Proskauer

UK Tax Round Up

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Welcome to the December edition of the UK Tax Round Up. The month has been reasonably quiet, but there have been two interesting Upper Tribunal decisions on the loan relationships unallowable purpose test and application of the *Ramsay* principle to a dividend redirection scheme. The government has also announced Wednesday 15 March 2023 as the date for the Spring Budget.

UK Case Law Developments

Replacement loan has unallowable purpose

In *Kwik-Fit Group Ltd and others v HMRC*, the Upper Tribunal (UT) upheld the First-tier Tribunal's (FTT's) decision that loans which had been entered into by and/or transferred between group Kwik-Fit companies as part of a group debt reorganisation had an unallowable purpose and, accordingly, the interest on them should be disallowed (or, in the case of existing loans which had their interest rate increased, partly disallowed).

The Kwik-Fit group (various debtor companies of which are the Appellants) had in place a number of existing intragroup loans which were originally advanced for commercial purposes. At the time of the reorganisation, one of the group's companies, Speedy 1 Limited (Speedy), had a carried forward non-trading loan relationship deficit (NTLRD) of £48 million which was expected to be utilised over a period of 25 years due to the low level of taxable income that it was expected to receive. As part of the reorganisation, a number of loans already assigned to Speedy had their interest rate increased from 0.74% to LIBOR plus 5% some other existing group loans were assigned to Speedy with the same interest rate and Speedy entered into two new loans at this interest rate. The rationale given by the group for the increased interest rate was that it reflected an arm's length rate under transfer pricing principles at the time of the reorganisation. The evidence was, however, that the reorganisation had been entered into in order to accelerate the utilisation of the NTLRD by Speedy from an estimated 25 years to two to three years as a result of its increased interest income, while the debtor companies could claim deductions for their increased interest expense. HMRC sought to disallow the interest on the loans on the basis that the relevant borrowers were party to them for an unallowable purpose.

The relevant legislation (sections 441 and 442 CTA 2009) sets out circumstances in which debits should be disallowed due to an unallowable purpose. In short, an unallowable purpose exists where the purpose is not one of the business or commercial purposes of the company.

If one of the main purposes for being party to the transaction is to secure a tax advantage for any person then that will constitute an unallowable purpose. Where there is more than one main purpose, the interest should be disallowed on a just and reasonable basis.

The UT dismissed the Appellants' argument that the use of losses, already existing in the group (being Speedy's brought forward NTLRD which the loan reorganisation did not affect) could not amount to securing a tax advantage and, more specifically, could not result in a "relief from tax" under the definition of that term (which includes obtaining tax relief). The UT stated that, taking its ordinary meaning, the use of losses is a relief from tax. There was an obvious benefit and clear tax advantage here as Speedy was able to utilise losses which would otherwise not have been utilised in each accounting period. The reorganisation was an arrangement which resulted in relief being obtained and used which would not otherwise have been available. Therefore, if the main purpose of the new debt transactions was to allow Speedy to use its NTLRD more quickly, that was an unallowable purpose.

The UT agreed with the FTT's findings that that the principal purpose of the reorganisation was to accelerate Speedy's utilisation of its NTLRD. The FTT had noted that the purpose of the loans and the purpose of being a party to the transaction are two separate points to consider. On that basis, the new loans, the assigned loans and the existing loans could be viewed differently. With respect to the new loans and the assigned loans, the principal purpose of the loans and of the borrower being a party to the loans was to secure a tax advantage. With respect to the existing loans, these did have an initial commercial purpose, so that the obtaining of a tax advantage was not the principal purpose of these loans. However the increase in interest on loans gave an additional purpose of obtaining a tax advantage.

The UT further agreed with the FTT's decision to dismiss the Appellants' argument that the rationale for the change in interest rate was simply to fall in line with transfer pricing rules. There was clearly another purpose for the change. Only the interest on those group loans for which Speedy was the lender were amended and, fundamentally, transfer pricing principles do not need to apply when setting the actual rate of an intragroup loan. Instead it should simply be applied when assessing the tax effect of a loan.

The UT upheld the FTT's decision that the main purpose of the new loans and the assigned loans was unallowable, disallowing all of the interest on them. On the existing loans, the UT held that that main purpose for the increase in interest was unallowable and so disallowed the difference between the original interest rate and new interest rate.

This is the second recent decision where HMRC has been successful in applying the unallowable purpose test and should be a warning to taxpayers that they need to take a realistic approach to assessing the efficacy of structured lending arrangements that are intended to deliver specific tax advantages to lenders or borrowers.

Dividend replacement scheme ineffective

In *Clipperton and Lloyd v HMRC*, the UT has upheld the FTT's decision that a dividend replacement scheme was ineffective and that the taxpayers were subject to tax as if they had received certain distributions.

The case related to a structured tax avoidance arrangement put in place by Ms Shipperton and Mr Lloyd, the appellants, with a view to allowing them, as the owners and shareholders of a company, Winn & Co (Yorkshire) Ltd (Yorkshire), to receive amounts effectively distributed by it without paying tax on the receipt. The scheme involved Yorkshire setting up a wholly owned subsidiary, Winn Scarborough Ltd (Scarborough), with share capital of 199 £1 A shares and 1 £1 B share subscribed for £200, the B share being settled on a trust by Scarborough for the benefit of the appellants, Yorkshire subscribing for an additional A share for £200,000, Scarborough reducing its share capital by £200,000, Scarborough paying a dividend of £200,000 on its B share to the trust and the trust distributing £200,000 (less some fees and other minor payments) to the appellants.

The tax objective of the scheme relied on two propositions:

- the taxpayers did not receive a distribution from Yorkshire or Scarborough for the purposes of sections 383 to 385 ITTOIA 2005; and

- under the settlements code, Yorkshire was the settlor of the trust, it was the only person that could be subject to tax on the dividend paid to the trust by Scarborough and it was exempt from tax on the dividend.

HMRC argued that, applying the *Ramsay* principle of statutory construction to the scheme, the appellants were subject to tax under section 385 ITTOIA as the persons "receiving or entitled to" a distribution made by Yorkshire (being its £200,000 subscription to Scarborough). Alternatively, the appellants were the settlors of the trust as the guiding minds behind the scheme and Yorkshire's involvement in it.

The FTT had found that the appellants were subject to tax under section 385 ITTOIA as being entitled to a distribution made by Yorkshire but that, if that was wrong, they were not settlors of the trust and so could not be taxed under the settlements code. The conclusion in respect of section 385 ITTOIA involved a broad interpretation of what was a "distribution in respect of shares" and that, in the context of the scheme in question, this was satisfied by Yorkshire putting Scarborough in funds with an overall intention that the money paid to Scarborough would eventually be received by the appellants. The reality of the scheme was that the appellants, as shareholders in Yorkshire, received the £200,000 available for distribution, and distributed, by Yorkshire, albeit through the structure of Scarborough and the trust.

The UT agreed with the FTT that, applying a realistic view of the facts to a purposive approach to the meaning of the relevant law, Yorkshire had made a distribution through its subscription to Scarborough and the appellants were "entitled to" that distribution as shareholders in Yorkshire because it was always the intention under the scheme that they would receive it through the dividend declared by Scarborough and their rights under the trust. The UT also held, however, that, if that was wrong, the appellants were also settlors of the trust and could be taxed on the distribution that they received from the trust under the settlements code.

In respect of the entitlement to distribution point, the appellants' appeal to the UT was on the basis that, although Yorkshire had made a distribution out of its assets, it was not, or was not received by the appellants, "in respect of" its shares. They claimed that the "in respect of shares" required a formalistic, company law based approach and that they only distribution in respect of shares was that made by Scarborough on its B share and that this was supported by the Court of Appeal's decision in the recent, unfortunate case of *Khan v HMRC*, in which Mr Khan was subject to tax on a £1.95 million distribution received by him on a buyback of shares as part of an overall arrangement under which he acquired shares from their existing shareholders and did not actually receive (or retain) any of the £1.95 million. The appellants sought to argue that this required a formalistic approach to the question of whether a distribution was received in respect of shares. The UT in this case made clear, however, that whether or not a distribution was received in respect of shares would always require an application of a realistic view of the facts in question to the relevant payments and that, in this case, the £200,000 was distributed by Yorkshire and that the appellants did receive it because of their status as shareholders in Yorkshire.

The case shows that taxpayers must be very careful to take into account the potential everyday meaning of terms in legislation, particularly where structured arrangements are intended to deliver what might be considered unintended tax advantages.

Other UK Tax Developments

Date set for next UK budget

The government has announced that the UK's first official budget since October 2021 will be held on Wednesday 15 March 2023.

Following a particularly turbulent political period in which six ad hoc support packages and fiscal statements have been delivered by the Treasury, the hope is that the official budget may bring some stability to the UK's tax landscape.

Government Consultation: VAT treatment of fund management

The government has launched a consultation on proposed reform of the VAT rules for fund management found in Schedule 9, Group 5, Items 9 and 10 of the VAT Act 1994. The technical consultation is not aimed at policy change, instead it asks for feedback on whether the proposed changes improve legal clarity and certainty and assist in codifying the existing policy. In particular, the consultation has ruled out zero rating fund management services. The consultation closes 3 February 2023.

The proposal is to retain Items 9 and 10, Group 5, Schedule 9 VATA as is and to legislate to create more definite criteria on which funds qualify for the specialised investment fund (SIF) VAT exemption, in addition to those funds already listed in VATA, by incorporating relevant case law and guidance into UK law. The criteria proposed would require that the fund is a collective investment, the fund operates on the principle of risk-spreading, the return on the fund's investments depends on their performance and holders must bear the risk connected with the fund and the fund is subject to the same conditions of competition, and appeals to the same circle of investors, as UCITS (meaning funds intended for retail investors).

If this is the result of the consultation, while it might provide some degree of clarity it will not improve the competitiveness of UK-based fund management businesses or funds relative to those based in the EU, the Channel Islands or elsewhere.

HMRC publishes responses on its consultation on the scope of investment transactions to include cryptoasset transactions

HMRC has published a response to its consultation on the expansion of its list of specified investment transactions (the investment transaction list or ITL) for the purposes of the investment management exemption (IME) and other fund tax regimes to include transactions in cryptoassets. The ITL contains a list of transactions that can benefit from the IME, the exemption for UK investment managers to be treated as a permanent establishment of the funds that they manage or their investors and which is an important factor in maintaining the UK's attractiveness as fund management jurisdiction. Given the uncertainty around whether cryptoasset transactions could benefit from the IME, it had become clear prior to the consultation that investment managers were beginning to consider other jurisdictions for their investment strategies which involved cryptoassets.

HMRC's response confirms that certain transactions in cryptoassets will be included in the ITL. These are transactions that provide rights to other property provided the transaction does not result in delivery of the property, transactions that represent rights in relation to assets provided those assets fall within the ITL, transactions that provide for the supply of services provided they do not result in an actual supply of services in (or connected with) the period in which the non-resident holds the cryptoasset and transactions that provide rights to other cryptoassets provided that transactions in those other cryptoassets would benefit from the IME. The list will not include transactions in cryptoassets created or issued by the investment manager, the non-UK resident fund that it manages or connected parties.

The government also looked at demand for authorised investment funds, exempt unauthorised unit trusts and investment trusts to hold cryptoassets and found a lack of demand as well as a number of regulatory barriers preventing authorised investment funds from dealing in cryptoassets. The changes to the ITL will therefore not be extended to these funds at the stage but the position will be kept under review.

The changes will be brought in by regulations which will come into force by the end of 2022. For non-corporates this will affect transactions entered into in the 2022-23 tax year and thereafter and for corporates will affect transactions entered into during accounting periods current on or after 31 December 2022.

HMRC interest rates continue to rise

Following the recent increase in the Bank of England base rate to 3.5%, HMRC has followed suit and increased its interest rates for late and early payments. From 26 December 2022, the rate of interest for underpayments on corporation tax quarterly instalments will be 4.5% and the rate of interest on overpayments will be 3.25%. Further, from 6 January 2023, the rate of interest for late payment for non-quarterly instalments payments will be 6% and the rate of interest on repayments will be 2.5%.

EU Case Law Developments

ECJ rules that DAC6 violates lawyer-client confidentiality

In *Orde van Vlaamse Balies and others v Vlaamse Regering*, the ECJ underlined the recognition of legal professional privilege within the context of the mandatory automatic exchange of information in relation to reportable cross-border arrangements (known as DAC6).

Under current DAC6 regulations, intermediaries (or taxpayers if no such intermediary exists) must report reportable cross-border transactions and arrangements to their relevant local tax authority. In its current form, DAC6 provides that lawyers do not have to file reports where such reporting obligation would be contrary to the rules of legal professional privilege that apply under that Member State's national law. This applies to all intermediaries, where applicable, and not just to lawyers. Such intermediaries do still, however, have an obligation under DAC6 to notify all other intermediaries, or the taxpayer directly if no other intermediaries exist, that the reporting obligation has transferred to them.

In this judgement the ECJ concluded that this obligation to notify other intermediaries or taxpayers breaches Article 7 of the Charter of Fundamental Rights of the European Union, being the right to respect for his or her private and family life, home and communications. The ECJ's decision was predicated on the following;

- the notification obligation was a restriction on the fundamental right because it required other intermediaries and the tax authorities to be informed of the lawyer's (an intermediary for DAC6 purposes) identity and that they had been consulted on the reportable cross-border arrangement; and

- despite the ECJ's acknowledgement that the obligation fell in line with the principle of legality and did not require disclosure of the content of the lawyer's legal advice, it went beyond what was considered strictly necessary to achieve the objective of DAC6 as all other intermediaries (and the taxpayer client) were required to report that same information in any event.

The ECJ was clear that this decision related only to those intermediaries for which legal professional privilege applies and who operate within the limits of the relevant Member State's national laws that define their profession. The ECJ was also clear that the intermediary's obligation to inform its client of its reporting requirements remains (whether that client is another intermediary or the relevant taxpayer).