SLAUGHTER AND MAY

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Brexit – impact on financial services

After months of speculation, the Prime Minister's confirmation last month that, although the UK cannot remain in the single market after Brexit, the deal to be negotiated with the EU might contain "elements" of the current single market arrangements such as the freedom to provide financial services across national borders, was welcomed by the City. The "phased process of implementation" to allow businesses time to plan and prepare for any legal and regulatory change has at least gone some way to answering the cries of the industry for transitional arrangements.

This recognition of the contribution of the financial services industry to the economy is essential. PwC's November 2016 report for the BBA estimated that the total tax contribution of the banking sector for 2016 was £34.2bn – and that half of this was borne by foreign banks – so it is important that the UK remains attractive to the much-maligned banking industry.

Signs of a more favourable change in attitude towards financial services can be seen with the proposals for a new tax and regulatory regime for insurance linked securities from Spring 2017 and the promised exemption from the bank levy for certain UK liabilities relating to the funding of non-UK companies and non-UK branches as part of making the bank levy more territorial from 2021.

The government seems amenable to considering the potential opportunities arising from Brexit and finding out what is most important to particular sectors to ensure the UK continues to move in the right direction to create a competitive environment – especially if those measures are revenue-neutral. It might be thought that one advantage of the UK's leaving the EU would be, from the date of exit, putting the UK's tax rulings and the application of the UK tax system beyond the scrutiny of the EU Commission. UK entities with EU connections, however, can still find themselves the subject of State aid challenges in respect of aid granted to them by EU Member States (see State aid below).

The government is reiterating in every consultation document that mentions EU legislation that, although "the people of the United Kingdom voted to leave the European Union", the UK will continue, until the exit negotiations are concluded, to negotiate, implement and apply EU legislation. But there are definitely areas where there could be a suggestion that the UK is content to move slowly to react to EU case-law (on changes to VAT grouping, for example, and on changes to the VAT treatment of pension scheme management to remove the much loved (and much extended) 70:30 split rule) so that any changes to the domestic rules can be made post-Brexit when they can be tailored to what works best for the UK without EU constraints.

State aid – the Commission's investigations into State aid go deeper than examining tax rulings

The non-confidential version of the Commission's preliminary view on possible State aid in favour of GDF Suez (renamed Engie in 2015) published on 5 January shows the Commission is looking at the heart of the tax rules in Luxembourg – not just looking at what the Luxembourg tax authority said about them by way of tax ruling. The GDF Suez group had undertaken transactions involving zero-coupon convertible bonds, the effect of which was to give the debtor company a deduction but without the creditor receiving any taxable income. The structure used by the GDF Suez group is a popular one in Luxembourg which many other groups have used. (Indeed, this sort of group mismatch scheme was also possible in the UK until

2008 when an earlier version of the current group mismatch schemes legislation (now in Part 21B of CTA 2010) was enacted.) The mismatch arose because the tax rules required taxpayers to follow the accounts, and the accounting standards required the debtor to recognise a finance charge, whilst preventing the creditor from recognising any finance income.

The existence of this deduction/non-inclusion mismatch under Luxembourg law is, in the Commission's view, State aid. According to the Commission, the Luxembourg tax authority should have eliminated the mismatch by (i) denying the debtor a deduction, (ii) requiring the creditor to pay tax on the income, or (iii) invoking the abuse of law doctrine which has been part of Luxembourg's law since the 1940's but which had not been applied until recent years.

The Commission's argument is essentially that the existence of the mismatch conferred a selective advantage on the GDF Suez group because it reduced the group's taxable profits. It is notable that this "follow the accounts" rule applied to all companies and the abuse of law rules were, at the relevant time, a dead letter. Although the investigation was triggered by the Commission's review of tax rulings handed over by Luxembourg, parts of the preliminary view show that it does not appear to matter to the Commission whether there is a tax ruling or not – if a taxpayer submits a tax return which is accepted by the tax authority, that acceptance can be a grant of State aid.

Even if, as the government seems to intend, Brexit removes the UK's legislation and tax rulings from the scope of the Commission's scrutiny in respect of post-Brexit periods, EU State aid will remain on the watch list of any UK multinational with EU subsidiaries or EU permanent establishments. In light of the Commission's more aggressive attitude, such groups should brace themselves for the possibility of the Commission opening up investigations into previously acceptable-looking structures for the group, especially if they involve Luxembourg.

Partnerships

On 16 January, the Department for Business, Energy & Industry Strategy launched a call for evidence in relation to a Review of Limited Partnership Law to understand why there has been a rapid increase in the number of limited partnerships and the value they bring to the economy, against the backdrop of a concern that aspects of their legal characteristics (e.g. lack of information of location of partners or persons who control the partnership) may act as enablers for criminal activity.

It is somewhat ironic that HM Treasury laid before Parliament a draft statutory instrument (The Legislative Reform (Private Fund Limited Partnerships) Order 2017) that same day to create the new regime for limited partnerships designated as private fund limited partnerships with stated aims of improving the UK's competiveness as a centre for the asset management industry and reducing the administrative and financial burdens of using limited partnership structures.

Nevertheless, this call for evidence does offer taxpayers the opportunity to set out the benefits to be gained from using limited partnerships as investment vehicles; but it remains unfortunate that the law relating to partnerships is viewed as capable of being reformed piecemeal rather than by a wholesale review thereof. (This criticism was also applicable to HMRC's consultation last summer on the review of partnership taxation.)

Additional draft Finance Bill 2017 legislation

Revised draft legislation was published on 26 January on the corporate interest restriction and on carried-forward losses.

In the carried-forward losses draft legislation, detailed provisions are now included in Part 4 for insurance companies to deal with carried-forward BLAGAB trading losses and in Part 5 for carrying forward trade losses made in certain creative industries (e.g. film trades). Detailed provisions on consortium relief of carried-forward losses have been included.

As promised, anti-avoidance fills many of the additional pages of draft legislation. The promised regime TAAR follows the standard pattern of recent TAARs to counteract any loss-related tax advantages arising from relevant tax arrangements. The purpose, or one of the main purposes, of the arrangements must be to obtain a loss-related tax advantage. It must be reasonable to regard the arrangements as circumventing the intended limits of relief or otherwise exploiting shortcomings in the relevant provisions, and all relevant circumstances are to be taken into account in determining this, including whether the arrangements include any contrived or abnormal steps, or if they lack a genuine commercial purpose.

The provisions on the £5m deductions allowance (ss 269ZG+) and the definition of group (section 269ZO) have not been amended. It had been expected that additional conditions would be imposed to prevent groups of companies seeking to split the group to obtain more than one £5m allowance but nothing specific has been added here – it is reassuring that HMRC appear to be content to rely on the regime TAAR to catch such contrived behaviour.

Specific anti-avoidance provisions are contained in Part 6 to deal with refreshing losses and deduction buying. And, of course, the new legislation would not be complete without yet more rules restricting relief in the case of a change in company ownership.

Hybrids and other mismatches

Those still trying to get to grips with the UK legislation in Part 6A TIOPA on hybrids and other mismatches should note that there is still time to comment on HMRC's draft Guidance.

The draft Guidance illustrates some of the ways in which the UK legislation goes further than the OECD recommendations. An example dealing with financial instruments which are treated as debt in one jurisdiction and equity in another (at INTM 551200) states that Chapter 3 applies to a release of a debt between connected companies where the lender obtains a deduction but the borrower is not taxed on the release credit – which would be how the loan relationship rules could operate for a non-UK group lending to a UK subsidiary, and is identical to an OECD example which is accompanied by the opposite recommendation and fails to take account of the express exclusion from Chapter 3 for such credits.

The draft Guidance also fails to provide the hoped-for clarity on the meaning of fundamental concepts used within Part 6A, notably on what might be "reasonable to suppose".

What to look out for:

- The consultation period on revised draft legislation for carried-forward losses and corporate interest restriction ends 23 February.
- The consultation period on VAT grouping ends 27 February.
- The consultation on requirement to notify HMRC when arranging offshore structures ends 27 February.
- The Spring Budget on 8 March.
- The consultation on hybrids guidance ends 10 March.

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