Tax and the City Briefing for June

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Speed read

Carried-forward losses on succession of a trade must be streamed and may be set against only that part of the successor's trade arising from the succeeded trade according to the Court of Appeal's construction of ICTA s343 in Leekes. Business looks beyond Brexit and continues to value the UK's stable and competitive tax regime according to the latest tax competiveness report. The Coal Staff Superannuation Scheme Trustees Limited test case determines that the pre-2014 manufactured overseas dividends (MODs) regime was a restriction on free movement of capital, the remedy for which is repayment of the £8.8 million income tax equal to the relevant withholding tax deducted from the gross amount of the MODs. The government confirms it intends to publish consolidated versions of double tax treaties that have been amended by the MLI 'in good time' before the modifications take effect.

Loss streaming after succession of trade

In *Leekes Limited -v- HMRC* [2018] EWCA Civ 1185, the Court of Appeal unanimously agreed with the Upper Tribunal's construction of ICTA 1988 s343 that loss streaming is required.

Leekes carries on the trade of running out-of-town department stores. Leekes purchased the entire share capital of Coles for £1 in November 2009. At the time of the acquisition Coles had trading losses in excess of £2m. Coles carried on a similar trade to Leekes from three furniture stores and a distribution centre. Following the acquisition, the business of Coles was hived up into Leekes which then carried on the combined trade. The Coles stores were rebranded as Leekes stores but they were not profitable. In 2010, Leekes made a claim to offset £1.7m of the carried-forward losses of Coles against the profits of the merged trade.

Prior to this case, there was no authority on the issue of whether carried-forward losses on succession of a trade may be set against the whole of the successor's trading profits or only that part arising from the succeeded trade. It came as a surprise to many that the First-tier Tribunal (FTT) (Judge Rachel Short and Mr Dee) found in favour of the taxpayer that the losses of the predecessor's trade could be set against the whole of the successor's trading profits. The Upper Tribunal set aside the decision of the FTT and restored the conclusion of HMRC's closure notice. The Upper Tribunal had held that the purpose of s343(3) is not to put the successor in a better position than that in which the predecessor would have found itself if it carried on the trade, but to transfer the potential for relief to the successor. The effect of s343(3) is that the losses carried forward on a succession of trade can only be set against that part of the successor's trading profits which corresponds to the predecessor's trade.

Lord Justice Henderson gave the lead judgment, observing that HMRC's interpretation of the legislation does not appear to have been challenged during the period of some fifty years between the enactment of FA 1965 and the present case, nor does its practical application appear to have given rise to significant difficulties. Henderson LJ commented that any difficulties can be avoided or minimised by careful record-keeping, which is, he says "hardly an onerous requirement".

The "transfers of trade without a change of ownership" legislation is now contained in CTA 2010 Part 22 and the equivalent of s343(3) is CTA 2010 s944(3) which uses similar language. In between the Upper Tribunal's decision and the Court of Appeal's judgment in *Leekes*, the legislative goalposts were moved which limits the impact of this case. The carry forward loss reforms that came into effect on 1 April 2017 relaxed the requirement that carried-forward losses can only be used against profits of the same trade (although the reforms also introduced a restriction for larger companies on the amount of taxable profits which can be offset). This means that in the context of a succession of trade, trading losses arising after 1 April 2017 can now, where the conditions are met, be carried forward and set against the successor company's total profits, not just against the part of the profits attributable to the succeeded trade.

The relevance of the *Leekes* judgment will be limited, therefore, to where losses arose before 1 April 2017 or where streaming is still required for post-1 April 2017 losses because the conditions for the more flexible offset are not satisfied.

UK continues to be regarded as a competitive tax regime

The latest KPMG tax competitiveness report published on 15 May shows that business looks beyond Brexit and continues to value the UK's stable and competitive tax regime. This is explained in part by a relatively long-term focus in the UK on a consistent and transparent tax policy while other countries are now going through a period of change.

The survey's main findings include:

- The UK remains in second place (behind Ireland but closing the gap since last year's report) in the rankings of tax competitiveness as a location for foreign direct investment. The Netherlands is in third place.

- The positive results for the UK, though, are driven by the views of UK companies and foreign businesses with UK operations. The UK is a less attractive prospect among companies that currently have no operations here, ranking fifth behind Ireland, The Netherlands, Singapore and Luxembourg (although the field is more concentrated here so the UK is not as far behind leading tax regimes as fifth place might imply).

- The number of participants citing Brexit as a concern has fallen from 46% to 42% over the past year (continuing frictionless trade and ongoing regulatory equivalence are the biggest Brexit worries).

Most industry sectors, including financial services, agree that Ireland has the most competitive tax regime, with the notable exception of business services, where the UK maintains a comfortable lead over other countries.

Consistent with last year's report, there are more firms looking to move activities out of the UK rather than in to it, but exceptions to this are holding companies and investment holding companies which showed significantly more companies were looking to relocate these activities to the UK. The largest net withdrawal from the UK is from US parented companies.

The report makes suggestions to help the UK government ensure the UK remains a leading location for business which include continuing to improve the relationship between companies and HMRC (14% of the companies surveyed said relations have improved in the last year but the report proposes further improvements to resourcing should be made).

Withholding tax on manufactured overseas dividends was contrary to EU law

Although the test case of *Coal Staff Superannuation Scheme Trustees Limited v HMRC* [2018] UKUT 152 (TCC) is of mostly historic interest, because since 2014 there is no longer any UK withholding tax imposed on manufactured overseas dividends (MODs), there are a number of UK pension funds, life insurance companies, investment funds and charities which have made similar claims in respect of tax previously withheld on MODs.

In the relevant tax years, the UK imposed no charge to UK income tax or corporation tax on manufactured dividends (MDs) paid in respect of shares in UK companies; however, it imposed a withholding tax on MODs where a withholding tax would have been imposed by the country of origin had the MOD been an actual dividend. The issue in this case is whether the MODs regime (as it existed pre-January 2014) involved a restriction on the movement of capital contravening EU law.

The Upper Tribunal held that the FTT had erred in law both in finding that there was no restriction and that, even if there were a restriction, it could be justified. The Upper Tribunal considered that for the purposes of testing whether there was a restriction, the correct comparison was between the UK tax treatment of MDs and the UK tax treatment of MODs (not the comparison the FTT had used between the taxation of the real overseas dividend and the taxation of the MOD).

The Upper Tribunal decided that the appropriate remedy for the unjustified restriction is the limited disapplication of the UK legislation by way of conforming interpretation. ICTA 1988 Schedule 23A paragraph 4(4) is to be construed as being subject to an exception in the case of a recipient of a MOD which, by virtue of Finance Act 2004 s186 has no liability to income tax, to the extent the recipient is, by virtue of ICTA 1988 s796, not entitled to credit for the relevant withholding tax.

The result is that Coal Staff Superannuation Scheme Trustees Limited is entitled to be repaid the £8.8 million income tax equal to the relevant withholding tax deducted from the gross amount of the MOD.

The UK moves closer to treaty changes

The multilateral convention to implement BEPS tax treaty related measures (MLI) enters into force on 1 July 2018 for the 5 countries (Austria, Isle of Man, Jersey, Poland and Slovenia) to have already ratified the MLI. The UK ratified the MLI on 23rd May, 2018 by making the Double Taxation Relief (Base Erosion and Profit Shifting) Order 2018. Three months after the government has deposited the instrument of ratification with the OECD, the MLI will come into force for the UK. The MLI will only come into force for a specific treaty if the MLI has also come into force for the other party to that treaty and both parties have opted for the MLI to apply to that treaty. Only the MLI changes adopted by both parties will apply, so, for example, because the UK has reserved against the extension of the permanent establishment definition to catch commissionaire arrangements, the UK's treaties will not contain those changes. Once the MLI is in force for both parties to a treaty, the MLI will come into effect for withholding taxes on the first day of the following calendar year (so earliest 2019) and for other taxes the MLI will come into effect for taxable periods beginning six months later than the date the MLI came into force.

Most, but not all, of the UK's treaties have been notified to the OECD as to be covered by the MLI. An example of a treaty not so covered is the treaty with Switzerland. The UK/Switzerland treaty has been amended bilaterally rather than under the MLI as this is how the Swiss intend to implement changes.

Finding out what a tax treaty says is a whole lot more complicated in the post-MLI world. Fortunately, the UK government has confirmed it intends to publish consolidated versions of double tax treaties that have been amended by the MLI 'in good time' before the modifications take effect. Where possible, the government will seek to agree the amended wording with the relevant treaty partners. In the meantime, the best place to help you work out what a treaty will look like after the MLI works its magic is the OECD's matching database which shows a matrix of options and reservations for MLI signatories.

What to look out for:

- Between 11 and 13 June, the Upper Tribunal is scheduled to hear HMRC's appeal in the *Smith and Nephew* case. Before the FTT, HMRC argued that the (now repealed) "fairly represents" wording in the loan relationships code operates as a "sanity check" or a "fail-safe" to prevent what is in effect an arithmetical difference from giving rise to a loss for tax purposes. The FTT gave short shrift to that argument, on the basis that it had been rejected by the CA in *Greene King v HMRC* [2017] STC 615. Instead, the FTT found that the "fairly represent" wording has a timing and/or identification purpose.

- The deadline for comments on the scope of the OECD's future revision of the transfer pricing guidelines chapters VI (administrative approaches) and VII (intra-group services) is 20 June. The OECD proposes that the revision of Chapter VII could include considering whether, and if so, how, to incorporate the ongoing work on the use of profit split methods and financial transactions. The OECD aims to finalise the scoping exercise by the end of 2018.

- The Upper Tribunal is scheduled to hear the taxpayer's appeal in the *Union Castle Mail Steamship Company Limited* case between 25-28 June. The FTT held that the derivatives derecognition scheme had failed to produce the loss claimed by the taxpayer.

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