SLAUGHTER AND MAY/

CLIENT BRIEFING

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TAX AND THE CITY REVIEW

In *Royal Bank of Canada*, the Court of Appeal overturns the Upper Tribunal's decision and holds that the Canadian bank is not subject to UK tax on contractual payments relating to the production and price of UK oil which it had received pursuant to the receivership of a debtor. The consultation on reforms of the legislation on transfer pricing, permanent establishment and diverted profits tax is published for comments until 14 August. The Court of Appeal in *Civic Environmental Systems Ltd* considers the effect of an increase in prior period profits, following an HMRC enquiry, on a claim for loss carry back. HMRC issues partial draft guidance on the multinational top-up tax covering the scope of the rules and administrative provisions with more draft guidance to follow.

Royal Bank of Canada: UK/Canada double tax treaty

In *Royal Bank of Canada v HMRC* [2023] EWCA Civ 695, the Court of Appeal unanimously overturned the Upper Tribunal's decision and found in favour of RBC that the UK/Canada double tax treaty does not permit the UK to exercise taxing rights over the profits of the Canadian bank from certain contractual payments described as 'royalties' calculated by reference to oil production and oil prices. The right to these payments had been assigned to RBC during the receivership of Sulpetro, a Canadian company to which RBC had advanced a loan. As RBC won its appeal on the grounds of interpretation and application of the treaty, it was not necessary for the Court of Appeal to consider the taxpayer's other ground of appeal, that the UK legislation (CTA 2009 s1313) did not render the profits chargeable to UK tax.

RBC had advanced a loan to Sulpetro which, together with its UK subsidiary, SUKL, carried on oil exploration/exploitation activities in the Buchan Field, within the UK continental shelf. A crucial fact for the Court of Appeal was that the licence to explore and exploit the Buchan Field was granted by the UK government to SUKL and not to Sulpetro as the requirements at the time were that such a licence could be granted only to a UK incorporated company. When Sulpetro went into receivership, the amount outstanding on the loan was CAD $185m. This was written off by RBC as a bad debt. One of Sulpetro's assets was a right to payments in respect of all production from the Buchan Field broadly equal to half the amount by which the market value of each barrel of oil produced exceeded US$20 which was granted to Sulpetro as part of the consideration for the sale of Sulpetro's interest in the Buchan Field to BP. BP later novated this contract to Talisman on the transfer of its interest in the Buchan Field to Talisman. Under a court order, the right to receive the relevant payments was assigned to RBC and RBC treated the receipts as income of its Canadian banking business accounted for as recovery of the bad debt and paid Canadian corporate tax on them. RBC accordingly did not report them in any UK tax return.

HMRC became aware that Talisman had treated the payments as deductible in computing its ring-fence profits from its UK oil exploitation trade whereas RBC had not paid any UK tax on the payments. Discovery assessments were subsequently made by HMRC on the basis that the payments were subject to UK tax under the ring fence trade regime in CTA 2010, Part 8. The total amount of tax at stake, without interest, is around £19m.

Not income from immoveable property

Article 6(1) of the treaty provides that income from immovable property may be taxed in the Contracting State in which such property is situated. The Court of Appeal analysed the fifth limb of Article 6(2) of the treaty which provides that the term 'immoveable property' includes 'rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources' and concluded it was to be confined to income derived from the grant, rather than the transfer, of rights. It applies only to 'rights to payments held by a person who has some form of continuing interest in the land in question to which the rights can be attributed.' This narrow interpretation was supported by the commentary on the OECD Model Treaty, other provisions of the treaty (see paragraph 78) and the French text of Article 6(2) (see paragraph 87). The 'right to work' the oil field was held by SUKL and not by Sulpetro so the payments were not consideration 'for …the right to work' the Buchan Field. Sulpetro had a contractual right to sums calculated by reference to oil production and oil prices and it is this right that was assigned to RBC. At no stage did RBC hold an interest in the Buchan Field.

HMRC had argued that even if the right to the payments did not fall within the fifth limb, the payments were sufficiently connected with UK oil exploitation to constitute income from immoveable property within Article 6(1). The Court of Appeal disagreed. The test is not one of connection but rather whether the income is 'from' immoveable property. The source of the payments is the contractual right originally created in favour of Sulpetro. In addition, the payments are calculated by reference to the sale price of a moveable asset - the oil extracted. The source is not land or any interest in land (paragraph 103).

Odd approach by HMRC

The Court of Appeal points out that HMRC's approach in this case is odd. As the 'royalty' payments to Sulpetro were part of the consideration for the sale of its interest in the Buchan oil field to BP, who later novated the contract to Talisman, you would expect that Sulpetro would have been within the scope of UK tax under Articles 13(4) and (5) of the treaty and that under the principle of *Marren v Ingles* the value of the right to receive the payments at the time of the sale would have been brought into account in computing Sulpetro's gain. Correspondingly, you would expect that the consideration paid, including the payments, would form part of BP's acquisition cost (and then Talisman's acquisition cost) for chargeable gains purposes. Yet HMRC treated the 'royalty' payments made by BP and then by Talisman as deductible revenue expenditure rather than acquisition costs and then sought to tax RBC on the payments. As Lady Justice Falk points out (in paragraph 99), the approach of HMRC to the treatment of the payments made by the payor as deductible revenue expenditure, rather than as part of its acquisition cost of the interest in the Buchan Field, cannot determine the tax treatment of the payee.

Although the Court of Appeal's decision has confirmed RBC's treatment of the payments as income of its Canadian banking business and not subject to UK tax, it is unclear yet if HMRC will appeal. In any event, this case serves as a reminder for banks to take care when enforcing a security over a loan as assets received in lieu of repayment of the loan may have different tax consequences from a cash repayment of the loan. Consideration should be given to the nature of any payments received and, where appropriate, which jurisdiction has taxing rights.

Transfer pricing/DPT/permanent establishment consultation

HMRC is consulting until 14 August on potential reforms to three areas of legislation which deal with ensuring the appropriate amount of profit is taxed within the UK: transfer pricing, permanent establishments (PEs) and diverted profits tax (DPT). The stated intention of the reforms is to improve fairness, simplify existing rules, and promote inward investment into the UK by improving tax certainty and continued access to treaty benefits. According to HMRC, legislation to implement the reforms will be included in the next Finance Bill, which leaves little time for consultation on the technical legislation.

Transfer pricing

A number of changes are being considered to TIOPA 2010, Part 4 and to other legislation which applies TIOPA 2010, Part 4. Some areas of ambiguity and uncertainty will then be addressed in guidance. One aspect under consideration is the tax advantage rule 'one-way street' at section 155 TIOPA. This rule operates at an entity level, on a chargeable period by chargeable period basis, to prevent unilateral negative adjustments to profits or losses which would otherwise give rise to non-taxation where a counterparty does not make a corresponding adjustment. The government notes that the importance and proper application of the one-way street is not fully understood by taxpayers and intends to clarify its general purpose and application in guidance.

There is a proposal to remove UK:UK transfer pricing (which was originally brought in to comply with EU law) in order to reduce the compliance burden but in such a way as to avoid creating opportunities for arbitrage. This might be done by way of a general exception for UK:UK transactions where there is no overall UK tax advantage conferred by the mispricing. This could be achieved by adjusting the one way street tax advantage to look instead at the overall UK tax advantage in quantum or in timing.

Amendment of ss152-154 and 191-194 TIOPA is proposed to better align the legislation with Chapter X of the OECD Transfer Pricing Guidelines on financial transactions. At present, there is friction between Chapter X and the UK legislation, particularly in the approach to implicit support (the incidental benefit an MNE is assumed to receive solely by virtue of group affiliation) and the treatment of guarantees.

Permanent establishments

The intention is to align the UK's domestic rules on PEs more closely with OECD principles which may enable subsequent changes to be more quickly incorporated into UK law. The current legislation on UK PEs predates the 2017 update to the OECD Model Treaty and the 2008 OECD Report on the Attribution of Profit to Permanent Establishments. Consideration is being given to two options for amending the PE definitions and profit attribution rules to better align with tax treaties and the OECD Model. To the extent that the UK adopts the OECD Model's definition of PE, it would expand the scope of the agency PE which the consultation notes could cause uncertainty in the application of the independent agent exception to investment managers. It is envisaged that the broker exemption and the investment manager exemption would be retained.

DPT

DPT targets two types of arrangements to divert profits from the UK: use of transactions or entities lacking economic substance to exploit tax mismatches (Finance Act 2015 section 80 or 81 cases); and use of contrived arrangements to avoid a UK PE of a foreign trading company (FA 2015, section 86 cases). The government is considering whether to integrate DPT fully into the

transfer pricing regime, bringing it within the corporation tax framework. There would be a new assessing power (a diverted profits assessment) available to HMRC in essentially the same circumstances as those where a DPT charging notice applies. The assessment would be at a rate higher than the standard corporation tax rate.

One of the advantages of DPT becoming part of corporation tax is that treaty relief would be available in respect of the diverted profits assessments which will avoid the double taxation currently faced by taxpayers as a result of DPT being considered by HMRC as outside the scope of double tax treaties.

There are a number of areas of the DPT legislation which are earmarked for a wider review to align the legislation more closely with HMRC's preferred reading. For example, the consultation notes that section 107(3)(a)(ii) of the Effective Tax Mismatch Outcome (ETMO), (which concerns the testing of a reduction in income in the first party, usually the UK company), has been liable to misinterpretation which HMRC has tried to address in guidance but 'disagreement about scope remains'. This section will be amended to 'make unequivocal the fact that a reduction in income refers to a reduction compared to the situation had an alternative provision been in place'.

Civic Environmental Systems – no further carry back of losses to offset against increased profits

The Court of Appeal in *Civic Environmental Systems Ltd v HMRC* [2023] EWCA Civ 722 had to consider the effect of an increase in prior period profits, following an HMRC enquiry, on a claim for loss carry back. This case illustrates that the way the claim for loss carry back is made is critical. The taxpayer had losses of £445K for the year ended 30 April 2008 and made a freestanding claim to carry back those losses against the profits of £143k for 2007 (it was too late to amend the 2007 return). Following an enquiry, HMRC decided the profits for 2007 had been understated by £540k and assessed the taxpayer to tax on the full £540k. The taxpayer argued that the remainder of the losses should be set against the increased profits with the result that tax would be payable on £237k. The FTT, UT and now the Court of Appeal all sided with HMRC.

If the taxpayer had made the original loss carry back claim in an amended return for 2007, it would be treated as an amendment to that return under FA 1998 Schedule 18 paragraph 58(2). If such an amended return was further amended (following an HMRC enquiry or assessment) to increase the profit for the period, a corresponding larger amount of losses would be treated as carried back up to the full amount of the losses. Unfortunately for the taxpayer, it had made the loss carry back claim when the return for 2007 could no longer be amended and so it fell to be dealt with under TMA 1970, Schedule 1A. There is no provision that would allow a free standing loss carry back claim dealt with under Schedule 1A to be reopened where the profits for the relevant period were increased on assessment. There is a provision in paragraph 3(1)(b) of Schedule 1A which allows the taxpayer to amend claims, but this is subject to a time limit which had expired.

It is unclear why as a matter of policy there is this distinction. If, in principle, losses can be carried back to offset against profits of an earlier period it seems unduly harsh not to allow a further carry back of losses where profits are increased following an enquiry, but this is clearly the effect of the legislation so is something to bear in mind!

Multinational top-up tax: draft HMRC guidance

HMRC has issued partial draft guidance on the multinational top-up tax covering the scope of the rules and administrative provisions. Further instalments of draft guidance will be released over time with HMRC concentrating on areas in which they can add value. A useful feature of the first tranche of guidance is that it includes a table referencing the parts of the Model Rules, Commentary and/or Administrative Guidance on which each section is based (see MTT09990). This is helpful given that the UK legislation often uses different defined terms from the Model Rules and does not necessarily follow the same order, so finding the relevant parts of the OECD documents would otherwise be challenging.

What to look out for:

- **'L Day' is set for 18 July. This is when draft legislation for the next Finance Bill will be published alongside responses to consultations and other supporting documents.**
- **The Supreme Court is scheduled to hear the appeal in the *Fisher case* (transfer of assets abroad regime) on 19 July.**
- **The Supreme Court is scheduled to hear the appeal in the *Target Group Limited* case (VAT treatment of supplies of outsourced loan management services to a bank) on 12-13 July.**
- **14 August is the closing date for comments on the consultation on reform of transfer pricing, PEs and DPT.**

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