Proskauer

UK Tax Round Up

June 2018

UK Case Developments

Streaming of losses on trade succession (*Leekes v. HMRC*)

This case involved a taxpayer who purchased a business (the "predecessor business") and combined it with their existing business (creating the "enlarged business"). The predecessor business had large accumulated losses and, even when combined to form the enlarged business, continued to be loss making. As the purchaser's existing business was profit making, the taxpayer sought to set off the losses of the predecessor business against the profits of the enlarged business following the purchase.

The Court of Appeal dismissed the taxpayer's appeal on the basis that losses of the predecessor business could only be set off against future profits of that business, and not the profits of the enlarged business. There was nothing in the drafting of the legislation that would allow the taxpayer the advantage of using the losses of the predecessor's business to be set off against anything other than that same business carried on by the purchaser. The taxpayer argued that "streaming" profits of separate parts of the enlarged business would be complex and so it should be allowed to set the losses against the profits of the enlarged business including the predecessor business. While this was an argument that found favour in the earlier judgment of the FTT, the Court of Appeal found that there was no reason that this difficulty should override the words of the legislation.

The outcome of this case is unsurprising given the high potential for tax avoidance through "loss buying". It is also worth noting that it will only apply to pre-April 2017 losses following the changes to the carry forward loss rules last year.

Is interest "UK source"? A multifactorial approach (*Ardmore Construction v. HMRC*)

The key question for consideration in this case was whether interest payments made by the taxpayer has a UK source, meaning that tax should have been withheld.

The taxpayer argued that the interest in question did not have a UK source, on the basis that the credit was provided outside the UK and the relevant loan instrument was non-UK as the lender, governing law and jurisdiction of that instrument were non-UK. It argued that the first tier tax tribunal (**FTT**) had erred in placing too much emphasis of the residence of the borrower (a UK company) when concluding that the interest was UK source.

The Court of Appeal confirmed that the correct approach to analysing this question was a multifactorial test on the basis of the longstanding *National Bank of Greece* case. The relevant factors include where the funds to pay interest are sourced, location of any assets on which the loan is secured, location of assets on which a judgment might be enforced and governing law and jurisdiction clauses.

This case does not establish much that is new, but it reconfirms that each factor must be considered before making a judgment as to which factors have the most substance. It was clear that the Court of Appeal considered the location of the lender to be of little significance and, ultimately, the taxpayer's extensive business operations and assets in the UK, including the bank accounts from which the interest payments on the loan were funded, were crucial to its conclusion that those interest payments had a UK source.

Project Blue case (*Project Blue Ltd v. HMRC*)

On 13 June the Supreme Court ruled on a longrunning stamp duty land tax (**SDLT**) case that involved the interaction sub-sale relief and the exemption for alternative property financing to a complex series of steps involved in a Sharia-compliant financing transaction.

The interesting aspect of this case concerns section 75A Finance Act 2003, an SDLT anti-avoidance provision which can operate to counteract a transaction under which a chargeable interest in land is disposed of and acquired through a series of steps where the SDLT payable is lower than it would have been on a simple disposal and acquisition. The Supreme Court found that this anti-avoidance rule applied to the transaction under consideration regardless of the fact that no avoidance motive to the transactions involved was established. This was because, although the title to the rules referred to "anti-avoidance", the conditions for the rules to apply were simply those set out in the legislation, none of which concerned the motivation of the parties to the transaction.

It is likely that this concept would also apply to other anti-avoidance rules where an avoidance motive is not expressly referred to and it is not possible (or necessary) to infer one into the legislation, which might possibly lead to other commercial transactions being caught by so-called "avoidance" rules.

Consultations and Reports

HMRC launch consultation on off-payroll working in the private sector

HMRC have published a consultation on the best way to tackle non-compliance with the off-payroll working rules (known as "IR35") in the private sector. IR35 is aimed at ensuring that someone who works through a personal service company (or "PSC") who would have been an employee if directly engaged pays similar taxes to an employee. HMRC believes that non-compliance with these rules is high (it estimates a 10% compliance level), with a significant cost to the Exchequer.

The key proposal from HMRC is to extend the recent reform of the equivalent public sector rules into the private sector. This proposal would make the company engaging the PSC (i.e. the client company) responsible for deciding whether IR35 applied and also for deducting the relevant taxes through PAYE. Evidence from the public sector reform suggests that the change to responsibility for applying employment tax has increased compliance with IR35. HMRC is seeking views on whether these reforms would be appropriate in the private sector and whether any improvements could be made to make them more suitable. An alternative suggestion is to require the client company to diligence whether their labour supply chains are compliant with IR35, potentially underpinned by a penalty or denying the client company a deduction for the costs where they had not made appropriate checks.

Although a number of different proposals are made in the consultation document, it is clear that HMRC thinks the answer lies in shifting some or all of the burden of and responsibility for employment tax compliance to the client company.

Responses to the consultation are requested before 10 August.

Law Society issues response to HMRC's consultation on preventing tax avoidance through profit fragmentation

In our April Tax Round Up, we reported on a new consultation published by HMRC on tax avoidance through profit fragmentation. On 15 June, the Law Society's Income Tax Sub-Committee published their response to the consultation.

The essence of the response is that there is no need for additional legislation or an additional potential basis of charge to counteract the examples given in the consultation. Where fees in respect of services rendered by a UK individual are paid (pursuant to an agreement) to an offshore entity, the Law Society struggles to see any basis that these fees should not be recognised as trading income in the UK under current rules.

Equally, where excess deductions in the UK are used to divert profits to an offshore entity and the expense has no commercial purpose (e.g. by a UK entity paying high fees to an insubstantial offshore entity), there is no reason why a deduction from the profits of the UK trade should not be disallowed under current rules on the basis that they are not incurred wholly and exclusively for the purpose of the UK trade. Prosecution is put forward as an alternative approach to deterring and counteracting such arrangements, rather than using new rules with an additional basis of charge.

The Law Society does see the merit in HMRC being notified of such schemes, although cautions against the scope of required notifications being drawn too broadly and including it within the existing Disclosure of Tax Avoidance Schemes (**DoTAS**) regime. This could lead to purely commercial arrangements being caught by the notification procedure, which would be inappropriate, especially given the negative connotations and consequences of making a disclosure under DoTAS.

OTS report on accounting depreciation or capital allowances

We discussed a report from the Office of Tax Simplification (**OTS**) on the simplification of corporation tax in our July 2017 Round Up, in which one of the suggestions for further consideration was the simplification of the capital allowances regime.

The OTS has now published a further report on this, principally discussing whether accounts-based depreciation should replace the current system of capital allowances. In short, the OTS concludes that any move to accounting depreciation would be extremely challenging and should not be pursued at this time. Instead the OTS has put forward a number of suggested simplifications to the current capital allowances system to ease complexity and the associated compliance burden.

- **Catherine Sear**
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