and, as such, the German tax authority sought to tax the taxpayer on a proportion of the subsidiary's undistributed profits. The German company challenged this assessment on the basis that the German CFC rules are contrary to the principle of free movement of capital. The UK's CFC rules were considered by the Court in the *Cadbury Schweppes* case in the context of the freedom of establishment and the UK's rules were changed as a result of that decision.

The CJEU confirmed in its judgment that the German CFC rules do constitute a restriction on free movement of capital, as the rules only apply in a cross-border situation and not in a purely domestic arrangement. However, the restriction may be justified on the basis of public interest, namely the requirement to prevent "wholly artificial arrangements" the purpose of which is the avoidance or evasion of tax in a Member State. Whilst the CJEU did not make a determination on this issue, it did offer guidance that legislation would be justifiable where it prevented schemes which had as a primary objective the artificial transfer of profits generated by activities carried out in a Member State to a non-EU country with a low tax rate. This has been regarded as a substantial broadening of the CJEU's previous comments on this issue. The Court further stated that, as the German CFC rules apply automatically to income of a passive company established in a non-EU country with a low tax rate, the rules may not be justifiable as these features may indicate that the arrangements involve tax avoidance or evasion, but may not be indicative in all circumstances. The court also said that the tax information sharing agreements between Germany and Switzerland would be relevant, as this would allow the German tax authority the opportunity to verify the activities of the Swiss subsidiary and whether this amounted to tax avoidance or evasion (the implication being that, if no such arrangements exist, the automatic application of the CFC rules may be justifiable). This is a similar conclusion to that in the *Cadbury Schweppes* case.

Following this judgment, this case will now return to the German courts for a final decision to be made. It is an interesting reminder that anti-avoidance regimes may be challenged under the EU's fundamental freedoms, particularly when they are not appropriately targeted, and the relevance that the development of international tax information sharing regimes have in this regard.

Jersey, Guernsey and Isle of Man moved to EU "white list"

On 12 March, the EU published an updated black list of non-cooperative jurisdictions in tax matters. It has added 10 new jurisdictions. Most notably, however, Jersey, Guernsey and the Isle of Man have been moved from the grey list to the white list. For further details please see our report on this update here.

UK developments

HMRC preferred creditor consultation launched

A consultation has been launched on making HMRC a preferred creditor in respect of certain tax liabilities in insolvency, a proposal that was originally announced in the Budget 2018. The measure is proposed to apply to insolvent businesses in respect of taxes paid by it in respect of employees or by customers only, such as VAT, PAYE (income tax, employee NICs and student loan repayments) and deductions under the Construction Industry Scheme. In respect of these tax liabilities only, HMRC would rank ahead of floating charge holders and unsecured creditors. In respect of all other forms of tax, HMRC will remain a non-preferential unsecured creditor.

The proposed new rules are intended to come into for after 6 April 2020. The closing date for responses is 27 May 2019 and the full consultation document can be found here.

Further consultation on off-payroll working in the private sector consultation

On 5 March, HMRC published a consultation on extending the off-payroll working rules to the private sector from 6 April 2020. This is further to last year's initial consultation on how best to address non-compliance with off-payroll working rules in the private sector which we reported on in our June 2018 UK Tax Round Up, [see here]. In essence, these rules will supersede the so-called IR35 "deemed employee" tax rules.

The proposed rules essentially require the client (i.e. the contracting recipient of the services of the worker and not the worker's personal service company) to determine whether or not that worker is a deemed employee. If that worker is deemed to be an employee, the client must account for income tax, national insurance contributions and the apprenticeship levy as though that worker were an employee. There will be an exclusion from these rules for small companies (based on the existing corporation tax definition) and small non-corporate entities will also be excluded. The consultation also considers the process which the client should adopt to make a determination and how this may be challenged by the worker, and how the determination should be shared with other parties.

If implemented, these rules will push the employment tax liabilities back from a worker's personal service company (where it currently sits) onto the actual recipient of the worker's services.

The consultation document can be viewed here. The closing date for responses is 28 May 2019 and draft legislation is expected to be published later this year.

Corporate criminal offences on the facilitation of tax evasion – self-reporting and compliance survey

In 2017, a number of new criminal offences were introduced relating to the facilitation of tax evasion (known as the "corporate criminal offences" or "CCO") under the Criminal Finances Act 2017. At the end of February, HMRC published new guidance on the process for organisations to self-report failures to prevent the facilitation of tax evasion. Although self-reporting is voluntary, HMRC state that self-reporting may be taken into account when assessing whether an organisation has reasonable procedures in place to prevent its employees' facilitation of tax evasion (which provides a defence against the criminal corporate offences), and may be taken into account in decisions on prosecutions and/or penalties imposed, although the self-report will not guarantee that no prosecution will be made. The new guidance can be viewed here.

Following the Spring Statement, an independent research report was published evaluating corporate behaviour change in response to the new corporate criminal offences. Generally the report concludes that awareness of the new offences is relatively low (only around one quarter of businesses were aware of the new offences) with around a third of businesses saying that the offences had some relevance to their business. It seems that larger businesses, international businesses and businesses in the financial and insurance sectors were (unsurprisingly) more likely to be aware and to have carried out a risk assessment and implemented prevention procedures. Given the low awareness and implementation, whether the introduction of the new offences will be effective in encouraging behavioural change in business remains to be seen. For those who are interested, the full report can be found here.

Court of Appeal finds that only VAT group representative member can make claims for repayment of VAT

In the case of *Lloyds Banking Group and others v. HMRC* [2019] EWCA Civ 485, the Court of Appeal considered a number of cases relating to the reclaim of overpaid VAT. The reclaims all related to VAT overpaid in relation to supplies made by a company which was the member of a VAT group and as such the VAT payments in question had been accounted for by the representative member of that VAT group rather than the supplier company itself (referred to in the judgment as the "real world supplier"). The key issue for consideration was whether the real world supplier could reclaim the overpaid VAT or whether such reclaim could only be made by the representative member of the VAT group. This was a pertinent question as the real world suppliers attempting to make the reclaims had since ceased to be a member of the VAT group in question.

The Court of Appeal rejected the appeals by real world suppliers to reclaim overpaid VAT, holding that only the representative member of the VAT group could reclaim overpaid VAT from HMRC and that this result was not inconsistent with EU VAT rules. This confirms that the UK's approach to VAT groups, which in effect deems the representative member to be the only taxable person for VAT purposes, still holds true. This case serves as a useful reminder to ensure that, where transactions involve companies leaving a VAT group, appropriate contractual measures are put in place to ensure that the VAT affairs of those companies can still be enforced through the representative member in the future. The full judgment can be viewed here.

First Tier Tribunal holds that the intermediaries legislation does not apply where a brand was supplied

In *Albatel Limited v. HMRC* [2019] TC07045, the First Tier Tribunal (the FTT) considered an appeal by Albatel Limited (Lorraine Kelly's personal service company) that the employment intermediary rules (also known as IR35) did not apply to contracts it entered into for Lorraine Kelly to present shows for ITV. IR35 would only apply to the company if, were the arrangements made between Lorraine Kelly and ITV directly, Lorraine Kelly would have been an employee of ITV rather than self-employed. If IR35 applied, the company would have been liable to operate PAYE and her agency fees would not have been deductible expenses.

The FTT held that IR35 did not apply to the company and that the contract between the company and ITV was a contract for services, not a contract of service. They added that ITV was purchasing the brand and personality of Lorraine Kelly under the contract which meant she was a self-employed entertainer rather than a de facto employee of ITV. The FTT found that ITV did not have the requisite level of control over Lorraine Kelly or any other persuasive factors that indicated an employment-like relationship.

This case demonstrates the difficulty in making a determination on employee status, which is particularly pertinent given the consultation discussed above where a determination on status must be made by the engaging business. The full judgment can be viewed here.

Changes to time limits for stamp duty land tax filings effective from 1 March

All relevant and transactions effective or notifiable after 1 March will now be subject to a shorter time period for making filings and payments in respect of stamp duty land tax ("SDLT") (14 days rather than 30 days). However, it should be noted that there are a limited number of transactions that will continue to be subject to the 30 day time limit.

BEPS update

HMRC has published one more in its series of “synthesised” texts of double tax agreements to incorporate the effects of the changes made by the adoption of the Multilateral Instrument (MLI). The latest in this series is the agreement with Australia. The revised treaty will not be backdated and instead will come into force in April 2020, apart from in respect of tax withheld at source which will be effective from 1 January 2019 and taxes levied by Australia other than corporation tax, income tax and capital gains tax which will apply from 1 July 2019.