FIELD COURT TAX CHAMBERS

FCTC DIGEST

19th Edition (March 2024)

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EDITORIAL

Patrick Soares

Welcome to all our readers to the 19th Edition (March 2024) of the FCTC Digest.

We have some very interesting articles in this edition – from tax traps to planning points.

The first article by the editor deals with the proposed abolition of the remittance basis of assessment with effect from 6 April 2025. This is **a revolutionary change which will involve domicile ceasing to be a relevant connecting factor for tax purposes** and the re-writing of huge parts of the tax code. HM Treasury issued a technical note dated 7 March 2024 on the proposed changes as announced in the Budget and this article repeats in part the technical note with the editor's comments.

The second article also by the editor deals with the general **IHT exemptions available on death: these can total £1m.**

The third article is by **Patick Way KC**. He warns of the circumstances where a company can be denied corporation relief under the loan relationship code for interest payments under the **unallowable purpose rule or its ugly companion the RAAR** (the regime-wide anti-avoidance rule). Patrick states: *The golden rule is to make sure that all the contemporaneous documentation is helpful in demonstrating the rationale for taking out the loan and incurring interest*. These are the words of a seasoned litigator – evidence, evidence and yet more evidence!

The fourth article is by **Peter Vaines**. He examines 2 important recent cases on **what is meant by employment income** for the purposes of section 9 ITEPA 2003 namely the First Tier Tribunal case of *OOCL UK Branch v HMRC TC 9007* and the Court of Appeal case of *HMRC v E.ON [2023] EWCA Civ 1383*. **Knowing the ambit of the employment charge is critical – employment income commands the highest rates of income tax (and the application of PAYE) and the highest rates of NIC.** These cases are a must read. The charge on employment income is like an octopus with its tentacles everywhere.

In the fifth article **Dilpreet K. Dhanoa** looks at **the non-discrimination clauses in double tax treaties** and brings together the guidance and case law in this area. She concludes the position is not satisfactory and *the principles of international comity push for a strong case to develop a more robust set of non-discrimination provisions.* Read the article to see why she comes to that well-reasoned conclusion.

The sixth article is by **David Southern KC** the editor of *Taxation of Loan Relationships and Derivative Contracts*. He examines the corporate interest restriction (the CIR) with three worked examples. He warns about the double whammy which can be suffered by companies under these rules. He explains the position thus (my emphasis): *The problem about the CIR is that, for corporation tax purposes, finance costs which are deductible in the commercial accounts are treated as income and taxable as such…….* ***the company's effective rate of corporation tax can exceed 100%.*** *That is the CIR double whammy*. I dare you not to read this article!

The seventh article is by **Riya Bhatt** and is on the government approved **Employee Ownership Trust** (an EOT). They act as a magnet for both the owners who want to sell their shares to the trust and the employees who benefit from the trust. **They are extremely attractive vehicles**: as the article states (my emphasis) – *One key tax benefit for shareholders who wish to sell their shares to an EOT is that the sale will be free of* capital gains tax. Practitioners should send this article to all of their private company shareholder clients!

The eighth article, is by **Dr Rita da Cunha**. This article explains why, despite recent changes to the "golden visa" regime, **Portugal remains an attractive destination for high-net worth individuals.** UK resident non-dom clients who will be frightened off by the proposed UK non-dom changes will have Portugal on their check list.

The ninth article is by **Alex Spencer** in which he looks at **two recent cases on the VAT Tour Operators Margin Scheme (TOMs)** and these act as a warning that the scheme has a much wider application than might be implied by the use of the words "tour operator".

The tenth and final article is by **David Tipping**. He looks at the situations where **HMRC can add businesses together (under VATA 1994 Sch 1 para 2) so that combined they exceed the £85,000 VAT turnover registration limit**. Ultimately, the test is whether the separation between the businesses is artificial or not. One saving grace with this legislation is a notice to combine businesses cannot have retrospective effect.

Patrick C Soares

FCTC

PROPOSED ABOLITION OF THE REMITTANCE BASIS OF ASSESSMENT AND DOMICILE AS A TAX CONNECTING FACTOR

Patrick C Soares

HM Treasury have issued a technical note dated 7 March 2024 on the proposed abolition of the remittance basis of assessment with effect from 6 April 2025 mentioned by the Chancellor in his Budget.

This article repeats in part the technical note and the writer has added his comments on the same.

Summary

Abolition of remittance basis of assessment

From 6 April 2025, the remittance basis of taxation will be abolished for UK resident non-domiciled individuals. This is a revolutionary change although the use of domicile as a tax connecting factor has been reduced over the years. Many parts of the tax code will have to be revised to cater for these changes

as domicile and the remittance basis of assessment lie at the heart of the tax code.

The 4 year FIG tax holiday

The remittance basis will be replaced from 6 April 2025 with a new 4-year foreign income and gains (FIG) regime for individuals who become UK tax resident after a period of 10 tax years of non-UK residence.

Thus if an individual has not been resident in the UK for a period of 10 years or more and then becomes resident in the UK he will benefit from the FIG regime for a period of 4 years. If he has been non-UK resident for less than ten years and becomes UK resident he gets no tax free FIG holiday for any of the 4 years.

The individual will not pay tax on FIG arising in the first 4 tax years after becoming UK tax resident and will be able to bring these funds to the UK free from any additional charges.

Thus if an individual takes up residence in the UK for the first time **he has a four year tax free FIG holiday**. *His FIG income and gains are tax free*

whether or not remitted to the UK. He also will not pay tax on non-resident trust distributions.

The individual will pay tax on UK income and gains, as is the case for non-domiciled individuals now. There is no change in that respect.

Individuals who on 6 April 2025 have been tax resident in the UK for less than 4 years (after 10 years of non-UK tax residence) will be able to use this new regime for any tax year of UK residence in the remainder of those 4 years.

Overseas Workday Relief

Overseas Workday Relief (OWR) for the first 3 tax years of UK residence will be retained and simplified. From 6 April 2025 eligibility for OWR will be based on an employee's residence and whether they opt to use the new 4-year FIG regime.

End of the golden trust regime

From 6 April 2025, the protection from taxation on *future* income and gains as they arise within trust structures (whenever established) will be removed for all current non-domiciled and deemed domiciled

individuals who do not qualify for the new 4-year FIG regime.

FIG arising in non-resident trust structures from 6 April 2025 will be taxed on the settlor or transferor (if they have been UK resident for more than 4 tax years) on the arising basis. This is the same basis on which trust income and gains are taxed on UK domiciled settlors or transferors under the current regime.

FIG which arose in the trust or trust structure before 6 April 2025 will be taxed on settlors or beneficiaries if they are matched to worldwide trust distributions or other benefits. The taxpayers will thus be taxed on a benefits basis. Where the benefit is provided will not be relevant. Such income and gains should thus be kept separate from income and gains which arise or are realised on and after 6 April 2025.

Single premium bonds

Taxpayers in such cases may want to consider putting the funds into a single premium offshore insurance

bond making use of the 5% annual tax free surrenders.

Transitional relief for one year on income

Individuals who move from the remittance basis to the arising basis on 6 April 2025 and are not eligible for the new 4-year FIG regime will, for 2025-2026 only, pay tax on 50% of their foreign income.

This reduction applies to foreign income only; it does not apply to foreign chargeable gains.

For 2026-27 onwards, tax will be due on all worldwide income in the normal way.

From 6 April 2025, an individual who is not, or who later ceases to be, eligible for the new 4-year FIG regime will be taxed on foreign gains in the normal way.

Rebasing

Transitionally, individuals who have claimed the remittance basis will, on a disposal of an asset held personally at 5 April 2019, be able to elect to rebase that asset to its value as at that date.

Temporary Repatriation Facility (only years 2025-26 and 2026-27)

Individuals

From 6 April 2025, individuals who have been taxed on the remittance basis will be able to elect to pay tax at a reduced rate of 12% on remittances of pre-6 April 2025 FIG under a new Temporary Repatriation Facility (TRF) that will be available for tax years 2025-26 and 2026-27.

Trusts

TRF will not apply to pre-6 April 2025 FIG generated within trusts and trust structures.

IHT – end of domicile as a connecting factor

From 6 April 2025 the government intends to move inheritance tax from a domicile based regime to a residence based regime.

This will be subject to consultation. What form this change will take is difficult to tell. It may be if a taxpayer is resident in the UK for a certain number of years he will pay IHT on his world wide assets: the

concept of domicile will no longer have a role to play except under transitional provisions.

The new regime for income and capital gains tax in detail

4-year FIG regime overview

From 6 April 2025, a new regime for personal FIG will be available to individuals for the first 4 tax years once becoming UK tax resident after a period of 10 years non-UK tax residence. Thus if the taxpayer has been resident in the UK he must break his residence for 10 years or more if he is to benefit from the FIG regime.

Eligible individuals will not pay tax on FIG arising in the first 4 years, where a claim is made, and will be able to remit these funds to the UK free from any additional charges. Taxpayer must remember to make a claim.

Under the new regime individuals will not be required to track the movement of their FIG through investments in the way they are required to do now under the current regime. This will make the new 4-year FIG regime much simpler than the remittance

basis regime. The details are awaited – hopefully a simpler regime will result.

The Statutory Residence Test will be used to determine tax residence for any one tax year. This is what one may have expected.

Treaty residence or non-residence and split years will be ignored.

If an individual chooses to be taxed under the new 4-year FIG regime, they will lose entitlement to:

1. personal allowances and
2. the capital gains tax annual exempt amount.

This may be a small price to pay for claiming the tax free FIG holiday.

Claims to use the new 4-year FIG regime are to be made for each year to which it is to apply. Individuals need not make a claim for every year of the 4-year period.

For example, an individual who makes a claim for the new 4-year FIG regime in year 1 but chooses not to

make a claim for year 2 will still be able to claim for years 3 and 4.

If an individual leaves the UK temporarily during the 4-year period they will be able to make a claim under the 4-year FIG regime for any of the qualifying tax years remaining on their return to the UK.

Example

A taxpayer becomes non-UK resident in year 2 and 3 but is UK resident again for year 4. He will be able to use the 4-year FIG regime for year 4.

Individuals who on 6 April 2025 have been tax resident in the UK for less than 4 years (after a period of 10 years non-UK tax residence) will be able to use this new regime for any tax year of UK residence in the remainder of those 4 years.

Example

An individual who became resident in the UK in 2022-23, after a 10-year period of non-residence, will have been resident in the UK for up to three tax years on 6 April 2025. They will be able to claim under the new 4-year FIG regime for 2025-26 because this is

their fourth year following a period of 10 years non-UK tax residence.

Overseas Workday Relief

Relief will continue to be available for employees who opt to use the new 4-year FIG regime. The new Overseas Workday Relief (OWR) will be like that currently available, providing relief on earnings for employment duties performed outside the UK. The new OWR will be available for the first 3 tax years of UK residence. Employees who are eligible for OWR in 2023-24 or 2024-25 for their first year since returning to the UK should still be able to claim OWR for the full three years. However, those re-entering from 2025-26 will not be able to claim OWR, if they are not eligible for the FIG regime.

The new OWR will provide relief from income tax whether or not these earnings are brought to the UK. As under the current rules, the new OWR will not provide relief from National Insurance contributions (NICs), so any NICs liabilities on these earnings will be determined as usual.

Trust Protections

From 6 April 2025, the protection from tax on income and gains arising within settlor-interested trust structures will no longer be available for non-domiciled and deemed domiciled individuals who do not qualify for the new 4-year FIG regime.

FIG arising in the trust (whenever established) from 6 April 2025 will be taxed on the settlor on the same basis as UK domiciled settlors at present, unless the settlor is eligible for the new 4-year FIG regime. Thus if the settlor of a trust has been tax resident in the UK for many years and has become deemed domiciled in the UK he is taxed on a benefits basis with regards to his foreign income and with regards to all of his capital gains. Income arising on and after 6 April 2025 and gains made on or after that date will be taxed on the UK resident settlor as it arises or when the gain is realised.

However from 6 April 2025 the matching of pre-6 April 2025 FIG to trust distributions will continue, but UK resident non-domiciled individuals will no longer be entitled to the remittance basis in respect of worldwide trust distributions. Beneficiaries and

settlors who are within the 4-year FIG regime will also be able to receive benefits from 6 April 2025 free from any UK tax charges whether or not the benefits are received in the UK. However, such benefits are not matched to trust income and gains and will be subject to a modified onwards gift rule.

Reduced amount of foreign income subject to tax

There will be a one-year reduction in the amount of foreign income that will be subject to tax for individuals who move from the remittance basis to the arising basis from 6 April 2025 and who are not eligible for the new 4-year FIG regime.

For these individuals only 50 percent of the foreign income arising in 2025-26 will be subject to tax. The reduction in the amount of foreign income subject to tax will apply for one tax year only and the reduction will not apply to foreign chargeable gains.

This is small compensation for taxpayers who have been resident in the UK for many years and have become use their foreign income being taxed on a benefits basis and in some cases on a benefits basis

provided the income has also been remitted to the UK.

Capital Gains Tax rebasing

From 6 April 2025, an individual who is not, or who later ceases to be, eligible for the new 4-year FIG regime will be taxed on foreign gains in the normal way.

Transitional rules will apply for individuals who have claimed the remittance basis and are neither UK domiciled nor UK deemed domiciled by 5 April 2025. If, on or after 6 April 2025, they dispose of a personally held foreign asset that they held at 5 April 2019, they will be able to elect to rebase that asset to its value as at 5 April 2019. This rebasing will be subject to conditions that will be set out later.

Temporary Repatriation Facility (TRF)

A new 12% rate of tax will be introduced for remittances of FIG made in tax years 2025-26 and 2026-27 where the FIG arose to the individual personally in a year when the individual was taxed on the remittance basis and the individual is UK resident in the relevant tax year.

There will be some relaxation of the mixed fund ordering rules to make it easier for individuals to take advantage of the TRF if, for example, they have FIG in a mixed fund or they are unable to precisely identify the quantum of their FIG.

From 2027-28 remittances of pre-6 April 2025 FIG will be taxed at normal tax rates.

Ending the existing income tax and capital tax regime

The remittance basis of taxation will be abolished for UK resident non-domiciled individuals from 6 April 2025.

The last year for which a remittance basis claim can be made will be the 2024-25 tax year.

FIG that has arisen to a remittance basis user prior to 6 April 2025 will continue to be taxed if they are remitted on or after 6 April 2025, subject to the TRF set out above.

If the taxpayer is not tax resident in the UK in the year of the remittance not tax will be payable subject to the temporary non-residence rules.

BIR

Business Investment Relief (BIR) will be available for qualifying investments of pre 6 April 2025 FIG made on or after 6 April 2025 and will continue to be available for qualifying investments made prior to 6 April 2025.

Inheritance tax

Inheritance tax (IHT) is currently a domicile-based system. The government intends to move IHT to a residence-based system, subject to consultation and applying this only from 6 April 2025.

Current IHT treatment will continue for any non-UK property that is settled by a non-UK domiciled settlor and becomes comprised in a settlement prior to 6 April 2025.

New trusts and additions to existing trusts made by a non-UK domiciled settlor on or after 6 April 2025 will be subject to new residence-based rules.

Current rules – Property owned outright

The scope of IHT for assets owned outright is currently broadly based on the situs of assets (with

UK assets being subject to IHT, with some limited exceptions) and a person's domicile or deemed domiciled status at the date of the tax charge.

A person is deemed to be UK domiciled for three years after they lose their UK domicile.

If a person is UK resident for 15 out of the last 20 tax years, they are deemed to be UK domiciled, and remain deemed domiciled until their fourth year of non-UK residence.

If a person is a formerly domiciled resident, they are deemed to be UK domiciled. A formerly domiciled resident is an individual with a UK domicile of origin who was born in the UK, is resident in the UK and was also resident for one of the last two tax years.

If a person is UK domiciled or deemed domiciled, they are liable for IHT on their worldwide assets.

If a person is non-UK domiciled, they are liable for IHT only on UK assets, including UK residential property held through foreign entities.

The position from 6 April 2025 – Property owned outright

It is envisaged that the new rules will involve charging IHT on worldwide assets owned outright when a person has been resident in the UK for 10 years (the "residence criteria"), with a provision to keep a person in scope for 10 years after leaving the UK (the "tail" provision). The design of the system (including consideration of further criteria such as other connecting factors) will be subject to consultation. UK situs assets will remain in charge on the same basis as at present, regardless of residence.

Current rules – Property held in trust

The scope of IHT for assets comprised in a settlement is currently broadly based on the situs of the assets (with UK assets being subject to IHT, with some limited exceptions) at the date of the tax charge and the domicile of the settlor (the person who adds assets to a trust) at the time when the assets became comprised in the settlement.

Worldwide assets settled by a UK domiciled or deemed domiciled settlor are subject to IHT.

UK assets settled by a non-UK domiciled settlor are subject to IHT.

Non-UK assets settled by a non-UK domiciled settlor are currently "excluded property" under section 48(3) of the Inheritance Tax Act 1984 and not subject to IHT unless it is an interest in a foreign entity that owns UK residential property, or where the settlor is a formerly domiciled resident in the year the IHT chargeable event arises.

The position from 6 April 2025 – Property held in trust

It is envisaged that the new rules for chargeability of assets comprised in a settlement will depend upon whether a settlor meets the residence criteria or is within the tail provision at the time the assets are settled and/or when charges such as 10-year anniversary charges or exit charge arises.

The design of the system (including consideration of further criteria such as other connecting factors) will be subject to consultation. UK situs assets will remain in charge on the same basis as at present, regardless of residence.

The treatment of non-UK assets that are settled by a non-UK domiciled settlor and become comprised in a settlement prior to 6 April 2025 will not change.

For these settled assets:

- provided the assets in the settlement continue to meet the legislative requirements to be excluded property under current legislation, and subject to any future anti-avoidance provisions, there will be no IHT charges; and
- the interaction between the gift with reservation provisions and excluded property trust rules will also remain, meaning excluded property will not be brought into charge on the settlor's death even if the settlor retains a benefit in the trust assets.

The exception to this is that the treatment of non-UK property comprised in a settlement that currently comes back into scope where the settlor is a formerly domiciled resident (see above) will be subject to consultation.

The IHT consultation

The IHT consultation will deal with the design of a new residence based system to apply from 6 April 2025. There are a number of detailed issues and interactions that will be consulted on, such as transitional provisions, the length of the residence criteria and tail provision, any connecting factors other than residence, gifts with reservation, domicile elections, formerly domiciled residents and calculation of trust charges.

Conclusions

It is likely there will be a change in government before any of these changes are implemented but it is unlikely a Labour government will introduce a less harsher regime.

It is possible if a Tory government is returned they may forget the whole thing but that is unlikely.

It seems to the writer that the 4 year FIG tax free holiday is attractive but it does not help the long term resident non-doms who are used to being taxed on a benefits basis on their golden trust's foreign income and the trust gains. The FIG which arose prior to the

change however does benefit from the transitional rules.

Trusts where the settlor and the spouse of the settlor are excluded from benefit may not be affected by this new regime: the income is taxed on the beneficiaries on a benefits basis. Gains made by such trusts may still be taxed upon the settlor under TCGA 1992 s86.

In future the writer suspects taxpayers will concentrate on ensuring they are not UK tax resident under the statutory residence test which has many quirks of its own.

What form this legislation ultimately takes is very much in the air.

ANOTHER BUDGET 2024 CHANGE – SDLT AND MULTIPLE DWELLINGS RELIEF

Multiple Dwellings Relief (Section 58D and Schedule 6B)

Subject to transitional provisions this relief is to be abolished from 1 June 2024.

The HMRC policy paper is dated 6 March 2024 and reads thus:

“For contracts which exchanged on or before 6 March 2024, MDR will continue to apply, even where completion of the purchase takes place on or after 1 June 2024. This is subject to there being no variation of the contract after 6 March 2024.

MDR will also continue to apply to contracts which substantially perform before 1 June 2024.

For transactions which are linked and include the purchase of dwellings both before and after the change, those pre and post change transactions will be treated as unlinked for the purposes of MDR.

…

Legislation will be introduced in Spring Finance Bill 2024 repealing Schedule 6B.

…

Those businesses purchasing 6 or more dwellings or mixed property (meaning

purchases which consist of both residential and non-residential property) will continue to qualify for the non-residential rates of SDLT."

INHERITANCE TAX: BENEFITTING FROM THE NIL-RATE BAND, THE SPOUSAL UNUSED NIL-RATE BAND AND THE EXTRA NIL-RATE BAND FOR THE FAMILY HOME

Patrick C Soares

FOUR POSSIBLE NIL-RATE BANDS ON DEATH

FIRST: STANDARD NIL-RATE BAND

On the death of an individual the first £325,000 of his or her chargeable estate is chargeable to IHT at nil percent on present rates (IHTA 1984 s7 Sch 1).

SECOND: UNUSED NIL-RATE BAND INHERITED ON DEATH OF FORMER SPOUSE OR CIVIL PARTNER

The surviving spouse will inherit *the percentage* of the unused nil-rate band applicable on the death of the first spouse and that percentage will be applied to the amount of the unused band available on the second death (IHTA 1984 s8A-s8C).

The effect of the surviving spouse inheriting the unused nil rate band of the first spouse to die is that when a surviving spouse dies, the nil rate band in place at the death of the surviving spouse will be increased by the proportion of the nil rate band that was not used on the earlier death of the spouse.

Example

The first spouse (H) died on 5 April 2004 when the nil-rate band was £255,000. He left all his estate to his wife (W) and so he did not use up any of his nil rate band: 100% was therefore unused. W died in 2017 when the nil rate band was £325,000. The estate goes to the children. She gets an additional nil-rate band of £325,000 (i.e. 100% of £325,000). The nil-rate band available to W on her death is thus £650,000.

THIRD: EXTRA NIL-RATE BAND FOR HOME LEFT TO CHILDREN ETC

The above nil-rate bands can be increased further if the taxpayer on his or her death leaves a residential interest (e.g. the freehold home) to the children or other lineal descendants and it was the residence of

the deceased (widely defined). Any unused band can be inherited by a surviving spouse. The legislation is in IHTA 1984 ss8D-8M.

The relief was phased in and the full amount became available only in the year 2020–21, as follows—

(a) 2017–18 additional nil-rate band: £100,000;

(b) 2018–19 additional nil-rate band: £125,000;

(c) 2019–20 additional nil-rate band: £150,000;

(d) 2020–21 additional nil-rate band: £175,000.

For a married couple this can enable the nil-rate band to amount to £1 million (£325,000 + £325,000 + £175,000 + £175,000).

The relief is subject to tapering where the estate of the deceased, before reliefs and exemptions, exceeds £2 million. In such cases the additional nil-rate amount is reduced by £1 for every £2 of the excess over £2 million. The relief does not help the wealthy.

Like the relief for the unused nil-rate band of a former spouse the surviving spouse inherits *the percentage* of the unused house nil rate band of the deceased spouse and one applies that percentage to the house nil rate band available to the surviving spouse when the surviving spouse dies (IHTA 1984 s8G and IHTM46040). For deaths before 6/4/17 the house nil-rate band is deemed to have been £100,000 (IHTA 1984 s8G(4)).

Example

Thomas died in 2015 and left his entire estate, valued at £950,000, to his wife Edwina. Edwina dies on 30 July 2020 and leaves all her estate including a residence worth £400,000 to her daughter. On the death of Thomas the house nil-rate band (deemed to be of £100,000) could not have been used so the 100% figure is available to transfer to his wife's estate. On Edwina's death in 2020-21, the maximum available house nil rate band is £175,000. Her executor makes a claim to transfer the unused house nil-rate band from her late husband to her. The total available unused house nil-rate band for Edwina's estate will therefore be her own amount of £175,000,

plus a further 100% being the percentage inherited from her husband. This is £350,000 (£175,000 + (100% x £175,000)). The total house nil-rate band figure is thus £350,000.

CONCLUSION

These nil-rate bands can add up. Timely claims may need to be made. They can take many estates out of the IHT regime. Up to £1m may be taxed at the nil rate.

LOAN RELATIONSHIPS AND UNALLOWABLE PURPOSE

Patrick Way KC

Speed read

Relief on interest falling within the loan relationships regime (being interest paid by a company within the charge to corporation tax) can be disallowed if care is not taken. Specifically, there is the original unallowable purposes rule, and there is also the more onerous "regime anti-avoidance rule" ("RAAR") which was introduced with effect from 18th November 2015.

Accordingly, corporate borrowers need to tread warily and make sure that relief for the interest which is paid is not unexpectedly denied.

Basics

References in this article are to the Corporation Tax Act 2009 except where otherwise shown.

Under ss.302 and 303 a company which is within the charge to corporation tax (which can therefore include foreign companies trading within the United

Kingdom) has a loan relationship (specifically a debtor relationship) if it has borrowed money and entered into some form of loan instrument.

Debits, such as interest payments, are then allowable under s.297 if the borrowing company is trading and under s.300 Chapter 16 if the company is not trading, e.g. if it is an investment company.

Debits, however, may be disallowed under:-

(a) the unallowable purposes rule; or

(b) the RAAR introduced into the legislation later.

The unallowable purposes rule

The (longstanding) unallowable purposes rule remains. Accordingly, a company may not bring into account so much of any debit as, on a just and reasonable apportionment, may be said to be attributable to an unallowable purpose (s.441(3)). The meaning of "unallowable purpose" is found at s.442 and broadly applies if the purpose of the borrowing includes a purpose ("the unallowable purpose") which is not amongst the business or other commercial purposes of the company.

Further, if there is a tax avoidance purpose the position can still be acceptable (yes I do mean acceptable) as a satisfactory business or commercial purpose if the avoidance purpose is not the main purpose or one of the main purposes of the borrowing.

Broadly, the unallowable purpose rule should not deny a deduction for interest expense provided that:

- there is commercial justification for the borrowing, i.e. the borrower actually needs the money;
- the borrowing arrangements are on commercial terms and do not include any ancillary provisions that are there simply to generate tax advantages;
- the purpose of the borrowing is to fund the borrower's activities that fall within the scope of UK corporation tax; and
- any tax advantage (such as a tax deduction for interest expense) is not a main purpose of the borrowing (see CFM38190)

The unallowable purpose provision is likely to apply to a borrower in cases where:

- it enters into or retains a borrowing for artificial, tax-driven arrangements;
- it retains a loan that it no longer needs for its commercial or business purposes – including where a UK tax resident company no longer requires the loan for its business within the scope of UK corporation tax, for instance, where it retains the loan for the activities of its non-UK permanent establishment which benefits from a valid foreign branch exemption;
- it refinances an existing (commercially justifiable) borrowing purely to obtain a tax advantage; or
- it uses the loan to fund activities from which the company involved cannot (or does not expect to) make a pre-tax profit.

HMRC's guidance provides helpful examples of when it considers that the unallowable purpose

provision is or is not likely to apply (CFM38180, CFM38190)

Bear in mind that the unallowable purpose rule may be invoked if tax is a consideration in the steps included in the commercial transaction under review. (*HMRC v. BlackRock Holdco 5 LLC* [2022] UKUT 199 (TCC), and *JTI Acquisition Company (2011) Ltd v. HMRC* [2022] UKFTT 166 (TC))

Regime-wide anti-avoidance rule ("RAAR")

The Finance (No.2) Act 2015 introduced a "regime-wide anti-avoidance rule" known as the RAAR and the new rules came into effect from the 18th November 2015. These rules, in essence, deny a tax deduction for interest (or other debits) where there is an RAAR unallowable purpose and they can also counter loan-related tax advantages which may relate to quantum or to timing. (Sections 455B to 455D. See also CFM35910 to 35930 and also 39560.)

In a nutshell, the RAAR applies where the main purpose of any loan arrangement is to obtain a loan-related tax advantage unless the tax advantage can "reasonably be regarded as consistent with any principles on which the [loan relationships]

provisions … are based" (s.455C). So it can be seen that the RAAR imposes an additional method of counteracting avoidance arrangements over and above the "standard" provision dealing with loan relationships for unallowable purposes.

So stepping back from this we can see that there is the unallowable purpose rule which has been around for quite some time (s.441 and s.442) and there is the new RAAR provision which has "more teeth" (ss.455B to 455D).

Dealing now with the RAAR, the legislation provides that any loan-related tax advantage that would otherwise arise can be counteracted by the making of just and reasonable adjustments.

Section 455C tells us that a company obtains a "loan-related tax advantage" if:-

(a) it brings into account a debit to which it would not otherwise be entitled,

(b) it brings into account a debit which exceeds that to which it would otherwise be entitled,

(c) it avoids having to bring a credit into account,

(d) the amount of any credit brought into account by the company is less than it would otherwise be, or

(e) it brings a debit or credit into account earlier or later than it otherwise would.

Helpfully, s.455D then gives us examples of arrangements which are caught (and not excluded):

(a) the elimination or reduction, for purposes of corporation tax, of profits of a company arising from any of its loan relationships, where for economic purposes profits, or greater profits, arise to the company from that relationship;

(b) the creation or increase, for purposes of corporation tax, of a loss or expense arising from a loan relationship, where for economic purposes no loss or expense, or a smaller loss or expense, arises from that relationship;

(c) preventing or delaying the recognition as an item of profit or loss of an amount that would apart from the arrangements be recognised in the company's accounts

as an item of profit or loss or be so recognised earlier;

(d) ensuring that a loan relationship is treated for accounting purposes in a way in which it would not have been treated in the absence of some other transaction forming part of the arrangements;

(e) enabling a company to bring into account for the purposes of this Part a debit in respect of an exchange loss, in circumstances where a corresponding exchange gain would not give rise to a credit or would give rise to a credit of a smaller amount;

(f) enabling a company to bring into account for the purposes of this Part a debit in respect of a fair value loss in circumstances where a corresponding fair value gain would not give rise to a credit or would give rise to a credit of a smaller amount;

(g) ensuring that the effect of the provisions of Chapter 4 is to produce an overall reduction in the credits brought into

account for the purposes this Part or an overall increase in the debits brought into account for those purposes;

(h) bringing into account for the purposes of this Part an impairment loss or release debit in a case where the provisions of Chapter 6 would but for the arrangements have prevented this.

Interest recharacterised as a distribution

As is well known distributions are not deductible (s.1305 and CCTM15150). So interest which is a deemed distribution will be disallowed and a typical example will be where the interest is more than a reasonable return or may be said to fluctuate with profits. See, for example, CTA 2010 s.1009.

Effect of the transfer pricing rules

At this stage, we should look at the transfer pricing rules as they apply to loan relationships.

These deny a borrower deduction for any part of the interest that exceeds an arm's length rate of interest, or which relates to a loan or a portion of a loan that exceeds what would have been arm's length. TIOPA 2010 s.147(3), (5).

It is to be noted that the comparison is between the actual loan involved, on the one hand, and an arm's length loan on the other. In *BlackRock* there was an intra-group loan and it was held that the absence of third party covenants meant that the loan in question was not on all fours with a loan that independent third parties would have signed up to. Accordingly, in the *BlackRock* case no debits were allowed for the interest paid even when various of the other terms were commensurate with arm's length lending.

Planning points

So how do we deal with all of this?

The golden rule is to make sure that all the contemporaneous documentation is helpful in demonstrating the rationale for taking out the loan and incurring interest. The key is the word *contemporaneous*: much more compelling than "*after-the-event*" documentation.

This involves:-

- Board decisions;
- views of important shareholders; and

- where relevant third party interests.

But in essence it is all about the decision makers. In other words, identify who the real people are who determine the provisions of the loan as a matter of hard nosed fact and asked why they chose the particular form of the loan. See, for example, *Kwik-fit* [2022] UKUT 314 para.97.

Note also that although the purpose is generally ascertained at the time the loan is taken out, the position can evolve and therefore change. See, for example, the case of *Fidex* [2016] STC 1920 and CFM38150 where a later tax avoidance motive came into play which meant that there was an allowable purpose after all.

It should be said, however, that merely seeking to obtain the deduction for interest should be satisfactory. See the case of *Versteegh* [2013] UKFTT 642.

In a nutshell

Contemporary evidence is critical:-

- board minutes;
- board resolutions;

- e-mails;
- memorandums;
- even WhatsApps (providing they have not been deleted on a daily basis – only joking).

Further reading

This article has benefited from my reading of a practice guide entitled "Restrictions on tax deductibility of loan interest". It can be found in the Tax Journal of 31st March 2023 at page 18.

PAYMENTS FROM AN EMPLOYMENT

Peter Vaines

Two recent cases have examined what is meant by employment income for the purposes of section 9 ITEPA 2003. The First Tier Tribunal case of *OOCL UK Branch v HMRC TC 9007* and the Court of Appeal in *HMRC v E.ON [2023] EWCA Civ 1383*.

Both cases are significant as they explain the scope of the legislation relating to the taxation of earnings.

In *OOCL* UK Mr Tung was the controlling shareholder of a company and when it was sold for a colossal sum, he chose to make personal gratuitous payments to 99 of the company's employees. HMRC argued that these payments were taxable as earnings in the hands of the individuals being payments "from the employment" falling within section 9 ITEPA 2003. Section 9 refers to "general earnings" and "specific employment income"; in both cases the chargeable amount is the earnings or specific income "from the employment".

Mr Tung was not their employer and the FTT held that the payments were not for past or future services and were not *from* the employment. Therefore, they were

not earnings within section 9 ITEPA 2003.

Unfortunately for the recipients that was not enough to save them from tax on the amounts received because there is also the benefits code under Chapter 10 ITEPA 2003 to consider.

Section 203 provides that "earnings" means:

> "the cash equivalent of an employment related benefit is to be treated as earnings from the employment."

And an employment-related benefit is defined in section 201 as being a benefit or facility of any kind for an employee "by reason of the employment".

The Tribunal agreed with HMRC that section 201 applied to benefits provided not only by the employer but also to benefits provided by third parties.

So, the question was not whether the payments by Mr Tung were *from the employment,* but whether they were provided *by reason of the employment*.

It is on the distinction between these two phrases that serious liabilities depended.

The Tribunal had already decided that the payments were not *from* the employment – so how does that

differ from “by reason of the employment”?

The Tribunal held specifically that the employment was not the “causa causans” of the payments, but still concluded that because the individuals had to be employees, the employment was “a cause of the payment” and the payment was therefore made by reason of the employment.

For the Tribunal to say that the test is “***a*** cause of the payment” rather than “***the*** cause of the payment” would seem to be questionable. To be the *causa causans*, the employment must be the true or main cause of the payment. It is not unusual for a shareholder to make a personal gift to an employee of the company – not for their services but for personal reasons. But of course, they would probably only know each other because of the employment, so it would always be “a cause” of the payment.

The crucial feature would seem to be that if a specific condition for the payment is that the recipient must be an employee, the line is crossed and the payment is by reason of the employment. A fine line perhaps, but clearly one where it is necessary to tread extremely carefully.

Coincidentally, a few days later the Court of Appeal was faced with a similar issue in the case of *HMRC v E.ON [2023] EWCA Civ 1383*: whether a payment was within section 9 ITEPA 2003 as being *from* an employment.

The payment in question was made to employees in consequence of a change to the E.ON pension scheme. The employees were offered a package which included a Facilitation Payment of 7.5% of their salary.

The employees argued that this payment was not taxable as it was not "from the employment" but represented compensation for the reduction in pension rights.

The Court of Appeal considered that the payment should properly be described as an inducement to provide future services on different terms – and merely replaced the lower earnings that would be suffered if they wanted to maintain the same pension benefits.

Nugee LJ summed up the issue succinctly thus:

> "The employees are being asked to agree to a change in the terms on which they might be employed in the future, and in return

> receiving a payment in money. The payment seems to me plainly to have come from the employment".

The Facilitation Payment was therefore an amount within section 9 and chargeable to tax as earnings. However, it is unclear why the payment would not have been taxable anyway under section 201 being a benefit provided by reason of the employment – whether it was *from* the employment or not. The payment was clearly a benefit and section 201(3) makes it even clearer by deeming it to be by reason of the employment:

> "A benefit provided by an employer is to be regarded as provided by reason of the employment".

The taxpayer would obviously have preferred the Court of Appeal to have held that the payment represented compensation for the loss of pension rights, in which case it would not have been taxable at all, on the authority of the House of Lords in *Tilley v Wales [1943] AC 386*. But it wasn't. It was a payment from the employment – and even if it had not been a payment from the employment, it would seem to have been taxable as a benefit (either actually or deemed to

have been) provided by reason of the employment under section 201 ITEPA 2003.

MURKY WATERS:

CAN A NON-DISCRIMINATION ARTICLE DISCRIMINATE?

A consideration of the non-discrimination article: its purpose, application and consequences

Dilpreet K. Dhanoa

"The present system of tax agreements creates the anomaly of aid in reverse – from poor to rich countries."[1]

Introduction

The 'non-discrimination norm'[2] is a principle embodied in all tax treaties: in essence it is that non-residents from a treaty country should not be treated worse than residents.[3] Difficulties often arise due to the different treatment of residents and non-residents for tax purposes and as a result, the non-

1 Charles Irish (1974).
2 Avi-Yonah, *International Tax as International Law*, p.6
3 *Ibid.*

discrimination principle has been embedded into tax conventions.

Avi-Yonah argues that this non-discrimination norm exists beyond the scope of treaties and is in fact part of customary international law.[4] This perhaps gives some insight into how and why there is relatively little objection per se to its inclusion in a more formalised respect as part of a tax treaty. After all, customary international law is law that 'results from a general and consistent practice of states followed by them from a sense of legal obligation'.[5] Yet the purpose of an article in a treaty must be consistent with international norms that stipulate that a treaty must be 'interpreted in good faith in accordance the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.'[6]

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4 *Ibid.*

5 American Law Institute's 1987 Restatement of Foreign Relations Law, §102.

6 Halsbury's Laws of England, *Treaties and International Agreements*, Vol.6(3), s.95 relying on the Vienna Convention on the Law of Treaties, Art.41 §1(b). Ironically, the term 'object and purpose' is not defined anywhere (see: David S. Jonas and Thomas N. Saunders. "The Object and Purpose of a Treaty: Three Interpretive Methods" Vanderbilt Journal of Transnational Law Vol. 43 Iss. 3 (2010)).

Article 24 of the OECD's Model Tax Convention ('the OECD Model'), the traditional starting point for non-discriminations discussions in tax treaties[7] is designed with the intention of preventing foreign taxpayers being discriminated against.[8] It is to be noted that the phrasing of the article refers specifically to 'nationals' as opposed to 'residents', which according to some academics is a wider concept.[9] The phraseology is important in this regard, and this essay will seek to explore this further.

Baker notes that articles (similar to Article 24) prohibiting discriminatory taxation 'have a history longer than that of the modern form of double taxation convention',[10] such as in trade treaties. Article 24 is simply an extension and development of such earlier provisions.[11]

<u>What is its intended purpose?</u>

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7 Avery-Jones, J. F., *The non-discrimination article in tax treaties* [1991] BTR 359 (Part 1).
8 Miller and Oats, *Principles of International Taxation*, §7.45.
9 *Ibid.*
10 Baker, P., *Double Taxation Conventions*, §24B.01.
11 Baker, P., *Double Taxation Conventions*, §24B.01.

Non-discrimination clauses are typically drafted as 'narrow equality norms',[12] and this requirement of equal treatment for taxpayers sits comfortably with the principles of international comity. However, when probed deeper a heated debate has arisen in the international tax world as to purpose, application and consequences of including such a broad-brush article that fails to appreciate the differences and complexities of international taxation and modern legal arrangements.

Avery-Jones[13] identifies Article 24 of the OECD Model as having two main objective: first, to prevent discrimination of any kind by a state in taxing nationals of the treaty partner state or statement persons;[14] and secondly, to prevent discrimination by one state in relation to residents of the other state with respect to business income – namely, permanent establishments,[15] the deduction in computing business profits of interest, royalties and

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[12] Haslehner, W., *Tackling complex discrimination in international taxation* (British Tax Review: 2012), p.1.
[13] Avery-Jones, J. F., *The non-discrimination article in tax treaties* [1991] BTR 359 (Part 1), p.1.
[14] OECD Model, Art.24(1)-(3).
[15] OECD Model, Art.24(4).

other disbursements paid to[16] enterprises owned by treaty partner residents.[17] The Article makes plain that it applies to all taxes,[18] but the taxation relates to that of the person and not the income – and therein lies the first problem of such an Article.[19]

The reference to 'nationality' is a curious one. Save and apart from references to it in the dual residence and Government services articles, Article 24 is the only other article to make mention of it. Given the confusion of terms and lack of precision with regards to some of the key terms in international taxation, the use of nationality only adds to the muddying the waters with respect to non-discrimination. Indeed, one might have expected that the League of Nations model on non-discrimination might be adopted, given it stated a 'prohibition on discrimination against residents of the treaty partner state'.[20] One could take the argument further with respect to such

16 OECD Model, Art.24(5).
17 OECD Model, Art.24(6).
18 OECD Model, Art.24(7).
19 Avery-Jones, J. F., *The non-discrimination article in tax treaties* [1991] BTR 359 (Part 1), p.1.
20 *Ibid.*

'classes' of person, and posit the argument that the 'stateless persons' provision is discriminatory.[21]

Is it clear re: intended purpose, application and consequence?

Miller and Oats note that Article 24 of the OECD model is the article 'that generates the greatest number of international tax law disputes'.[22] It does not sit neatly with the rest of the OECD Model, and goes far beyond the scope of the Treaty to include all taxes. However, not all countries are aware of this.

Baker argues that in a number of respects, Article 24 'fits badly into the overall structure of the OECD Model.'[23] He argues that Article 1 which limits the benefit of the treaty to residents of the Contracting States, and Article 2 which limits the treaty to the taxes specifically named in the Article, both have to be overridden in order to give effect to Article 24. This being the case, even where a person who is a national[24] of a State may benefit despite not being a

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21 *Ibid*, p.2.
22 Miller and Oats, *op. cit.*, §7.45.
23 Baker, P., *Double Taxation Conventions*, §24B.01.
24 As defined by Article 3(1)(g) to include both individuals and legal persons, partnerships and associations deriving their status from the laws in force in a Contracting State.

resident of either State. Furthermore, Article 24(6) widens the scope of Article 2 to apply to taxes of every description.[25]

Application of Non-Discrimination Norm

Van Raad and Baker are both of the view that the drafting and underlying principles of non-discrimination as contained in Article 24 'constitutes an incoherent collection of fairly narrow clauses'.[26] There is undoubtedly an issue with respect to definitions. Being a 'national' of a country and its 'resident' may encompass overlapping characteristics, but this is not necessarily always the case. It is the only article[27] where nationality (as opposed to residence) is mentioned as the test parameters.[28] There is also a sore lack of clarity in the Commentary which states that the provision is subject to reciprocity, without explaining precisely why this ought to be the case.[29] However, upon close

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25 Baker, P., *op. cit.*, §24B.01.

26 Van Raad, *Issues in the Application of Tax Treaty Non-Discrimination Clauses* (1988) Bull. IBFD 347, p.351.

27 Save and apart from Articles referencing nationality in respect of dual residence and Government service.

28 Avery-Jones, *The Non-Discrimination Article in Tax Treaties*, [1991] BTR 359, 421 and 31.

29 *Ibid.*

examination of the text, this is patently not the case, unless both states are equally bound and in the case of breach then the usual remedies become available.[30]

Whilst the concept of taxing 'insiders' and 'outsiders' appears deceptively simple, one only needs to glance at who and what authorities tax to know that this is not as simple an issue as may appear at first blush. Thus far, judges, academics, government officials and drafters of the non-discrimination provisions appear to have 'failed to clearly articulate the value or values that legal prohibitions of tax discrimination promote'.[31]

Article 24 of the OECD Model Tax Convention on Income and on Capital contains four independent non-discrimination rules, focusing on the potential disadvantages imposed by a source state. The four independent non-discrimination rules in Article 24 of the OECD model are understood to apply on an a case by case basis as opposed to implementing an overarching equality rule, however, they have faced criticisms of being incoherent and lacking a

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[30] *Ibid.*

[31] Mason, R. and Knoll, M. S., *What is Tax Discrimination?*, [2012: The Yale Law Journal 121], p.1017.

principled basis. Yet, a problem with this arises since a narrow interpretation can lead to incorrect conclusions, moreover in situations where the disadvantages in the tax law arise from numerous factors rather than a solitary one.[32] Avery-Jones[33] proposes a sequential application of several non-discrimination rules ("complex discrimination") as a progressive step and one that would not require changes in any tax treaties or conventions.

Another solution to the difficulties in non-discrimination cases, as recommended by JFAJ and others, would be to refer to discrimination in the same way as the EEC treaty and in turn, this would allow different treatment when it be deemed necessary.[34]

Consequences of Non-Discrimination Clauses

Van Raad and Baker state that the uncertainty around non-discrimination clauses exists not only directly in its application, but also indirectly as most

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[32] Avery-Jones, J. F., *Tackling complex discrimination in international taxation*.

[33] *Ibid.*

[34] Avery-Jones, J. F., *The non-discrimination article is about discrimination – official*, British Tax Review 2007 Case Comment.

States are unaware of the non-discrimination clauses that they are committing to when signing treaties,[35] highlighting the depth of the problem of implementing the clauses in practice. They suggest that the unsavoury outcome of this is "a shift from theoretical analysis to courtroom action".[36]

Considering then some of the cases which have arisen as a result of non-discrimination clauses. The case of *FCE Bank*[37] made clear the proposition that a country could not discriminate against foreign entities, and that foreign entities must be treated and taxed as compared to local entities. Absent the non-discrimination article, Ford would not have been able to use losses to set off against group relief. The curious feature that this case causes one to look at is that in EU law, if there is breach one is required to look at the justification. For the tax treaties, there is no such measure in place. If an individual or entity falls within one of the four scenarios put forward by Article 24, then they will be captured, but if not then there is argument for unjustifiable discrimination.

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35 Van Raad, *Issues in the Application of Tax Treaty Non-Discrimination Clauses* (1988) Bull. IBFD 347, p.351.

36 *Ibid.*

37 *FCE Bank plc. HMRC* [2011] UKUT 420 (TCC).

This was brought to a head in the case of *Felixstowe*[38] in which two arguments were submitted along EU and non-discrimination grounds. In short, if one is party to a consortium, and the operating company owned by the consortium makes losses then you would be entitled to 40% of those losses. The entity (Hutchison) wanted to take some of those losses and use them against Felixstowe. This was a case post-*FCE*, by which time the UK had changed the law saying realised it was wrong and said you can have the parent of a group that is not in the UK. However, one thing they did not change was that the consortium company, the link company, had to be a UK company. No reason was proffered for this course of action. It appears that the best answer found is that when they were amending the legislation they forgot about consortium relief. With respect to the non-discrimination element, the UK domestic decision revolved around the UK-Luxembourg Treaty. This Company (LuxCo) argued that it was being discriminated against by 3G because owned and incorporated in Luxembourg as opposed to UK.

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[38] *Felixstowe Dock and Railway Company v. Revenue and Customs Commissioners* [2014] STC 1489.

Arguments raised on what falls to be captured by Article 24 and the idea of a 'notional national' were highlighted in the New Zealand case of *United Dominions Trust*.[39] The distinction as regards to a 'notional national' was caught immediately by para.1 of the Article 24, and the question as to how to determine residence of a company came into play. Generally, incorporation is what many countries use, but others apply tests of central management and control. Yet again, the non-discrimination article's broad brush approach was challenged when it came to considering the details – and to some degree, failed in its purpose to prevent discrimination. Compared with *Commerzbank*, where overseas branches were operating in the UK, and the UK resident business obtained interest in the form of repayment supplement. A non-resident was not entitled to pay the supplement so it was argued this was discrimination, not because they were treated as foreign nationals, but foreign bank operating through a branch did not get a repayment.

Conclusion

[39] *United Dominions Trust Limited* (1973), Wellington Court of Appeal

In essence, there are four types of discrimination:

1. Nationals of a contracting state: nationality discrimination. May not like certain nationals but cannot tax them in a discriminatory fashion. If you lose your nationality or state, cannot be discriminated against due to statelessness. Adjunct to nationality.

2. Permanent Establishment ('PE') discrimination. Cannot discriminate against a local PE of a foreign company, simply because it is a PE and not because they have set up in your jurisdiction, so a state cannot discriminate because it is a PE and not a subsidiary.

3. Deductions discrimination. If you allow a deduction to your companies for interest, you cannot refuse that deduction simply because the interest is paid to a foreigner.

4. Ownership discrimination. Cannot discriminate against a taxpayer because they are resident of another state.

As noted by Van Raad: these are a hotch potch of incoherent provisions. They simply do not amount to a single coherent policy. There remains also the outstanding issue of what is the correct comparator (foreign parent with local subsidiary). In *Herzmetal Gesellschaft*[40] group elections under which the entity did not pay the ACT, but the parent could then pay the ACT when paid dividend to a third party. When a Japanese company said it too would like the same treatment but was not part of the EU, but pursuant to the UK-Japan Treaty sought the same treatment, the case went to the Supreme Court: what is the correct treatment for a similar company? It was held that the reason for the discrimination was not that the entity was a UK subsidiary with a Japanese parent, but rather because the entity was a UK subsidiary with a parent that cannot enter into a UK election. This remains an entirely unsatisfactory position, and the principles of international comity push for a strong case to develop a more robust set of non-discrimination provisions.

[40] *Herzmetal Gesellschaft*

THE CORPORATE INTEREST RESTRICTION DOUBLE WHAMMY

David Southern KC

The corporate interest restriction

The corporate interest restriction ('CIR') was introduced for accounting periods starting on or after 1 April 2017. The legislation is largely contained in Taxation (International and Other Provisions) Act 2010 ('TIOPA'), Part 10.

The rules operate on a group basis, not an individual company basis. They apply to a worldwide group (WWG). However, a single UK company can be a worldwide group. UK companies, i.e. members of a group liable to UK corporation tax, are relevant companies. In calculating aggregate tax-EBITDA (on which, see below), the starting point is the 'taxable total profits' [Corporation Tax Act 2010, s 4(2); TIOPA s 406(3)(a)], i.e. amounts taken into account in calculating corporation tax liabilities, so a UK tax nexus is implicit. Accordingly, members of a group

within the charge to UK corporation tax, form a sub-group for tax purposes.

Purpose of the CIR

The aim is to make the deductible finance costs of a UK sub-group commensurate with the activities of a group which are subject to UK corporation tax. This is achieved by imposing a cap on finance costs which are deductible from taxable profits as trading expenses or management expenses. In effect excess debt finance expenses are treated as distributions for tax purposes as regards the payer. A proportion of finance costs will have to paid out of taxed income, like dividends, thereby increasing the effective rate of corporation tax.

Where the restriction applies the CIR imposes a surcharge on the standard rate of corporation tax.

The broad aim of the CIR is to ensure that 70% of general profits are taxable in the UK, i.e. post-tax profits are 70% of pre-tax profits. This is achieved by limiting the interest deduction to 30% of (net profits + finance costs). These restrictions are calculated at

the group level, but then allocated to individual companies within the sub-group.

The CIR implements OECD BEPS Action 4, which is intended to prevent multi-national enterprises from placing debt in high tax countries to shift profits to low tax jurisdictions. A broader aim is to encourage equity financing in place of debt financing.

Impact of CIR

The CIR's initial impact was muted by three factors:

(i) interest rates were artificially low, so finance costs were accordingly minimised;

(ii) the legislation only applies if the annual group interest expense exceeds £2 million [TIOPA s 393(3)]. Though this level of interest expense is modest, this kept many smaller groups outside the legislation;

(iii) the corporation tax rate was 19%, so the economic cost of denial of £1 of interest

costs was £0.19, being the additional corporation tax payable.

Now, however, the situation has changed markedly:

(i) as interest rates rise to more normal levels, companies' finance costs are sharply increasing, and in many cases have doubled;

(ii) the CIR restricts their ability to set this additional cost against their profits for corporation tax purposes. Highly leveraged companies are particularly exposed in this situation. These include commercial property companies;

(iii) commercial property companies have also experienced falling income from rentals. This further limits their ability to secure a tax deduction for interest costs, because the profits component of aggregate tax-EBITDA is reduced.

<u>The CIR double whammy</u>

The problem about the CIR is that, for corporation tax purposes, finance costs which are deductible in the commercial accounts are treated as income and taxable as such. This is the CIR double whammy: interest costs go up, but tax costs as a proportion of pre-tax profits increases, because the deduction from commercial profits for finance costs is restricted.

If a company's finance costs go up, so does its effective corporation tax rate. The same result follows if its profits go down. As a result, the company's effective rate of corporation tax can exceed 100%. That is the CIR double whammy. This article seeks to explain why and how this may happen.

How the CIR works

The group interest costs for an accounting period are the Aggregate Net Tax-Interest Expense (ANTIE): [TIOPA ss 382, 389, 390]. This is the sum of finance expenses of each UK company in the group, less aggregate net tax-interest income (ANTII) [TIOPA s 390]. The main component of ANTIE is 'relevant loan relationship debits': TIOPA ss 382(2), 383.

The interest capacity is the percentage of finance costs which can be deducted from profits for corporation tax purposes [TIOPA s 392]. The interest allowance [TIOPA s 396] is the main component of interest capacity. There are two basic measures of interest allowance for an accounting period: the Fixed Ratio [TIOPA s 396] and the Group Ratio [TIOPA s 397]. In either case, the ratio is fixed by reference to the aggregate tax-EBITDA ('earnings before interest, tax, depreciation and amortisation') of the relevant companies in the group [ITEPA ss 405, 406, 407].

The key point about tax-EBITDA is that it includes finance costs, so a restriction on deductions for tax purposes will include a proportion of the otherwise deductible finance costs.

The aggregate tax-EBITDA is the sum of the corporation tax profits of each relevant company [TIOPA, ss 405, 406, 407]. Aggregate tax-EBITDA cannot be less than zero.

The Fixed Ratio Rule for calculating the interest allowance is to take 30% of aggregate tax-EBITDA [TIOPA s 396, Fixed Ratio Rule]. The alternative

Group Ratio Rule [TIOPA s 397] may be used if it produces a lower rate of restriction. This is the Group Ratio Rule.

Example 1

The group finances its investments largely by borrowings. The group borrowings are £200,000,000. The borrowing rate is 3% variable.

Taxable total profits	10,000,000*
ANTIE: 200m @3%: add back	6,000,000
Aggregate tax-EBITDA	16,000,000
Interest allowance:	
30% x 16,000,000	4,800,000
Interest disallowance: 6m – 4.8m	1,200,000
Corporation tax profits	10,000,000
Add back: disallowed interest	1,200,000
CIR Corporation tax profits	11,200,000
Corporation tax charge @25%	2,800,000
Rate of tax	28%

*after deducting finance costs of £6m

Example 2

The group finances its investments largely by borrowings. The group borrowings are £200,000,000. The borrowing rate rises to 6%.

Taxable total profits	4,000,000*
ANTIE: 200m @ 6%: add back	12,000.000
Aggregate tax-EBITDA	16,000,000
Interest allowance:	
30% x 16,000,000	4,800,000
Disallowed interest: 12m – 4.8m	7,200,000
Corporation tax profits	4,000,000
Add back: disallowed interest	7,200,000
CIR Corporation tax profits	11,200,000
Corporation tax charge @25%	2,800,000
Rate of tax	70%

*additional interest of £6m payable

Example 3

The group finances its investments largely by borrowings. The group borrowings are £200,000,000. The borrowing rate rises to 6%. Group profits after deduction of interest fall by 50%

Taxable total profits	2,000,000
ANTIE: 200m @ 6%: add back	12,000.000
Aggregate tax-EBITDA	14,000,000
Interest allowance:	
30% x 14,000,000	4,200,000
Disallowed interest: 12m – 4.2m	9,800,000
Corporation tax profits	2,000,000
Add back: disallowed interest	9,800,000
CIR Corporation tax profits	11,800,000
Corporation tax charge @25%	2,950,000
Rate of tax	147.5%

Discussion

CIR is intended to operate on an automatic, objective, accounts-driven basis, to replace largely in practice Arm's Length Principle-based transfer pricing, which was regarded as excessively subjective. However, the mechanism can develop a life of its own and produce outcomes which make no commercial or common sense. The basic difficulty is that the larger the proportion of finance costs as a component of aggregate tax-EBITDA, the greater the disallowance relative to taxable total profits.

In short, automatic operations are fine and dandy as far as they go, there has to be an override where results depart from common sense.

While the tax system may seek to promote greater equity financing, the problem about equity financing is that it is inherently more expensive than debt financing. Certain major investors – the obvious example is pension funds – require regular payments, making equity unsuitable for their needs. Moreover, anything which increases the cost of capital makes companies less competitive in an international environment.

Indeed, a fundamental flaw of the BEPS project was that it attributed all profit-shifting to the notorious ingenuity of tax advisers, and overlooked the role of tax competition between states competing for investment, jobs and profits.

For groups caught in the CIR double whammy, various expedients may be available. However, the first step is to recognise the scope of the problem.

David Southern KC

The 11th edition of David's *Taxation of Loan Relationships and Derivative Contracts* (Bloomsbury Professional) will be published later this year.

EMPLOYEE OWNERSHIP TRUSTS

Riya Bhatt

Introduction

Business owners looking to sell their companies may find employee ownership trusts (or "**EOT**"s) to be an attractive ownership structure.

Employee ownership trusts are government approved, and were introduced by the Finance Act 2014 as an initiative to promote employee ownership in companies. The incentive allows for commercial and attractive tax benefits for both the owner of the company (who may want to sell some of their shares) as well as the employees.

What is an employee ownership trust?

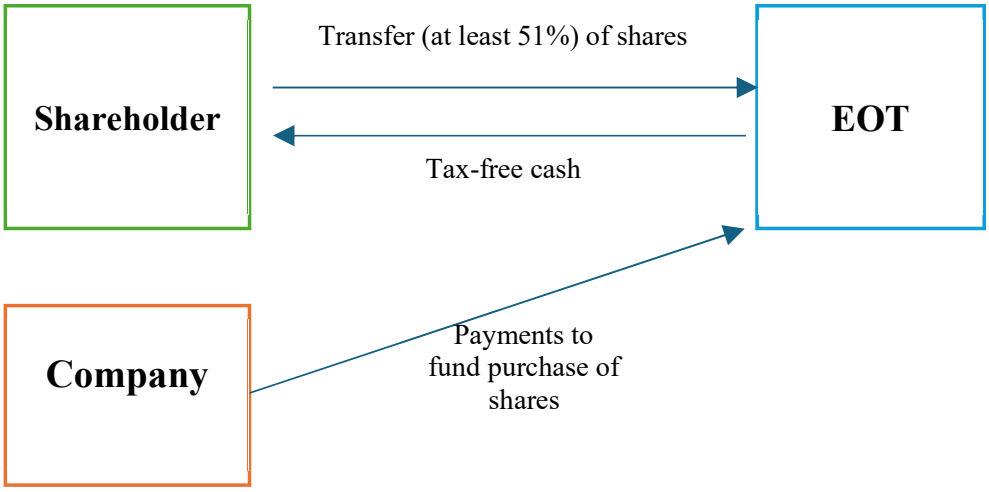
An EOT is a structure which allows employees to indirectly own a company, either partly or wholly.

An EOT involves the setting up of a trust to hold a majority shareholding in the company. This will involve the shareholders selling their shares to the

trustees of the EOT, and those shares will be held on trust for the benefit of the employees of the company.

The purchase price of the shares sold to the trustees will depend on the valuation of the company at the time of the sale. Often, the purchase price of the shares is left outstanding and the trustees of the EOT will pay the vendor back through the company's own future profits.

The EOT will control the company and will be governed by the trustees. As the shares in the company will be held for the benefit of the employees, the trustees of the EOT must act in the best interest of the beneficiaries.



Commercial benefits

There are many commercial benefits of a selling the whole or part of a shareholding to an EOT, for both the shareholders and the employees.

For shareholders, the main benefits include flexibility for the future of the company. For example, an EOT provides the ease of selling the company where it may be difficult to find a third party purchaser, and can avoid a hostile takeover. If the owner wishes to retain a shareholding in the company, they can do so up to 49%. The EOT creates an internal market for the shares and the purchase monies come from the company itself.

As the employees will be the beneficiaries of the EOT, there is no need for individual employees to have shareholdings within the company. This provides ease of administration. However, if desired, share capital which has not been transferred into the EOT can still be distributed to employees.

The productivity and efficiency of the company is likely to increase due to the added engagement of the employees who own the company.

For employees, benefits include having a share in the company's financial success, as well as being more motivated, committed and engaged. An EOT requires no change to an individual's employment within the company or any personal investment from employees. A company which is employee-owned is likely to align its values to those of its employees, making the company a fulfilling and enjoyable place to work.

Tax benefits

One key tax benefit for shareholders who wish to sell their shares to an EOT is that the sale will be free of capital gains tax and inheritance tax, as long as the requirements below are met.

For employees, the key benefit includes an income tax-free annual bonus of up to £3,600 and the company can claim corporation tax deductions for the payment of such bonuses to employees.

Requirements to qualify as an EOT

CGT

For CGT purposes, there are four requirements which must be met in order to qualify as an EOT. They are:

1. The company must be a trading company, or must be the principal company of a trading group. The company must remain a trading company from the time of the disposal of the owner's shares until the end of the tax year in which the disposal takes place.

2. The trust must benefit all the employees of the company on the same terms, and must continue to do so until the end of the tax year in which the disposal takes place. However, the trustees of the EOT may distinguish between the employees on the basis of salary, length of service, and hours worked. Employees who have served for less than 12 months can be excluded. As part of this requirement, the EOT must also not transfer the trust property into another settlement (other than another EOT), or permit the trustees

to make loans to beneficiaries of the trust. In addition, the terms of the trust must not permit the trustees to amend the EOT in such a way that the trust would no longer comply with the above.

3. The trust must have, and continue to hold, a controlling interest in the company. This means it must hold at least 51% of the shares in the company. It must have majority voting power and a majority entitlement to receive equity available for distribution.

4. The number of shareholders of the company who own (or have owned) 5% of the shares in the company (or persons connected to such shareholders) must not exceed 2/5 of the workforce generally, until the end of the tax year in which the disposal occurs. This is a relatively complex requirement and advice should be sought as to whether it is met in each company's case.

If any of these requirements cease to be met before the end of the tax year following the transfer of shares into the EOT by the shareholders, any CGT relief claimed by the shareholders will be clawed back.

If any of the above requirements cease to be met after the end of the tax year following the transfer of shares, a CGT charge will arise on the trustees of the EOT, who will be treated as having disposed of the shares they hold and reacquiring them for market value. This may result in a CGT charge on the trustees of the EOT.

IHT

For IHT purposes, the EOT will be exempt from a charge at the point of transfer by the shareholders if the following three requirements are met:

1. The company must be trading.
2. The trust must benefit all the employees of the company on the same terms (subject to the exceptions above), and must continue to do so until the end of the tax year in which the disposal takes place.

3. The trust must not own more than 50% of the shares in the company immediately before the beginning of the tax year in which the shares are transferred into it, but it must do so at the end of that year.

In addition, if the following conditions are met, the EOT will also be exempt from ten-year anniversary charges for trusts, as well as exit charges on capital distributions from the EOT. Those requirements are:

1. The property in the EOT must include the ordinary share capital in a trading company or the principal company of a trading group.

2. The EOT must hold at least 51% of the shares and voting power in the company, and it must have a majority entitlement to receive equity available for distribution.

3. All employees must receive benefits from the EOT on the same terms (subject to the exceptions above).

Conclusion

EOTs have a number of benefits and companies adopting this structure have been successful in realising the same. Majority shareholders wishing to sell their interest in a company may wish to consider using an EOT.

IS PORTUGAL (STILL) AN ATTRACTIVE DESTINATION FOR HIGH-NET-WORTH INDIVIDUALS IN 2024?

Dr Rita da Cunha

1. Overview

The ongoing housing crisis and political instability in Portugal make tax policy unpredictable. In the beginning of 2023, the socialist government restricted the attribution of golden visas. At the end of 2023, it put an end to the flagship non-habitual residents (NHR) regime on the grounds that it contributed to the housing crisis and favored wealthy foreign nationals with prejudice to Portuguese families. The election of a centre-right coalition on 10 March 2024 is likely to mark a significant shift of direction in tax policy matters.

The first and second sections of this article provide an overview of the changes to the golden visa regime and the transitional regime put in place to protect legitime expectations in the aftermath of the abolition of the NHR tax regime. The third and fourth sections underscore the most attractive features of the Portuguese tax regime for high-net-worth individuals in 2024: the tax treatment of

certain distributions of trust income and property, lifetime gifts and transfers on death. The fifth section explores the main tax proposals in the manifest of the centre-right coalition who will form the incoming government.

2. The Portuguese golden visas in 2024 – *What's left?*

The Residence Permit for Investment Activities (known as "golden visa") regime was created in 2012 to attract foreign investment. Over the years, the scope of this regime was extended to encompass the following "qualifying investments":

- Purchase of property worth (at least) EUR 500k;
- Purchase of property in need of repair worth (at least) EUR 350k;
- Investment of (at least) EUR 500k in Portuguese investment funds;
- Investment of (at least) EUR 500k in a Portuguese company accompanied by the creation of 5 jobs;
- Transfer of capital to Portuguese banks or other investment of (at least) EUR 1,5m (e.g. shares);

- Creation of (at least) 10 jobs; or
- Donation of (at least) EUR 250K to certain charities.

In early 2023, the socialist government reduced the definition of "qualifying investment" to include the following:

- Investment of (at least) EUR 500k in Portuguese investment funds;
- Investment of (at least) EUR 500k in a Portuguese company accompanied by the creation of 5 jobs;
- Transfer of capital to Portuguese banks or other investment of (at least) EUR 1,5m (e.g. shares);
- Creation of (at least) 10 jobs; or
- Donation of (at least) EUR 250K to certain charities.

Individuals with golden visas granted before the 2023 amendment entered into force may renew their golden visas if they meet the conditions required prior to 2023.

3. The end of the non-habitual resident (NHR) tax regime

The most attractive feature of the NHR regime for high-net-worth individuals was the tax exemption for foreign-sourced dividends and interest, which was available for a period of ten years to those who became tax resident in Portugal and obtained NHR status. Its ending on 1 January 2024 will not affect those individuals who already acquired NHR status.

Moreover, the benefits of the NHR regime will be available to:

- Individuals meeting the conditions to acquire NHR status on 31 December 2023 (who may apply for NHR status until 31 March 2024);
- Individuals who become tax residents by 31 December 2024 and meet one of the following conditions:
    (i) Employment contract signed by 31 December 2023;
    (ii) Acquisition or lease of a property concluded by 10 October 2023;
    (iii) Enrolment of children in a school by 10 October 2023;

(iv) Request a residence visa or permit by 31 December 2023.

4. Distributions of trust income and property

Distributions during the lifetime of the trust: personal income tax at the flat tax rate of 28% (for trusts in blacklisted jurisdictions, the tax rate is increase to 35%).

Distributions arising from the liquidation, revocation or extinction of the trust:

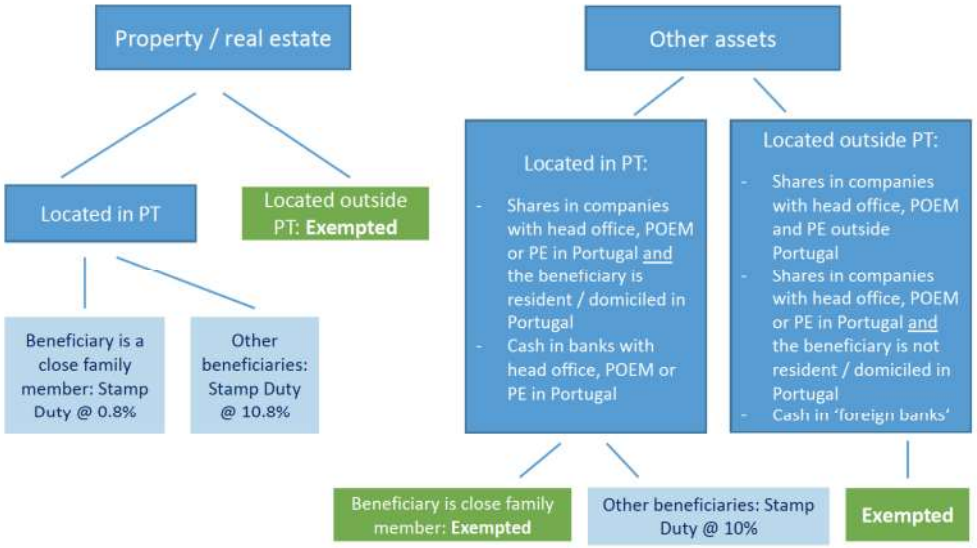
- Received by the settlor: personal income tax on gains at the flat rate of 28% (for trusts in blacklisted jurisdictions, the rate is increase to 35%).
- Received by beneficiaries: stamp duty at the flat rate of 10% for assets located in Portugal; non-taxation for assets located outside Portugal.

It is worth underscoring that the NHR regime is an income tax regime. It will not affect the competitive tax treatment of distributions of trust income and property, lifetime gifts and transfers on death.

5. Taxation of lifetime gifts and transfers on death

There is no inheritance tax or wealth tax in Portugal.

The tax treatment of lifetime gifts and transfers on death depends on the location of the assets and on whether the donor / deceased and the beneficiary are close family members (spouse, children, grandchildren, parent and grandparent), as shown in the graph below:



6. Looking forward

It is hard to argue that Portugal did not lose tax competitiveness as a location for high-net-worth individuals in 2023 (mainly because of the end of the NHR regime). The change from a socialist to a

centre-right government in the beginning of 2024 may reverse this trend.

The manifest of the centre-right coalition elected on 10 March 2024 to form a new government – AD, or Democratic Alliance – encompasses the following tax measures:

- Gradual reduction of the corporation tax rate down to 15% by 2028;
- Maximum 15% personal income tax rate for taxpayers below 35 years;
- Reduction in the general personal income tax rates (from between 0,5% and 3%);
- Tax exemption for performance bonuses up to the amount of one monthly salary.

THE TOUR OPERATOR'S MARGIN SCHEME ('TOMS') – RECENT CASE LAW AND THE TENTATIVE CASE FOR ITS ABOLITION

Alex Spencer

The Tour Operator's Margin Scheme, or 'TOMS' is a mandatory alternative means of accounting for VAT on travel services. In summary, it applies to businesses which buy-in and resell, as undisclosed agent or principal, travel services to parties who consume those travel services (whether businesses or individuals). The TOMS has been part of EU and UK VAT law since 1977.

The rationale for the TOMS has always been that because the place of supply of services relating to travel is typically derived in EU and UK VAT law from where those services are performed, businesses that provided travel services within the EU would have faced multiple registration liabilities in each member state where they made those supplies. At least in 1977, that was seen as giving rise to significant administrative and compliance obligations which would obstruct the

smooth running of the taxpayer's business.[1]

In principle, the TOMS alleviates these problems by treating supplies of travel services by a business within the scheme as made in the member state where the business is established and treating the tax base for the supplies – the amount on which VAT is calculated – as the profit margin made by the business on each trip supplied to a consumer. The effect is to simplify the place of supply rules and avoid a requirement for businesses to register in multiple territories.

This article considers two recent First-tier (Tax) Tribunal cases which demonstrate that the TOMS is not always straightforward in its application and has a broader scope than might be implied by the ordinary meaning of the term 'tour operator.' *Sonder Europe Limited v HMRC* [2023] SFTD 1083 ('Sonder') concerned supplies of accommodation made by a taxpayer who had taken Repairing Insuring Leases over apartments and let them out to consumers. *Bolt Services Ltd v HMRC* [2023] UKFTT 1043 (TC) ('Bolt') concerned supplies of private hir cab trips supplied by the taxpayer to consumers through an app.

[1] Beheersmaatschappij Van Ginkel Waddinxveen BV and Others v Inspecteur der Omzetbelasting, Utrecht (Case C-163/91) [1996] STC 825 at [4]

In both cases, the Tribunal held that the taxpayers' services fell within the scheme.

Diversion – do we still need the TOMS?

Pausing briefly: in 2024, there is a compelling case for abolishing the TOMS in both the UK and EU. Tax compliance is significantly more sophisticated in 2024 than it was in 1977: compliance systems are now digitalised – tax code determination and calculations can be carried out instantly by accounting software – and, in the EU, single registration regimes like the mini one-stop-shop (or 'MOSS') allow in principle for both EU and non-EU established taxpayers to account for VAT on supplies across the EU through a single VAT registration in one member state, and for VAT revenues to be shared by that member state with the member states where the VAT is due.

In light of the above, the principle rationale for the TOMS of avoiding the imposition of unduly onerous compliance obligations falls away. That is especially true for the UK TOMS, which effectively now only applies to supplies made within the UK. Supplies made by UK-established businesses of travel services performed outside the UK and which fall within the UK TOMS are zero-rated. Businesses which make

supplies from establishments outside the UK do not fall within TOMS. Only supplies of services performed in the UK made from establishments within the UK are subject to the requirement to account for VAT on the margin received by the taxpayer. It is, however, intuitive that there is simply no need for a TOMS regime to simplify the place of supply rules for UK established businesses supplying travel services which are performed in the UK.

As the cases discussed below illustrate, while the potential advantages of the TOMS are significantly less significant (if they persist at all) now than they were in 1977, the complexities inherent in the scheme remain. It is the author's view that, on balance, there is little justification to retaining the TOMS and, in fact, its abolition would have the welcome effect of reducing complexity in the UK VAT system.

Legislation

EU Law

The TOMS is mandated by Articles 306 – 310 of the Principle VAT Directive ('PVD') which effectively restated the previous law as set out in Article 26 of the Sixth Directive:

Art 306(1):

Member States shall apply a special VAT scheme, in accordance with this Chapter, to transactions carried out by travel agents who deal with customers in their own name and use supplies of goods or services provided by other taxable persons, in the provision of travel facilities.

Article 307:

Transactions made, in accordance with the conditions laid down in Article 306, by the travel agent in respect of a journey shall be regarded as a single service supplied by the travel agent to the traveller.

The single service shall be taxable in the Member State in which the travel agent has established his business or has a fixed establishment from which the travel agent has carried out the supply of services.

Article 308:

The taxable amount and the price exclusive of VAT, within the meaning of

point (8) of Article 226, in respect of the single service provided by the travel agent shall be the travel agent's margin, that is to say, the difference between the total amount, exclusive of VAT, to be paid by the traveller and the actual cost to the travel agent of supplies of goods or services provided by other taxable persons, where those transactions are for the direct benefit of the traveller.

Article 309:

If transactions entrusted by the travel agent to other taxable persons are performed by such persons outside the Community, the supply of services carried out by the travel agent shall be treated as an intermediary activity exempted pursuant to Article 153.

If the transactions are performed both inside and outside the Community, only that part of the travel agent's service relating to transactions outside the Community may be exempted.

Article 310:

VAT charged to the travel agent by other taxable persons in respect of transactions which are referred to in Article 307 and which are for the direct benefit of the traveller shall not be deductible or refundable in any Member State.

UK Law

The requirements of the PVD have been incorporated into the VAT Act 1994 ('VATA 1994') and the Value Added Tax (Tour Operators) Order 1987 (as amended) (the 'Order'):

Section 53, VATA 1994:

(1) The Treasury may by order modify the application of this Act in relation to supplies of goods or services by tour operators or in relation to such of those supplies as may be determined by or under the order.

...

(3) *In this section "tour operator" includes a travel agent acting as principal and any*

other person providing for the benefit of travellers services of any kind commonly provided by tour operators or travel agents.

Regulation 2 of The Order:

This Order shall apply to any supply of goods or services by a tour operator where the supply is for the benefit of travellers.

Regulation 3 of The Order:

(1) Subject to paragraphs (2) …1 and (4) of this article, a "designated travel service" is a supply of goods or services—

(a) acquired for the purposes of his business; and

(b) supplied for the benefit of a traveller without material alteration or further processing;

by a tour operator who has a business establishment, or some other fixed establishment, in the United Kingdom.

(2) The supply of one or more designated travel services, as part of a single

transaction, shall be treated as a single supply of services.

...

(4) The supply of goods and services of such description as the Commissioners of Customs and Excise may specify shall be deemed not to be a designated travel service.

Regulation 12 of the Order:

Subject to article 9A of this Order, input tax on goods or services acquired by a tour operator for re-supply as a designated travel service shall be excluded from credit under sections 14 and 15 of the Value Added Tax Act 1983.

Definitional problems

There are a number of difficulties in interpreting these provisions.

On first reading it appears that Regulation 3(1)(b) of the Order goes further than the PVD in excluding those supplies from TOMS that have been materially altered or processed. That requirement must, if possible, be

construed consistently with the provisions of the PVD (even after 1 January 2024).

Furthermore, the language of Articles 306 – 310 variously refers to 'using' supplies of goods and services 'provided to other taxable persons', 'entrusting' transactions to other taxable persons, and the transactions of other taxable persons 'directly benefiting' travellers. However, there is no indication as to what relationship these terms have with one another and whether they are intended to be equivalent in meaning or refer to different species of transaction.

It is also apparent that nowhere in the PVD or the Order are the terms 'tour operator' or 'travel agent' specifically defined. The PVD is silent on the point. Regulation 3 of the Order defines 'tour operator' as including 'travel agents' but then does not define 'travel agent.' Regulation 3 of the Order also refers to 'services commonly provided by tour operators or travel agents' without giving any indication of what those services are. There is, similarly, no definition of the services to which the TOMS is intended to apply in the PVD, beyond the somewhat enigmatic wording of Article 307: 'transactions…in respect of a journey.'

The task of delineating the scope of the TOMS has instead fallen to the CJEU. In *Madgett & Baldwin* [1998] STC 1189 at 1202 ('*Madgett*') the Advocate General suggested that a travel agent was any taxpayer who 'habitually arranges travel or tours, dealing with the traveller in his own name and making use of services supplied directly to the traveller by third parties.' The Court (at 1206) appeared to follow the Advocate General in holding that the TOMS 'applies to traders who organize travel or tour packages in their own name and entrust other taxable persons with the supply of the services generally associated with that kind of activity.' The Court's formulation thus makes it clear that whether a party is a tour operator or travel agent depends, firstly, on what services they supply and, secondly, the way in which they supply those services.

The CJEU has shown some reticence in defining the services that fall within the TOMS. In *Beheersmaatschappij Van Ginkel Waddinxveen BV and Others v Inspecteur de Omzetbelasting* [1996] STC 825 at 837 ('Van Ginkel') the Court held that the phrase 'transactions…in respect of a journey…is probably meant simply to emphasise that the service must be a feature of a journey, but not that the journey,

that is, the transport, is necessarily to form part of the service provided.' In *Finanzamt Heidelberg v ISt international Sprach- und Studienreisen GmbH* [2006] STC 52 at 67 ('ISt'), the Court held that it was unnecessary to go any further and attempt to define the concept of 'travel'. In *Minerva Kulturreisen GmbH v Finanzamt Freital* [2011] STC 532 at 536 ('*Minerva*'), the Court's passing remark that 'passenger transport and accommodation' are services typically provided by travel agents or tour operators would, intuitively, imply that both those services relate to journeys and fall within the TOMS.

There has also, arguably, been a lack of clarity on the way in which a service is to be supplied in order for it to fall within the scope of the TOMS. The CJEU case law distinguishes between 'bought-in' and 'in-house' supplies of travel services. Only the former fall within TOMS (*Kozak v Dyrektor Izby Skarbowej w Lublinie* (Case C-557/11) at [24]). There is, however, little discussion in the case law as to what the difference between the two terms means. Nevertheless, a distinction can be inferred from the wording of the PVD and the facts of those CJEU judgments which consider apportionment between TOMS and normal VAT accounting for bought in and in house supplies,

respectively.

Article 309 of the PVD refers to services 'entrusted' to other taxable persons which are 'performed' by those taxable persons outside the EU (in the context of determining the liability for the tour operator's supply under Article 307 PVD).[2] Similarly, Article 310 refers to 'VAT charged to the travel agent by other taxable persons in respect of transactions…for the direct benefit of the traveller.' It seems reasonable to infer from the related ideas of 'entrusting' supplies to third parties (in Article 309) and transactions with third parties being for the 'direct benefit' of travellers (in Article 310) that a 'bought-in' service is one which requires the participation of a third party other than the tour operator in performing a service for the traveller.

That inference is commended by the facts of the various CJEU cases involving both bought-in and in-house supplies. Thus, in *Madgett* (at 1205), the taxpayer's laying on of a coach for taxpayers, where the coach company was responsible for the performance of the service, was identified by the CJEU as a bought-

[2] In *Madgett*, the Advocate General stated in similar terms that the activities of a tour agent involve entrusting other taxable persons with supplies of services.

in supply. Similarly, in ISt (at 66), passenger transport performed by airlines for the purposes of enabling the taxpayer's clients to attend language schools was identified as a bought-in supply. The CJEU's observations in these cases lends further credence to the view that the term bought in refers to services which are performed by a third party for the traveller but supplied by the third party to the 'tour operator.'

Sonder

Sonder concerned supplies of short stay accommodation. The taxpayer entered Internal Repairing Insuring Leases with landlords for a term of years. The taxpayer let out apartments in the buildings it had leased to business and leisure travellers for, on average, 5 nights. It was common ground that those supplies would, if supplied outside the TOMS, be subject to VAT at the standard rate.

The taxpayer argued that their supplies fell within the TOMS and that they were therefore required to account for VAT on one sixth of the margin they made on their supplies. The taxpayer claimed its position was indistinguishable from that of the taxpayer in *Van Ginkel* and *Alpenchalets Resorts GmbH v Finanzamt Munchen* (Case C-552/17) in that they were buying in

supplies of accommodation and making onward supplies of it to travellers.

HMRC argued that the taxpayer was doing no more than renting VAT-exempt residential accommodation from landlords and subletting it to travellers. Therefore, the supplies to travellers were not onward supplies of the landlord's supply to the taxpayer (and so were not bought in) but were used by the taxpayer in making in house supplies of short-stay accommodation.

The judge agreed with the taxpayer. There was, in the judge's view, no requirement in the TOMS for the supply received by the taxpayer to be identical to the supplies provided by the tour operator to the traveller. The judge's view of the authorities (at [62] and [65]) was that in interpreting the words '*use supplies of goods or services provided by other taxable persons, in the provision of travel facilities*' in Art 306 of the PVD, the only relevant question was whether 'the right to use the apartments was acquired by a tour operator for the purposes of its business before being supplied for the benefit of a traveller.'

The judge's formulation of the principles is arguably too broad. It can be said of any supply received by a

taxpayer that it is 'used in the provision of' another supply. However, the mere fact that a supply is used by a taxpayer in providing another service does not mean that it is bought in and therefore falls within the TOMS. When considering whether a supply falls within the TOMS, there must be further consideration of whether it is a bought in supply. The concept of 'use' does not by itself inform that distinction.

The missing factor, which (with respect) the judge appears to have overlooked, is that, per Article 309 of the PVD, the nature of a bought in supply is that its performance is 'entrusted' to another taxpayer. There is little discussion of the terms under which the taxpayer let the apartments to its customers in *Sonder*, but there is no suggestion that the landlords had any involvement in setting those terms beyond granting a lease under the terms of which it was permissible for the taxpayer to make supplies of holiday accommodation in whatever manner it saw fit. That would in turn imply that the supplies by the taxpayer were not bought in and so did not fall within the TOMS. By contrast, the CJEU noted that in *Van Ginkel* – which the taxpayer relied on for the proposition that supplies of accommodation could fall within the TOMS – the parties from whom the taxpayer rented

the bungalows were involved in setting the terms on which the taxpayer could provide the bungalows to the taxpayer (*Van Ginkel* at [1b]).

Bolt

In *Bolt*, the Tribunal considered two issues. The first was whether on-demand private hire cab rides supplied by the taxpayer to consumers through an app, but provided by self-employed drivers, constituted a supply of passenger transport of a kind generally associated with the activities of a tour operator or travel agent. The second was whether – if the taxpayer was a tour operator within the meaning of the TOMS – the taxpayer's services fell foul of the requirement in Regulation 3(b) of the Order in that they were bought in but materially altered by the taxpayer.

HMRC argued that the supply of private cab hire through an app was not a supply of a kind generally carried on by travel agents and tour operators: first, tour operators do not provide any service on demand and, second, the service received by the customer was more than a private hire cab journey but a bundle of services provided through the app (including access to a booking platform and carrying out background and insurance checks on drivers).

The judge disagreed with both propositions. It was not necessary or desirable within the scheme established by the TOMS to adopt a narrow meaning of the term 'passenger transport' as supplied by tour operators. The relevant test was whether the services related to journeys. A private cab hire service clearly was so related: it took a traveller from point A to point B. In that regard it was a kind of service generally associated with the activities of tour operators or travel agents.

It is difficult to see how the judge could have held otherwise on this first point. To have distinguished the taxpayer's services on the grounds that the services were on-demand and not pre-booked would have been to rely on a distinction absent from the CJEU's case law and would, as the judge noted, have resulted in an arbitrary differentiation between services based on the interval of time between their booking and performance. Applying the CJEU's definition in *Madgett*, the taxpayer organized travel for its customers in its own name and entrusted that travel to third parties – it is clear from the case law that that ought to be enough to bring it within the TOMS without the imposition of any further requirement.

As to whether the taxpayer had materially altered the

services of the private hire drivers in supplying them to customers, the judge [111] held that 'the drivers' services directly benefitted the travellers and, therefore, they were not in-house services or materially altered or processed.' The judge's interpretation arguably places some strain on the ordinary meaning of 'alteration' and 'processing.' Those are, on an ordinary reading, terms pertaining to a service's intrinsic qualities and characteristics, not to the service's potential beneficiaries.

However, the judge appears to have taken the view that the criteria in Regulation 3(1)(b) reflected the distinction in CJEU case law between in house and bought in supplies: in house supplies include supplies that have been bought in but materially altered, because the material alteration renders the participation of the third party supplier minimal or irrelevant by comparison with the involvement of the tour operator. As much appears to be borne out by the judge's comment (also at [111]) that 'in house supplies are those made from the travel agent's own resources which may be…derived from supplies by other taxable persons that directly benefit the travel agent.'

While the judge's implicit definition of a bought in

supply as one that has a 'direct benefit to a traveller' is potentially confusing in light of the language contained in Regulation 3(1)(b) of the Order, the idea of a 'direct benefit' to a traveller, and the notion of 'entrusting' performance of a service to a third party can be understood as two sides of the same coin: both (i) a service supplied by a tour operator to a customer, the performance of which is entrusted to a third party (Article 309), and (ii) a service performed by a third party for the direct benefit of a customer but supplied to a tour operator (Art 310) involve the participation of the third party without recourse to the tour operator's own resources. They are both different ways of describing a 'bought in' supply.

In that light, it appears that the judge understood the requirement in Regulation 3(1)(b) of the Order to be, first, a codification of the clear principle in the CJEU case law that TOMS only applies to bought in supplies and, second, a means of defining bought in supplies as supplies which are not made in house because they have not been altered, processed, or derived from the tour operator's own resources. They have instead been 'entrusted' to third parties. In the author's view, that is the correct interpretation of Regulation 3(1)(b) of the Order.

Conclusion

Both *Sonder* and *Bolt* demonstrate that the application of the TOMS as part of the UK VAT system continues to trouble taxpayers and the Tribunal despite the (superficial) simplicity of the regime. Both cases are salutary reminders of the breadth of the regime and its applicability to taxpayers who might not properly be considered tour operators. The cases also demonstrate that the distinction between bought in and in house supplies for the purposes of the TOMS is sometimes less than clear.

As discussed above, now is an apt time to ask whether retaining the TOMS as part of UK VAT law is desirable or whether the abolition of the TOMS would result in greater certainty for both taxpayers and HMRC alike, and whether such drawbacks as there may be to the TOMS' abolition are a worthy price to pay for that certainty. Until those questions are answered, however, the TOMS is likely to continue to trouble advisers for the foreseeable future.

TOO CLOSE FOR COMFORT – WHEN CAN HMRC TREAT BUSINESSES TOGETHER FOR VAT PURPOSES?

David Tipping

Introduction

Co-operation between different businesses can be a cost-effective and streamlined way of providing a greater range of services to clients. It can unlock new synergies and be beneficial for both clients and businesses alike. However, the artificial separation of a single business into multiple entities can be abused to maintain a turnover beneath £85,000. For that reason, paragraph 2 of Schedule 1 to the Value Added Tax Act 1994 ("**VATA 1994**") provides HMRC with a power to issue a Notice of Direction requiring two or more persons to be treated as a single entity for the purposes of VAT.

This can clearly have serious consequences for a business, incurring significant costs. Therefore, the purpose of this article is to examine when HMRC may consider issuing a Para 2 Notice and on what grounds they can be challenged.

One Supply or Many Supplies

Before considering whether there is a potential risk of being issued with a Para 2 Direction, one must consider the VAT consequences of the arrangements in place, as can be demonstrated by looking at two cases.

The well-established starting point is the contractual arrangements between the parties. In *A1 Lofts Ltd v HMRC* [2009] EWHC 2694 (Ch); [2010] STC 214, a single individual acted through a number of different companies: A1 Lofts Ltd, A1 Designs Ltd, MM Administration Ltd and MM Logistics Ltd. The individual was the sole director of all of the companies.

Under the contractual arrangements in place, the customer dealt with A1 Lofts Ltd and contracted for A1 Lofts Ltd to serve as project manager of the renovation work to be carried out. The paperwork provided was branded A1 Lofts Ltd and, as a matter of fact, the customers were generally unaware of the existence of the other companies. Then, acting as project manager, A1 Lofts Ltd contracted with other companies, including but not restricted to the related companies, to provide the necessary services in

designing and constructing the loft in accordance with the client's wishes.

A1 Lofts Ltd argued that, under its contract, it was acting as the agent of the client and each of the other companies was providing a separate supply to the client. HMRC, however, contended that A1 Lofts Ltd was making a single supply of all of the services to the client and was required to account for VAT on the whole amount.

Lewison J reviewed a number of the cases in the area and concluded that the starting point for determining the VAT consequences of any particular relationship is to analyse the contractual arrangements in place. Once the legal rights and obligations of the parties are identified, in accordance with the usual rules of construction, then it is possible to understand the VAT consequences of the arrangements in question.

Lewison J remitted the case to the FTT to reconsider in light of his judgment. The FTT held that the contractors were acting for A1 Lofts Ltd, and not for the client. The contractual documentation made clear that A1 Lofts Ltd was undertaking to provide the client with a completed loft renovation and so the

correct VAT analysis was that A1 Lofts Ltd was making a supply of a complete loft renovation to the client.

There were a number of important factors in the contractual arrangements which led the FTT to this conclusion:

- The contract between the client and A1 Lofts Ltd did not expressly authorise A1 Lofts Ltd to engage contractors on behalf of the client;
- The client may not have even been aware of the identity of the contractors, between whom there was no written contract; and
- The contract stated that A1 Lofts will "build your loft conversion" and, upon completion, the client signed a document which stated the work had been completed "by A1 Lofts".

This decision must be contrasted with the earlier case of *Kieran Mullin Ltd v Customs and Excise Commissioners* [2003] STC 274. The case concerned a hairdressing salon, which operated by renting

chairs to self-employed stylists under identical, standard contracts.

HMCE contended that it was KML as the salon who was providing a supply of hairdressing services to its clients, using the self-employed stylists as agents. However, Park J held that the individual stylists made separate supplies of hairdressing services to their clients and, as a consequence, no VAT was due.

Again, the starting point was the contract between KML and the stylists. The key provision was that KML contracted to provide a chair in its salon and the stylist agrees to rent the chair for a certain sum. Park J held it would be contrary to the provisions of that agreement for the stylist to provide services as a hairdresser to the salon. There were other provisions, under which the salon exercised tight control over the stylists, such as over pricing and holiday taken by the stylists. However, these provisions did not change the nature of the supply being made by the stylists to the customers.

As *Kieran Mullin Ltd* makes clear, it is possible for independent businesses (the salon and the stylists) to operate closely together without accidentally incurring additional VAT liabilities. However, this

requires close attention to the contractual obligations of the parties and, equally importantly, strict adherence to the performance of those obligations as specified in the contract.

VATA 1994, Schedule 1

Once it is established that the businesses in question are making separate supplies to customers, it is then necessary to examine the structure in order to determine whether there is a potential risk of a Paragraph 2 Direction being issued.

Paragraph 2(1) of Schedule 1 to VATA 1994 provides that:

> "**Paragraph 2**
>
> (1) Without prejudice to paragraph 1 above, if the Commissioners make a direction under this paragraph, the persons named in the direction shall be treated as a single taxable person carrying on the activities of a business described in the direction and that taxable person shall be liable to be registered under this Schedule with effect from the date of the direction or, if the direction so provides,

from such later date as may be specified therein."

This makes clear that the effect of a Direction under paragraph 2 is to create a hypothetical taxable person and treat him as if he was carrying on a business.

Paragraph 2(2) then makes clear that there are three requirements which must be satisfied for HMRC to issue a Notice. These are that:

(a) The persons named in the Notice are making, or have made, taxable supplies;

(b) That the activities of each person named form part of overall activities which are carried on concurrently or previously with other persons; and

(c) That, taken together, the business of the taxable person would be required to register for VAT under paragraph 1 of Schedule 1.

The consequences of a Paragraph 2 Direction are specified in paragraph 2(7). The hypothetical taxable person is required to register for VAT and any supply made by or to any of the persons named in the Direction are to be treated as a supply made by or to

the taxable person. Each person named is jointly and severally liable for any VAT due from the taxable person. In effect, the persons named are treated as a single entity for the purposes of VAT.

On the face of it, this appears to be a legalistic and technical test which is likely to catch a number of genuine business arrangements. However, paragraph 2 must be read in conjunction with paragraph 1A of Schedule 1, which states:

> "**Para 1A**
>
> (1) Paragraph 2 below is for the purpose of preventing the maintenance or creation of any artificial separation of business activities carried on by two or more persons from resulting in an avoidance of VAT.
>
> (2) In determining for the purposes of sub-paragraph (1) above whether any separation of business activities is artificial, regard shall be had to the extent to which the different persons carrying on those activities are closely bound to one another by financial, economic and organisational links."

Notably, it is no longer a requirement that the purpose of operating the businesses separately was to avoid the requirement to register for VAT. Although this was originally a fourth requirement of paragraph 2(2), it was repealed in 1997. This was confirmed by the VAT Tribunal in *Venubeast v HMCE* (VAT Decision 18863), where it was held that it was not necessary to reach any conclusion about the taxpayers' intentions. However, if there was an apparent intention to avoid registration for VAT, this would clearly be relevant to the question of whether the separation of the businesses was artificial.

Challenging a Paragraph 2 Direction

The ability of a taxpayer to challenge a Direction under paragraph 2 is limited. A right of appeal is available under section 83(1)(u) of VATA 1994. However, section 84(7) VATA 1994 makes clear that the appeal can only be allowed if the tribunal considers that HMRC could not have reasonably been satisfied that there were grounds for issuing a direction.

The starting point will be to ensure that HMRC have complied with all the necessary procedural requirements in paragraph 2. For example, a

Paragraph 2 Direction cannot operate retrospectively. Paragraph 2(1) specifies that the taxable person shall be liable to register for VAT "with effect from the date of the direction or, if the direction so provides, from such later date as may be specified therein." This makes clear that a direction can only take effect from either (i) the date of the direction or (ii) a later date that is specified in the direction. There is no statutory basis for it to take effect from a date earlier than the date of the direction and therefore cannot operate retrospectively.

This interpretation of the law was confirmed by the VAT Tribunal in *Elder v HMCE* (1999) VAT Decision 15881. HM Customs & Excise had issued a direction that specified a date earlier than the date of the direction by mistake. The tribunal held that:

> "The issue of the Direction is an important step in the registration process, and the Direction itself is an important document. The Tribunal cannot regard the error as immaterial; and cannot rewrite the terms of the Direction. The Direction seeks to do

> what, in law, cannot be done. It is therefore invalid and of no effect."

It follows that any direction which seeks to apply retrospectively will be void and ineffective.

Similarly, it was held in *Thompson, Thompson & Giblin v HMCE* (1989) VAT Decision 4196 (unreported) that if the identity of one of the persons named in the Direction is inaccurate, the Direction is invalid.

However, if the procedural requirements are satisfied and the taxpayer wishes to challenge the substance of the Direction, section 84(7) poses a significant challenge which must be overcome, although not impossible. This will likely turn on the question of whether the separation of the businesses is "artificial".

When is a Separation 'Artificial'?

Paragraph 1A(2) requires HMRC to have regard to "financial, economic and organisational links" between the different persons named in the Direction. These factors will not be the only considerations in determining artificiality – it was noted in *Venubeast* above that a deliberate intention

to avoid registration for VAT will be indicative of artificiality.

Conversely, it must be recognised that two or more businesses can have financial, economic or organisational links between them even if their separation is genuine. For example, in *Forster v HMRC* [2011] UKFTT 469 (TC), HMRC issued a Direction under paragraph 2 in respect of a farm and bed & breakfast accommodation in the farmhouse. The B&B business shared the use of the farmhouse, which belonged to the farm, and certain expenses of the B&B were paid for by the farm. Despite these links between them, the FTT held that HMRC could not have reasonably concluded that the separation between the businesses was artificial. In reality, the B&B business had been started separately from the farm and was run independently of the farm for legitimate reasons.

Nevertheless, the presence of financial, economic and organisational links will no doubt be important in any analysis, given their prevalence within paragraph 1A.

In *The Grand Folkestone Limited v HMRC* [2016] UKFTT 291 (TC), the tribunal entered into a detailed

discussion of the economic, financial and organisational links that existed between the different entities in question and it therefore provides a helpful starting point in determining whether a separation of businesses is genuine or artificial.

The facts of *The Grand Folkestone Limited* are a number of businesses operated out of the same premises. One offered short and long-term accommodation; another operated a restaurant; another operated a bar etc. In effect, the result was that the businesses together provided the services of a hotel, but through a number of supposedly separate and distinct entities.

HMRC concluded that this separation was artificial and that the conditions for issuing a Direction under paragraph 2 were satisfied. A number of reasons were given in the Direction in order to justify this conclusion, which was ultimately upheld by the FTT on appeal.

HMRC identified a number of financial links between the different businesses. For example, the entities in question operated through a single bank account, into which only one payment was made for the

services of many of the different entities operating on the premises. Further, all cheques were paid into the same bank account; purchases by many of the entities were made on the same credit card and one entity would incur costs on behalf of another entity without imposing any charge for doing so. This was exacerbated by attempts in the annual accounts of the entities to suggest that such charges were being made.

Economic links, in contrast, refer to the viability of the businesses in carrying out their activities separately from each other. For example, in *The Grand Folkestone*, the different entities operated through a single website and a single "corporate profile". Consequently, customers were likely to associate all of the businesses together and would only be familiar with the overarching brand, rather than the businesses' individual identities. This was the case even though it was not possible to book "packages" with the separate entities, so that each service needed to be arranged separately.

Finally, there were a number of organisational links between the entities. All of the entities were either managed or owned by one of a husband or wife; stock

was centrally managed and ordered on behalf of all of the entities and all of the entities made use of the same accounting company, which had the same husband and wife directors as the other entities. The mere fact that the businesses operated through distinct legal entities, and therefore dealt with their corporation tax obligations separately, was unsurprisingly insufficient.

In conclusion, the FTT held that the taxpayer had failed to demonstrate that HMRC could not have reasonably been satisfied that there were grounds to issue a Direction under paragraph 2.

The management of the entities and their finances in *The Grand Folkestone* serves as a good example of what not to do. Simple steps could have been taken to cement the separation of the entities. For example, each entity should have its own bank account and should generally be responsible for making its own purchases. Where the entities provide services to each other or share assets, it would be advisable for the entities to cross-charge each other.

Economically, it may not be possible to avoid developing strong links between separate businesses that are dependent on each other as part of their

successful business model. However, steps can be taken to ensure that their individual identities remains clear. It should be clear to potential customers that the services are being provided by separate and distinct entities. This should be apparent from advertising and promotional materials, such as through individual websites for each entity. The essential distinction is between multiple entities providing a bundle of services, rather than being perceived to be a single unit which provides a comprehensive package.

Finally, a number of organisational links can be avoided by maintaining clear and accurate paperwork between the separate entities. For example, ensuring that invoices are sent out in the names of the correct entity. Although it is a little more difficult, it would also be advisable to ensure that each entity maintains a distinct and clear line of management, so that it is clear to whom employees within each entity are accountable.

Conclusion

There are many reasons why businesses may operate closely with one another. It may provide greater flexibility for each individual business, or offer a

more comprehensive package of services for customers. However, any business must tread carefully to ensure that they do not accidentally create significant VAT liabilities for themselves.

Ultimately, the test is whether the separation between the businesses is artificial or not. As is so often the case, it will be easier and cheaper for the entities to take pre-emptive steps to maintain their individual identities and the separation between them. Although it may be tempting to achieve small cost-savings by cutting corners, this may leave them exposed to much more significant liabilities in the future. Prevention will be less painful than seeking a cure through the tribunals.