Tax and the City Review

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In *Panayi*, the FTT decides conforming construction of UK legislation to make it compatible with EU law is possible even where the Tribunal has to choose between different potential deferral methods, in contrast with the approach previously taken by a different FTT judge in *Gallaher*. The UK is rated the 8th best place to do business in the world and moves up one place to 25th in the latest International Tax Competitiveness Index, but a PwC report for UK Finance shows a decline in the fiscal competitiveness of the UK for banking business relative to other global financial centres. In the *Irish Bank* case, the Upper Tribunal finds in favour of HMRC that the attribution of notional capital to a permanent establishment as required by UK law (rather than looking at actual capital) is compatible with the terms of the UK/Republic of Ireland tax treaty. Regulations are laid before Parliament to be made by the end of the year to make technical changes to the offshore receipts in respect of intangible property rules to avoid unintended consequences.

Panayi: conforming interpretation of exit tax rules

In *The Trustees of the P Panayi Trusts* [2019] UKFTT 0622, the First-tier Tribunal (FTT) had to apply the CJEU's ruling that the exit charge on trustees relocating from the UK contained in TCGA 1992 s 80 was incompatible with EU law where trustees relocated to another EU member state because there was no possibility of deferral of the tax charge.

In *Panayi*, shares had been sold by the trustees in December 2005, which was before the date for payment of the exit charge under UK law (31 January 2006), a fact pattern which has not arisen in previous cases before the CJEU which have concerned the taxation of latent gains before actual realisation. The CJEU ruled, in line with other exit tax cases, the lack of possibility of deferral of the tax charge under the legislation at the relevant time made it lack proportionality. The FTT, therefore, had to determine whether a conforming interpretation of the UK legislation to make it more proportionate was possible.

A conforming interpretation must, by definition, go further than the normal rules of interpretation: the question for Judge Mosedale was how much further? If a right to deferral can be read into the UK legislation, should it be deferral until realisation of the asset, or payment over a number of instalments?

This issue is reminiscent of *Gallaher* [2019] UKFTT 207 (TC) in which the offending exit tax provision was TCGA 1992 s 171. At the relevant time this provided, broadly, that intra-group transfers were on a 'no gain/no loss' basis if the transfer was between UK companies, but not if the transfer was from a UK to a non-UK company. Judge Beare decided that a conforming interpretation was not possible because reading a deferral provision into the legislation would require choosing between different deferral regimes: a choice which should be made by the legislature rather than the judiciary. (Draft legislation for inclusion in Finance Bill 2019/20 amends the existing deferred payment tax rules in TMA 1970 Sch 3ZB to provide for payment in instalments over a five year period of this exit charge.)

Judge Beare considered that conforming interpretation would have required him to make decisions such as over how many years the tax should be deferred and whether interest should be charged on the deferred tax, which he considered to be inappropriate for the Tribunal to make. By

contrast, the fact that making a conforming interpretation would necessarily involve her deciding which of the proposed conforming interpretations was the most appropriate did not deter Judge Mosedale in *Panayi*. Judge Mosedale followed the principles established by case law that a conforming interpretation should be the one most consistent with the UK's legislative regime and should be simple.

Judge Mosedale concluded that TMA 1970 s 59B, before being amended to comply with EU law, should be read (in the circumstances where the taxpayer's right of freedom of establishment would otherwise be infringed) as including an option to defer payment of the s 80 exit tax in five equal annual instalments, without liability to interest, the first of which was payable on 31 January 2006. Interest would then arise under the normal legislative provisions (TMA 1970 s 86) to the extent an instalment is unpaid after its due date. Judge Mosedale, keeping it simple, concluded there is no need to read in any rules about interest, early realisation precipitating liability, nor about requiring security.

HMRC will no doubt be pleased with this result. HMRC has lodged an appeal in *Gallaher* before the Upper Tribunal. It will be interesting to see what the Upper Tribunal makes of the difference in the approach to conforming construction between the judges in *Gallaher* and *Panayi*.

Ease of doing business, tax competitiveness and bank taxation

According to Doing Business 2020 published by the World Bank, the UK is ranked 8th in the world for ease of doing business, up from 9th in the 2019 report. New Zealand and Singapore remain first and second, respectively. Widespread use of electronic systems is a common factor for those that scored highest for ease of doing business. The top 20 economies in the list have online business incorporation processes, electronic tax-filing platforms, and allow online procedures related to property transfers.

The UK has also moved up one place to 25th in the latest International Tax Competitiveness Index published by the Tax Foundation. Estonia remains in first place. The UK is criticised for its very high top rate of income tax on dividend income as this has an adverse effect on the cost of investment. Luxembourg, Belgium, the Netherlands and Ireland all fall in the rankings this year, which illustrates that the implementation of ATAD has eliminated some of the advantages these countries previously had over other EU states.

It is not all good news, however. A report prepared by PwC for UK Finance, '2019 Total Tax Contribution of the UK banking sector', reveals that banks have seen a 50% rise in UK taxes borne over the past five years. A combination of the bank levy, bank surcharge, employment taxes and irrecoverable VAT have increased the tax burden of banks operating in the UK. 43.3% of the taxes borne are not dependent on profits. The report shows that the fiscal competitiveness of the UK for banking business has declined relative to other global financial centres such as New York. UK Finance hopes that the report will inform the debate over bank taxation.

Irish Bank Resolution Corporation - attribution of notional capital to permanent establishment

Irish Bank Resolution Corporation Limited (in special liquidation) and Irish Nationwide Building Society v HMRC [2019] UKUT 0277 (TCC) is an important case on the interaction of UK domestic legislation with double tax treaties. The taxpayers, IBRC and Irish Nationwide, are companies resident in the Republic of Ireland (RI) and both traded in the UK through a permanent establishment (PE) at the relevant time. The taxpayers are, therefore, chargeable to UK corporation tax on the profits attributed to their respective UK PE.

Each PE borrowed from the respective taxpayer and paid interest on the borrowing. Each taxpayer claimed deduction of interest expenses paid to them by their respective PE. The amount of interest deductible depends on the level of

borrowing by the PE, which in turn depends on the level of capital attributed to the PE. HMRC disallowed the interest on the basis of ICTA 1988, s11AA(3) (now CTA 2009, ss 21(2)(b) and 30). These provisions:

- require an assumption to be made that a PE is attributed a notional level of capital expected of a distinct and separate enterprise dealing wholly independently with the non-resident company; and
- disqualify for deduction interest and other costs which would not have been incurred if the assumed level of capital was in fact held by the PE.

The taxpayers appealed to the FTT arguing that the UK/RI double tax convention (DTC) obliged HMRC to compute a PE's profit by the PE's books of account, including the capital actually attributed to the PE. The taxpayers argued that s11AA(3) was precluded by the DTC.

The FTT had concluded that s11AA(3) does not offend Article 8 of the UK/RI DTC. In fact, it found it gives effect to the Article 8(2) requirements that it should be assumed that the PE is trading 'under similar conditions' and that it has 'such equity and loan capital as it could reasonably be expected to have', reflecting the Article 8(2) assumption that it is a 'distinct and separate enterprise'.

The UT also decided the case in favour of HMRC. The UT concluded that s 11AA(3)(b) is not the only way of implementing Article 8 but is entirely consistent with and permitted by the terms of the DTC. Although the UK/RI DTC requires the UK to assume that the PE is a 'distinct and separate enterprise', it does not lay down one single specific way to do this (the 2008 Commentary makes clear the considerable variation in terms of state practice when applying Article 7 of the 1963 OECD Draft Convention on which the UK/RI DTC was based).

Article 8(3) makes it clear that the starting point for allowing deductions for expenses of the PE is the actual records, including, for example, the capital actually attributed to the PE. If, and to the extent that, the PE's business has not been conducted as if it were a distinct and separate enterprise, the books of account must be adjusted to reflect the hypothesis laid down in Article 8(2) of the UK/RI DTC.

The UT was satisfied that s11AA(3)(b) ICTA implements Article 8(3) by ensuring that the PE's books of account are cross-checked and adjusted by attributing to the PEs a notional amount of equity and debt capital, including an amount of 'free capital' (on which no interest is deemed to have been incurred), which differs from the actual capital employed in the trade of the UK branches of the taxpayers. Consequently, HMRC was correct to disallow the interest deductions because the taxpayers had understated the amount of equity capital each PE was deemed to hold and so overstated the amount of loan capital and the associated interest charges.

This case will be of interest to other UK DTCs with similar business profits articles based on the pre-2010 OECD Models. The wider points about interpretation of DTCs will be of more general interest, however. For example, the conclusion that the unilateral past practice of a tax authority, no matter how well informed, is irrelevant to the interpretation of a tax treaty.

Offshore receipts regulations

The offshore receipts in respect of intangible property (ORIP) rules introduced by FA 2019 are intended to target multinational groups that generate significant income from intangible property through UK sales and have made arrangements for the income to be received in offshore jurisdictions where it is taxed at no or low effective rates. FA 2019 included a power to make technical changes to the ORIP rules to alleviate any unintended outcomes.

Following the consultation on draft amending regulations between May and July, final regulations

have been laid before Parliament (although they have not yet been made). Further regulations for the new exemption from ITTOIA 2005, Part 5, Chapter 2A (where a company is resident in a specified territory) are expected to be made in the coming months.

The amendments to be made to Chapter 2A by the regulations are as outlined in our June review (*Tax Journal*, 14 June) but with the addition of a further exemption for tax transparent entities situated in a non-low tax jurisdiction which are 100% owned by residents in that jurisdiction. Without this exemption, such entities would be caught by the rules because they do not meet the technical criteria of being tax resident in the non-low tax jurisdiction even though the relevant IP income will be subject to tax there.

HMRC has also updated its draft guidance on the ORIP rules which will become INTM87000. The updated guidance includes the new exemption for certain bodies corporate that are transparent in a full treaty country. Other changes include the addition of 'Treaty claims' under 'Process and Procedures' and the addition to the 'Glossary' of the meaning of 'arising'. It is HMRC's view that UK-derived amounts arising to a person in a tax year should include amounts received and amounts to which the person is entitled, including where amounts become receivable by the person. The draft guidance notes that whether something is received or receivable is not determined by accounting principles, so the calculation of income arising for the purposes of the ORIP rules may differ from amounts recognised for accounting purposes.

What to look out for:

- The OECD consultation on the 'pillar one' proposal for digital economy taxation closes on 12 November. There will then be a public discussion in Paris on 21/22 November.
- The OECD consultation document on 'pillar two' (the global anti-base erosion proposal) is expected to be published in early November for a public consultation in December.
- The Hybrid and Other Mismatches (Financial Instrument: Exclusions) Regulations 2019 come into force on 29th November 2019 but have effect in relation to payments made on or after 1 January 2019 and quasi-payments (amounts which arise or accrue that give rise to allowable tax deductions) in relation to which the payment period begins on or after that date, in accordance with FA 2019, s 19(8). These regulations ensure that anything that was a regulatory capital security for the purposes of the RCS Regulations is still exempt from counteraction under the hybrid and other mismatches legislation. These regulations also ensure that certain other hybrid instruments that banks issue that meet the definition of own funds and eligible liabilities are also exempt.
- The annual report on HMRC's Code of Practice on Taxation for banks is expected by the end of the year, together with revised guidance on the Code.

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