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Tax and the City Review

The General Court upholds the European Commission's assessment that the group financing exemption in the UK's CFC rules partially constituted unlawful State aid. Since the Qualifying Asset Holding Company (QAHC) regime was launched in April, a number of QAHCs have already been established and HMRC continues to work on various policy issues. The Energy Profits (Oil and Gas) Levy Bill is published but as drafted does not provide the incentive to invest as announced by the Chancellor.

UK CFC case: disappointing judgment of the EU General Court

After a run of less successful cases on fiscal State aid, the General Court's judgment of 8 June 2022 (T-363/19 and T-456/19) will have been particularly welcomed by the Commission and may well encourage it to pursue other State aid investigations, in particular in relation to aid schemes, with renewed vigour. But there is much to criticise in the judgment which is a significant blow to the UK and to the affected groups who have benefited from the offending legislation.

The UK's finance company exemption from the controlled foreign company (CFC) rules (in TIOPA 2010 Part 9A Chapter 9) was intended to provide certainty for taxpayers and HMRC of how the CFC rules would be applied. This was for some taxpayers a simpler alternative to showing that the CFC rules did not apply at all, either by proving they did not have significant people functions (SPFs) in the UK, or relying on *Cadbury Schweppes* (C-196/04) to show they had sufficient substance in the CFC for the CFC rules not to apply at all. In many cases (including that of ITV), the relevant exemption may have resulted in taxpayers paying more tax than if they had argued the CFC rules did not apply in the first place.

In 2019, however, the EU Commission concluded that the exemption for non-trading finance profits constituted unlawful State aid to the extent that the relevant SPFs for those profits were located in the UK.

The UK and ITV (one of the 70 affected taxpayers to have lodged an appeal) applied to the General Court to annul the Commission's decision. The General Court upheld the decision, dismissing all of the arguments of the UK and ITV.

The starting point for the State aid analysis is identifying the reference system. The question is then whether there has been a derogation from that reference system and, if so, whether the difference in treatment can be justified. The General Court considered that the Commission had been correct to use the CFC rules as the reference system (rather than the UK corporation tax system as a whole within which the CFC rules sit).

The General Court also agreed with the Commission that the group financing exemption constituted a derogation from this reference system because it treated taxpayers whose CFC's profits arose from intra-group loans to non-UK companies (qualifying loans) more favourably than those whose CFC's profits were from intra-group loans to UK companies (upstream loans) or those whose CFC's profits were from loans to third parties (money box lending). The UK's CFC rules are complex and carefully structured to do more than, as the Commission and the General Court oversimplified them as doing, taxing 'artificially diverted profits'. The Commission and the General Court jumped to the same conclusion that if there are SPFs in the UK, profits are necessarily artificially diverted. But that is not, as practitioners know, how the risk-based, carefully structured, CFC rules are supposed to work.

The General Court equally dismissed the arguments on justification of the derogation based on administrative simplicity and compliance with freedom of establishment under EU law. The onus was on the UK to show the derogation is justified but the General Court found that the UK had not shown why it was difficult to identify SPFs for intra-group loans to non-UK companies but not for intra-group loans to UK companies. The UK failed to provide evidence to quantify the administrative costs of identifying where SPFs are located, merely stating that it was a costly exercise.

The second justification put forward by the UK was that it adopted a reasonable approach in order to comply

with the CJEU judgment in *Cadbury Schweppes* to comply with freedom of establishment. *Cadbury Schweppes* concerned the compatibility of the UK's CFC rules with the freedom of establishment and established, broadly, that CFC rules could be a justified restriction on the freedom of establishment "on the ground of prevention of wholly artificial arrangements".

In its rather swift dismissal of the UK's and ITV's arguments based on *Cadbury Schweppes*, the General Court, however, seemed to apply a different, lower standard based on the artificial diversion of profits which it concluded the CFC rules met without the need for the group financing exemption.

ITV also argued that it had received no advantage from the contested State aid scheme. It had deliberately adapted its financing structure in order to rely on the group financing exemption, solely for reasons of administrative simplification. It reasoned that if it had not made the adjustment to its structure and had not relied on the exemption, the amount of tax it would have paid under the CFC rules would have been less. However, because the Commission had identified a State aid scheme, the Commission was not required to carry out an analysis of the aid granted in individual cases under the scheme to identify for each recipient the extent of the advantage received. ITV was unable to challenge the legality of the Commission's decision in this way. It is only at the State aid recovery stage that it is necessary to look at the individual situation of each undertaking concerned. It is now for the UK to quantify the advantage of each beneficiary of the State aid.

Many taxpayers who initially relied on the exemption have since settled with HMRC on other grounds but the appeal is still relevant to those hoping to get back the amounts recovered by HMRC as unlawful State aid.

It remains to be seen whether the UK or ITV will appeal the decision to the CJEU. Any such appeal must be on matters of law (there appear to be plenty of those to base an appeal on!) and must be lodged by mid-August.

Review of UK Funds Regime and Asset Holding Companies

The UK Funds Review was launched at Budget 2020. The Qualifying Asset Holding Company ("QAHC") regime was identified as something to be moved forward quickly given the increasing trend towards co-location of funds/holding companies and so this new regime went live in April 2022. It was confirmed by HMRC at a recent HMRC/IFA conference that 14 QAHCs have been formed since the regime went live in April. There are, however, a number of outstanding policy issues which a QAHC working group is considering and there is a chance some tax reforms may be included in Finance Bill 2023. Further reforms being considered include the interaction of the REITs regime and QAHCs; under the current legislation a company cannot be a QAHC if it is a REIT.

In order to qualify as a QAHC, an asset holding company (AHC) must meet a number of eligibility conditions including those relating to its activity and its investment strategy. The activity condition is that the AHC must carry out mainly investment activity. Trading activities will accordingly prevent QAHC status unless they are insubstantial and ancillary to the investment activities. There is deliberately no bright line test or safe harbour percentage of acceptable trading activity.

HMRC recently updated its guidance at IFM40260 - Eligibility criteria: trade versus investment to provide illustrative examples, particularly in the context of a credit fund. As ever with the trade versus investment discussion, the facts are critical to the analysis. The revised guidance provides five illustrative, but not exhaustive, examples which highlight the importance of retaining evidence of intention at the point of acquisition of assets of how long assets will be held and evidence of any changes in that intention. Evidence might include board minutes, internal correspondence or promotional literature or offering memoranda for investors setting out the AHC's investment strategy.

An AHC which acquires only assets which it intends to hold short term, with a high turnover of assets and transactions over the life of the AHC is likely to constitute a trade. An intention to hold assets for the medium to long term would typically constitute investment activity. The HMRC guidance is not specific about what length of time constitutes 'medium to long term' but suggests that regular sales of assets within months or weeks of acquisition may indicate the AHC does not have an intention to hold them for the medium to long term. Regular retention of assets for several years, on the other hand, may be considered evidence of intention to hold for the medium to long term.

In practice, an AHC may acquire a bundle of assets in order to obtain a target asset within that bundle and dispose of the unwanted assets fairly promptly. Example three is helpful here and explains that if the unwanted assets do not make up a substantial proportion of the bundle acquired, so long as there is evidence of intention to retain the target asset for the medium to long term and this is borne out by what the AHC actually does, the activity condition would likely to be satisfied in the absence of other characteristics of a trade. Other examples given in the guidance include loan origination activities (treatment of fees) and investments in distressed debt.

A further eligibility condition is that the AHC's strategy must not 'involve' investing in listed securities or other interests deriving their value from them (other than to allow stake-building prior to a public takeover bid). It

was mentioned at the IFA/HMRC conference that there is some uncertainty about what 'involve' means. The purpose of the condition is to stop listed shares being held by a QAHC with a view to rolling up dividend returns and then passing those income returns to investors in the form of capital. HMRC is working on providing clarification on the meaning of "involve" and on whether minority holdings are permitted.

A key missing piece of the jigsaw, crucial to improving the attractiveness of the UK for AHCs, is, of course, the VAT treatment of fund management fees, the consultation on which is expected to be launched this year.

Energy Profits (Oil and Gas) Levy Bill

Banks are familiar with new taxes being imposed to extract more revenue from the industry in times of need when banks were seen to be doing rather well. This time it is the oil and gas industry that is being subjected to a 'targeted' and 'temporary' levy, which, combined with taxes already levied on the same ring fence profits bring the effective rate of tax up to an eye-watering 65%.

The promised sunset date of 31 December 2025 is implemented through the definition of "qualifying accounting period" in clause 1(3) of the Energy (Oil and Gas) Profits Levy Bill but the announcement of the levy on 26 May 2022 had also committed the Government to a phasing out of the levy before that date "if oil and gas prices return to historically more normal levels". This is not reflected in the Bill but it is important that the Government is transparent about what level of pricing would be required to phase out the levy and how this would be done.

At the time the Chancellor announced the new levy, on 26 May, in order to counteract criticism that such a levy could deter oil and gas companies from reinvesting in the UK, he made it clear that those companies who chose to invest more would pay less tax and that an investment allowance would be built into the levy.

The draft legislation reveals how the investment allowance is tied into the new levy but closer inspection highlights a number of problems. Firstly, as a result of the lifecycle of energy infrastructure projects, it is likely that the investment allowance will mainly benefit investment already in the pipeline rather than new investment unless amendments are made to when expenditure is treated as incurred (in clause 7) or a mechanism is added to enable a claim for rebate of the levy for expenditure decided on within the time frame of the levy but actually paid within a certain period after the levy ends.

Secondly, in requiring expenditure to be on oil-related activities (in clause 2(2)(b)) the Government is missing an opportunity to encourage expenditure on projects to prevent climate change such as carbon capture and storage projects. Thirdly, the purpose test in clauses 2(2)(c) and 5 means that the investment allowance will be unavailable in circumstances where the stated policy intention is that it should be available. It is clear that the Government wants companies to make an investment which they would not have made, but for the allowance, in order to benefit from that allowance. But clause 5 then provides that, if a company makes an investment to get the allowance, it will not receive it.

Does this kind of overly wide anti-avoidance provision ring any bells? A similar problem arose in relation to the bank levy legislation as originally drafted and this was resolved through the inclusion of a white list of acceptable behaviours in what are now paragraphs 47(7) to (12) of Schedule 19 to the Finance Act 2011. In the case of the energy profits levy, however, the draft legislation already restricts the availability of the allowance by reference to certain categories of expenditure (see clause 2(2)(a)). Provided that the expenditure falls within these categories (and therefore by definition is within a category of investment that the Government wants to encourage), it is hard to see why any additional restriction by reference to the purpose of the expenditure should be required.

It is hoped there is enough time for HMRC to consider and take on board comments received on the draft legislation to make the investment allowance attainable prior to the Bill being passed before the summer recess.

What to look out for:

- The OECD is expected to publish a document shortly providing a framework for how discussions on Pillar One have evolved and setting out the new timeline for implementation.
- The consultation on extending the investment manager's exemption and the list of approved non-trading transactions for funds regimes to include cryptoassets closes on 18 July.
- Draft legislation for inclusion in Finance Bill 2023 will be published on "L Day" which is expected in July (based on last year's timing).
- Further HMRC guidance on compliance for large business is expected to be published within the next month as part of improving best practice on co-operative compliance with large business.

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