SLAUGHTER AND MAY

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The Court of Appeal saw no basis on which it could properly interfere with the Upper Tribunal's practical application of the multifactorial test to determine a UK source of interest in *Ardmore*. Professional advisers and their clients are considering how to track potentially reportable cross-border arrangements from 25 June 2018 under the new EU intermediaries rules. The Supreme Court in *Project Blue Limited* demonstrates that FA 2003, s75A is a novel type of anti-avoidance rule, the purpose of which is to correct insufficiencies of tax. HMRC updates its 2016 guidance for large businesses on publishing their tax strategy. The decision in the Netherlands to abolish deductions for the coupons on contingent convertibles (CoCos) issued by banks and insurers with effect from 1 January 2019 based on concerns about State aid creates uncertainty for banks, insurers and their investors.

Ardmore: When does interest have a UK source?

This was the question the Court of Appeal recently considered in *Ardmore Construction Limited v HMRC* [2018] EWCA Civ 1438 before unanimously dismissing Ardmore's appeal. Since *National Bank of Greece v Westminster Bank Executor and Trustee Co* (1970) 46 TC 472, the question of source has been answered by the application of what has become known as the "multifactorial test". The Court of Appeal confirmed this involves an overall assessment of the situation, weighing and comparing the relevant factors.

The Court of Appeal noted that the application of the test is highly fact sensitive and accordingly the tribunals are best placed to examine the facts and apply a practical approach. A higher court should only interfere if it appears that the test has been incorrectly applied. Ardmore had failed to show that the Upper Tribunal left out of account any material factor or took into account any immaterial factor.

On the facts of Ardmore, the two candidates for the source of the interest were the UK (place of business of the borrower and place from where the interest was paid) and Gibraltar (the place of residence of the lender and the place where the credit was provided). The Court of Appeal concluded that the Upper Tribunal had applied the test correctly with the result that interest paid on the loan was from a source within the UK and Ardmore ought to have deducted tax from it.

Is there an easier way of determining UK source? Fifteen years ago, a consultation document proposed a statutory definition of "UK source" which would have followed the approach taken by the OECD model tax convention (reflected also in the Interest and Royalties Directive). Therefore, a payment would have a UK source simply if the payer were resident in the UK. The definition never made it on to the statute book, however. This is unsurprising as although it may look like a simplification on the face of it, it would have raised tricky issues such as how it would have applied to UK PEs of non-resident companies or to a payer that is a partnership with some UK and some non-UK resident partners. So the case law multifactorial approach lives on.

But how do you determine which factors carry more weight? Counsel for HMRC emphasised that the court should prioritise "substantive" factors based on the underlying commercial reality (such as the residence of debtor and guarantor) rather than factors that can be "manipulated" (such as the residence of the lender, the location of the

bank accounts from which funds were advanced, the place of payment of the interest, the jurisdiction in which proceedings might be brought to enforce the interest, the proper law of the contract and the situs of the debt). This appears to have gained some traction with Lady Justice Mary Arden whose evaluation of the Upper Tribunal concluded that it had looked to the substantive matters rather than theoretical factors and so had taken a practical, or realistic, point of view.

EU intermediaries disclosure rules

Another month, another compliance regime! This month it is the new EU intermediaries disclosure rules which provide for the mandatory disclosure of cross-border "potentially aggressive tax planning arrangements" by intermediaries (EU directive 2018/882). The information will then be automatically exchanged between the tax authorities of all member states. The aim of the new rules is to enable tax authorities to react more effectively to aggressive tax planning.

"Intermediary" for these purposes means "any person that designs, markets, organises or makes available for implementation or manages the implementation of a reportable cross-border arrangement". It is therefore broader than lawyers, accountants and tax advisers and could pick up, for example, in-house legal teams. Where an intermediary is prevented from disclosing because of privilege, the obligation falls on the taxpayer. A cross-border arrangement is disclosable if it meets at least one of the hallmarks set out in the directive. A tax benefit is required for some, but not all, of the hallmarks so it is possible that commercial transactions without a tax benefit may still require disclosure.

The latest date for adoption of the rules is 31 December 2019. It is expected that the UK will adopt the rules (which go further than the UK's DOTAS rules) but it is not known yet what changes may be made to our existing DOTAS rules, or what other form UK implementation may take. In the absence of any UK guidance or legislation, intermediaries and taxpayers are in a difficult position: although the first notifications are not due until August 2020, the first reports will cover the period from 25 June 2018. Taxpayers and intermediaries need to be tracking relevant arrangements now to enable them to file the reports in 2020, even though we do not yet know what the UK requirements for disclosure will be.

We eagerly await information about how this directive will be implemented in the UK. Instead of extending the DOTAS rules, for example, the transfer pricing hallmarks could be dealt with by adding to the international movement of capital rules a requirement to provide an early warning about relevant transfers (e.g. the transfer of hard-to-value intangibles and certain business restructurings causing a significant decrease in earnings before interest and tax). This would be preferable to introducing new hallmarks without a tax benefit test into the DOTAS rules.

Project Blue: FA 2003 S75A - a novel type of anti-avoidance rule

The much awaited decision of the Supreme Court in *Project Blue Limited v HMRC* [2018] UKSC 30 demonstrates that FA 2003, s75A is a novel type of anti-avoidance rule, the purpose of which is to fill the gaps in the legislation where the "avoidance" is not based on any motive or purpose of achieving a tax advantage, but rather is an insufficiency of tax due to defects in the legislation; in particular, where the interaction of reliefs/exemptions produces the "wrong" tax result. It operates by identifying a notional transaction on which SDLT is required to be paid, disregarding the actual land transactions, if the chargeable consideration payable under the notional transaction exceeds the amount that would otherwise be payable.

The insufficiency of SDLT in question arose in this case because of the interaction between the exemption for Ijara financing (an Islamic finance scheme compliant with Shari'a law) (s71A) and sub-sale relief (s45). In brief, the facts of this case are that Project Blue Limited (PBL) purchased the

Chelsea barracks from the Ministry of Defence (MoD), sold it to a Qatari bank which leased back the land to PBL. Options were granted to ensure PBL would acquire the freehold of the land from the bank at the end of the finance period. PBL claimed that there was no SLDT on the acquisition from the MoD because of sub-sale relief and the bank claimed that there was no SDLT on the sale to it under the alternative finance arrangements because of s71A.

The Supreme Court said, in essence, that s75A requires you to look at what has gone wrong with the legislation: Parliament introduced an exemption for Ijara-type financing which prevents an SDLT charge arising for the bank but failed to spot that, if there were a subsale too, there would be no SDLT for the purchaser. What Parliament should have done (and did eventually do) is disapply sub-sale relief when that exemption is relied on. This leaves in charge the real transaction whilst exempting the finance transaction – which is clearly the "right" tax result. On this basis, the purchaser for the notional transaction is PBL rather than the bank (PBL having benefited from the legislative loophole) and the notional transaction is the acquisition by PBL of the MoD's freehold interest in the barracks. The Supreme Court agreed with Judge Nowlan's statement in the Upper Tribunal that it is appropriate to have regard to the overall structure of SDLT which seeks to impose the tax on purchasers and not financiers.

The next issue for the Supreme Court to resolve was whether the consideration for the notional transaction is the £1.25bn financing amount or the £959m consideration given to the MoD as seller of the former Chelsea Barracks. According to s75(5), the chargeable consideration on the notional transaction is the largest amount given by any one person for the scheme transactions. This is £1.25bn (the purchase price the bank contracted to pay PBL for the purchase of the freehold in the barracks). This seems like a bizarre result as the SDLT ends up being paid on the financing amount, not on the purchase price paid to the MoD. As the legislation is drafted very mechanically to identify the highest consideration, it was not possible for the Supreme Court to do what Morgan J had done in the Upper Tribunal to construe the legislation so as to get to the £959m figure.

This decision also affects 24 similar commercial cases and similar avoidance schemes with around 900 users, so HMRC will be pleased with this win. For others, this case is important for shedding light on the purpose and scope of s75A and how to identify parties to the notional transaction.

Tax Strategy

HMRC has updated its 2016 guidance for large businesses on publishing their tax strategy. The June 2018 version contains more information on which businesses need to publish a tax strategy and when they must be published. There are also several subtle changes in the way the guidance is written which, taken together, show a move towards greater openness and transparency. Some examples of this are:

- in the section on how your business works with HMRC, the new version refers specifically to how the business works "to be transparent with HMRC" – the 2016 version just asked for details of how the business meets its requirement to work with HMRC;
- "your approach to structuring tax planning" has been added to the section of "Your business's attitude to tax planning"; and
- in the section on level of risk, the new version asks for an explanation of "what levels of risk your business is prepared to accept, and give details of the internal governance process for measuring this", whereas the 2016 version asked "if your business's internal governance has rigid levels of acceptable risk". Both versions require an explanation of how tax risk is influenced by stakeholders.

Another "small" change which might in practice be a sign of something more significant is that in in

the section "how to appeal against a tax penalty", the 2016 version stated that a business should first speak to the Customer Relationship Manager (CRM). The new version no longer suggests this but specifies an appeal must be in writing within 30 days of the penalty being issued. Is this another sign that the new Customer Compliance Managers have less authority to resolve issues than the old CRMs did?

Finally, the sentence from the 2016 version that the tax strategy does not need to be called a tax strategy is missing from the new version. As the new version states "A member of the public should be able to easily find the tax strategy by browsing your business's website, or searching online", it would imply it does now need to be labelled "tax strategy", otherwise anyone searching for it using that term will not easily find it!

Regulatory capital

The Dutch Ministry of Finance surprised the markets by announcing on the evening of 29 June that coupons on contingent convertibles (CoCos) issued by banks and insurers would no longer be deductible with effect from 1 January 2019, at least in part to address a State aid concern. The Dutch tax authority expects this change to result in about €150 million in extra revenue.

It is understood that this change is expected to apply to any AT1 or RT1 issued by a bank or insurer regardless of form. However, it was the implication in the announcement that the European Commission was looking at comparable regimes in other EU member states which really set the cat amongst the pigeons. Was the UK's equivalent regime, The Taxation of Regulatory Capital Securities, SI 2013/3209, in scope and, if so, could it too be vulnerable to a State aid challenge? What did this mean for banking and insurance groups planning an imminent issue? Should investors holding debt be poring over the tax event provisions?

As ever in (potential) State aid matters, it will take time for the full picture to emerge. However, for the time being we note the following:

- it is not at all obvious that banks and insurers with their (often EU based) particular regulatory capital requirements are comparable with ordinary corporate taxpayers (though anyone familiar with the Commission's challenge to the UK's finance company exemption would not be surprised if any references to EU requirements (in that case *Cadbury* (Case C-196/04)) were omitted);

- there are clearly very strong arguments that can be made that the right reference system is not the UK corporate tax code as a whole, but rather the tax rules applying to banks and insurers respectively. If banks and, for example, retailers are subject to the same rules and comparable, and it is State aid to allow the banks, but not retailers, deductions on certain debt with some equity like features, then is it not also State aid not to subject the retailers' profits to the banking surcharge, their balance sheets to the bank levy and so on and so forth? On any sensible view the answer should be that none of these differences is State aid because the banks and retailers are subject to different tax regimes and are not comparable; and

- there has been no change in the UK's clear policy that regulatory capital in the form of debt should be tax deductible.

What to look out for:

- On 26 July the Court of Appeal is scheduled to hear the appeal in *Brain Disorders Research Limited Partnership* concerning a partnership tax deferral scheme.
- This summer we expect to see published the draft bill creating a register of the beneficial owners of overseas companies and other legal entities that own UK property or engage in UK government procurement. The government plans for the register to become operational in 2021.
- Comments are requested by 7 September on the OECD's non-consensus discussion draft financial transactions guidance. This draft was initially expected in 2017 but was delayed because every issue to be covered (including cash pooling, the relevance of the group-wide credit rating in pricing a group entity's debt, captive reinsurance and guarantee fees) has proved to be contentious. It is understood a consensus draft will then follow in late 2018/early 2019.

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