SLAUGHTER AND MAY

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The FTT's decision in *Warshaw* shows that cumulative preference shares may, if they are also compounding, constitute ordinary share capital. The much-awaited draft regulations on the changes to the offshore receipts in respect of intangible property rules to ensure they are appropriately targeted at tax-motivated arrangements and robust against abuse are published alongside guidance on the rules. In *Hancock*, the Supreme Court dismisses a literal interpretation of the legislation as being contrary to Parliament's intention. A no-deal Brexit may give financial businesses greater input VAT deductions than at present but concerns are raised about the lack of progress made on the UK's long-term future relationship with the EU as regards financial services.

Warshaw: ordinary share capital

In *Stephen Warshaw v HMRC* [2019] UKFTT 268 the FTT had to grapple with the old chestnut of when is a fixed rate preference share "ordinary share capital". Since the late 90's the Inland Revenue (as it then was) was understood to take the view that to fall outside the definition any dividend right had to be both cumulative and non-compounding. This annoyed the company law purists, because HMRC took the view that a non-cumulative dividend meant the holder had a right to a variable dividend whereas a cumulative dividend meant the right was simply deferred to later periods. Whereas the company law purist would point out that the holder of a non-cumulative dividend right has the same dividend right in each dividend period, the only question is the extent to which it is satisfied, whereas the holder of a cumulative dividend right is entitled to a bigger dividend in later years when there have been earlier shortfalls. And it annoyed the economic purists because compounding better preserved the holder's economic return and was thus less equity-like in nature. But it was the received wisdom.

And so it proved in *Warshaw*. There the FTT had to determine whether the particular cumulative compounding preference shares held by Mr Warshaw were 'ordinary share capital' as defined by ITA 2007, s989 for the purposes of entrepreneurs' relief. The FTT found that they were and so Mr Warshaw met the condition for the company being his 'personal company' and was entitled to entrepreneurs' relief in respect of the disposal of his shares. However, the oddity here was the fact that it was HMRC which was trying to argue against the received wisdom. Further, HMRC itself had muddied the waters by allowing the CIOT to publish, in September, 2018, a document setting out its respective views on when preference shares were ordinary share capital which suggested (at example 11) that a fixed rate cumulative compounding preference share was not an ordinary share.

Although the case is about entrepreneurs' relief, the term 'ordinary share capital' is also relevant to other parts of the legislation such as group relief, consortium relief and stamp duty group relief. It is a good reminder that this is an area where the devil is very much in the detail. And that where, for whatever reason, a taxpayer wants to avoid having ordinary share capital, they should stick to the received wisdom and go for cumulative non-compounding fixed rate preference shares!

Offshore receipts in respect of intangible property: guidance and changes to the rules

The policy objective of the widely drafted offshore receipts in respect of intangible property rules introduced by Finance Act 2019 is to prevent

multinational groups from achieving artificially low tax rates on income derived from UK sales by holding IP in low-tax jurisdictions. The rules provide for a 20% self-assessed UK income tax charge on the income realised by an entity resident in certain low-taxed jurisdictions, in respect of IP used to enable, facilitate or promote UK sales. Various detailed exemptions and de minimis thresholds apply.

Following consultation with stakeholders, the draft regulations published on 24 May for consultation until 19 July propose welcome changes to ensure the rules are appropriately targeted to meet the policy objective. The regulations are expected to be made in autumn 2019 but many of the changes will be retrospective to 6 April 2019.

The changes to be made by the draft regulations include:

- modifying the definition of 'UK sales' – in particular allowing the look through of persons (such as distributers and resellers) who acquire and resell goods or services without making any change or modification;
- a new exception for sales by third parties where the IP or associated rights make an insignificant contribution to those UK sales;
- a new exemption for companies resident in specified territories that do not pose a risk to the purpose of the rules but which are in scope of the rules because they do not have an appropriate double taxation agreement with the UK. Such territories will be specified by another set of regulations to be made in the coming months which will be retrospective to 6 April 2019;
- relieving double taxation where more than one tax on offshore receipts charge applies to the same income in respect of related entities and relieving double taxation for partners of opaque partnerships taxable in full treaty territories; and
- extending the scope of the charge to low tax jurisdictions where the non-UK person is resident in a jurisdiction with which the UK has an appropriate double tax treaty but the provisions of that treaty mean there is no tax relief available to the person.

The guidance brings some welcome clarity and addresses some of the concerns about the scope of the legislation. For example, the rules have a widely drawn targeted anti-avoidance rule (TAAR) to counteract arrangements to circumvent the rules or which are contrary to the object and purpose of a treaty. There have been concerns that the TAAR could apply where groups wish to change behaviour to avoid being within the scope of the rules by bringing IP into the UK. Does the TAAR bite on such on-shoring transactions?

Section 5.1 of the guidance recognises that in interpreting the TAAR it is necessary to take into account the wider statutory purpose of the rules. The guidance states that it is accordingly unlikely that HMRC will make a counteraction where there has been a full, unconditional and outright transfer of all the transferor's legal and equitable rights in, and to, the relevant IP to the UK, a full treaty territory or to a specified territory, which results in a very strong alignment of the relevant IP with the underlying economic activities needed to support that IP.

The guidance recognises that financing arrangements on a sale of IP could be used to recreate existing income streams from the IP, such that profits continue to arise in the 'bad' jurisdiction. Example 2 of section 5.1 lists circumstances in which HMRC is likely to make a TAAR counteraction and includes where arrangements surrounding the transfer of IP lead to 'economically equivalent circumstances' so that the income on the disposal continues to accrete in a no or low tax jurisdiction. Financing put in place as part of an IP transfer (e.g. through the purchase price being left outstanding or the issue of notes) should not be problematic so long as the financing arrangements do not involve 'economically equivalent circumstances' such as interest payments being made to the 'bad' jurisdiction which are tied to income/profits on the exploitation of the underlying IP.

Another concern addressed by the guidance is whether 'UK-derived amounts' include amounts received by the chargeable person for the outright disposal of IP. Some of the old case law on the definition of 'royalty' and the meaning of 'payments for the use of IP rights' cast doubt on whether an outright sale would necessarily take payment for the ownership of IP outside the scope of the 'UK-derived amount' definition. Section 7.2 of the guidance explains that UK-derived amounts are not generally expected to include amounts received by the chargeable person for the outright disposal of the relevant IP. The evaluation of whether amounts are in respect of an outright disposal will, however, depend on the facts and circumstances of the transaction.

Inevitably, the guidance does not (yet) answer all the remaining questions, but it is a helpful starting point.

Hancock: literal interpretation of the statute would be contrary to Parliament's intention

The Supreme Court unanimously dismissed the taxpayers' appeal in *Hancock & Hancock v HMRC* [2019] UKSC 24. The case involved a scheme to avoid a large CGT charge on the redemption of loan notes by the use of a conversion structure which the taxpayers argued fell outside the Taxation of Chargeable Gains Act 1992, s 116. Mr & Mrs Hancock exchanged shares for loan notes which, being convertible into foreign currency, were not qualifying corporate bonds (QCBs). The gain on the disposal of the shares was rolled over into these non-QCBs under s127 TCGA. The non-QCBs were then converted into QCBs in two stages. First, around 10% of the non-QCBs were initially converted into QCBs. Then the remaining majority of the non-QCBs were converted, along with the existing QCBs, into new QCBs. The new QCBs were subsequently redeemed for cash. In this way, the taxpayers argued that the conversion of the majority of the loan notes fell outside the strict wording of s 116 and the hold over provisions did not apply. The gain was therefore rolled over into the exempt QCBs, thus escaping a CGT charge.

The issue before the Supreme Court was whether s 116 applies where by a single transaction, both non-QCBs (which are within the charge to capital gains tax on redemption) and QCBs (which fall outside the charge to capital gains tax on redemption) are converted into QCBs. The Supreme Court unanimously dismissed the appeal holding that s 116 does apply. Lady Arden, with whom the others agreed, delivered the judgment. She concluded that, in summary, on the true interpretation of s 116(1)(b), the potential gain within the non-QCBs was frozen on conversion and did not (to use Lewison LJ's words) 'disappear in a puff of smoke'.

Although the legislation contained clear words which could be read literally in favour of the taxpayers, that result would be contrary to Parliament's intention which was that each security converted into a QCB should be viewed as a separate conversion – which in this case amounts to the same thing as regarding the conversion as consisting of two conversions (one of QCBs and one of non-QCBs).

Brexit and financial institutions

Although about 80% of the UK economy is composed of services industries, so far, the focus of the government has been on the supply of goods. There are some tax implications to consider but the barriers to the cross-border provision of services are mainly regulatory. Andrew Bailey, Chief Executive of the FCA expressed concern to the Financial Times that little progress has been made on the UK's long-term future relationship with the EU as regards financial services. Last year, the government pledged that some form of equivalence regime would be included. Bailey would prefer an 'outcomes-based' regulatory relationship with the EU, rather than the UK having to follow rules set by Brussels. The UK and US have fostered strong capital markets on the basis of less interventionist regulatory regimes so there is evidence that this can work.

In the short term, banks have had to do more than just contingency planning on paper. In order to ensure they can meet regulatory requirements whatever the Brexit outcome, some have had to arrange for the movement of capital and sufficient people from the UK to one of the EU 27 countries. A recent example, reported in the *Irish Times*, is of Barclays injecting EUR 2.6bn into Barclays Bank Ireland in order to have a business in the EU that would be able to maintain access to clients across the EU.

'No-deal' is still the default option if nothing else is agreed by 31 October. In the event of a no-deal Brexit, assuming the VAT regulations made in February 2019 (SI 2019/408) come into effect as currently drafted, UK businesses supplying insurance and financial services to EU customers will have an entitlement to increased input VAT recovery when the supplies they currently make into the EU become treated in line with the VAT treatment of supplies to customers in the rest of the world.

As part of its no-deal 'Brexit preparedness' legislation, the EU has legislated for temporary, limited measures to ensure that there is no immediate disruption in the central clearing of derivatives, central depositaries services for EU operators currently using UK operators, and for facilitating novation, for a fixed period of 12 months, of certain over-the-counter derivatives contracts, where a contract is transferred from a UK to an EU27 counterparty.

While uncertainty over Brexit continues, EU Member States have also been taking unilateral measures to mitigate a no-deal impact on the economy, alongside the domestic implementation of the EU legislation. Many of these measures apply to financial services. Some of the unilateral measures require action to be taken to benefit from a transitional regime to protect the status quo, others apply automatically. The transitional periods vary in length across different jurisdictions. Although it is helpful to have these unilateral measures, there will inevitably be gaps and there will be complexity in applying the piecemeal regulatory and tax rules. Fingers crossed for some sort of sensible deal with the EU for the future relationship of financial services.

What to look out for:

- The Court of Appeal hearing in *Coal Staff Superannuation Scheme Trustees* on whether the pre-2014 manufactured overseas dividends rules constitute a restriction on free movement of capital is scheduled to begin on 25 June.

- The Supreme Court hearing in the Franked Investment Income Group Litigation is scheduled for 27 June.

- HMRC is consulting until 17 July on the operation of insurance premium tax (IPT) (but not on rates or exemptions). HMRC is calling for evidence to understand how the administration and collection of IPT can be modernised for optimal efficiency and the extent to which unfair tax outcomes exist and might be addressed.

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