Tax and the City Briefing for March

9 March 2018

Insurance provider did not have a fixed establishment in the UK

Hastings Insurance Services Limited v HMRC [2018] UKFTT 0027 (TC) concerned the supply of broking, claims handling and underwriting support services by a UK company, Hastings, to a related company in Gibraltar, Advantage. Advantage had its business establishment (BE) in Gibraltar and supplied motor vehicle insurance to UK customers acting through Hastings as its broker. The issue was whether Hastings could recover input VAT on the supply of services to Advantage. Input VAT would be recoverable if the supplies were made outside the EU. HMRC argued that the supplies were made in the UK on the basis that Hastings constituted or created a UK fixed establishment of Advantage.

A fixed establishment is defined as an establishment other than a BE characterised by a "sufficient degree of permanence and a suitable structure in terms of human and technical resources" (Council Implementing Regulation (282/2011/EU), article 11). The First-tier Tribunal (FTT) carried out a thorough review of the facts, case law and legislation in a 132-page decision. The conclusion was that Advantage was established only in Gibraltar where it had its BE and so Hastings could recover its VAT costs. It was key to the FTT's decision that Hastings and Advantage were acting independently under arm's length contractual terms and management structures (notwithstanding they were in fact related) and that Advantage had sufficient resources and functions in Gibraltar to allow it to run its insurance business. Hastings' resources were not available to Advantage with a sufficient degree of permanence for them to constitute a fixed establishment. The contractual arrangements resulted in the operation of two separate businesses each with their own commercial aims.

This case is a significant one for the insurance industry – other UK service providers to non-EU business recipients may wish to compare their facts (particularly their management structures and contractual arrangements) with those of Hastings and Advantage. The case will also be important outside the insurance area for any cross border supply chains.

This is only the first stage of this case – given the significant amounts at stake and the wide impact of the case, it is likely to be appealed.

Effect of US tax reform on financial services

Taxpayers and advisers have had a couple of months to digest the detail of the US tax reform. Although the need for technical corrections to the legislation has been identified, it will not be possible to get Congress to pass the changes so it is expected that US Treasury guidance will be issued in the form of draft regulations by the end of 2018 and final regulations in 2019 to clarify how the legislation is intended to work. In particular, clarification is awaited on to whom the primary liability for the repatriation charge attaches (to the US parent or to a US subsidiary which owns the foreign investments). This will be of concern to a purchaser of a company which has the liability to make the tax payments over the course of eight years for the repatriation charge. For the next few years, while the numbers are being finalised, we would expect any buyer of a US company which might be liable for the repatriation charge to carry out due diligence to check that the amount of repatriation tax forecast to be paid over the eight year period is correct. We would expect to see the repatriation tax charge factored into pricing or picked up by an indemnity.

A number of points are worth highlighting for banks and insurers in particular. The headline rate of US corporation tax falling from 35% to 21% is, on the face of it, good news for anyone within the US corporation tax net. The downside of the rate cut, however, is that groups with significant US tax losses, such as many global banking groups, saw the value of those carried forward losses drop as they now shelter profits at 21% not 35%. Additionally, any post-2017 operating losses cannot be set off in full against profits but are restricted to being set against 80% of the profits. Significant valuation adjustments for US deferred tax assets are expected.

The base erosion minimum tax (BEAT) is causing pain for inbound US investment by foreign corporations and inbound transactions by foreign subsidiaries of US corporations. There is considerable and complex number-crunching to be done even though, in some cases, the conclusion will be that there is little or no additional tax to pay as a result of BEAT.

BEAT applies to US corporations with turnover above $500 million and "base erosion payments" above 3% of taxable income (or above 2% taxable income for banks and securities dealers). BEAT requires a comparison between the regular tax payable by the US corporation (taking into account the usual credits and deductions) and the tax payable under BEAT (based on taxable income plus base erosion payments). The amount by which the BEAT amount exceeds the regular tax is the amount of BEAT which has to be paid. Base erosion payments are all payments (other than cost of goods sold or some derivative payments) to related non-US persons. The BEAT rate is 5% for 2018, then 10% until 2026 when it increases to 12.5%. There is a 1% additional annual charge for banks and registered securities dealers.

Where interest payments are concerned, BEAT picks up where the new interest barrier rules leave off and applies to the remainder of the interest expense. BEAT may be a significant cost for banks in 2018 as these groups typically have significant intra-group payments that will be considered base erosion payments. Structural changes are likely and in future we are more likely to see more third party funding into the US rather than intra-group funding. However, planning to avoid BEAT may be caught by the anti-abuse rule so any restructuring or unwinding of current arrangements should be carefully considered.

Insurers also suffer under BEAT because reinsurance premiums to affiliates are treated as base erosion payments. This was heavily lobbied against and it is unsure whether the US Treasury will provide some relief for insurers in the guidance expected later this year. Certain derivative payments were excluded from being base erosion payments as a result of successful lobbying.

Review of the corporate intangible fixed assets regime

As promised in the Autumn Statement 2017, a consultation document has been published proposing changes to the intangible fixed assets (IFA) regime in the light of "the growing importance of intellectual property (IP) to the productivity of modern business, and the restructuring of IP ownership within multinational groups in response to recent international tax changes". The changes being considered include bringing pre-Finance Act 2002 assets into the IFA regime; providing relief for goodwill amortisation (so long as it doesn't cost too much); and looking at the extent to which the IFA de-grouping charge causes difficulties with M&A transactions in practice.

For a number of years it has been possible to hive a trade into a newco and then sell the newco without generating a CGT exit charge. This is because, although the transfer of the CGT assets is an intra-group transfer, the exit charge should, if the conditions are satisfied, benefit from the substantial shareholding exemption (SSE). Under current rules, whereas pre-Finance Act 2002 IP is within the CGT regime and so any degrouping charge is potentially exempt under the SSE, any degrouping charge in relation to IP within the IFA regime is outside the SSE. It is becoming increasingly complicated and expensive to identify where each regime applies and the number of IFA intangibles increases as time passes. Accordingly, the proposal to bring pre-Finance Act 2002 IP within the IFA regime is welcome from a simplification perspective. Without further change, however, this means that the whole degrouping charge would be outside the scope of the SSE. It is encouraging that the consultation document recognises this issue and asks to what extent the IFA de-grouping charge causes difficulties with M&A transactions in practice and how it could be modified to eliminate such difficulties.

The consultation runs until 11 May. Responses are requested to the specific questions but comments are also welcome on other targeted changes that could be made to the IFA regime to support its policy objectives and deliver value-for-money in terms of the economic and fiscal impacts on the UK. The government will publish its response to the consultation together with any proposed changes in the second half of 2018.

Mutual Agreement Procedure (MAP)

Statement of practice SP 1/18 has been published setting out the UK's practice in relation to methods for reducing or preventing double taxation. It supersedes the previous statement, SP 1/2011, and cross-refers to more detailed guidance in HMRC's *International Manual*. The revisions were prompted by experience and developments in dispute resolution, in particular, the work done as part of the OECD's Base Erosion and Profit Shifting (BEPS) project under Action 14 ("Making Dispute Resolution Mechanisms More Effective") and Action 15 ("A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS").

SP 1/18 explains that the UK has committed to implementing the minimum standard in respect of preventing disputes, availability and access to MAP, resolution of MAP cases and implementation of MAP agreements. The paragraph on arbitration now states that the UK has committed to mandatory binding arbitration through the multilateral instrument.

What to look out for:

- The Office of Tax Simplification report on capital allowances is expected "in the Spring". The Chancellor requested this report on replacing capital allowances with accounting depreciation. It will be interesting to see the results of the review because, in the context of HMRC's consultation on the tax changes required in the light of lease accounting changes, HMRC received feedback that business wanted to keep the status quo of the capital allowances system and not change to a system based on accounting depreciation.

- The Court of Appeal is set to hear *Leekes* (loss-streaming following succession of a trade) on 13 March and *Ardmore* (interest on loan from offshore trust arose in UK) on 14 March.

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- The European Commission's plan for digital taxation is expected to be released in March. Financial Secretary, Mel Stride, has already told the BBC in an interview on 22 February that a tax on revenues (rather than profits) is the preferred option for the UK. The Chancellor might take the opportunity at the Spring Statement on 13 March to formally announce the government's digital taxation plans.

- The Finance Bill 2018 is scheduled to complete its Lords' stages on 8 March so Royal Assent is likely the following week.

- The Supreme Court hearing is set for 11 April 2018 in the *Taylor Clarke* case on VAT grouping.

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