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Slaughter and May Podcast
Tax News Highlights: January 2022

Zoe Andrews	Welcome to the January 2022 edition of our tax news highlights podcast. I am Zoe Andrews, PSL Counsel & Head of Tax Knowledge.
Tanja Velling	And I am Tanja Velling, Senior Professional Support Lawyer in the Tax department. For this podcast, we are again joined by a colleague from our Competition department.
Nele Dhondt	I am Nele Dhondt, PSL Counsel in the Competition department, and I am delighted to be joining this edition to discuss the latest developments in EU State aid tax cases.
Tanja Velling	We will also highlight a few key points in respect of recent developments on Pillar Two and discuss the consultation on improvements to the tax regime for hedging risks on future share transactions, as well as two cases: the First-tier Tribunal's decision in *Hotel La Tour* and the decision of the Court of Session in *Ventgrove*. This podcast was recorded on the 11th of January 2022 and reflects the law and guidance on that date. Nele, is there any news on the UK's CFC case?
Nele Dhondt	Unfortunately not yet, Tanja. After the hearing was completed in October last year, we're awaiting the European General Court's judgment. But there were some other very interesting developments. In early October, for example, the European Court of Justice ruled on the Spanish financial goodwill dispute that has been on-going for more than a decade. The Court dismissed eight appeals brought against earlier rulings of the General Court, in which the latter, adjudicating on a previous referral back from the Court of Justice, had dismissed the appeals against European Commission decisions relating to a Spanish tax amortisation measure. Under this measure, companies subject to taxation in Spain can deduct from their taxable base the financial goodwill arising from an acquisition of a shareholding of at least 5% in a foreign company. The EC had found that this measure amounted to an aid scheme incompatible with the internal market – and had ordered recovery – because the measure introduced an unjustified difference in treatment between undertakings that decided to carry out comparable transactions involving Spanish targets.

	In its October ruling dismissing the appeals, the Court of Justice clarified its case law on the selectivity of tax measures adopting a relatively broad interpretation of this condition. So as many of you may be aware, selectivity is one of the cumulative criteria required for a measure to qualify as State aid. The Court first recalled the three-step test for selectivity of national tax measures that the EC must apply: • first, it must identify the common or normal tax system applicable in the Member State; • second, it must demonstrate that the tax measure at issue is a derogation from that reference tax system, differentiating between undertakings that—in light of the objective pursued by the legal system—are in a comparable factual and legal situation; and • third, it must establish whether that differentiation is justified. Upholding the General Court's interpretation of the second limb of this test, the Court of Justice ruled that, and I quote: "*the mere fact that the measure is of a general nature, in that it may a priori benefit all undertakings subject to corporate tax, depending on whether or not they carry out certain transactions, does not mean that it cannot be selective*". Also according to the Court, the selectivity condition is fulfilled when the EC is able to demonstrate that such a measure derogates from the normal tax system applicable in the Member State, thereby introducing, through its actual effect, as in this case, a difference in the treatment of operators in a comparable factual and legal situation.
Zoe Andrews	That's a very interesting development. Have there been any other noteworthy developments in this area in the last couple of months?
Nele Dhondt	There have been – absolutely. For example, it's worth mentioning the December 2021 opinion of Advocate General Pikamäe in the *Fiat* case, which also focuses on the selectivity condition, and which is one of several ongoing, high-profile cases relating to tax rulings. So this case relates to an advance pricing agreement granted by the Luxembourg tax authorities in 2012 in favour of an undertaking in the Fiat group that provided treasury and financing services to group companies established in Europe. The EC concluded that this agreement, this APA, constituted unlawful State aid, broadly, on the basis that it allegedly allowed intra-group transactions to be priced at below arm's length prices. The General Court confirmed the EC's decision but its ruling was appealed and so the case is now pending before the Court of Justice. In his opinion, the

	AG proposes that the Court allow the appeal, interestingly, and annul the EC's decision.
Tanja Velling	So what does the AG's opinion say?
Nele Dhondt	Well, one key point is the AG's conclusion that the normal taxation regime must be determined based on rules of national law, including EU law and international law transposed into the domestic legal system. According to the AG, it comprises only the rules and principles constituting the legislative expression of the national legislature's intention, and it cannot be based on the objective allegedly pursued by that legislature. The AG therefore suggests that the Court uphold the first ground of appeal that the General Court erred in law when endorsing the way in which the EC had identified the normal taxation regime for the purpose of examining the existence in the present case of an advantage. According to the AG, the arm's length principle on which the EC relied didn't actually form part of the normal regime as it wasn't expressly codified in national law. So the AG considered that, in confirming the EC's approach, the General Court had disregarded the Treaty provisions governing the division of competences between the EU and the Member States. It will be interesting to see whether the Court of Justice follows the AG's opinion and settles the question of where the Treaty draws the line between the Member States' fiscal autonomy and the State aid prohibition.
Zoe Andrews	State aid has been used by the EC as tool for tackling tax competition but I would say that it is not the right tool for the job. The EU is not a fiscal union and, as we have seen, attempts by the EC to fully harmonise corporate taxes across the EU have so far been unsuccessful and the CCCTB proposal has now been taken off the agenda. But, as we mentioned in our June 2021 podcast, there is a new EU proposal, "BEFIT", a single corporate rulebook with a common tax basis and formulary apportionment for allocation of profits which, if implemented, would enable greater fiscal uniformity. This should mean that the State aid rules would not need to be used as a method of tax harmonisation. As the BEFIT proposal is intended to piggy-back off the international tax reform rules under Pillar Two, the proposal will not be published until 2023. Should we have a brief look at the most recent developments in respect of Pillar Two?
Tanja Velling	Sure. On the 20th of December 2021, the OECD/Inclusive Framework published the Global Anti-Base Erosion Model Rules, covering the Income Inclusion Rule and Undertaxed Payments Rule aspects of Pillar Two. The European Commission's proposal for a Directive to implement the same aspects in the EU followed on the 22nd of December.

	The EC's choice to structure the Directive proposal differently from the OECD's Model Rules complicates a comparison. Substantively, the former does, however, largely follow the latter, although we would like to highlight a key difference in respect of the proposed territorial scope.
Zoe Andrews	While the Model Rules apply to international groups – they apply to groups which include at least one entity or permanent establishment that is not located in the jurisdiction of the ultimate parent – the Directive proposal would also apply to purely domestic groups to avoid any infringement of the EU's fundamental freedoms. In contrast to the Model Rules, the Directive proposal would also apply the Income Inclusion Rule to constituent entities located in the same jurisdiction as the ultimate parent. Two other points I thought worth highlighting concern aspects where the Commission has replicated provisions in the Model Rules, but expanded on their requirements. • The Model Rules allow countries to apply a domestic top-up tax to effectively take what would otherwise be under-taxed income outside the scope of another jurisdiction's Income Inclusion Rule. The Directive proposal contains the same optionality, but requires Member States to notify the Commission whether they wish to make use to this option within 4 months following the adoption of their implementing legislation. That's the first point. • The second point could be highly relevant to the question of whether the US GILTI rules will be regarded as a qualified Income Inclusion Rule. The Directive proposal appears to set out specific criteria which would have to be met in order for another jurisdiction's laws to be regarded as equivalent and that the Commission would make the determination. The Commission's explanatory memorandum does refer to an expected peer-review process at OECD/IF level, but does not explicitly clarify how this would interact with its own determination – although one would think that the Commission would follow any peer-review conclusion.
Tanja Velling	The explanatory memorandum also addresses potential implications for other EU tax measures. Those hoping for some simplification will have been disappointed to learn that the Commission concluded that the ATAD CFC rules should be maintained in their current form alongside the new Income Inclusion Rule. This conclusion is, however, hardly surprising given the OECD's own statement in the FAQs accompanying the Model Rules that they are complimentary to existing corporate tax rules, such as CFC regimes. The explanatory memorandum further reiterates the Commission's view that the implementation of Pillar Two "should pave the way" for a recast Interest and Royalties Directive, the benefits of which would be conditional

	on the interest's being subject to tax in the destination state. We can, however, expect to wait another while until it becomes clear whether this project will be brought to fruition. In the meantime, what are the next steps for the OECD's Model Rules and the Commission's Directive proposal?
Zoe Andrews	Concerns have already been expressed by Business at OECD (or "BIAC") that the Model Rules for Pillar Two are too complex which will lead to increased uncertainty and instability, and likely double taxation. BIAC has highlighted aspects of the rules (such as imposing a top-up tax even where there is no income in a jurisdiction in a year and limiting deferred tax attributes to the minimum tax rate, even if the jurisdiction has a higher tax rate) which are inconsistent with the fundamental policy of Pillar Two. This shows that there are still major policy and technical issues to be resolved and more detail to follow. The OECD is planning to release its commentary on the GloBE rules in early 2022. A number of other documents, including an implementation framework for the GloBE rules and a model treaty provision to give effect to the Subject To Tax Rule, are also expected, and public consultations will be held in February on the implementation framework and in March on the Subject To Tax Rule. We are also expecting early this year the text of the multilateral convention to implement Pillar One together with an explanatory statement. In the EU, we can expect an intense period of negotiation. France has taken over the presidency of the Council for the first half of 2022 and its programme includes taking forward the Commission's Directive proposal. This is not going to be easy, given that it would have to be agreed unanimously by the Member States. Overall, if I were to hazard a prediction, I would say that we are likely to see some more or less significant changes to the Model Rules and the Directive proposal as we move through 2022.
Tanja Velling	But now for some good news in the UK. The government is consulting until the 24th of January on draft legislation to amend the hedging rules (specifically, the two sets of regulations known as the Disregard Regulations and the EGLBAGL Regulations) for foreign exchange risks on anticipated future share transactions. Currently, derivative contracts entered into to hedge currency risks on 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.
Zoe Andrews	The proposed changes will mean 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 (broadly, 10% or more of the ordinary share capital) are aligned with the treatment of the shares to remove this source of uncertainty and volatility for businesses. The new rules will apply where the derivative contract is entered into on or after 1 April 2022 to hedge foreign currency risk on an anticipated future acquisition or disposal of a substantial shareholding as defined in Schedule 7AC TCGA 1992. Specifically, the Disregard Regulations will be broadened so that exchange gains or 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.
Tanja Velling	This means that complicated work-arounds to effectively eliminate foreign exchange risks on anticipated share transactions will no longer be required. This change is intended to create a fair and internationally competitive hedging regime for foreign exchange risks on share transactions, which will also support the new asset holding company regime. Guidance in the Corporate Finance Manual will be updated by the 1st of April 2022.
Zoe Andrews	And now, onto recent cases. In *Hotel La Tour*, the First-tier Tribunal applied the Supreme Court's decision in *Frank A Smart* to conclude that VAT incurred on advisers' fees in relation to a share sale was recoverable given that the share sale had the purpose of raising funds for the holding company's taxable activity. But it seems to me that, in particular in relation to the purpose question, the facts did lend themselves to finding in favour of the taxpayer. The target operated a hotel in Birmingham which had limited growth prospects. So, the holding company decided to construct a new hotel in Milton Keynes and various funding options were considered before it settled on the preferred option which was to use the proceeds from a sale of the target and cover any shortfall with a bank loan. The bank loan was entered into on such terms that it could only be drawn down after the net sale proceeds had been expended. The FTT also found that, at the time of the hearing, the entirety of the net proceeds had been so expended.

	This is rather good evidence of a purpose of funding taxable activities. It is encouraging that the FTT did not draw a distinction between sale proceeds in the form of actual share consideration and the repayment of a loan made by the holding company to the target through funds provided by the purchaser. Whilst the FTT was not entirely clear on the weight to be attributed to these factors, it seems that, where shares are sold for the best price achievable in the market and that price is not increased to cover advisers' fees or some allocation made in this respect, they should not normally be regarded as cost components of the share price so as to bar input tax recovery.
Tanja Velling	In *Ventgrove*, a dispute between a landlord and a tenant on the exercise of a break option, the Court of Session construed the phrase "together with any VAT properly due thereon" in what might be regarded as a somewhat curious way. It concluded that VAT was not "properly due" for these purposes where HMRC policy was that no VAT is chargeable – seemingly irrespective of whether such policy was correct as a matter of law. On a second look, in the context of the case, this conclusion may not, however, be that curious. The purpose of the words was not to give the landlord the windfall benefit of any VAT which may have been due in accordance with the letter of the law, but would not have to be passed on to HMRC on the basis of their current policy. The judgment also noted that, if HMRC were to charge VAT contrary to their policy, the landlord could claim under a different contractual provision.
Zoe Andrews	Although the court did not actually go into this, it appears that, in the context of interpretation of contractual provisions (as opposed to the case where HMRC seeks to recover unpaid VAT), parties can rely on what HMRC's policy was at the relevant time regardless of the correct revenue law position. Another point worth noting is that the recipient of the supply, here the tenant, would normally want to ensure that the contract makes explicit that any VAT payment is conditional on the receipt of a valid VAT invoice. Based on the drafting of the relevant contractual provisions, the Court's *obiter* conclusion was here that the tenant would have been obliged to pay the VAT (if any had been due) without the landlord having had to first issue a separate demand in the form of a VAT invoice, and this could jeopardize input tax recovery.
Tanja Velling	And now, what is there to look out for? A number of interesting cases will be heard in the coming weeks, including *Blackrock* on the scope of the VAT exemption for investment management services and *Volkerrail* on group relief surrenders by the UK permanent establishment of a non-UK company in the Upper Tribunal.

	Anyone thinking about commenting on the draft mandatory disclosure rules with which the UK intends to replace its scaled-back implementation of DAC6 has until the 8th of February to do so. The OECD is due to publish the Transfer Pricing Guidelines 2022 later this month. And we may also hear something from the European Commission and the OECD on an extension of reporting rules to also cover crypto-assets and -currencies, given that neither institution released an update by the end of 2021 as was said to have been planned.
Zoe Andrews	And that leaves me to thank you for listening. If you have any questions, please contact Tanja, Nele or me, or your usual Slaughter and May contact. Further insights from the Slaughter and May Tax department can be found on the European Tax Blog – www.europeantax.blog. And you can also follow us on Twitter – @SlaughterMayTax.