SLAUGHTER AND MAY/

CLIENT BRIEFING

January 2022

Tax and the City Review

HMRC consults on draft regulations to improve the tax regime for hedging risks on anticipated future share transactions. In the *Hargreaves Property Holdings Limited* case, the FTT's purposive interpretation of "beneficial entitlement" in the context of the exclusion from withholding for payments to a UK resident company beneficially entitled to the interest has potentially far-reaching consequences. The 2021 annual report on the code of practice on taxation for banks shows that banks continue to show improved behaviour in the year to 31 March 2021. Further progress is made with international tax reform with the release of model rules for part of the Pillar Two global minimum tax rules.

Consultation on improvements to the tax regime for hedging risks on future share transactions

Draft regulations have been published for consultation until 24 January to create a fair and internationally competitive hedging regime for foreign exchange risks on anticipated future share transactions, which will also support the new asset holding company regime.

Under current tax rules, derivative contracts entered into to hedge currency risks on anticipated acquisitions and disposals of shares are often not fully effective in removing volatility, because the companies' tax liabilities can still be exposed to exchange rate fluctuations. It can be particularly difficult to achieve an effective post-tax hedge of currency risks relating to a future acquisition, as the company does not yet have the shares to match the derivative with for the purposes of SI 2004/3256 (known as the Disregard Regulations). Whilst there are structures that can be used to achieve that, often relying on "reverse matching", this will not always be possible and it is somewhat surprising for companies to be forced into using a relatively artificial structure to achieve a sensible commercial outcome.

The government has been examining the possibility of legislating to ensure that the treatment of gains and losses on an instrument entered into to hedge currency risks on an anticipated future acquisition or disposal of a substantial shareholding are aligned with the treatment of the shares to remove this source of uncertainty and volatility for businesses. Changes will be made to the Disregard Regulations and to SI 2002/1970 (known as the EGLBAGL Regulations) to align the tax treatment of a gain or loss on the derivative contract with that of the relevant shareholding where the derivative contract is entered into on or after 1 April 2022. Substantial shareholding takes its meaning for these purposes from TCGA 1992, Schedule 7AC, paragraph 8, so broadly a holding of 10% or more of the ordinary share capital of a company.

The Disregard Regulations will be broadened such that exchange gains and losses on the relevant hedging instruments are initially left out of account. The EGLBAGL Regulations will be amended to ensure that the net exchange gain or loss is brought back into account in the usual way if, as and when the shares which were the subject of the anticipated transaction are disposed of. The effect of this is that where what is hedged is an anticipated acquisition, and the acquisition never goes ahead, the disregard will be permanent. To ensure that pre-sale dividends on a sale can be effectively tax hedged too, the net exchange gain or loss brought into account will exclude gains or losses arising from the hedging the dividends.

Guidance in the Corporate Finance Manual will be updated by 1 April 2022.

Hargreaves: withholding tax on interest

The case of *Hargreaves Property Holdings Ltd v HMRC* [2021] UKFTT 390 (TC) considers whether payments of interest were subject to withholding tax. A simplified version of the facts is that the UK-resident parent of a group which derived the entirety of its revenue from investing in UK real estate attempted to restructure the group's loan finance so as to receive tax deductions for the interest but escape UK taxation on it. The First-tier Tax Tribunal (FTT), however, upheld HMRC's withholding tax assessments with only minor variations.

In order for withholding tax to apply, the interest had to be "yearly", have a UK source and not be exempt from withholding tax. The refinancing was structured with a view to ensuring the interest did not have a UK source and was not yearly. From 2012 the interest was first paid to a UK company which then made a payment to a non-UK resident company of what the taxpayers argued was no longer interest, with the intention that the exemption for UK to UK interest payments applied.

UK source

The FTT's conclusion that the interest had a UK source is unsurprising given that, in accordance with case law, little if any weight was given to easily manipulatable factors such as jurisdiction; governing law and location of lender. The interest payments clearly had a UK source because they were paid by a UK incorporated and resident company out of income, profits and gains made in the UK. At the relevant time, the group had no non-UK activities.

Yearly interest

Judge Beare concluded that all of the interest was "yearly" in nature, notwithstanding that most of the loans were for less than a year. This is because once a loan was repaid, a new advance was then made from the same lender. This meant that when taken together the loans satisfied the *Hay* tests relating to measures of permanence, a "tract of future time" and being in the nature of an investment. Judge Beare agreed with HMRC and concluded that despite the cycle of annual repayments of each lender's loans, each lender intended for its loan to form part of the longer term funding of the Appellant and were regarded by that lender as an investment in the Appellant, albeit an unsecured investment.

Judge Beare was keen to emphasise that he did not seek to recharacterise, as one single long-term loan, the multiple consecutive loans made by each lender. Rather, each loan should not be viewed in isolation but should be examined in context and in the light of all the circumstances in which it was advanced and repaid. When you do this, the long-term nature of the relevant funding becomes apparent.

It was clear that, ignoring the very occasional, minimal gap, each lender made a continuous provision of finance to the taxpayer over a lengthy period. In fact, the amount provided by each lender tended to grow because the later loans were often used to pay off the accrued interest as well.

UK company exemption: beneficial entitlement

What is more controversial, however, is what Judge Beare concluded on beneficial entitlement for the purposes of the exemption from withholding tax for payments made to a UK resident company. With £2.8m tax at stake for the taxpayer, an appeal on the beneficial entitlement point may be a possibility.

The Income Tax Act 2007 (ITA), s.933 provides that the withholding tax obligation in ITA s.874 does not apply if the person beneficially entitled to the income in respect of which the payment is made is a UK resident company. So for later years, the Guernsey company to whom the taxpayer paid interest assigned the interest to Houmet, a UK incorporated and tax resident company, in return for a payment from Houmet for the assignment. The taxpayer argued that Houmet was beneficially entitled to the interest paid to the Guernsey company and so the s933 exemption applied.

The FTT concluded that the basic English law meaning of beneficially entitled applies to s.933, rather than the so-called international fiscal meaning in the context of a double tax treaty; so as long as the recipient of income is not receiving the income as a fiduciary it is the beneficial owner of the income. The taxpayer argued that as Houmet was not acting as a fiduciary in receiving the interest, Houmet was beneficially entitled to the interest. The interest revenue was taken into account in the accounts of Houmet - which the taxpayer argued is further evidence that Houmet was the beneficial owner.

But Judge Beare concluded that in accordance with *Ramsay* [1981] 1 All ER 865 and following the House of Lords decision in *McGuckian* [1997] 3 All ER 817, you must adopt a purposive approach to construing the provision. There may be circumstances where beneficial entitlement for the purposes of UK tax legislation is not simply determined by reference to equitable entitlement as a matter of law. A contractual obligation which deprives the recipient of the commercial benefits of the receipt might well also deprive the recipient of the beneficial entitlement to the receipt as a matter of law.

No explanation for Houmet's role in the financing structure was provided and it seems that the only reason was to provide an alternative argument other than the UK/Guernsey Treaty for gross payment of interest in the event of a failure to argue no UK source and not yearly interest.

Judge Beare therefore found as a fact that there was no business purpose to the involvement of Houmet and said "…*McGuckian* compels the conclusion that" to the extent of the amount which Houmet paid to the Guernsey company as consideration for the assignment of the right to receive a payment of interest, Houmet was not beneficially entitled to that payment of interest. The UK company exemption therefore applied only to the small amount by which the interest paid to Houmet exceeded the consideration paid by Houmet for the assignment.

It is interesting that Judge Beare gave such importance to *McGuckian* in this case as there was no discussion in *McGuckian* of beneficial entitlement. *McGuckian* concerned the question whether something was purchase price or a dividend whereas in this case the question is whether the recipient is beneficially entitled to the interest payment. It was also surprising that there was no mention of *Bupa Insurance Limited v The Commissioners for Her Majesty's Revenue and Customs* [2014] UKUT 0262 (TCC) where the Upper Tribunal held that the taxpayer was beneficially entitled to dividends which it was required by contract to pay to another person ten business days following receipt.

Another way of looking at this case would be to say that the effect of the arrangement was to put interest through to a Guernsey company and that the payment from Houmet to the Guernsey company should be subject to withholding as it was still interest with a UK source. In this scenario you would apply *Ramsay* to say interposing a UK company does not change the source or nature of the interest payment and take it outside the withholding tax obligation. This analysis makes *Ramsay* do more work but is closer to respecting *McGuckian*.

It will be interesting to see how far Judge Beare's 'beneficial entitlement' principle goes as it could potentially be quite radical as the question of beneficial entitlement comes up in lots of contexts, not just interest.

Bank code of conduct annual report

The [2021 annual report on the code of practice on taxation for banks] shows (unsurprisingly) that banks continue to show improved behaviour. It also appears that banks have a better sense of what is the right side of the line because in the last year there was only one code approach (where a bank is unsure whether the tax result of a proposed transaction is contrary to the intentions of Parliament discusses those plans with HMRC in advance). There were seven code approaches in the previous year. The report attributes the low level of code approaches to a range of factors, such as a better understanding of the code, a continuing evolution in attitudes to tax avoidance and boundary pushing, and changing commercial pressures in the light of EU Exit. It is also possible that COVID 19 has impacted the number of approaches.

International tax reform

This topic is going to feature a lot during the course of 2022 as we get more flesh on the bones of the international tax reform proposals. We have already had a pre-Christmas gift of the model rules for Global Anti-Base Erosion (GloBE) (a.k.a. Pillar Two of international tax reform) and a draft EU Directive to implement an EU-compliant version of these rules.

There's a lot of detail to work through in this first tranche of technical rules but we have to wait until early 2022 for guidance on the interpretation of the model rules. Details of the interaction with US GILTI rules (which is dependent on whether changes to GILTI are successfully enacted by the US to align it with Pillar Two) are also expected early 2022.

In addition to various further outputs and consultations promised on Pillar Two, the multilateral convention to implement the reallocation of taxing rights of some of the profits of the largest and most profitable MNEs to market jurisdictions under Pillar One is also awaited. It would not be surprising if implementation is delayed beyond 2023 given the amount of work still required on both Pillars.

The UK's online sales tax consultation was delayed until the New Year while the government continues to explore the arguments for and against. This is unsurprising as the UK needs to ensure the new tax is not within the definition of "relevant similar measures" to digital services taxes – and this definition, a crucial part of the standstill and rollback of unilateral measures required by Pillar One, has yet to be agreed at an international level.

What to look out for:

- **On 13 January the CJEU is expected to hand down its decision in *Zipvit* on questions referred by the UK Supreme Court on the topic of input tax recovery, including on whether VAT had been "due or paid".**
- **The closing date for consultation on the draft regulations to make improvements to the tax regime for hedging risks on future share transactions is 24 January.**

- The Upper Tribunal is scheduled to hear the appeal in *Volkerrail Plant Ltd* (whether a UK permanent establishment of a non-UK company can surrender losses to other UK group companies) in the window 26-28 January.

- The Court of Appeal is scheduled to hear the appeal in *Andreas Rialas* (transfer of assets abroad) on 9 February.

This article was first published in the 14 January 2022 edition of Tax Journal.

CONTACT

Mike Lane
PARTNER
T: +44 (0)20 7090 5358
E: mike.lane@slaughterandmay.com

Zoe Andrews
PSL COUNSEL & HEAD OF TAX KNOWLEDGE
T: +44 (0)20 7090 5017
E: zoe.andrews@slaughterandmay.com

Published to provide general information and not as legal advice. © Slaughter and May, 2022.
For further information, please speak to your usual Slaughter and May contact.

www.slaughterandmay.com