Tax and the City Review

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The Court of Appeal in *Union Castle* decides that an accounting debit linked to the derecognition of derivative contracts is not a loss 'arising from' the derivative contracts for the purposes of corporation tax and, as obiter, that it does not 'fairly represent' a loss. HMRC publishes draft guidance on the main tax impacts for businesses of changes to financial instruments in the light of the withdrawal of LIBOR and other benchmark rates. COVID-19 raises some interesting tax implications, such as the impact of travel restrictions on tax residence and permanent establishment and whether lockdown can result in a cessation/change of trade; it also prompts the Stamp Office to (temporarily) accept electronic submission of documents for stamping. HMRC consults on further tweaks to the hybrids rules.

Union Castle: not an allowable loss

In *Union Castle Mail Steamship Company Ltd v HMRC* [2020] EWCA Civ 547 the Court of Appeal considered whether an accounting debit linked to the derecognition of derivative contracts was a loss for the purposes of corporation tax under FA 2002 schedule 26, now rewritten in CTA 2009. The derecognition of the derivatives was triggered by the issue of bonus shares carrying dividend rights which entitled the shareholder to 95% of the economic benefit of the derivative contracts. This structure was chosen because the shareholder did not wish to invest in derivatives itself for fear of prejudicing its investment trust status and so its subsidiary, Union Castle, entered into the contracts instead.

The First-tier Tribunal (FTT) had decided the case in favour of HMRC on the basis that there was no loss because Union Castle remained entitled to receive the cash flows under the derivative contracts and chose to give most of those cash flows away: there was no diminution of resources of Union Castle and therefore no real loss. The Upper Tribunal (UT) then decided the appeal in favour of HMRC holding that there was a loss but it did not 'arise from' the derivative contracts as the legislation required, rather it arose from the issue of the bonus shares. If, however, they were wrong and the loss did arise from the derivative contracts, the UT held that the resulting debits would have fairly represented those losses.

The Court of Appeal dismissed the appeal, agreeing with the UT that, ignoring the 'fairly represents' issue, there was a loss, because ignoring 'fairly represents' profits and losses fell to be determined by the entries in a company's GAAP compliant accounts, but that loss did not arise from the derivative contracts. Where the Court of Appeal disagreed with the UT, however, was on whether the debits fairly represented the losses. The UT had limited the scope of the 'fairly represents' override to cases of accounting mismatch and as they found there was no such mismatch in this case they held the debits did fairly represent the losses. The Court of Appeal, with the benefit of the Court of Appeal's decisions in *GDF Suez* [2018] EWCA Civ 2075 and in *Smith & Nephew* [2020] EWCA Civ 299 (concerning the 'fairly represents' override in a loan relationships context), took a broader reading of the effect of the override. Examining the totality of the transaction in its factual context, the Court of Appeal concluded the accounting debit did not, as a matter of legal analysis or economic reality, fairly represent a loss.

The Court of Appeal was influenced, in particular, by the fact that distributable reserves were created to pay dividends on the bonus shares by writing back the accounting debit which had been disregarded. The effect of this was to pay the dividend out of profits constituted by the reversal of the very debit said to be a loss, which David Richards LJ referred to as 'a remarkable piece of 'now you see it, now you don't' accounting'. He noted that, as a matter of company law, the payment of a dividend is a distribution of profit which is the very opposite of realising a loss and observed that: 'If the payment of a dividend is not a loss, I am unable to accept that an obligation to pay a dividend, in this case out of future profits, can be a loss.'.

The 'fairly represents' aspect of this case is of historical interest only as, in parity with the loan relationships rules, the 'fairly represents' test has been repealed from the derivative contract rules and replaced with a regime targeted anti-avoidance rule and some specific anti-avoidance provisions. The discussion of what is a loss and whether it 'arises from' a derivative contract are applicable to the current legislation, however. In particular, the confirmation that the starting point for determining credits and debits under the derivative contracts rules is the profits and losses in the GAAP-compliant accounts is welcome and applies equally to the current legislation in CTA 2009, s595.

Further twist

The decision on 'loss' in this case illustrates that you determine whether a company has a 'profit' or 'loss' for derivative contracts/loan relationships purposes by reference to whether its net worth, as per its GAAP compliant accounts, has gone up or down or not. After seeing the draft judgment, Union Castle sought to amend its corporation tax return for the relevant period to reduce its corporation tax liability by £4.6m to reflect the total net reduction in the fair value of its derivative contracts in the relevant period which it argues should be recognised for corporation tax purposes now the derecognition debit has been disallowed.

HMRC, obviously not happy with this alternative case being raised so late in the day, opposed this course of action. The Court of Appeal has remitted the matter to the FTT for it to decide whether Union Castle should be permitted to seek amendment of its tax computation in this way and if so, whether it has a good case for such amendment.

Transfer pricing of shareholder transactions

When we wrote about the UT's decision in our October 2018 Tax and the City briefing (*Tax Journal*, 11 October 2018), one interesting aspect, although obiter, was that the UT agreed with HMRC's alternative argument that the issue of bonus shares fell within the transfer pricing rules, reducing the deductible debit to nil. The UT held that the issue of the shares was a 'provision' within ICTA 1998, schedule 28 AA (now rewritten in TIOPA 2010 Part 4). Unfortunately, the Court of Appeal did not have an opportunity to comment on the transfer pricing issue as it was considered not necessary to hear argument on it in the light of the conclusions reached on the other issues so we will have to wait for another case to raise it in order to get any further analysis of this.

Beneficial ownership

As something of an aside, followers of the Danish beneficial ownership saga will have been interested to see the ease with which Richards LJ concluded that agreeing to pay away 95% of the cash flows by way of dividend did not affect Union Castle's beneficial ownership of the derivatives. As he put it 'This is simply tested by considering the position if Union Castle became insolvent. The cash flows would have been available to meet its liabilities'. Much like a 'profit' or a 'loss', it seems that an English court simply knows 'beneficial ownership' when it sees it!

LIBOR withdrawal: tax changes

HMRC is consulting until 28 August on the tax changes required as a result of the withdrawal of London Interbank Offered Rate (LIBOR) and other benchmark interest rates. Publication of LIBOR (and other benchmark rates) is expected to cease after the end of 2021. This means any financial instrument which refers to LIBOR (or another discontinued benchmark rate) will either need to be amended or replaced to use a different reference rate.

The consultation launched on 19 March has two objectives. Firstly, ensuring that where tax legislation makes reference to LIBOR, it continues to operate effectively. Secondly, ensuring HMRC is aware of all the significant tax issues that arise from the reform of LIBOR and other benchmarks.

There are only a few statutory references to LIBOR in the tax legislation (dealing with treatment of leases) but these will need to be replaced with a different reference rate and HMRC is consulting on the various replacement options.

HMRC has produced fairly comprehensive draft guidance setting out its view on the tax implications for businesses of changes to financial instruments driven by benchmark reform. This guidance should give comfort to those borrowers/lenders who are simply amending the benchmark rate terms of their financial instruments that there will not be any adverse tax consequences.

Take, for example, the section on tax treatment of additional payments under a loan. In order to ensure the parties remain in the same economic position, the amendment/replacement will usually require making some other adjustments e.g. to the spread or including an additional payment so there is not a transfer of value between the parties. If the expected cash flows representing interest are lower under the new reference rate, the lender would expect the borrower to make a payment to the lender for the shortfall. The guidance provides this additional payment should be treated as interest and it would, therefore, be subject to withholding tax, or payable gross, consistently with the treatment of the 'normal' interest.

If the cash flows are higher, the lender would be expected to make a payment to the borrower to secure the borrower's agreement to make higher interest payments going forwards and the guidance provides this will be treated as an expense. There should be no withholding tax on this payment as it is not an 'annual payment' as it is clearly not 'pure income profit' in the borrower's hands.

The guidance also provides that additional payments relating to derivatives will be exempt from withholding tax under ITA 2007, s980.

Somewhat surprisingly, the guidance is silent, however, on the VAT treatment of additional payments. It should be fairly clear that any payment by the borrower to the lender is for an exempt supply under VATA 1994 Sch 9 Group 5, but it would certainly be helpful if HMRC could expand the guidance to confirm that any payments by the lender to the borrower would similarly be exempt.

Depending on the responses received, any legislative changes necessary will be published in draft for inclusion in Finance Bill 2020-21.

COVID-19: tax implications

The virus has achieved what years of lobbying failed to do: getting the Stamp Office to move away from embossing stamps on hard copy documents and instead requiring electronic submission of documents and electronic payment of duty, at least for now.

The restrictions on travel and the necessity for some board meetings to be held remotely led to concerns about whether companies could find their place of tax residence changed or if such circumstances have created a permanent establishment. Both the UK and OECD guidance is reassuring that such temporary changes will not create a permanent establishment or cause a company to change its tax residence.

Another concern is whether businesses forced by lockdown to close temporarily are within the cessation of trade rules even if there are plans to continue the business once restrictions are lifted. Likewise, have businesses which have switched production, for example, to produce equipment required by the NHS, had a major change in the course of trade?

A parallel can be drawn with the first and second world wars, when non-essential production was strictly limited, and many companies switched to producing arms. The courts considered the tax consequences of these changes several times. The case law shows that the key to showing there has been no cessation or major change is the intention to resume trading. It is, therefore, important for groups with UK subsidiaries/permanent establishments to keep contemporaneous records of both the fact that any decision to stop or change trading was a temporary, crisis-driven measure and also that there is an intention to resume the original trade as soon as circumstances permit.

Hybrid rules: HMRC consults on further tweaks

In the *Hybrid and other Mismatches* consultation document published 19 March, HMRC consults until 29 August on three areas of the hybrids regime in TIOPA 2010, Part 6A which continue to cause difficulty and unfairness in practice:

- **Impact of the double deduction rules:** relaxing conditions in the tightly drafted s259ID for double deduction structures which generate inclusion of income without a corresponding deduction. HMRC is looking at, in particular, the meanings of 'in consequence of' and 'the investor'.
- **Scope of the acting together rules:** reducing the scope to prevent persons being treated as acting together when there is insufficient control over the third party to enable the required relevant information about the third party's structure to apply the rules to be obtained. If the acting together rules are narrowed, HMRC would then rely on the TAAR in chapter 13 in the event that arrangements intended to benefit from any such amendments were put in place for non-commercial reasons.
- **Treatment of exempt investors in hybrid entities** – three options are suggested but HMRC is interested in exploring other potential options. HMRC is concerned if a carve-out from the hybrid rules were offered in all cases where an investor in a hybrid entity would not have been subject to tax had it received direct payment of the amount paid to the hybrid entity, the effectiveness of the hybrid rules would be undermined.

What to look out for:

- Various consultations which were due to close in May (including the LIBOR and hybrids consultations) have now been extended by 3 months to corresponding dates in August, although HMRC welcomes earlier responses where they are available.

- A ministerial statement on 28 April by Jesse Norman confirms that a summary of responses to the call for evidence on the operation of Insurance Premium Tax and a response on HMRC's civil information powers are expected to be published this spring/summer. The discussion document on the wider application of tax conditionality is delayed until the Autumn, however. The statement also explains that HMRC will provide in due course an update on various other promised consultations/reviews including the review of the UK funds regime and the consultation on the Economic Crime Levy.
- The House of Commons programme agreed on 27 April 2020 provides that the Finance Bill will be committed to a Public Bill Committee, proceedings of which must end no later than 25 June 2020

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