FIELD COURT TAX CHAMBERS

FCTC DIGEST

22nd Edition (October 2024)

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EDITORIAL

Patrick Soares

Welcome to the 22nd Edition (October 2024) of the FCTC Digest.

The first article by the editor looks at a **gift of shares which qualifies for IHT business property relief (BPR) and the CGT relief for gifts of business assets** (under Taxation of Chargeable Gains Act 1992 s165). There are some (pleasant) surprises in store if the shares do not later qualify for the IHT business property relief. It also looks at the "BPR 7 year insurance policy."

The second article is by **Patrick Way KC**. This article considers **what liabilities can be deducted for IHT purposes** and focuses on the anti-avoidance provisions in the Inheritance Tax Act 1984, and in the Finance Act 1986, s.103 as that section was considered in the *Pride* and *Elborne* cases. His conclusions on four types of debts are as follows: if the liability has been artificially created it is not going to be deductible; if the liability drives down the value of a chargeable asset in order to give money to a "tax-free asset" that will not work either; if the relevant liability is never going to be repaid anyway then there is no deduction for it; if there is circularity of assets for a liability in return – forget it! Read the article to see how he came to these conclusions.

The third article is by **Peter Vaines** on IR35 and the intermediaries legislation and the recent decision of *HMRC v Barnes [2024] UKUT 262*. This is the latest case in the **"absurd saga of IR35."** Strong language from Peter – read the article and see if you agree with him.

The fourth article is by **Dilpreet K. Dhanoa**. In this article Dilpreet looks at the relevant cases – old and new – which provide much needed sign posts to taxpayers when they have the unenviable task of applying the multifactorial test to determine **the location of a source of interest for income tax purposes.**

The fifth article is by **David Southern KC.** He gives his practical tips on how to deal with **COP enquiries**. These boil down to three cardinal rules:

- never ignore correspondence;

- never write rude letters;
- throw the occasional bone.

The sixth article is by **Richard Collier** and he reflects on the CJEU decision of the *Apple Ireland State Aid case*. This concerned the **profits to be attributable to an Irish branch** of a foreign resident company. The court seemed to apply a crude "default" test – read the article to see what it was and the implications of the same.

Patrick C Soares

FCTC

GIFTS OF SHARES WHICH QUALIFY FOR IHT AND CGT RELIEFS

PATRICK C SOARES

There are two relevant reliefs to consider when shares in a family trading company (which includes a property development company but not a property investment company) are given away to the next generation or into trust.

The first is IHT business property relief ("BPR") (IHTA 1984 s103 et seq) and the second is the CGT relief for gifts of business assets ("RGBA") (TCGA 1992 s165).

Assume the gift of the shares dealt with in this article qualify for both reliefs: generally it is easier for shares to qualify for BPR than for RGBA.

SITUATION 1 FATHER GIVES SHARES OUTRIGHT TO SON

IHT

IHTA 1984 s104 reduces the value of the property transferred to nil.

There can be no possible charge to IHT after 7 years. Note there must not be a reservation of benefit by the father (FA 1986 s102).

<u>7 year retention period</u>

There can be a charge within the 7 years if the gifted property does not qualify for BPR at the time of the father's death: that is *the general rule*.

<u>Switch to investment company not a problem</u>

A special rule applies, however, where the gift is of shares in an unquoted trading company, which qualifies for BPR at the time when they are given away.

In this case, if the shares continue to be held by the donee until the donor's death within the 7 year period the relief is available: *it is not required that the company concerned continues to qualify as a trading company*.

So, if the shares given away qualify for BPR at the time of the gift, but not thereafter, this in itself will not affect the IHT relief (IHTA 1984 s113A(3A)(b)) on the gift on the death of the transferor.

The retention of the shares by the son therefore acts as an IHT insurance policy.

This can be relevant for example if a property development company converts to a property investment company in the 7 year period.

<u>Example</u>

The father owns unquoted shares in a property development company. It is anticipated this will become an investment company. He gives the shares to his son while it qualifies for BPR. After the gift it becomes an investment company. The father dies within the 7 years when it is an investment company and whilst the son still owns the shares. No IHT is payable on the shares.

CGT

The CGT gain can be held over when the gift is made if an election is made under TCGA 1992 s165(4).

Generally the son must be resident in the UK (TCGA 1992 s166: note s167A)

If the son becomes non-UK resident within 6 years of the gift the gain will crystalise.

<u>Unusual – no holding period for the CGT relief</u>

One attraction in the RGBA is there is no share holding period (by the father in this case) before the relief applies. This is unusual as most reliefs of this nature require a one or two year holding period. BPR requires a 2 year ownership period by the father.

SITUATION 2 FATHER GIVES THE SHARES TO A SETTLEMENT

There will be no charge to IHT as BPR will be available and the CGT gain can be held over under RDBA. The trustees should hold on to the shares for 7 years. The father must not reserve a benefit in the gifted property.

SITUATION 3 FATHER HAS INTEREST IN POSSESSION (CREATED BEFORE 22 MARCH 2006) AND SHARES ARE ADVANCED TO SON

There will be a nil value transfer for IHT purposes (IHTA 1984 s104) by the father and the gain can be held over under RDBA if the son is resident in the UK.

The son must hold on to the shares for 7 years (IHTA 1984 s113A) and the father must not reserve a benefit in the gifted shares (FA 1986 s102).

McCutcheon on IHT at 5-18 states the *general rule*;

> "...if A, a life tenant with a qualifying interest in possession, surrenders his qualifying interest so that the trust fund passes to his daughter, B, absolutely, A will have made a PET
>
> The father's interest in possession will enable him to have satisfied the 2 year holding period for BPR purposes."

HMRC accept this in IHTM25302 which reads thus (my emphasis):

> "**IHTM25302 - The ownership test: Meaning of ownership**
>
> For the purposes of the ownership test (IHTM25301) ... we consider ownership to have the following meaning

- in the case of settled property in which there is no qualifying interest in possession, legal ownership by the trustees,
- **in all other cases, beneficial entitlement (IHTM04031), which includes entitlement to settled property in which the deceased/transferor had a qualifying beneficial interest in possession (IHTM16060).**

SITUATION 4 FATHER HAS INTEREST IN POSSESSION (CREATED BEFORE 22 MARCH 2006) AND SHARES CONTINUE TO BE HELD IN THE TRUST BUT ON NEW SUB-TRUSTS FOR THE SON UNDER WHICH THE FATHER IS EXCLUDED FROM ALL BENEFIT

There cannot be a PET as the estate of the son on any analysis is not increased.

However to the extent the gift does not increase the value of the estate of the son (because it remains in the settlement) there is a chargeable transfer unless

BPR is available. IHTA 1984 s49(1A) states the trust funds (if the funds remain in the settlement) are not to be treated as part of the estate of the son so there is a chargeable transfer problem under general principles unless BPR is available.

Dymond's Capital Taxes at 3.722-725 states the *general rule*:

> D has a qualifying interest in possession being the life tenant of a settlement set up in 2003 by his father. D's interest in possession is terminated in …. part and his daughter E takes an interest in possession in that part. ……… if D's interest is terminated on or after 6 October 2008 this cannot be a PET unless E takes the trust fund absolutely. If E merely takes an interest in possession her estate is no longer increased (because she is not treated as acquiring a qualifying interest in possession and therefore is not deemed to own beneficially the underlying property).

Thus BPR is vital in this situation.

There will be no CGT disposal in the normal case where there is such a trust reconstruction: see the *Hart v Briscoe* [1979] Ch 1 line of cases culminating in *Swires v Renton* [1991] STC 490.

SITUATION 5 FATHER HAS INTEREST IN POSSESSION (CREATED BEFORE 22 MARCH 2006) AND SHARES ARE ADVANCED TO A WHOLLY NEW UK SETTLEMENT FOR THE SON

There will be a CGT disposal but the gain can be held over (TCGA 1992 Sch 7 para 2).

BPR will be available and the 2 year BPR ownership requirement is satisfied by the father having the interest in possession for 2 years.

The new settlement must hold on to the shares for 7 years (note there are certain reliefs for share exchanges and the like).

CONCLUSION

As the law presently stands (pre-Budget 30 October 2024) there is an attraction in the father keeping the shares until his death: the gain on death is washed and no IHT is payable because of BPR. The fear is the gain washing on death will be removed by the government and BPR restricted.

DEDUCTIONS FOR INHERITANCE TAX LIABILITIES, AND THE S.103 TRAP

Patrick Way KC

Speed read

The value of an estate on death is reduced, of course, by the quantum of allowable liabilities.

This article considers what liabilities can be deducted and focuses on the anti-avoidance provisions in the Inheritance Tax Act 1984, and in the Finance Act 1986, s.103 as that section was considered in the Pride and Elborne cases.

Liabilities generally

The following is a short set of building blocks taking us through the definition of an estate and into the definition of qualifying liabilities.

Transfers on death

Under the Inheritance Tax Act 1984 ("IHTA 1984") s.4, as we all know, inheritance tax arises on an individual's death as if they had made a transfer of value equal to the value of their estate immediately before their death.

Under IHTA 1984 s.5 "estate" is widely defined but, in s.5(3), we find that one can take account of an individual's liabilities so far as the Act does not exclude them.

Section 162 liabilities

The basic rule is found in s.162 and provides that, for example, a liability in respect of which a right to reimbursement exists can only be taken into account if that reimbursement right cannot reasonably be expected to be obtained – so nothing strange there.

Key anti-avoidance sections

Now we get to the anti-avoidance provisions in IHTA 1984.

Section 162A – liabilities attributable to financing excluded property

This section provides that you cannot borrow against ("charge") UK property in respect of loans to you which are then used to finance the purchase of excluded property (if you are a non-domiciled individual). So, you cannot "have your cake and eat it" by getting a deduction against chargeable assets and acquiring non-chargeable assets with the borrowings.

Section 162AA – liabilities attributable to financing non-resident's foreign currency accounts

This section means that you cannot fund a non-resident's foreign currency account by borrowings which are then charged against UK assets. Again, you cannot "have your cake and eat it".

Section 162B – liabilities attributable to financing certain relievable property

Next, you cannot charge borrowings against chargeable assets in order to buy relievable assets which, for example, might afford you Business Property Relief.

IHTA 1984 s.175A – discharge of liabilities after death

Finally, we need to look at the s.175A provisions. These provide that when looking to see (basically) whether a liability is "real" you ignore it if it is unlikely to be repaid in the near future. (This is putting a big gloss on detailed wording – but you see what I mean, no doubt.)

This anti-avoidance provision came about because so many people were using structures such as employee benefit trusts together with "artificial loans". For example, a company might set up an EBT for the benefit of an individual. The EBT might then lend that individual a lot of money (say, £10m.) but with soft terms (to put it mildly) as to repayment and rates of interest. For example, the repayment of the loan might be postponed for 50 years or more and there might be no interest in the meantime. By virtue of s.175A the liability in the individual's estate is effectively ignored – it is never going to be repaid. So there will be no deduction for the liability – it's "a sleight of hand".

The main anti-avoidance provision – FA 1986 s.103

This brings us to the main thrust of this article which is to look at FA 1986 s.103 particularly because of the *Pride* and *Elborne* cases from last year.

The simplest thing is just to set out s.103(1) below:

> "(1) Subject to subsection (2) below, if, in determining the value of a person's estate immediately before his death, account would be taken, apart from this

> subsection, of a liability consisting of a debt incurred by him or an incumbrance created by a disposition made by him, that liability shall be subject to abatement to an extent proportionate to the value of any of the consideration given for the debt or incumbrance which consisted of—
>
> (a) property derived from the deceased; or
>
> (b) consideration (not being property derived from the deceased)given by any person who was at the time entitled to, or amongst whose resources there were at any time included, any property derived from the deceased."

It might help if I say that the word "consideration" is read in the following context, "you will have the benefit of a debt in my estate provided that you pay me (consideration) by way of lent money sums that entitle you to that debt in my estate".

Anyway, what does s.103(1) mean?

You apply the following process by asking two questions and then coming to a conclusion:-

(a) is there a liability incurred by the deceased?;

(b) is there an incumbrance created by the deceased?;

(c) in each case was there "circularity" so that the amounts lent back or representing the incumbrance came from the deceased in the first place.

If so, the liability or incumbrance will be reduced accordingly by the amount passing back round the circle:

> "Here is £1m. Please lend it back to me so that I have a liability in my estate of £1m."

> "Oh, no you won't!" Section 103 will abate the £1m. liability to nil.

The next bit of s.103 to look at is subsection (2) which reads as follows:-

> "(2) If, in the case where the whole or part of the consideration given for a debt or incumbrance consisted of such consideration as is mentioned in

subsection (1)(b) above, it is shown that the value of the consideration given, or of that part thereof, as the case may be, exceeded that which could have been rendered available by application of all the property derived from the deceased, other than such (if any) of that property—

(a) as is included in the consideration given, or

(b) as to which it is shown that the disposition of which it, or the property which it represented, was the subject matter was not made with reference to, or with a view to enabling or facilitating, the giving of the consideration or the recoupment in any manner of the cost thereof, no abatement shall be made under subsection (1) above in respect of the excess."

What does this mean? In effect, it means that if some of the liability is not caught by s.103 (i.e. it does not emanate from a scheme) then the excess is OK and will qualify as a deductible liability.

Finally, we need to look at s.103(3) which reads as follows:-

> "(3) In subsections (1) and (2) above "property derived from" means, subject to subsection (4) below, any property which was the subject matter of a disposition made by the deceased, either by himself alone or in concert or by arrangement with any other person or which represented any of the subject matter of such a disposition, whether directly or indirectly, and whether by virtue of on or more intermediate dispositions."

What does this mean? It simply means that the anti-avoidance provisions are very wide. "Here are £1m. of assets and a debt of £1m." and there is an over-arching arrangement – s.103 probably catches it.

How do the courts look at these sorts of schemes and tax avoidance generally?

We need to remind ourselves that the courts hate tax avoidance. You won't win a case involving avoidance. Seriously, you won't.

This is because these days, most judges look at the words of Lord Reid (or similar) as expressed in *UBS AG v Revenue & Customs Commissioners (and DB Group Services (UK) Limited v Revenue & Customs Commissioners)* ([2016] UKSC 13, [2016] 1 WLR).

At paragraph 63 of the UBS case there is a reference to the *Barclays Mercantile Business Limited v. Mawson* – [2005] 1 AC 684, HL (E), para.32:

> "32. The essence of the new approach was to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description … As Lord Nicholls of Birkenhead said in *MacNiven v Westmoreland Investments Limited* [2003] 1 AC 311, 320, paragraph 8: 'The paramount question is always one of interpretation of the particular statutory

> provision and its application to the facts of the case.'"

Lord Reid then said at paragraph 64 of *UBS*:-

> "64. This approach has proved to be particularly important in relation to tax avoidance schemes as a result of two factors identified in *Barclays Mercantile*, paragraph 34. First, "tax is generally imposed by reference to economic activities or transactions which exist, as Lord Wilberforce said, 'in the real world'". Secondly, tax avoidance schemes commonly include "elements which have been inserted without any business or commercial purpose but are intended to have the effect of removing the transaction from the scope of the charge."

In a nutshell, therefore, the new likely approach to s.103 in effect involves the following process requiring two questions and then a conclusion:-

(a) are there debts and/or incumbrances?; and

(b) were these introduced pursuant to tax planning?;

(c) if so, s.103 is probably in point to abate the value of the liability by reference to the value of other "related" transactions.

<u>Pausing there</u>

Perhaps we can just look at what s.103 was effectively meant to catch.

The original intention of s.103 – long since gone because of the new approach which catches much more complicated arrangements – was meant to deal with the following typical situation:

Example

A father has £1m. cash in his estate.

He makes a gift of the £1m. to his son and (hopefully) survives by 7 years.

The son then lends the £1m. back to the father.

The intention of the planning, of course, is that, therefore, on the father's death there should be a liability as to the sum of £1m. in his estate but because the consideration for that liability has come by way of a transfer from the father to the son – in the first place (here by way of a gift) – then (pursuant to FA 1986 s.103) the liability has to be abated by the value of that gift from the father. The gift forms the consideration for the debt. Therefore the liability is reduced to nil.

<u>The *Pride* and *Elborne* cases</u>

FA 1986 s.103 has been considered recently in two cases, namely *Pride* and *Elborne*.

Pride v HMRC [2023] UK FTT 00316 (TC)

Mrs. Pride was the beneficiary for a pre-2006 life interest trust (the "Property Trust") which meant that the value of the assets in that trust would be taxed in her name (IHTA 1984 s.49).

The trustees gave an indemnity in respect of loan notes that were acquired by a separate Children's Trust.

It was argued on Mrs. Pride's death that the indemnity was effectively a deductible liability for the purposes of the inheritance tax liability on her death.

The First-tier Tribunal disagreed.

Effectively the loan notes in the separate Children's Trust were acquired with the help of the liability in Mrs. Pride' own Property Trust in which she had a beneficial interest. Therefore it was held that s.103 applied and the liability incurred by the Property Trust could not be deductible.

Put another way, in the view of the FTT, in determining the value of her estate, account should be taken of any liability consisting of a debt incurred by Mrs Pride or an incumbrance created by a disposition made by Mrs Pride. Viewed realistically, the loan notes were a debt incurred by the Property Trust, and it was the Property Trust that assumed the liabilities through the indemnity it gave when the loan notes were acquired by the Children's Trust. Further, by operation of the deeming provision in s.49(1), ITA, the loan notes were to be treated as a debt incurred by Mrs Pride. That was because the purpose of the statutory fiction of s.49(1) was that trust property, subject to trust liabilities, was beneficially held by the trust beneficiary, and the inevitable consequence of Mrs Pride's deemed 'holding' of the liability was that she 'incurred' the debt represented by the loan notes for the purposes of FA 1986 s.103. In determining the value of her estate, and in accordance with s.103(1), the loan note liability fell to be abated in its entirety as the whole of the consideration given for the loan note debt consisted of property derived from Mrs Pride.

Executors of Elborne v HMRC ([2023] UK FTT 626 (TC))

Finally, we come to the *Elborne* case which also considered the ambit of FA 1986 s.103.

This case involved the so-called famous "home loan scheme". Accordingly, Mrs. Elborne sold her house to an old-fashioned interest in possession trust for a consideration taking the form of an IOU which was issued back to her by the trustees. She then gave away that IOU (as the beneficial owner of the benefit of the IOU) to a separate children's trust, and then she survived seven years.

On her death the interest in possession trust therefore had a liability to pay the children's trust the IOU and the question was whether s.103 applied to abate the value of the liability represented by the IOU.

There were all sorts of arguments which were put forward including reservation of benefit but in the end the Tribunal dismissed each of HMRC's arguments save for one vital ("killer") exception. This was that under s.103 the amount of the liability under the loan note should be abated to nil.

As we know, s.103 provides that a liability incurred by the deceased should be abated proportionately to the value of any consideration given for the debt which derived from the deceased. In the Tribunal's view, HMRC's s.103 argument succeeded. The result was that, "in valuing Mrs Elborne's estate immediately before her death, the liability under the IOU should be abated by an amount equal to the value of her home on the date when beneficial ownership in the home passed to the trustees of the interest in possession settlement. This meant that the value of the liability was abated to nil. The planning had therefore failed to take the value of Mrs Elborne's home outside her estate for IHT purposes.

In other words, HMRC was successful in submitting that the value of the IOU should be abated by the full value of the consideration provided by Mrs Elborne in the first place – the value of her home.

Thus, the value of the interest in possession at the date of the death was the value of the home less nothing. In other words, the debt was abated in full to zero pursuant to s.103.

Conclusion

It will come as no surprise to hear that in ascertaining what liabilities are deductible one applies what might one call the "new approach" or even a "common sense approach". If the liability has been artificially created it is not going to be deductible. And if the liability drives down the value of a chargeable asset in order to give money to a "tax-free asset" as it were that will not work either. Also, if the relevant liability is never going to be repaid anyway then there is no deduction for it.

And finally, if there is circularity of assets for a liability in return – forget it!

IR35 AND THE INTERMEDIARIES LEGISLATION

HAVE WE LOST THE PLOT?

Peter Vaines

The recent decision in *HMRC v Barnes [2024] UKUT 262* (the outcome hardly matters) is the latest in the increasingly absurd saga of IR35 and the intermediaries legislation in sections 48 to 61 ITEPA 2003, and the equivalent provisions for NIC in Regulation 6 of the Social Security Contributions (Intermediaries) Regulations 2000. This won't be the last. In fact, this litigation will continue indefinitely until this wasteful and damaging legislation is amended to something workable.

The absurdity and wastefulness comes from the fact that the courts are able to come to opposite conclusions on virtually, if not exactly, the same facts. There are so many decided cases that HMRC can look at the list and see loads of them which support their view – and the taxpayer can do exactly the same. Both sides are therefore encouraged to litigate (and to appeal) and we end up with cases like *Atholl House* where the taxpayer won in the FTT, won again in the Upper Tribunal but then the Court of Appeal remitted the case to the FTT to start all over again. The costs involved exceeded the tax at stake. This means that both sides ended up losing; not for the first time, the only winners were the lawyers.

(See also the note below on the decision of the Supreme Court in *Professional Game Match Officials Ltd v HMRC [2024]UKSC 29* which has just been published.)

The inconsistency is not only a colossal waste of time, but it undermines the authority of the Tribunals to have so many cases which are in direct conflict with each other. It is also frustrating for taxpayers and their advisers who do not know where they are – quite apart from the significant question of costs, not least from the public purse. In any other walk of life, the words "not fit for purpose" would spring to mind, and so would the words "something must be done".

This situation is the result of legislation which seeks to tax people on the basis of a fantasy. A person may enter into a bona fide commercial contract with another person – but as far as tax is concerned, this is ignored. The legislation assumes that there is a different contract on different terms with somebody else, and HMRC then charges tax on the basis of this fantasy.

We can all understand that where the contract between the parties is not genuine, being some kind of artifice or sham, HMRC are quite properly entitled to disregard the pretence and charge tax on the real commercial relationship. But the intermediaries legislation does not deal with artifice – it deals with real, binding contracts which have been vigorously negotiated by lawyers on both sides and there is no doubt about the true commercial relationship. Never mind about that. The legislation enables HMRC to disregard it and to charge tax on the basis of a contract which does not exist (and which neither party intended nor wants – nor would have entered into) but is the result of imagination. Such are our powers of imagination (which is truly a gift, enhancing our lives in so many fields) that it is no wonder that the courts can come to contradictory conclusions.

HMRC are very keen (and rightly so) to insist that people should be taxed on the basis of the legal consequences of their actions and give short shrift to anybody who says they could have done the transaction in a different way with the same result and would have paid less tax. In *Boston Khan v HMRC 2020 UK UT 0168* the Upper Tribunal explained that the taxpayer:

> "is to be taxed in accordance with the transaction that he did enter into and not by reference to the transactions that he was about to enter into (but did not) even if they might have left him in the same economic position".

The enthusiasm for contractual integrity seems to run out when it comes to personal service companies where HMRC seek to charge tax by reference to a transaction that the taxpayer did not enter into – and had no intention of entering into – if it would yield more tax. (A moments thought will reveal the enormous tax revenues which could arise from adopting this approach more widely).

The position is made worse by the difficulty in determining whether a person is employed or self-employed. These are very different concepts giving rise to very different legal consequences. I need not go into them – they will be well known to anybody with commercial experience of a business. The problem is that in some circumstances they can appear very similar, and nobody knows where the dividing line is.

It ought to be one of legal analysis. I would suggest that some rigour needs to be applied to the distinction between an employment and self-employment. Unfortunately, the tests for distinguishing an employment from self-employment are subject to such variation that they have lost any real meaning, and everybody can come to their own conclusion which they can claim is right. One could equally well ask: Is Vivian Richards or Sachin Tendulkar a better batsman than Donald Bradman? – or is Ben Stokes a better all-rounder than Ian Botham? There will be many views – and no right answer. It depends on your view about which tests to apply and what weight you give to them. (And if you don't know anything about cricket, it would be even more difficult).

In the context of employment and self-employment, let us consider the position of a famous concert pianist who is engaged to play Beethoven's Piano Concerto No 3 at the Albert Hall. He turns up and he is paid for the performance – so there is your mutuality of obligation. Do they have control over his services? Of course. He must attend at a specific place on a specific day, at a specific time and will play a specific piece on a specific instrument. Indeed, the control is even more profound. The piece he is being paid to play has certain specific notes and he will be told that he must play every one of them the right number of times and in exactly the right order. And at all times he will be under the express direction of a man with a stick. He is not permitted to send a substitute, nor will he provide his own equipment; the piano will be supplied, and all the supporting people in the orchestra will also be provided, and he will not be permitted to hire his own helpers.

On all the tests we are required to consider from the multiplicity of cases (including those relating to personal services companies), the pianist would undoubtedly be regarded as an employee. However, we know with equal certainty that he is not – and that will be the case whether he was directly engaged or whether he provided his services through his personal service company.

This is not a bizarre or contrived set of circumstances; it is a perfectly normal situation which occurs in various ways all the time. Accordingly, the principles which are said to be relevant ought to provide the answer. But they clearly do not. Nowhere near. They just result in a lot of head scratching.

How do we reconcile this with the various FTT and Upper Tribunal decisions? With difficulty. It must partly be the way the principles are applied – or more likely, there are many more factors which ought to be taken into consideration before the right answer can be found. Or maybe HMRC's paranoia about people being self-employed is distorting everything and we ought to return to some proper principles.

Whatever the reason, clearly something has gone wrong. IR35 has grown into a monster which is out of control and gobbling up resources – and interfering with the capacity for reason. It is time for a sensible analysis of the distinction between employment and self-employment and an appreciation of the genuine differences which exist between them – and for the tax rules to be applied in an appropriate way. Without reform, the litigation will simply continue unchecked to everybody's (well, nearly everybody's) detriment.

Postscript: Supreme Court decision

On 17th September the Supreme Court released their judgment in the case of *Professional Game Match Officials Ltd v HMRC [2024]UKSC 29* which related to part time football referees. This is not an IR35 case because there was no intermediary company but it is crucial to the intermediaries legislation which always depends on whether or not the hypothetical relationship would represent a contract of employment.

HMRC claimed that the part time referees were employees. PGMOL said they were not employees by reference to all the conventional tests – mutuality of obligation, control etc. The FTT agreed with PGMOL; the Upper Tribunal also agreed; the Court of Appeal did not disagree but were not happy about the manner in which the tests had been applied to the facts and remitted the case to the FTT for reconsideration.

The Supreme Court have now decided that this was the right thing to do – so back it now goes to the beginning for consideration by the FTT, but with some important legal guidance from the Supreme Court on the meaning of mutuality of obligation and control.

(Actually we can forget mutuality of obligation; that only relates to whether a contract exists, and gives no indication of the nature of the engagement. So we are left with *control*. But we know from *Ready Mixed Concrete* that "control is not everything" – but maybe that is an argument for another day).

We seem to be a long way from a conclusion here. Whatever the FTT decide next, the matter seems destined to end up for a second time in the Supreme Court on the substantive issue – after many more years. I will probably read about it in my Care Home.

TAXABLE JURISDICTION OR JURISDICTIONAL TAX?

Some lessons learnt from *Bank of Greece* and *Ardmore* and a few other cases in-between…

Dilpreet K. Dhanoa

"The Income Tax Acts, however, themselves impose a territorial limit, either that from which the taxable income is derived must be situate in the United Kingdom or the person whose income is to be taxed must be resident there."[1]

Introduction

This well-known paragraph from Lord Herschell's judgment in *Colquhoun v Brooks*, remains to this day the starting point when considering territoriality and jurisdiction as a principle with respect to taxation.[2]

This case concerned an Australian citizen resident in England, who was a sleeping partner in a business

[1] *Colquhoun v Brooks* (1889) 14 App Cas 493, *per* Lord Herschell at p. 504.
[2] See: *R (on the application of Prudential plc and another) v Special Commissioner of Income Tax and another* [2013] UKSC 1, at [117].

wholly conducted in Australia. Part of his share of the profits was remitted to him in England, with the remainder being retained in Australia. The Inland Revenue sought to charge tax on the unremitted profits (by the then in force Income Tax 1852, sections 1 and 2). The relevant provision provided that income tax is charged for and in respect of annual profits accruing to any person resident in the United Kingdom from any trade. The Court held that tax was not chargeable on the unremitted profits, despite the fact that the literal meaning of section 1 plainly covered them. The Court came to the view that the literal application of the provision would render a result contrary to the comity of nations. Lord Esher MR (in the Court of Appeal) said specifically:

> "...the English parliament cannot be supposed merely by reason of its having used general words to be intending to do that which is against the comity of nations. It is true that if we came to the conclusion that this had been intentionally done we must carry out the law and leave to the government of the country the task of answering objections, but unless that is perfectly clear we ought to limit the words so as to make them reasonable and proper
> ... I come to the conclusion that the statute was only dealing with that with which it has a right to deal, and not with land or

> business carried on in other countries with which we have no right to interfere, and that the words must be limited, and do not apply to an absolutely foreign trade, no part of which is connected with this country."

This was the clear position set out by the court in its interpretation and application of a provision that, in theory, extended the territorial limits of the jurisdiction to tax. In reversing the decision before them, the Court of Appeal came to the resounding conclusion:

> "The maxim "Expressio unius, exclusio alterius,"[3] has been pressed upon us. I agree with what is said in the Court below by Wills, J., about this maxim. It is often a valuable servant, but a dangerous master to follow in the construction of statutes or documents. The exclusio is often the result of inadvertence or accident, and the maxim ought not to be applied, when its application, having regard to the subject-matter to which it is to be applied, leads to inconsistency or injustice.
>
> I think a rigid observance of the maxim in this case would make other provisions of

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[3] *A Latin phrase meaning 'the expression of one thing is the exclusion of the other'.*

> the statute inconsistent and absurd, and result in injustice. I cannot, therefore, permit it to govern my decision."

This article argues that there has been a relatively significant shift since the judgments of Lord Esher and Lord Herschell. In the more recent case of *Hargreaves*[4] – whereby it was argued before the First-tier Tribunal and Upper Tribunal, that the interest should not be regarded as 'arising in the UK' – certain factors were seen as containing more weight than others. This article looks to exploring what lessons have been learnt since the late nineteenth century concerning the jurisdiction to tax (in the context of interest).

<u>The case of *National Bank of Greece*</u>

The first case to consider is the *National Bank of Greece*[5] case.

The brief facts of the case were that a banking company incorporated in Greece and neither resident nor carrying on business in the UK, issued sterling mortgage bearer bonds secured on lands and

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4 See: [2021] UKFTT 390 (TC), [2022] UKUT 34 (TCC) and [2024] EWCA Civ 365 – all of which Patrick Way KC and Dilpreet K. Dhanoa, members of Field Court Tax Chambers, were involved.

5 *National Bank of Greece SA v Westminster Bank Executor and Trustee Co (Channel Islands) Ltd* [1971] 1 All ER 233.

public revenues in Greece which carried interest payable in London. The principal and debt were guaranteed by another Greek bank neither resident nor carrying on business in the UK, and the transaction was governed by English law.

Of importance to the factual background: Greece at the time passed a moratorium law making it illegal for the Green bank or its guarantor to repay the principal or interest and the National Bank of Greece therefore took over the repayments. They deducted income tax before making the payments, contending that, because the guarantee could only be enforced in England, the payments were annual payments from a UK source taxable under (former) Sch. D, Case III. It was held that the National Bank of Greece had no different obligation from the original guarantor under the terms of the bonds and since the bonds were a foreign source, the payments were taxable under (former) Sch. D, Case IV and tax was not deductible at source. In a passage often quoted as the starting point in this arena, Lord Hailsham LC said:

> "Speaking for myself, I do not see how an obligation originally situated in Greece for the purposes of British income tax could change its location either by reason of the fact that one guarantor had been substituted for another, or by reason of the fact that the second guarantor so substituted subsequently acquired a London place of business, or by reason of

> the fact that the Government of Greece had by retrospective legislation altered by moratorium and substitution of a new guarantor for the purposes of Greek law the obligations imposed upon the principal debtor and the guarantor. The Appellants acquired no obligation different from that of the original guarantors, and that was the obligation imposed on the original guarantors by the terms of the bonds. In my view, the bond itself is a foreign document, and the obligations to pay principal and interest to which the bond gives rise were obligations whose source is to be found in this document."

Although at first blush, Lord Hailsham's judgment appears to set out a position that a foreign obligation could not acquire a UK element such that it was to become subject to UK tax, there is a small twist. The underlying documentation said that the transaction was to be governed by English law, and payment of interest was to be in London. Looking again then at Lord Hailsham's judgment, it is a little less clear as to what factors were to be attributed particular elements in a factual matrix. Especially when considering, for example, that the underlying documentation in *Bank of Greece* had pointed both to England and Greece is possible territories for taxing.

Accordingly, the most that can be drawn from the case is that: to be a foreign security, the obligation had to be either a bearer document or executed under seal, and had to be governed by a foreign law, executed and kept outside the UK and to provide for interest, in a currency other than sterling, to be kept payable and paid outside the UK.

<u>The case of *Hafton Properties*</u>

Almost two decades later, a similar set of issues was raised in the case of *Hafton Properties*.[6] T Co was a property investment company which in 1980 borrowed GBP 350,000 from Savings and Investment Bank Ltd, which was an Isle of Man Bank having its registered office in Douglas. T Co made payments of interest to the bank without deducting income tax under the Income and Corporation Taxes Act, section 54.

The Inland Revenue sought to argue that the debt (originally owed by an American company), had been assumed by a UK-resident company. The Revenue therefore argued that because the new debtor was a UK-resident company, the debt had a UK situs, and the source of interest was also in the UK and thus chargeable under (former) Case III. The Special Commissioner rejected that submission, referring to Lord Hailsham's disinclination to regard sources of income as being peripatetic. In the event,

[6] *Hafton Properties v McHugh* [1987] STC 16.

the Special Commissioner found that the UK company had not become the debtor under the obligation in question, and since this part of the Special Commissioner's decision was not appealed, the matter was not considered in the High Court – where it later came before Mr Justice Peter Gibson (as he then was).

In dismissing the taxpayer's appeal, it was held that the bank – although making loans to UK residents – was not carrying out a *bona fide* banking business in the UK, so that income tax should have been deducted by T Co from the interest paid.

<u>The case of *Ardmore*</u>

The Court of Appeal addressed a similar issue in *Ardmore*,[7] and the analysis is essential to understanding the way in which *National Bank of Greece* should be construed, and a possible approach to similar factual matrices today.

The facts were Ardmore was a UK resident company owned and managed by two brothers. Its assets and activities were almost entirely in the UK. Using working capital, it subscribed for shares in two companies incorporated in the British Virgin Islands ("BVI") and owned by Gibraltar trusts established by the brothers respectively. The sum of £1.35m, being

[7] *Ardmore Construction Limited v HMRC* [2018] EWCA Civ 1438. This was another case in which Patrick Way KC, a member of Field Court Tax Chambers, was involved.

a sum equal to the amount subscribed (by way of part payment of share premium) by Ardmore to the BVI companies, was lent by those companies to the trusts and by the trusts to Ardmore, in the latter case under a facility letter.

The terms as to interest and repayment of capital were unremarkable. The relatively unusual features of the loan were that (1) it was not required not to be supported by any UK security, (2) the facility letter and loan documentation were governed by the law of Gibraltar and the parties submitted to the exclusive jurisdiction of the Gibraltar courts, and (3) (although this did not happen) payments of interest were to be made in Gibraltar from a non-UK source.

What makes *Ardmore* and the judgment handed down by the Court of Appeal so interesting, is the fact that one can see the operation of the 'multi-factorial' test being applied in Lady Arden's leading judgment. She made clear the following:

(i) there is *"no universal test for applying the source principle"*. One must apply the 'multi-factorial' test which requires an *"overall assessment of the situation"*;

(ii) the multi-factorial test in and of itself does not give an indication of the weight to be attached to the various factors;

(iii) accordingly, when giving weight to the indicia it is necessary to look at the matter *"substantively to prevent manipulation"*;

(iv) a practical approach must be adopted: where would a practical person regard the source of interest (the issue under challenge in *Ardmore*) to be situated;

(v) all available facts must be assessed singly and cumulatively (how one does this in practice was not expanded upon further by the Court).

Although the *National Bank of Greece* is a House of Lords judgment, one has to reconcile as best as possible with the more practical and up-to-date version of the picture as set out by the Court of Appeal in *Ardmore*.

Conclusion

The multi-factorial test, as mentioned, is fundamentally imbued with the practical approach mentioned above and it is submitted that there are two important elements which are included within this multifactorial test which are not just the debtor's residence but also the creditor's residence. It can be distinguished from the legalistic approach adopted in *National Bank of Greece*, and the important point which is highlighted in *Ardmore* is that in determining where interest arises one must always ask oneself the question: where would a practical person say the interest does arise.

Factors such as place of incorporation of the borrower, the borrower's residence, location of the guarantor, security, the lender's place of residence, the place where the loan is made and the source of the loan monies, the place where the obligation is to pay the interest, where the funds come from to pay the interest, where business transactions are actively carried out (to produce funds to cover the interest), governing law clauses, link of the borrower with an overseas jurisdiction and payment in sterling – all carry some relevance, but not all are necessarily considered equal in the application of the multi-factorial test.

Will the multi-factorial test be clarified further? That space is still one to watch…

OH HORROR! HMRC ENQUIRIES. COP8, COP9 AND VAT: WHAT THE TAXPAYER MUST AND MUST NOT DO

David Southern KC

A cautionary note

First, a cautionary note. All HMRC enquiries are a serious matter. You can never tell what they may lead to. They may produce surprises, which are invariably unpleasant. They can lead to personal, financial and matrimonial breakdown, insolvency, prison and suicide. As Tolstoy says, '*It is a fearful thing to fall into the hands of the state.*'

The new approach to HMRC enquiries

In the last 20 years there has been a profound change in the Revenue's approach to enquiries. This has been caused less by a policy change than by organisational and technological changes. It has in turn fed through into changes in the courts' conduct of tax cases.

Broadly speaking there are two approaches to tax:

(i) The pragmatic: tax is a bit like football. Win a few, lose a few. Be robbed now and again;

(ii) the prescriptive: there is a correct amount of tax which each taxpayer should pay. A taxpayer should not be able to negotiate his tax liabilities.

Formerly, the pragmatic approach prevailed. That was based on a local presence, direct contact with taxpayers and physical, statistical and human sources of information.

HMRC, like banks, have given up their local presence and only deal with customers/taxpayers on a depersonalised basis. If you want a loan for £5,000 from a bank, the answer will be given, not by the local bank manager, but by a computer program, which will also produce and processes all the necessary forms.

The structure of tax districts was dismantled in the 1990s. HMRC now does not have local premises. HMRC is – geographically – a collection of postcodes. In-person contact between HMRC and taxpayers is an exception.

These changes were driven by and the product of the introduction of self-assessment for individuals in 1996 and for companies in 1997. Self-assessment depersonalised and disintermediated the tax system.

Also, there have been major changes in the development, application and sophistication of HMRC IT. The tax system, like the banking system, is largely computerised and automated

Inevitably, this new system lacks the flexibility of the old system and prescribes the correct outcome, rather than first testing the water. It is warfare by drones controlled by AI.

This changed world has also produced a new approach to Revenue litigation, set out in the HMRC's Litigation and Settlement Strategy. This contains formal guidelines, applied nationally. This limits flexibility in individual cases, in favour of a uniform approach. If decisions by individual officers have to accord with pre-determined policy and be referred back to a higher level of decision-making, it is impossible to do deals. In practice, the Strategy tends to mean: litigate everything, settle nothing.

The introduction of self-assessment also led to the abolition of the General Commissioners of Income Tax. The General Commissioners were a local, lay, unpaid body. They were on nobody's payroll. They would broadly decide cases brought on what seemed to them a sensible basis. They were replaced in 2009 by the professionally qualified and remunerated judges of the First-tier Tribunal (Tax Chamber), who bring a quite different perspective.

Many advisers are still living in a bubble of intellectuality. HMRC are now inclined to ignore the technical and legal arguments advanced by advisers and simply say: we are not playing your game; the taxpayers are crooks; tax liabilities should be decided accordingly. That approach has in turn influenced the way in which the courts and tribunals decide cases.

All these are factors which the tax adviser has to take on board when his client is faced with an enquiry.

Because of the depersonalisation of tax administration, enquiries have moved from the pragmatic to the prescriptive approach. This makes enquiries in contentious cases much more difficult to settle, other than on terms of capitulation.

How things used to be done

In the good old days, most enquires were conducted at the local level, through the District Tax Office. They would be supervised by the District Inspector, who was in most cases a thoroughly able and experienced official, who applied a good deal of common sense and was one of the worthies of the local community – like the bank managers.

Matters outside the Tax District were dealt with by three bodies:

i) Board's Investigation Officer, e.g. misuse of subcontractors' certificates;

ii) Special Office, e.g. artificial avoidance schemes;

iii) Enquiry Branch (EB), e.g. major fraud.

In this world most cases were capable of settlement, and most cases were in fact settled on a pragmatic basis.

Enquiry Branch were the heavy mob. If your client was investigated by Enquiry Branch, the only sensible advice was: you come out with your hands up, waving a white flag and saying ‘Don’t shoot’.

The new system

Enquiry Branch was abolished, and replaced by a Civil Fraud Office based in Southwark High Street, while criminal work went to the Revenue & Customs Prosecution Authority.

Nowadays there is no local or centralised investigation service, and instead each division undertakes its own enquiries. More serious cases will be undertaken by the Fraud Investigation Service (FIS).

The major problem with the new system is that every enquiry starts with a target figure for the amount of additional tax which the enquiry is intended to raise. Any settlement at less than that figure will have to be justified to higher levels of management.

The three major criticisms of the modern system are that:

(i) it is over-dependent on computerised sources of information and analysis, which are very difficult to challenge. The tragedy of the Post Office Horizon disaster is a warning which is insufficiently regarded. HMRC cannot go against or question their own computing systems or the results produced;

(ii) settlement is difficult to secure, save on HMRC's terms;

(iii) it is incompatible with the flexibilities of life.

<u>What should the professional adviser do?</u>

The first step is to apply the old Army wisdom:

> *'When your lorry breaks down, smoke a cigarette.'*

Do not make any assumptions about culpability, non-culpability, degree of risk or amounts. Do not assume that HMRC must have something to go on.

Dispense with moral indignation (‘How can they do this to me?’). Most moral indignation is 90% indignation, 10% moral.

The most important first step is to go through all available materials carefully and in detail, without making any assumptions. Get the client’s version of events, while exercising a healthy degree of scepticism. In particular, scrutinise SATRs and CTSAs, and VAT returns and accounts in VAT cases. Trace where the figures have come from.

Any neglect of this first, time-consuming step will be punished, and expensively punished, later one.

This will also enable you to identify gaps in information and evidence.

You should also assume from Day 1 that the enquiry will end in a court case which will go to the Supreme Court. This will almost never be the case, but it will lead you to document the steps and assemble your evidence in a systematic and methodical way.

Write formal letters. Do not be lazy and do everything be email.

Try and get information from HMRC about what has prompted the enquiry ('sources of concern'). The more serious the enquiry, the less they will tell you. In many cases, the particular cases will simply have been thrown up by or highlighted by a computer program, and HMRC will not be able to explain why this is so.

Never underestimate the importance of old fashioned forensic accountancy. HMRC neglect it, because of their reliance on IT. You must not. I have known a number of cases where a competent, experienced, methodical accountant has disregarded all HMRC assumptions, painstakingly worked through the papers and been able to demonstrate that there is no substantial basis for an enquiry.

Be prepared, and prepare the client, for the long haul. It is much easier to start a war than to end it. Time and costs are on HMRC's side. Enquiries and appeals can take many years.

Make a careful and complete record of all telephone conversations with HMRC, and an attendance note of all meetings with clients.

At an early stage, once you have done the essential preliminary work, you must make a rough judgment on whether this is a case which:

i) can be shown to have no sufficient basis;

ii) is capable of settlement on reasonable terms;

iii) is only going to be settled on HMRC terms;

iv) would justify the risk going to interview;

v) could end in criminal proceedings;

vi) should go to judicial proceedings.

The client will sometimes hope that it may be possible to buy off HMRC with a partial admission of liability and corresponding payment. In most cases this will produce the opposite result to that intended. HMRC are likely to interpret the offer as evidence that the true liability is much higher: otherwise the offer of a lower sum would not have been made.

The ideal adviser would merit the description that was applied to that great prime minister, Jim Callaghan:

> *'He always carried an air of menace. He conveyed the impression that if there was a rough house, he wasn't the one who was going to get hurt.'*

The client and adviser will invite HMRC to be reasonable. But as one of my old bosses used to say,

> *'Being reasonable comes expensive.'*

Costs

Costs are always an issue in enquiry cases. It is difficult to cap costs. Clients will ask what they are paying for. One thing leads to another. That is why costs control is so difficult.

Many small businesses have an insurance policy against the costs of tax enquiries. Indeed, many accountants offer these policies to clients.

The problem is that such policies have a let-out clause if fraud is alleged. HMRC are well aware of this, and know that by alleging fraud (no particulars required) costs pressure on a client can be greatly intensified. This temptation is not always resisted.

Co-operation

The mantra of the modern approach is 'co-operation'. Co-operation – like reasonableness – is a loaded term, because it is not voluntary co-operation. It is co-operation under threat of adverse consequences, if co-operation is not forthcoming.

It would be a bold adviser or taxpayer who refuses to co-operate, and simply says: 'prove your case'. However, co-operation can quickly degenerate into appeasement.

Enquiries

The term 'enquiries' covers a broad range of HMRC actions:

- i) information notices;
- ii) enquiries into self-assessment returns;
- iii) enquiries outside SA returns;
- iv) COP8 civil investigations;

v) COP9 civil investigations;

vi) criminal investigations;

vii) raids;

viii) test eats (where restaurants were thought to be understating turnover).

More than one office may be engaged in any particular enquiry

Code of Practice 8

COP8 letters are issued in cases of suspected deliberate or fraudulent conduct leading to loss of tax. This is likely to involve larger transactions, artificial schemes or offshore matters.

Code of Practice 9

COP9 letters are issued in cases of suspected deliberate or fraudulent conduct leading to loss of tax, where criminal conduct is suspected.

This offers a Contractual Disclosure Facility (CDF), the offer of which must be accepted within 60 days. Provided that the client makes a full, complete, open and honest outline disclosure of underpayment of tax, criminal prosecution will be barred. This will have to be followed up by a formal disclosure report, which is an elaborate document, sometimes extending over 20 years, which needs to be prepared by someone experienced in this work.

COP9 enquires should only be authorised by a senior officer on the basis of credible and sufficient evidence. How far these requirements are observed in practice is uncertain. HMRC refuse to disclose this information. Tribunals have upheld this refusal. Freedom of Information Act applications have been made, but these have either been refused on public interest grounds, or responded to by sending large amounts of documents, with everything blacked out except for the occasional 'or'. 'not', 'and'.

In these circumstances it is difficult to know how seriously to take the underlying threat of prosecution. It is never something to be taken lightly or unadvisedly. Refusing the CDF heightens risk and can become a game for high stakes. On the other hand, the enquiry may revert to a purely civil enquiry.

Payments on account

The useful mechanism of Certificates of Tax Deposit has been abolished. Instead HMRC ask for payments on account. This falls under the concept of 'Co-operation'.

Interviews

The aim of interviews is to find any inconsistencies between the written explanations and what the client says.

For this reason HMRC normally require the presence of the client at interviews.

HMRC will propose meetings under the mantra of 'co-operation'. Whether to go to a meeting raises a number of issues.

Meetings should not be on HMRC premises:

i) this gives HMRC the advantage of a home fixture;

ii) the coffee is terrible;

iii) HMRC will be under travel expenses pressures.

HMRC may caution the client. This is likely to be intimidatory and to unsettle the client.

If the client and the accountant disagree at the interview, the case is lost.

Keep a full and meticulous written record of everything that is said, and documents on which the client is asked to comment. Do not worry that this slows things down. These have become somewhat stage-managed events, which are bereft of spontaneity. Do not hesitate to walk out or threaten to walk out (with suitable drama) if the interview appears to be achieving nothing positive.

Applications to the courts

The most powerful resource of the taxpayer, apart from or to vindicate the merits of his case, is appeal or other application to the Tax Tribunal or civil courts. The point is that jurisdiction for a matter is transferred from HMRC to the tribunal or court.

Application or appeal can be made to the FTT:

- to discharge information notices;
- to discharge disclosure notices;

- against the calculation of penalties;
- for issue of a closure or partial closure notice;
- against an assessment or HMRC decision.

If there is an argument that HMRC has exercised its powers unreasonably, and there is no right of appeal, application may be made for judicial review. However, the time limits are strict, most applications will be out of time in any event and taxpayers' success in this area is a rare event.

Alternative Dispute Resolution (ADR)

ADR requires HMRC agreement, which is unlikely to be forthcoming where tax avoidance is suspected.

Prosecutions

Advisers should at all costs try to avoid a civil enquiry becoming a criminal prosecution.

Police and Criminal Evidence Act 1984, s 114 invests designated Revenue officers in tax investigations with all the investigatory powers of the police.

Prosecutions may be difficult following an enquiry because the client may be able to argue that he has incriminated himself if the prior proceedings without criminal law safeguards.

A possibly surprising policy decision was taken to take Missing Trade Inter-Community (MTIC fraud) to civil proceedings. This may have been a reaction to the London City Bond case.

Prosecuting authorities rely on the weight of numerous allegations to cover up the weakness of individual cases.

Conclusion

All this makes rather sombre reading. However, it is also worth remembering the three cardinal rules for dealing with HMRC:

- never ignore correspondence;
- never write rude letters;
- throw the occasional bone;

and it is amazing how accommodating they can be.

Further reading

CC/FS2. Checking a customer's tax affairs
HMRC 02/18. Code of Practice 8
HMRC Code of Practice 9 from 14 June 2023

SOME REFLECTIONS ON THE APPLE IRELAND DECISION

Richard Collier

(Note: the comments below reflect the personal views of the author and should not be taken as reflecting the views of Field Court Tax Chambers)

Introduction

The Court of Justice of the European Union (CJEU) released its judgement in the Apple Ireland State Aid case on 10 September 2024.[1] The decision is likely to be one of the more important – and certainly one of the more controversial – judgements of the Court. This note summarizes the facts of the case and outlines some important issues that are raised by the case.

The Facts in Outline

The facts concern two Irish-incorporated companies that were non-resident in Ireland for tax purposes, meaning they were to be treated as branches of non-

[1] Judgement dated 10 September 2024 in Case C-465/20 P, Ireland and Others v Commission.

resident companies for Irish tax purposes. The Irish branches carried on certain relatively routine procurement, sales and distribution functions and the manufacture and assembly of computer, etc. products in Ireland. Under the rulings, the branches were allocated a (taxable) return commensurate with this activity.

The disputed profits in this case were generated from certain IP licences. Pursuant to an international tax planning arrangement, those profits were booked in the two Irish companies, but they were created/ generated by the acts of employees of other non-Irish tax paying Apple group companies, notably of Apple Inc., the top company in the group (a significant number of directors of the boards of the two Irish companies were also directors of Apple Inc and they worked in Cupertino (US)). Those profits were not taxed in the US under US tax rules.

The question at issue was whether the profits from the IP licences should for tax purposes be attributed to, and so taxed in the hands of, the Irish branches. The Irish tax authorities did not treat those profits as taxable in Ireland because they were not generated by the functions and activities of the Irish branches.

The CJEU decision on the other hand sides with the interpretation adopted by the European Commission which holds that the profits booked in each of the Irish entities should be allocated by reference only to the activity in each of the legal entities of which they are part (i.e., taking account of the activity in the head office and any branches), without regard to activity in any other legal entities in the group (and specifically without regard to the activities outside those two Irish companies that generated the profits). Since there was minimal activity at the respective head offices of the two Irish companies, the CJEU interpretation holds that the profits should have been taxed in the Irish branches where there was the routine distribution and assembly activity referred to above, contrary to the approach taken by Ireland. The effect of the approach adopted by the CJEU is that the profits are attributed by default to the Irish branches. Further, the CJEU determination was the basis on which the Court determined that the Irish State had derogated from the normal system of corporate taxation in Ireland and that this resulted in a reduction in the tax liabilities of the two Irish branches: State aid arose as the rulings were selective and the reduction in tax liability granted an advantage.

Issues Raised by the Decision

The Apple Ireland decision raises several important issues. This note is concerned with three points, namely (1) did the Court apply the right approach in its analysis of the case and in the decision reached? (2) did the Court correctly apply the principles of the approach it elected to follow? and (3) what are the wider implications of the case?

Did the Court apply the right approach in its analysis of the case and in the decision reached?

The European Commission, as supported by the CJEU, analyse the question of what profits are attributable to the Irish branches by reference to the landmark OECD guidance on how profits are allocated to PEs, namely the guidance in the OECD's 2010 Report on the Attribution of Profits to Permanent Establishments. That Report overhauled the guidance in this area and introduced a new approach to the branch profit attribution exercise, commonly referred to as the "authorised OECD approach" or, more usually as simply the "AOA". The

AOA is intended to deliver PE profit attribution results that are aligned with the arm's length principle.

Given that the AOA was introduced some two decades *after* the first disputed ruling in the Apple case (and 3 years after the second ruling was given), the use of the AOA in this case raises significant difficulties.

There are also some fundamental concerns about how the use of the OECD guidance can in any event be squared with CJEU's own relatively recent decision in the Fiat case[2], which determined that the analysis in state aid cases should be restricted to the *domestic law system* of the state concerned. In this case, that would mean the Irish domestic law in section 25 of the TCA 97. However, the CJEU seemed to pay scant attention to the terms and application in practice of section 25, (notwithstanding its acceptance of the requirement to analyse the position by reference to domestic law) preferring instead to frame the requirements of the required attribution exercise by reference to the AOA on the basis that it

[2] Judgment dated 8 November 2022 in Cases C-885/19 P and C-898/19 P, Fiat Chrysler Finance Europe v Commission.

could be used as a guide in the application of the domestic law.

Did the Court correctly apply the principles of the approach it elected to follow?

Even if the questions raised above about the approach adopted by the CJEU are put to one side and it is assumed right to analyse the technical position by reference to the AOA, it cannot be concluded – as the decision does – that activities of other entities in generating the profits should not be taken account of in the analysis of what profits belong to the branches.

This follows from the core requirement of the provisions in tax treaties (specifically provisions that correspond with Article 7 (2) of the OECD Model Tax Treaty) which the AOA was designed to clarify. This requires a focus on the activities in the branch/PE in answering the question of, broadly, what profits a hypothetical distinct and separate enterprise would be expected to derive if it carried on the same activities (and under the same conditions) as those actually carried on in the branch. The more detailed guidance in the AOA adopts the same approach based on focusing on the actual functions and activities in the branch to determine what profit is properly attributable to the branch. The OECD guidance also includes instances where the contribution of separate entities is taken into account. It is therefore clear that the required OECD approach starts by analysing the activities in the branch to determine, by reference to those activities, what profits should be taxed in the hands of the branch. Where appropriate, that approach takes account of all other activity in the entity and in the group that contributed to the earning of profits. (This approach is similar to the approach under Irish domestic law, namely according to which it is only the position of the branch that is considered with profits allocated to the branch based on activities actually carried on in the branch). This is the opposite of what the CJEU judgement does – it starts not with the activity in the branch but with the profits in the entity. It then allocates those profits taking account only of the activities within the legal entity (so ignoring the contribution of other group entities). The result leads to a non-arm’s length attribution of profits to the branches. This follows from the use of the “default” allocation of profits which are derived from activities that are outside both branches.

If the contrary CJEU position were correct, it would lead to some absurd consequences. For example, if the activities conducted in Apple Inc that generated the profits, but which were ignored by the CJEU, were characterised as conducted in the US through a dependent agent PE of the Irish companies, then all contested profits would on the CJEU/European Commission theory presumably be attributable to that activity (because they would now, by virtue of the relevant US activity, be located in a (US) PE of the Irish companies, not in a separate group company). This would mean those profits would be no longer taxable in Ireland, notwithstanding no change whatsoever in the activity in Ireland. This would mean that whether the relevant profit is taxed in Ireland depends on whether a tax inspector in another state (here, the US) makes such a PE determination. This is contrary to the historical framing of the branch profits approach, and it is hard to see any basis on which it makes sense or delivers a workable system of PE profit attribution.

It is therefore concluded that the use in this decision of the AOA is highly questionable and that its interpretation by the Court is in any event misconceived. Given the numbers involved in the case, the result is to deliver a colossal failure in complying with the requirements of the arm's length principle.

What are the wider implications of the case?

There is no further appeal available in respect of this decision and it therefore brings the State Aid litigation to a conclusion.

At a technical level, the impact of the case is probably largely historical in that Irish law has now changed, meaning that the arrangements entered into by Apple would no longer work in Ireland as previously intended. This follows from changes to the Irish tax law including a new corporate residence test, and new branch profit attribution rules and transfer pricing rules, ATAD, Pillar 2, etc. Further, it is understood Irish tax rulings are not generally given and historic rulings that have been given have now expired. On a wider basis, the impact of the case is limited by the fact that the relevant factual situation in the case is not commonly encountered in practice (though nonetheless may be seen in some isolated situations).

Given the dearth of any detailed technical analysis in the judgement concerning the AOA, it seems (very) unlikely that the decision will impact the technical interpretation and application of the OECD guidance on the attribution of profits to permanent establishments.

However, it is at the time of writing (within days of the decision of the CJEU being released) too early to tell if the decision will lead to wider, including especially political, developments given the nature of the issues under discussion and the size of the monetary amounts involved.