SLAUGHTER AND MAY/

Slaughter and May Podcast
Tax News Highlights: October 2023

Zoe Andrews	Welcome to the October 2023 edition of our tax news highlights podcast. I am Zoe Andrews, PSL Counsel & Head of Tax Knowledge.
Tanja Velling	And I am Tanja Velling, Tax PSL Counsel. We will discuss the Upper Tribunal's decision in *ScottishPower* and the Supreme Court's decision in *Target Group* as well as the draft legislation for inclusion in the next Finance Bill to remove the 1.5% stamp duty and SDRT charge on issues and transfers integral to capital raisings. We will also highlight some of the latest developments on the two pillars of international tax reform and the UK's implementation of Pillar 2; and discuss two proposals by the European Commission for EU Directives which will be of interest to groups with EU entities. This podcast was recorded on the 17th of October 2023 and reflects the law and guidance on that date. Let's start with the cases.
Zoe Andrews	The Upper Tribunal's decision in *ScottishPower* concerns the deductibility of payments made under settlement agreements with OFGEM following regulatory breaches. OFGEM had opened four investigations into the taxpayers and each of them resulted in a settlement agreement, pursuant to which the Gas and Electricity Markets Authority imposed a £1 penalty on each of the taxpayers and the taxpayers made redress payments of around £28 million in aggregate. The case concerns the deductibility of these redress payments; the taxpayers had not sought to deduct the £1 financial penalties. Both HMRC and the taxpayers had appealed against the First-tier Tribunal's decision that had denied a deduction for the vast majority of the redress payments, but allowed it for around £550,000 paid directly to affected customers on the basis that these payments were compensatory in nature. The Upper Tribunal considered that all of the redress payments were non-deductible; it dismissed the taxpayer's appeal and allowed HMRC's.
Tanja Velling	The key issue in the case was the scope and application of the House of Lords' decision in *McKnight v Sheppard*. The issue in *McKnight* was whether legal expenses incurred by a stockbroker in "defending himself against proceedings before the disciplinary committee of the Stock Exchange and appearing before the appeals committee" were deductible under section 130(a) of the Income and Corporation Taxes Act 1988. Section 130(a) is the predecessor of

	section 54 of the Corporation Tax Act 2009 which now provides that "in calculating the profits of a trade, no deduction is allowed for expenses not incurred wholly and exclusively for the purposes of the trade". Whilst concerning legal expenses, the decision in *McKnight* discusses the deductibility (or rather non-deductibility) of penalties, and the Upper Tribunal considered that this discussion formed part of the *ratio* of the decision. But *McKnight* should not be taken to have established a free-standing judge-made rule that penalties are non-deductible; according to the Upper Tribunal, *McKnight* tells us how to interpret when something is "for the purposes of" a trade. What the Upper Tribunal appears to be saying is that, in construing these words, one should take into account the public policy issue that allowing a tax deduction for penalties would lessen their economic impact (and consequently their punitive effect). So, even where a penalty is incurred *in the course of a trade*, it should not be regarded as incurred *for the purposes of the trade*. And for these purposes, the Upper Tribunal appears to consider a "penalty" to be any payment that is "punitive in nature or in character".
Zoe Andrews	In my view, this is quite a significant gloss on the words "for the purposes of", arguably more akin to a judge-made rule than ordinary statutory interpretation. But leaving that aside, how did the Upper Tribunal apply the test to the payments at issue in *ScottishPower*?
Tanja Velling	Well, the Upper Tribunal considered that the FTT had been wrong to assess the payments individually. Where – as in this case – there are a number of different payments that form "part of an overall package", one has to look at the overall picture. If the overall package has a punitive character, one cannot then go on to single out certain payments which are more compensatory in nature and allow those to be deducted (as the FTT had done). In such a case, all payments are non-deductible. Of course, the Upper Tribunal said that, in the "global assessment", one can take into account to what extent the payments are in fact compensatory, but that is just one element of the assessment and, even where a payment has features of compensation, I quote, it "may still be properly characterised as punitive because it has been imposed for regulatory breaches and has been imposed by action of the regulator – or indeed by a court". In this context, it is worth remembering that, in this case, the redress payments had not actually been "imposed" by the regulator; they had been agreed between OFGEM and the taxpayers (although the FTT had found as fact that penalties of the same amount or more would have been imposed in absence of the agreement). So, taking this together, it seems that, following *ScottishPower*, taxpayers may face an uphill struggle in seeking to deduct any compensatory payment made as part of settling a regulatory investigation, except perhaps

	where it can be shown that the compensation paid exceeded the amount of the penalty that would have otherwise been imposed. How this would play out in respect of compensation paid to avert the threat or prospect of a regulatory investigation is another point to watch. But should we now move on to *Target Group*?
Zoe Andrews	Yes, let's do that. *Target Group* concerns the question of whether the VAT exemption for financial services applies to services provided by Target Group to Shawbrook in respect of loans made by Shawbrook to its customers in the course of its lending business. Target Group maintained accounts, calculated interest, dealt with arrears, gave instructions for direct debit payments, processed irregular payments and dealt with overpayments. Can these services be exempt under Article 135(1)(d) of the Principal VAT Directive as transactions concerning payments, transfers and/or debts?
Tanja Velling	The case ultimately turned on the question of whether the Court of Appeal's decision in *FDR* was still good law. *FDR* established that services which involve giving instructions that will automatically and inevitably result in a payment being made fall within the exemption, so long as they do not amount to debt collection. But HMRC argued that *FDR* was now bad law, following the later CJEU decision in *DPAS*. The Supreme Court agreed with HMRC and decided that *FDR* should be overruled. The narrower reading applied in *DPAS* was in line with the maxim to interpret exemptions strictly. The Supreme Court considered that, in order to be exempt, I quote, "the services must in themselves have the effect of transferring funds and changing the legal and financial situation. It is not enough to give instructions to do so thereby triggering a transfer or payment…Causation is insufficient, however inevitable the consequences." The services provided by Target Group did not meet this test, so they were taxable, as HMRC had contended. The test, as now confirmed by the Supreme Court, is stringent, and this may have significant consequences. For instance, it is unclear where this leaves HMRC's practice of treating BACS services as exempt from VAT.
Zoe Andrews	Another point I thought interesting was that the judgment discusses the exemption by reference to the wording of the Principal VAT Directive with no more than a cursory reference to the European Union (Withdrawal) Act

	2018. The Value Added Tax Act 1994 is mentioned only once to note that “nothing…turns on the precise wording of the UK statute”. VAT cases have often been argued primarily by reference to the Directive, so, in a way, this is unsurprising. Moreover, the case turned essentially on the question whether a CJEU decision of July 2018 rendered a Court of Appeal decision from 2000 obsolete. The answer to this question should be the same before and after the Withdrawal Act; the main change made by the Withdrawal Act was to authorise certain UK courts to depart from CJEU decisions. The taxpayer had raised this point before the Court of Appeal, arguing that, if *DPAS* had the effect of rendering *FDR* obsolete, it should be departed from. But this point was not subject to the appeal before the Supreme Court. So, no detailed analysis of the Withdrawal Act was required to answer the questions before it. Going forward, I would, however, expect to see a decline in VAT cases argued more by reference to the Directive than UK statute, and I am looking forward to a case that requires a more detailed analysis of the Withdrawal Act by the Supreme Court.
Tanja Velling	On the 14th of September, HMRC published draft legislation for inclusion in the next Finance Bill to remove the 1.5% stamp duty and SDRT charge on issues and transfers integral to capital raisings. As our listeners will be aware, the Finance Act 1986 provides for a 1.5% stamp duty charge in respect of instruments transferring shares to depositary receipt issuers and clearance service providers. It also provides for a 1.5% SDRT charge in respect of the issue or transfer of shares to such entities. These charges had to be disapplied under EU law (as contrary to the Capital Duties Directive) where share issues or transfers integral to a capital raising were concerned, and HMRC had confirmed that the charges would continue to be disapplied post-Brexit. This was essentially on the basis that the Withdrawal Act preserved the legal status quo. But the Withdrawal Act will be amended by the Retained EU Law (Revocation and Reform) Act 2023 in a way that could have led to the reintroduction of the disapplied charges from the start of 2024. The draft legislation for the Finance Bill is intended to “maintain the 0% charge”.
Zoe Andrews	It does that by removing references to share issues from the SDRT provisions and excepting “exempt capital-raising instruments” from the stamp duty charge and “exempt capital-raising transfers” from the SDRT charge. These terms are defined by reference to there being a transfer either in the course of a capital raising, or as soon as practicable thereafter, where the transferor acquired the relevant shares before or in the course of the capital raising, but was prohibited from transferring them. The draft legislation defines a capital raising as an arrangement involving the issue of securities by a company for the purpose of raising new capital.

	This is all good news. But it's also worth noting that, under the draft legislation, there would need to be an issue of securities for the new exceptions to be in play. The Capital Duties Directive, however, goes further than that; it also precludes charges on a transfer "to a clearance service for the sole purpose of listing those shares on a stock exchange, without there being any change in the beneficial ownership of those shares". Such transfers would seem to fall outside the scope of the new exceptions unless they are done in the course of a capital raising.
Tanja Velling	Another point to note relates to timing. The changes would apply from the start of 2024, but they will be included in the Finance Bill which may not receive Royal Assent until the middle of next year. The intention is clearly that the charges are not to be resurrected, but it is not clear how HMRC could provide comfort for the interim period from the start of 2024 until the Finance Bill is enacted.
Zoe Andrews	And now moving on to the recent developments on the two pillars of international tax reform. On the 11th of October, the multilateral convention to implement Amount A of Pillar 1, together with a number of supporting documents, were published. Amount A is the new taxing right to be given to market jurisdictions to tax a share of the excess profits of the largest and most profitable multinational enterprises regardless of their physical presence. However, the text of the instrument does not yet reflect full agreement of all the inclusive framework does it? There are still some technical issues to be resolved.
Tanja Velling	That's right, disagreements still remain over withholding taxes and digital services taxes. The multilateral convention prevents the imposition of digital services taxes and other similar measures on all companies (whether or not they are within scope for Amount A), so you can see this can be quite contentious for some jurisdictions. Annex A lists existing measures subject to removal which, as expected, include the UK's Digital Services Tax; but the list has a note at the top that the list will not be considered evidence as to whether the measures are digital services taxes or relevant similar measures.
Zoe Andrews	And there is still the elephant in the room – the question of whether the US will ever implement it. It is not open for signature yet but, once it is, for the multilateral convention to enter into force, it needs to be ratified by at least 30 jurisdictions including the headquarter jurisdictions of at least 60% of MNEs currently expected to be within Amount A's scope. So we will park Pillar 1 for now and turn to Pillar 2 where more progress has been made, starting with the subject to tax rule.
Tanja Velling	Since the 2nd of October, the multilateral convention to implement the subject to tax rule has been open for signature. This is a treaty-based rule which applies in priority to the GloBE rules to allow developing countries to tax certain intra-group payments, including interest, royalties and service

	payments where such payments are subject to a nominal corporate income tax rate below 9% in the payee's jurisdiction. The multilateral convention enables countries to implement the subject to tax rule in their existing bilateral treaties. The UK legislation gives effect to the priority of this rule over the GloBE rules in section 173(1)(c) which includes in covered taxes "taxes imposed in lieu of a generally applicable tax on profits". According to the Commentary on Article 4.2.1 of the Model Rules, this includes withholding taxes on interest, rents and royalties and taxes arising from the Subject to Tax Rule. Can you now tell us a bit about other developments on the UK's implementation of the the GloBE rules?
Zoe Andrews	On the 27th of September, HMRC published revised draft legislation for inclusion in the next Finance Bill to amend parts 3 and 4 of the Finance (No. 2) Act 2023 dealing with the multinational top-up tax and domestic top-up tax. The revised draft legislation takes on board comments received on the previous provisions (including corrections to the enacted legislation) and reflects the July Administrative Guidance which came out after the original draft legislation had been published and, amongst other things, includes two new safe harbours: the UTPR transitional safe harbour and QDMTT safe harbour, which we mentioned in our last podcast. So, we will update you on those safe harbours starting with the UTPR safe harbour.
Tanja Velling	The UTPR safe harbour will be a new paragraph 13 in Schedule 16 to the Finance (No. 2) Act 2023. To recap, under this safe harbour, the UTPR top-up is deemed zero for the ultimate parent jurisdiction for accounting periods of no more than 12 months starting on or before the 31st of December 2025 and ending before the 31st of December 2026, provided that the ultimate parent jurisdiction imposes corporate income tax at a rate of at least 20%. The UK's draft legislation looks at the aggregate of the "nominal national rate that generally applies" plus, where applicable, the "lowest nominal rate that generally applies that is imposed by a subdivision" of the relevant territory. This begs the question as to what "generally applies" means. In the UK, I should think that the generally applicable rate would be regarded as being 25% even though there are regimes where tax is imposed at a lower rate (such as under the patent box) or a higher rate (for instance, in relation to banking and ring fence profits). The Administrative Guidance indicates that implementing jurisdictions may consult the OECD's rates table, and requires the Inclusive Framework to provide "upon request, further Administrative Guidance identifying whether a jurisdiction has met the 20% rate test".

Zoe Andrews	It is also worth noting that the safe harbour is implemented as an election to be made by the filing member for an accounting period. As such, it would seem that it is intended as an annual election, but the draft legislation does not currently appear to apply the provisions on annual elections in Schedule 15. It remains to be seen whether this was an oversight that will be corrected in the Finance Bill. Where a group qualifies for more than one transitional safe harbour in respect of a jurisdiction, the Administrative Guidance indicates that the group may choose which to apply. It indicates that, if the transitional UTPR and the CbCR safe harbours apply concurrently, it may be advantageous to select the latter "in order to avoid losing the benefit of the Transitional CbCR Safe Harbour in a subsequent Fiscal Year under the "once out, always out" approach."
Tanja Velling	The QDMTT safe harbour election is a permanent election. It will be added as a new Schedule 16A and includes "switch-off rules" in certain circumstances where the qualifying domestic top-up tax (QDT) does not impose a valid charge on the relevant members, including where the enforceability of an amount of QDT accruing to the member is in question, either because the member disputes its enforceability on specified grounds, or the tax authority that imposed the QDT considers the amount unenforceable on specified grounds. New section 256A provides that the specified grounds are where the amount is unenforceable on constitutional grounds, as a result of other superior law applying in the territory in which the QDT is imposed, or as a result of a specific agreement with the government of that territory as to the tax liability of the member or the group. Where this switch-off rule applies, the QDT safe harbour will be switched off until the amount of QDT is paid and the enforceability can no longer be disputed.
Zoe Andrews	The election may only be made if there is an accredited QDT in place. There are three extra standards which must be met by a QDT in order for the safe harbour to apply, and a peer review process will confirm whether these standards have been met. The regulations will specify which QDTs are accredited. The filing member may make an annual election which would apply to all the standard members of the territory where there is an accredited qualifying domestic top-up tax in place. A separate election may also be made for a joint venture group, for investment entities, and for minority owned members if the conditions are satisfied. The effect of the election is that the relevant members of the group located in the territory are to be treated as not having top-up amounts or additional top-up amounts for multinational top-up tax purposes.

	So what has been going on in the EU of interest to us?
Tanja Velling	On 12 September, the European Commission published two proposals for directives both on the theme of harmonisation which are intended to achieve simplification and reduce tax compliance costs.
Zoe Andrews	The first is the Business in Europe: Framework for Income Taxation (BEFIT) which will introduce a single set of rules to determine the tax base of EU-based entities in groups where consolidated revenues exceed €750m and where the ultimate parent entity holds, directly or indirectly, at least 75% of the ownership rights or the rights giving entitlement to profit. The tax bases of all EU members of the group will be aggregated (automatically setting off losses against profits across borders) and a transitional allocation rule will allocate the tax base to each EU member based on their average taxable results in the previous three fiscal years. In time, the transitional allocation rule will be replaced with a permanent allocation method following a more thorough assessment of the impact of the Pillar 2 rules on national and BEFIT tax bases.
Tanja Velling	I understand that BEFIT is intended to reduce compliance costs for businesses operating in the EU by adopting a single set of rules for filing company tax returns, rather than businesses having to comply with 27 separate national tax systems. According to the Commission, the new, simpler rules of BEFIT could reduce businesses' current tax compliance costs up to 65%. So will this apply to groups headquartered in third countries such as the UK?
Zoe Andrews	It will, if their EU group members have at least €50 million of annual combined revenues in at least two of the last four fiscal years, or at least 5% of the total revenues of the group. But now, onto the second proposal. This is a directive on the harmonisation of transfer pricing rules in the EU to increase tax certainty and mitigate the risk of litigation and double taxation. The Commission expects it to also further reduce the opportunities for companies to use transfer pricing for aggressive tax planning purposes. Currently, there are inconsistencies between how member states apply the rules. For example, some Member States apply a threshold of 25% while others apply a threshold of 50% shareholding when it comes to determining whether the control criterion is met. The proposal is to incorporate the OECD's arm's length principles and the OECD guidelines into EU law so as to ensure consistent application of transfer pricing throughout the EU. Both directives will need to be approved by the Council. If adopted, BEFIT would come into force on the 1st of July 2028 and the transfer pricing proposal on the 1st of January 2026.
Tanja Velling	And now for what's coming up:

	- The revised draft legislation amending the multinational top-up tax and domestic top-up tax rules is open for consultation until the 25th of October. - The Autumn Statement is on the 22nd of November. - We are expecting revised OECD Commentary on the GloBE Model rules by end of year taking into account the Administrative Guidance and other agreed documents since the commentary was first written.
Zoe Andrews	And that leaves me to thank you for listening. If you have any questions, please contact Tanja 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.