SLAUGHTER AND MAY/

CLIENT BRIEFING

January 2021

TAX AND THE CITY REVIEW

The EU-UK Trade and Co-operation Agreement gives the UK the freedom to narrow the scope of DAC6 to just hallmark D (CRS avoidance and concealing beneficial owners). In *Warshaw*, the UT dismisses HMRC's appeal and concludes the FTT had made the right decision that the cumulative, compounding preference shares held by the taxpayer were 'ordinary share capital' and that the company was his 'personal company' for the purposes of entrepreneurs' relief. In *Development Securities*, the Court of Appeal reinstates the FTT's decision that the JerseyCos were tax resident in the UK. The latest report on the Code of Practice on Taxation for Banks shows the regime continues to work but that HMRC needs to improve its response time for pre-transaction approaches. The UT in *Gallaher* decides to make a reference to the CJEU in order to resolve the appeal on whether the UK's exit tax regime was compliant with EU law.

Brexit: UK's DAC6 rules scaled back

There is very little tax content in the EU-UK Trade and Co-operation Agreement (the TCA) but it is significant that the parties have committed to good tax governance and OECD/BEPS standards, rather than EU standards. So the main area of interest is how the UK's tax rules may now begin to deviate from EU rules. Already, one tangible benefit of the TCA is that it has enabled the UK to narrow significantly the scope of DAC6 (the EU's mandatory disclosure of reportable cross border arrangement rules).

The UK is now free to follow the OECD's global transparency standards instead of the EU's DAC6 rules. As the UK already has disclosure rules on which a number of the OECD's transparency standards were based, the only parts of DAC6 which are required by the TCA to apply in the UK relate to Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures (the MDRs).

So by the time the DAC6 reporting obligations became effective in the UK on 1 January 2021, only hallmarks D1 (arrangements to conceal income or assets) and D2 (to obscure beneficial ownership) were caught. Later this year it is expected that these will be replaced with the UK's own model disclosure rules that will implement the MDRs. This was a welcome surprise for UK businesses and their advisers, even if rather late in the day after much painstaking preparation had been done for compliance with the full DAC6 rules, although those with an EU presence will still have to contend with DAC6 in the EU.

Stephen Warshaw: ordinary share capital - bright line test

HMRC v Stephen Warshaw [2020] UKUT 0366 (TCC) concerns entrepreneurs' relief (now renamed business asset disposal relief). In order to benefit from entrepreneurs' relief, Mr Warshaw had to show that the shares he disposed of were shares in his 'personal company'. The Upper Tribunal (UT) dismissed HMRC's appeal and concluded the First-tier Tribunal (FTT) had made the right decision that the preference shares he held were 'ordinary share capital' and that the company was his 'personal company'. The sole issue in the appeal, as it was before the FTT, is whether the preference shares carried a 'right to a dividend at a fixed rate' for the purposes of the definition of ordinary share capital in Income Tax Act 2007 s989. The FTT's decision in *Warshaw* showed that cumulative preference shares may, if they are also compounding, constitute ordinary share capital.

HMRC amended its guidance at CTM00514 following the FTT's decision to state that it is finely balanced and depends on the facts whether preference shares where the coupon compounds over time or where a rate of interest is added if the dividend is unpaid, are ordinary shares.

The basis of HMRC's appeal was that the FTT had erred in holding that the dividend attached to the preference

shares was not at a fixed rate because it was cumulative – but the UT said the FTT's decision was based on the effect of the right to compounding, not on the effect of the right to a cumulative dividend. The UT therefore discussed whether the FTT had made an error of law on the effect of the right to compounding and concluded it had not.

The UT set out five principles to be applied when construing s989. These principles show that s989 is to act as a definition which produces a bright line between issued share capital which is ordinary share capital, and that which is not. It is necessarily formalistic and looks at the rights attached to the share, not the subjective intentions of the parties as to its tax status or what happens in practice. The UT did not accept HMRC's proposition that the statutory distinction between a share which is ordinary share capital and one which is a fixed rate preference share should be based, or even informed by, whether in economic terms it is 'debt-like'. Following these principles, the UT concluded that in order to have a right to a dividend at a fixed rate, both the rate and the amount to which it is applied must be fixed. The UT sees no principled basis for a distinction between a dividend expressed as a fixed percentage of profits and the dividend on the preference shares in this case which had a right to compounding.

Although the case is about entrepreneurs' relief, the term 'ordinary share capital' is also relevant to other parts of the legislation such as group relief, consortium relief and stamp duty group relief. It is a good reminder that this is an area where the devil is very much in the detail. We wait to see how HMRC will amend their guidance again in the light of the UT's decision as the Tribunal makes it clear that it is a bright line test and that the right to compounding puts the shares firmly on the ordinary share capital side regardless of why the right to compounding is attached to the shares. HMRC's argument that compounding effectively just provides compensation by way of interest for unpaid dividends was dismissed as not relevant to the construction of s989.

Development Securities: corporate tax residence

In HMRC v Development Securities plc and others [2020] EWCA Civ 1705, the first Court of Appeal decision on corporate residence since 2006, the Court of Appeal unanimously overturned the UT decision, reinstating that of the FTT. The fact that the decision has now been reversed twice shows the complexity of the issues in this case. Moreover, although the decision to overturn the UT's decision was unanimous, the three Court of Appeal judges themselves took three different views on the residence question.

The case concerned a scheme to enhance capital losses through certain transactions undertaken by three companies (the JerseyCos), newly incorporated in Jersey as 100% subsidiaries of UK Plc. In order for the transactions to work as intended, it was essential that the JerseyCos were Jersey tax resident when they acquired certain assets at a price significantly in excess of their market value.

The FTT concluded that the Jersey directors had abdicated their responsibility to UK Plc and that, therefore, the JerseyCos were UK tax resident at the crucial time. The FTT focussed on the uncommerciality of the acquisition undertaken in pursuance of a scheme propounded by UK Plc and the fact that the Jersey directors had essentially been hired to approve the acquisition and were replaced shortly thereafter. The FTT held that the JerseyCos' directors had not engaged with the substantive decision but had been instructed by UK plc to carry out the transactions.

The UT, however, decided that this was incorrect as a matter of law and concluded, on the basis of the facts found by the FTT, that the JerseyCos were resident in Jersey at the relevant time. The UT criticised the FTT's basis for its decision as being untenable and wrong, resting on a fundamental misunderstanding of the nature of the transactions entered into by the JerseyCos and of the duties of the Jersey directors. The UT took the view that the FTT's conclusion was founded on the directors having 'failed to decline to do something that was improper or inadvisable, in that they had entered into so-called uncommercial transactions'. The UT also thought the FTT had erred by confusing shareholder authorisation with instruction.

The Court of Appeal had been asked to rule only on the question whether the UT's reasons given for its decision were valid and not whether or not the UT's decision to overturn the FTT's decision should be upheld on another basis. There is an important procedural point here – the taxpayer should have put in a respondent's notice to enable the Court to consider whether the UT's decision could be upheld on another basis. In failing to put in a respondent's notice, the taxpayer effectively conceded that if the UT's reasons for the decision were invalid, the decision was itself wrong.

The Court of Appeal overturned the UT's decision on the basis that its criticism of the FTT decision had not been well-founded as it was based on a misunderstanding of the reasoning of the FTT. The UT was not right to conclude the FTT confused shareholder authorisation with instruction. The real reason for the FTT's decision was its finding of fact that the JerseyCos' directors had acted on what they perceived as an instruction from the parent, UK Plc and did not engage with the substantive decision and, thus, the central management and control of the JerseyCos was really in the UK throughout.

The residence question divided the judges. Nugee LJ agreed the UT got it wrong but clearly wanted to remit it to the FTT; David Richards LJ thought the FTT got it right; and Newey LJ ducked the question on procedural grounds. But whatever the differing views on residence expressed in this case, there are no new principles set here and Wood v Holden [2006] EWCA Civ 26 remains good law. It is clear that this is an extreme case which turns on its (extreme) facts and should be limited to similar scenarios. In practice, there should be no read-across to special purpose vehicles (SPVs) which enter into transactions which make commercial sense for them. The FTT was at pains to distinguish, for example, a finance SPV which is asked by its parent to enter into transactions which do make commercial sense for it, even where there is a strong expectation to do so.

Where a company resides is essentially a question of fact, so this case is a reminder of the importance of a company being able to provide adequate evidence of where central management and control is exercised. The key finding of fact by the FTT in this case was that UK plc instructed the JerseyCos to enter the transactions and the directors followed that instruction, subject to checking it was lawful to do so and not therefore taking any actual decision themselves.

The Code of Practice on Taxation for Banks Annual Report

The latest annual report on the Code of Practice on Taxation for Banks (the Code) shows it is continuing to support improved behaviour across the banking sector. Where a bank is unsure whether the tax result of a proposed transaction is contrary to the intentions of Parliament, it can discuss those plans with HMRC in advance. In the period 1 April 2019 to 31 March 2020 HMRC responded to seven pre-transaction Code approaches, as compared with five the previous year. HMRC considered five of the seven to be Code-compliant and one not Code-compliant and so the non-compliant transaction did not go ahead. HMRC did not provide a view on whether the remaining transaction would lead to a tax result contrary to the intentions of Parliament, as the uncertainty related to the application of a purpose test, and this could not be tested before the transaction took place.

The report does, however, show room for improvement in Code approach response times. In 2019, HMRC set a new target of responding to Code approaches within 28 days but the report shows this target was met only for three of the seven responses. Of the others, two required additional information to be provided by the customers and further analysis before HMRC could respond, and in two cases the response targets were not met because of delays by HMRC. As a result, HMRC has reviewed its relevant processes and provided further internal training to reduce the risk of delay.

Gallaher: exit tax questions referred to CJEU

The UT decided in Gallaher Limited v The Commissioners for HM Revenue and Customs [2020] UKUT 0354 (TCC), that a number of questions should be referred to the CJEU in order to resolve the appeal concerning whether exit taxes imposed by the UK legislation were compliant with EU law. The UT identified the EU law issues as critical to their decision but found they could not resolve the issues 'with complete confidence', although Judge Beare in the FTT had decided such a reference was not necessary or appropriate.

This was one of the last references made by a UK court to the CJEU prior to the end of the transition period on 31 December 2020 and addresses a number of questions on the application and interrelationship of two EU treaty freedoms: the free movement of capital and the freedom of establishment. The response of the CJEU has relevance beyond the facts of this particular case, for example, to other multinationals who have moved assets out of the UK to an EU country as part of Brexit planning. It may also inform the interpretation of the new instalment regime brought in by Finance Act 2020 as a result of the *Gallaher* case.

What to look out for in early 2021:

- **The public consultation on the OECD blueprints for international tax reform is scheduled for 14 and 15 January and can be viewed on OECD Web TV.**
- **The Court of Appeal is scheduled to commence hearing the appeal in the *South Eastern Power Networks (and others)* case on consortium relief and closure notices on 2 or 3 February**

- 5 February is the closing date for the consultation on insurance premium tax: administration and unfair outcomes.
- 23 February is the closing date for comments on the second consultation on taxation of UK asset-holding investment companies.
- The Budget will be held on 3 March and Finance Bill 2021 is expected to be introduced shortly after.

This article was first published in the 15 January 2021 edition of Tax Journal

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