Insight and analysis for the business tax community

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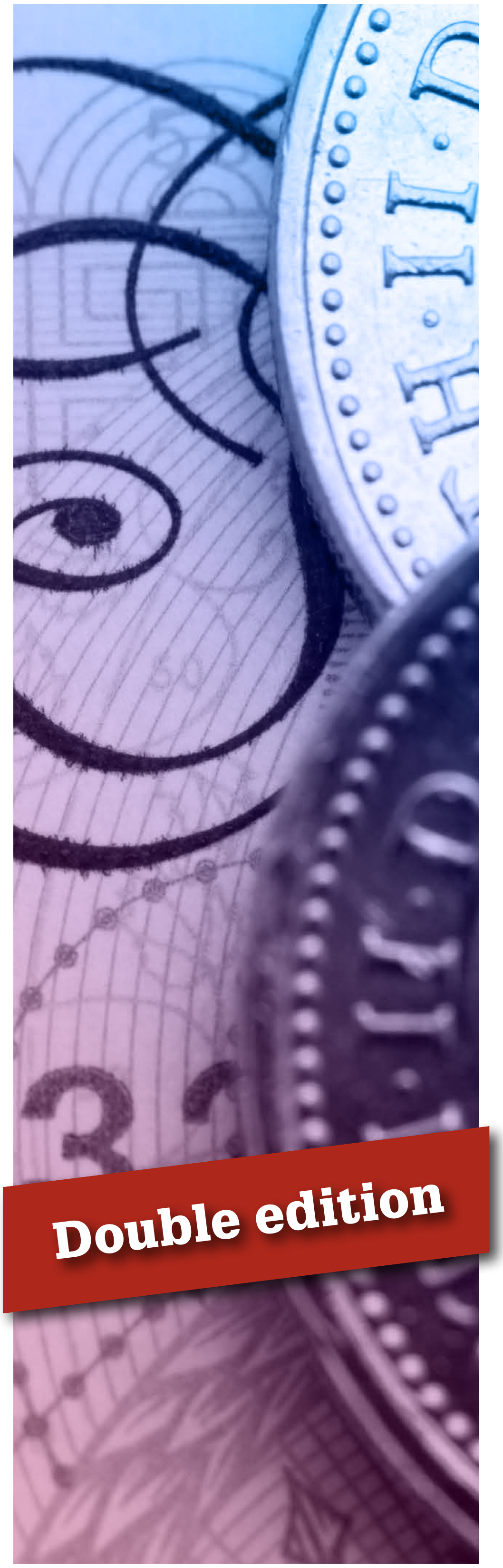

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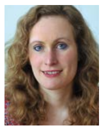

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From the editor

Finance Act 2015 adds another 340 pages to the already burgeoning UK tax code. It is not the longest Finance Act by any means – that honour goes to FA 2012 which, among other things, introduced a new regime for CFCs. But it is the longest Finance Act to be rushed through before a general election, with just a single day's debate in Parliament. Only a handful of (relatively minor) measures were deferred, but there was never going to be any delay to the introduction of the diverted profits tax. And the Act does include significant changes from the earlier draft provisions, including to the DPT rules.

The purpose of this edition is to provide you with a handy guide to the final rules. We have a four page overview, followed by detailed expert insight on some of the highlights. I thank all our authors for their contributions, and I hope you find this edition to be a useful reference guide.

We can look forward to another Finance Act later this year, presumably in July, when hopefully there will be a more meaningful Parliamentary debate.

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News

Covering the key developments in tax

Business taxes

Diverted profits tax guidance

HMRC has made minor changes to its guidance on the diverted profits tax, replacing the version published last December. The updated guidance corrects an error on page 66 in the section on the duty to notify and adds a factual description relating to partnerships to the bottom of page 10. See www.bit.ly/12Qn0GK.

Personal taxes

HMRC restricts EIS and VCT advance assurance applications

HMRC has published new guidance on changes to how it processes enterprise investment schemes (EIS) advance assurance applications and EIS compliance statements for investments made on or after 6 April 2015 in companies that exceed the prescribed age and investment limits.

With immediate effect, HMRC will not process advance assurance applications in respect of companies that, in general:

- are more than seven years old and have not received a risk finance investment in the past (which includes any investment received under the SEIS, EIS or VCT schemes; more details on what a risk finance investment is can be found in the HMRC's *Venture Capital Schemes Manual* at VCM12030); and
- have received more than £10m risk finance investment funding (formerly known as risk capital investment funding).

While HMRC will still process forms EIS1 compliance statements, in respect of investments into companies that exceed either of these limits, investors should be aware that HMRC may have to recover any tax relief claimed on investments made on or after 6 April 2015.

HMRC may also have to check that investors claiming tax relief under EIS are 'independent', i.e. independent from the company; and that they hold no other shares in the company at the time they first invest in the company, unless:

- the individual has made a previous risk finance investment in the company;
- the existing shares were issued to the individual when the company was founded; or
- the existing shares were acquired when a pre-formed dormant company was bought 'off the shelf'.

HMRC has also set out the new information that will now be requested to support advance assurance requests and forms EIS1, along with the reasons why the changes have been made.

See www.bit.ly/1Gf0V40.

People and firms

Grant Thornton has promoted two people in its real estate tax team, and made a senior hire. **Jessica Patel** has been promoted to director, **David Farr** has been promoted to associate director, and **Matthew Stannard** joins the firm from Hines as a senior manager.

Law firm **Boodle Hatfield** appointed partner **Simon Rylatt** as head of the firm's private client and tax team. The appointment takes place from 1 May 2015 as Sara Maccallum steps down from the role.

London-based chartered accountants **BKL** has announced the promotion of **Doug Sinclair** to partner. He joined BKL three years ago as head of tax investigations after four years at Crowe Clark Whitehill.

Mazars has merged with independent German firm **Roever Broenner Susat**. The move is said to be prompted by changes to European audit regulation. The merged business has more than 1,000 staff, including 68 partners, in 12 offices around the country. The merger has immediate effect, subject to the approval of the German competition authorities. Philippe Castagnac, Mazars' group CEO, said the merger 'strengthens our position at the heart of Europe's first economic power. It's a smart move.'

To publicise tax promotions, appointments and firm news, email *paul.stainforth@lexisnexis.co.uk*.

Stamp taxes

SDRT repayment claims following *HSBC/BNY Mellon*

HMRC has republished its April 2012 guidance on SDRT repayment claims, in respect of shares in UK companies issued to depositary receipt systems or clearance services located anywhere in the world. The original guidance was published in light of the CJEU decision in *HSBC Holdings and Vidacos Nominees* (C-569/07). The revised guidance contains details of the First-tier Tribunal decision in *HSBC Holdings and Bank of New York Mellon* [2012] UKFTT 163, which the department is not appealing and is now final. The guidance makes clear that repayment claims should be made within a period of four years beginning with the later of the date on which the tax was paid and the relevant accountable date for payment of SDRT under the SDRT regulations. See www.bit.ly/1btyZiW.

VAT

HMRC's handling of MOSS criticised

A report by Enterprise Nation criticises HMRC for its handling and communication of changes to European VAT legislation implemented in January, especially as concerns the mini one-stop shop (MOSS). *The EU VAT taxation report* (www.bit.ly/1zFRsOl) says that, in 2013, an HMRC investigation put the figure of non-VAT registered firms likely to be affected at 5,000. However, the Department for Business, Innovation and Skills (BIS)figures put the number closer to 350,000, but that information did not inform HMRC research; and HMRC did little to raise awareness of the changes in the marketplace until just weeks before implementation.

Emma Jones (Enterprise Nation) said: 'The EU VAT regulations caused havoc in the digital small business community. If details of the new charges and reporting responsibilities had been communicated earlier, we're sure there could not only have been more opportunity to make amendments to the bill, but that an entrepreneurial solution to the problem could have been developed. As it was, not even the marketplaces themselves had prepared new software or worked out the finances.'

Jordan Marshall of the Association of Independent Professionals and the Self Employed (IPSE) said: 'A shocking lack of joined-up thinking from government appears to be at the root of the problem … Moving forward, we urgently need to exempt our smallest businesses from the crippling compliance cost of this regulation.'

Between 2006 and 2014, the European e-commerce market nearly tripled, growing from €106bn in 2006 to €317.9bn in 2014.

CTG criticises HMRC's lack of VAT guidance on direct mail

The Charity Tax Group (CTG) has expressed its disappointment that HMRC has not yet published revised guidance on the VAT rating of charities' direct mail supplies, which had been promised 'in the new year'.

HMRC had previously announced that, from 1 October 2014, zero rating would only apply to the production of direct marketing material, rather than the entire package. HMRC subsequently agreed to postpone the change until 1 April 2015,

Our pick

Australia and UK urge G20 to stop MNEs diverting profits

The Australian government confirmed in a statement on Sunday that, during the meeting of the G20 in Washington DC, the Treasurer of Australia, Joe Hockey, and the UK's chancellor of the Exchequer, George Osborne, announced 'the urgent establishment of a joint working group to further consider and develop initiatives in relation to diverted profits by multinational enterprises'. The working group is open to all G20 members and any initiatives will be consistent with OECD BEPS work.

'The ministers have resolved, subject to the completion of the UK general election, to establish a senior officials working group that will develop measures to address the diversion of profits by multinational enterprises away from their host countries,' Hockey's statement said. 'Both the UK and Australia have sought to put in place competitive business tax regimes in order to encourage enterprise and investment, but those tax rates should be paid, not avoided through artificial structures.

'The working group will build on the UK's experience of introducing a diverted profits tax (DPT), which came into effect at the beginning of April. This is a global issue that needs to be quickly addressed'.

The move follows the Australian Parliament's Economics References Committee hearing on corporate tax avoidance the previous week, in which the director OECD's centre for tax policy and administration, Pascal Saint-Amans, gave evidence – and said the OECD was 'embarrassed' by the UK's decision to introduce the DPT ahead of the completion of the BEPS project, recommending that Australia not do the same.

In a television interview with ABC, Hockey said that Australia would not be implementing a UK-style DPT, but that 'certainly there are ways that we can beef up the integrity measures around our own taxation system [and] we can learn a lot from what the British are doing with their so-called "Google tax"'.

He added: 'Whilst we recognise that the OECD is undertaking work which Australia initiated and promoted last year, we obviously want to go further and faster … But importantly, the whole world needs to work together and by the UK and Australia coming together on this initiative, we are going to lead the world and work with the OECD and the G20 to ensure that companies pay the proper amount of tax where they earn the income.'

having accepted that its original guidance was unclear.

CTG chairman, John Hemming, said: 'HMRC has failed to publish guidance on VAT and direct mail, and failed to resolve outstanding concerns that the retrospective concession, which we negotiated, has been narrowed to exclude unaddressed mailings and data correction services in direct contradiction to earlier promises. It is unsatisfactory that charities have to operate according to new rules from 1 April without formal notice from HMRC of their responsibilities.

'In the light of HMRC's refusal to discuss matters further, the only course of action open to CTG is to publish the exchange of correspondence with HMRC and to warn our members to:

- take note of HMRC's letter (and the HMRC guidance when it is finally published) but bear in mind that there are points that are not fully dealt with;
- talk to their mailing providers/ professional advisers;
- stop treating services of print and delivery of charity mail packs as a composite zero rated supply of delivered goods;
- consider instructing print companies to arrange for all delivery services to the charity's targets to be provided as an agency disbursement; and
- contact CTG if HMRC attempts to assess VAT retrospective unaddressed mail services and data manipulation services (involving suppressions, as well as correction of names, addresses and postcodes) which were required to meet the mail operator's contractual standards as, in our view, these should be treated as being ancillary. Charities need to be aware that where such VAT is assessed, the print company may seek to charge the VAT on to their charity clients if there are VAT exclusive clauses in contracts.'

International taxes

Latest BEPS discussion draft

The OECD invites comments by 8 May 2015 on a discussion draft for action 11 of the BEPS action plan, which looks at collection and analysis of data on base erosion and profit shifting by multinational companies (see www.bit.ly/1IRjvTx). This discussion draft includes chapters that focus on three key areas as follows:

- an assessment of existing data sources relevant for BEPS analysis, describing the available data and their limitations for undertaking an economic analysis of the scale and impact of BEPS and BEPS countermeasures;
- providing potential indicators of the scale and economic impact of BEPS and their various strengths and limitations; and
- setting existing empirical analyses of BEPS and proposing two complementary approaches to estimating the scale of BEPS.

Heather Self (Pinsent Masons) said that the OECD was wrong to treat the need for accurate data as 'just another action item'.

'I find it staggering that so much resource is being put into solving a problem without defining the size and scale of the problem first,' Self said. 'There are perceptions that BEPS is a major issue, but there is a distinct lack of evidence – and therefore a risk that any "solution" is worse than the problem.'

Meanwhile, OECD secretary general Angel Gurría said that 'we are now in the decisive stages of the G20/OECD BEPS project'. In a speech at last week's G20 meeting in Washington DC, he said: 'In Lima, six months from now, at our dinner dedicated to discussing the G20 tax agenda, I will be presenting to you the full package of 15 BEPS deliverables agreed by consensus between the 44 members of OECD and G20. With just six months to go, there remain a few important items to finalise.'

FATCA: Uzbekistan signs IGA with US

Uzbekistan has become the latest jurisdiction to officially sign a Foreign Accounts Tax Compliance Act (FATCA) intergovernmental agreement (IGA) with the US. The Uzbekistan IGA is based on model 1B IGA. Uzbekistan previously reached an agreement in substance for a model 1A IGA with the US and has been treated by the US Treasury as having an IGA in effect from 30 June 2014.

Administration

HMRC updates list of ESCs

HMRC has updated its published list of former Inland Revenue extra-statutory concessions (*Notice IR1*) to reflect the status at 6 April 2015. See taxjournal.com for details.

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Cases

Reporting the tax cases that matter

Business taxes

EU law and the amortisation of goodwill in non-resident companies

In ***Finanzamt Linz v Bundesfinanzgericht, Aussenstelle Linz*** (C-66/14) (16 April), the advocate general (AG) considered that the rules on the amortisation of goodwill, which differentiate between participation in resident and non-resident companies, are not compatible with EU law.

The issue was whether the Austrian provisions on the taxation of groups are compatible with EU law, as acquisitions in Austrian companies are treated differently from those in non-resident companies. Goodwill amortisation is only available within Austrian companies.

The AG considered that this difference was potentially in breach of the principle of freedom of establishment. It robustly rejected the Austrian government's argument that this would not be an issue in situations where the goodwill is negative, noting that acquisitions of companies with negative goodwill are likely to be very rare. The AG also noted that, for these purposes, resident and non-resident subsidiaries are in objectively comparable situations; and that such a difference of treatment was not justified by the need to maintain the cohesion of the tax system.

The AG concluded that the measure in question contravened the principle of freedom of establishment.

Why it matters: **The CJEU has already examined in detail the taxation of groups in France, Holland and the UK. This case will be the opportunity for the CJEU to review the taxation of groups in Austria. It remains to be seen whether it will find that the Austrian provisions are incompatible with EU law.**

Personal taxes

Failure of a capital loss scheme

In ***Steven Price and others v HMRC*** [2015] UKUT 164 (17 April), the UT found that a capital loss scheme failed under the *Ramsay* principle.

The taxpayers had participated in schemes designed to create capital losses. Their success was predicated on the participants having spent large sums on acquiring assets and having realised very small amounts on their disposal. This, in turn, depended on the disapplication of TCGA 1992 s 17, which deems a transaction between parties who are not dealing at arm's length to be at market value. The FTT had found that the transactions had been at arm's length, so that s 17 was not in point; however, the FTT had drastically reduced the acquisition price (TCGA 1992 s 38) and therefore the loss. This was the main issue of this appeal.

The FTT had found, by way of example, that one participant in the scheme had paid £1 for an option and £6m when exercising the option. Under the scheme, however, he was the beneficiary of a trust endowed with assets which were available to him and worth £6m. The FTT had therefore concluded that the £6m had not been paid for some 'worthless shares', but for the scheme as a whole, the value flowing into the trust.

Referring to *Arrowtown* [2003] HKCFA 46, the UT stressed the requirements to 'construe statutory provisions purposively' and to 'view transactions realistically'.

The UT confirmed that the FTT had asked the right question; what did the taxpayer pay for? The obvious answer was that he had not outlaid £6m for some 'worthless shares'. Similarly, the FTT had adopted the appropriate realistic approach when concluding that the subscription for the shares had not been an isolated transaction, but had formed part of a composite and preplanned series of steps. The UT therefore found that the factual conclusion was open to the FTT, given that 'a person does not normally pay £6m for an asset worth £600'.

Why it matters: **This case is a practical example of the application of the *Ramsay* doctrine to a set of circular and preordained steps entered into for the purpose of tax avoidance. Interestingly, rather than simply recharacterising the transactions by ignoring artificially inserted steps, both tax tribunals simply found that the monies expended did not represent the acquisition cost of the shares – which was, therefore, much lower.**

Scrip dividends and the exit charge

In ***Meena Seddon and others v HMRC*** [2015] UKFTT 140 (9 April), the FTT confirmed notices of determination in relation to a settlement.

The appellants were the trustees of a settlement. They had received a scrip dividend and, a few days before the tenth anniversary of the commencement of the settlement, they had made a distribution worth over £1m to certain beneficiaries. The issue was the rate of the exit charge for IHT purposes.

The trustees contended that the scrip dividend was income and had not been accumulated as capital. As such, it did not fall to be taken into account in calculating the exit charge and so no tax was due on the distribution. HMRC argued that the scrip dividend was capital and that trust property had ceased to be 'relevant property', and so an exit charge was due at the rate of 4.81%. This rate was high due to the proximity to the tenth year anniversary.

The FTT noted that there were conflicting decisions on the tax status of scrip dividends. It added that it was bound by the most recent first instance decision, that of the UT in *Gilchrist* [2014] UKUT 169. Consequently, the scrip dividend was capital in the hands of the trustees.

The FTT then set out to assess the exit charge (IHTA 1984 s 68). The issue was the extent to which property should be treated as becoming comprised in a settlement after the date of commencement. The UT noted that a scrip dividend involves new shares becoming comprised in the settlement; and that property can become comprised in a settlement without being the object of a disposition. The scrip dividend was therefore comprised in the settlement for the purpose of s 68 and the exit charge was due. Finally, even if the scrip dividend had been income, the trustees had not established that it had not accumulated as capital.

Why it matters: **Despite conflicting authorities, the case establishes (for now) that a scrip dividend is capital in the hands of trustees of a settlement and can be comprised in that settlement for the purpose of the IHT exit charge.**

EIS and reverse takeovers

In ***Gregory Finn and others v HMRC*** [2015] UKFTT 144 (13 April), the FTT confirmed that a company which had undergone a 'reverse takeover' ceased to qualify for EIS.

PhotonStar LED had 12 to 15 enterprise investment scheme (EIS) investors. It sought an AIM listing and started negotiations with Enfis for a 'reverse takeover'. Both companies were in the LED lighting business and Enfis' shares also qualified for EIS. Enfis acquired PhotonStar by way of a share for share exchange, HMRC having confirmed that Enfis would continue to be 'a qualifying company' for the purpose of EIS.

Following the reverse takeover, HMRC wrote to PhotonStar informing it that it no longer qualified for EIS, stating that EIS is withdrawn where the company becomes the 51% subsidiary of another company (ITA 2007 s 185), or where shares in the company are sold within three years of their issue (ITA 2007 s 209).

The appellants' main argument was that PhotonStar and Enfis had become one company, so that PhotonStar had not

Our pick

European Commission v Federal Republic of Germany

Deferral relief and cross-border reinvestment

In ***European Commission v Federal Republic of Germany*** (C-591/13) (16 April), the CJEU found that German provisions which only allow the deferral of capital gains tax in circumstances where the sale proceeds are reinvested in assets located in Germany are contrary to the principle of freedom of establishment.

Under German tax law, tax payable on the disposal of certain capital assets used in permanent establishments located in Germany can be deferred until the sale of the replacement assets; this is on the condition that the replacement assets form part of the assets of a permanent establishment also situated in Germany. Such deferral is therefore not possible if the assets belong to a permanent establishment situated outside Germany but within the European Union.

The European Commission sought a declaration from the CJEU that these provisions were in breach of TFEU (Freedom of establishment) art 49. It argued that an economic operator will take account of the fact that reinvestment outside Germany is less advantageous than reinvestment in Germany.

Agreeing with the Commission, the CJEU found that the provisions hindered the freedom of establishment and went further than necessary. Allowing the deferral of tax in circumstances where the replacement assets are situated outside Germany would not force Germany to abandon its right to tax capital gains generated within the ambit of its powers of taxation. Taxable persons wishing to reinvest outside Germany should therefore be given the choice between immediate payment and bearing the administrative burden of deferral.

Why it matters: **The discrimination was established, but the German authorities argued that it was justified to preserve their taxing powers and achieve their policy objectives. The CJEU robustly disagreed. The administrative difficulties, linked with the necessity of taxing assets situated outside Germany, did not justify this hindrance to the freedom of establishment. The policy objective of encouraging reinvestment could be achieved with cross-border investment.**

become a subsidiary. The FTT found that whilst 'superficially attractive', treating two distinct body corporates as one would introduce uncertainty for many purposes. Although the two companies were carrying out the same business with the same management, it could not be said that they formed a single company; and so PhotonStar had become a 51% subsidiary.

Why it matters: **The FTT observed that it was 'unfortunate' that relief should be withdrawn in circumstances where a company which qualifies for EIS is taken over by another company which also qualifies.**

Indirect taxes

Supplies by a landlord

In ***Minister Finansów v Wojskowa Agencja Mieszkaniowa w Warszawie*** (C-42/14) (16 April), the CJEU found that supplies provided together with the letting of immoveable property could be either separate or part of a single supply, depending on the circumstances.

The Wojskowa Agency is a Polish public body responsible for letting state immovable property. In this context, it resells supplies, including electricity, heating, water and refuse disposal. Tenants are charged in advance and the amounts are corrected at the end of the year to reflect use. The Polish tax authorities contended that those supplies were part of a single supply of immovable property and therefore subject to VAT.

There were two issues: (1) whether the supplies were made by the agency; and (2) if so, whether they were part of the supply of property or separate.

Distinguishing *Auto Lease Holland* (C-185/01), the CJEU found that the supplies were made by the agency, as the tenants did not purchase them from third parties.

The CJEU noted that, under its own case law, supplies useful to the enjoyment of immoveable property could exist independently of the letting of immovable property or be inseparable from it, depending on the circumstances. In particular, if the tenant could choose the supplier, the services were more likely to be separate. However, if a property was offered as a whole with the supplies, for instance, a turnkey office, a single supply was more likely. In this case, the use of meters to determine the level of consumption suggested separate supplies, as did the itemisation on the invoices issued by the agency. It was, however, for the national courts to make the necessary findings of facts.

Why it matters: **Although the CJEU did not come to a firm conclusion, it focused on the economic reason for the transaction from the point of view of the parties, and the content of the agreement itself.**

Refusal to return a confiscated item

In ***Sabine Smouha v The Director of Border Revenue*** [2015] UKFTT 147 (14 April), the FTT allowed an appeal against the Border Agency's refusal to restore a bag.

Mrs Smouha was appealing against the refusal by the Border force to restore a crocodile skin handbag. Mrs Smouha had ordered the bag online from a Japanese company, which had mentioned the requirement to obtain CITES certificates (under the Convention on International Trade in Endangered Species of Wild Fauna and Flora) and confirmed that it would obtain these. On the bag's arrival in the UK, the Border Force had advised Mrs Smouha that it was being detained, as its importation also required an import licence. Mrs Smouha had then applied unsuccessfully to the Animal Health and Veterinary Agency (AHVLA) for a retrospective import licence.

The FTT only had supervisory jurisdiction in this respect. It could only allow the appeal if the refusal to restore was unreasonable, applying the *Wednesbury* principle [1948] 1 KB 223. The Border Force would then have to make another decision (FA 1994 s 16).

The Border Agency officer observed that restoration would only be possible in 'exceptional circumstances' and that 'if there is no retrospective licence, there are no exceptional circumstances'. Furthermore, the officer applied the term 'exceptional' as it was understood by the AHVLA, and not as required under CEMA 1979 s 152, which allowed a much wider discretion.

The FTT concluded that the officer's discretion had been fettered, which may explain why he had failed to take into account all relevant matters. In particular, he had not accounted for the facts that Mrs Smouha had no previous experience of such matters and had ordered the bag from a reputable company; and that the permit would have been granted had it been applied for on time, as the importation was perfectly legal.

Finally, it was the sender's responsibility to ensure compliance in any event. The decision was therefore both unreasonable and disproportionate.

Why it matters: **This exhaustive review of the relevant international and domestic provisions established that the Border Agency officer had both misunderstood and misapplied the relevant law.**

Cases reported by Cathya Djanogly (***cathya.djanogly@hotmail.com***).

Finance Act 2015

Your guide to the key rules

The following summary of FA 2015 is provided by EY. For further information, contact Claire Hooper (chooper@uk.ey.com) or Chris Sanger (csanger@uk.ey.com).

Overview

On 24 March 2015, the UK government published the 2015 Finance Bill and the Bill progressed through all its stages in the House of Commons on 25 March. Royal assent was granted on 26 March, prior to the dissolution of Parliament on 30 March.

The Act brings together and updates some of the draft clauses published in December 2014 with some of the measures announced more recently in Budget 2015. Changes have been made to a number of the draft clauses which were subject to consultation. Other proposals will be deferred to later Finance Bills, subject to the result of the upcoming election. All references below are to FA 2015, unless stated otherwise.

From a corporate perspective, the measure that has attracted most attention is the diverted profits tax (DPT) which took effect from 1 April 2015. The legislation has been restructured and rewritten with the aim of making it easier to follow and reducing the reliance on the phrase 'reasonable to assume.' While HMRC published an overview of proposed changes on 20 March, together with draft legislation on some of those changes, further changes became apparent with the publication of the rules in full. These include changes to the definition of economic substance and the tax mismatch condition.

Other significant corporate tax measures include anti-avoidance measures addressing the use of brought forward losses (effective 18 March 2015) and capital allowances in respect of sale and leaseback transactions between connected parties (effective 26 February 2015). There are measures supporting specific industries, notably the oil and gas industry, and the extension of the creative industry reliefs as well as measures asking the banks to contribute more, including the rise in the rate of the bank levy.

From a personal tax perspective, the Act includes the legislation imposing CGT on the disposal of UK residential property by non-residents. Details are now provided of the obligation on a person who makes a 'non-resident disposal' to submit a return to HMRC and pay tax due. Further detail of the interaction with existing provisions are also included in the Act, as well as a provision to allow non-resident companies which are part of a group to elect to pool losses and gains arising from the disposal of UK residential property. The new rules for disguised investment management fees (which treat sums received by individuals providing investment advice as trading income in certain circumstances) have been amended to extend the definition of 'carry' and thus exclude more commercial arrangements from the scope of these rules. There are also new provisions allowing anyone, including non-dependents, to receive payments from an annuity on the death of a pension scheme member, as well as amendments to ITEPA 2003 to allow payments of these beneficiaries' annuities to be tax-free on the death of an individual before age 75.

Detail to be provided in regulations: The Act provides the basis for future regulations which will bring in the detail behind measures such as the implementation of country-by-country reporting in the UK and an exemption from withholding tax for private placements. The measure aimed at UK partly exempt businesses, which seeks to restrict the recovery of VAT on overhead costs used to support their foreign branches, will similarly be introduced by secondary legislation.

Measures not in the Act: As 2015 is an election year, a number of measures have been held back for later Finance Bills and depending on the results of the election, there may be two more Finance Bills this year.

Measures announced at the time of the draft clauses but not included in FA 2015 include: proposals for the reform of the taxation of corporate debt and derivatives; new powers for the direct recovery of debts; and the strengthening of sanctions for tax avoidance.

A number of Budget 2015 measures including the proposed corporation tax disallowance for compensation payments for mis-selling of products such as payment protection insurance and the increased flexibility of the individual savings account (ISA) rules are also not included in the Act.

Corporate taxes

Diverted profits tax

Part 3 of the Act contains the DPT legislation which came into force on 1 April 2015. Updated guidance on the legislation was published on 30 March.

HMRC had already announced a number of changes on 20 March 2015 to the consultation draft issued in December 2014. These include a narrowing of the notification requirement and changes to the rules giving credit for other taxes to include controlled foreign companies (CFC) charges. The scope of the rules on avoided permanent establishments (PE) has also been expanded to include sales outside the UK that relate to UK activity, as well as supplies of any property (such as land and buildings). However, there are exclusions from the avoided PE rule for foreign companies that have less than £10m of UK-related sales not otherwise brought within the UK tax net or £1m of UK-related expenses (for instance, occasional visits to the UK by executives overseeing local operations).

The Act contains some changes over and above those highlighted on 20 March, including amendments to the tax mismatch condition and the insufficient economic substance conditions.

With the legislation now in force, businesses should consider in detail whether the rules apply and, in particular, undertake a review of their transfer pricing, applying a full value chain approach. Groups can then use the results to proactively engage with HMRC to demonstrate that no notification is required under the DPT rules. It is important to undertake a two-sided analysis as soon as possible as this may result in a different conclusion regarding the right point in an arm's length range compared with a historic one-sided analysis.

The application of the DPT to the oil and gas industry has been clarified to make it clear the supplementary charge is a 'relevant tax' for the purposes of the 'effective tax mismatch' test; consequently, transactions that give rise to a ring fence deduction may be an effective tax mismatch if the counterparty suffers additional tax at less than 40%. The rate of DPT has been set at 55% where the 'diverted' profits are ring fence profits.

Oil and gas support measures

Measures introduced to support the UK oil and gas industry include:

- A reduction in the rate of supplementary charge from 32% to 20% with effect from 1 January 2015.
- A reduction in the rate of petroleum revenue tax from 50% to 35% with effect from 1 January 2016.
- The introduction of the 'investment allowance,' which gives an allowance against supplementary charge of 62.5% of qualifying investment expenditure incurred from 1 April 2015 (Sch 12).
- The introduction of the 'cluster area allowance,' which gives an allowance against supplementary charge of 62.5% of qualifying investment expenditure incurred in relation to a determined cluster area from 3 December 2014 (Sch 13).
- An extension of the ring fence expenditure supplement from a maximum of six claims to ten, with the four additional claims being available in respect of losses incurred from 5 December 2013 (Sch 11).

The cluster area allowance and ring fence expenditure supplement legislation broadly follow the drafts released in December 2014, and the investment allowance legislation has been put together following a brief consultation period with the industry in early 2015. It is positive that government has reacted very quickly to the current difficulties faced by the industry by introducing the investment allowance. However, the speed of the process has meant that various issues raised during the consultation have been set aside to be dealt with by means of future legislation.

Restriction on use of brought-forward losses

This new anti-avoidance measure around the refreshing of brought-forward losses was announced in the Budget. The legislation in Sch 3 prevents the offset of brought-forward trading losses, non-trading deficits or management expenses against profits if the profits result in a 'deductible amount' arising in the company, or a connected company, as part of arrangements aimed at achieving a corporation tax advantage, and where it is reasonable to assume that the 'tax value' of the arrangements exceeds the 'non-tax value.' This new measure applies on or after 18 March 2015, when a notional accounting period starts.

A technical note has been published by HMRC which provides more detail on the circumstances and manner in which the proposed legislation will operate and provides examples.

Use of brought-forward losses by banks

This measure restricts the amount of banks' taxable profits that can be offset by losses existing at 1 April 2015 to 50%. There are minor amendments in Sch 2 to the provisions released in draft last December, including a change to the targeted anti-avoidance rule. In addition, following consultation, an amendment has been included to allow up to £25m of losses arising in groups headed up by building societies to remain unrestricted. These provisions are effective from 1 April 2015, though the anti-avoidance provision is effective from 3 December 2014.

Creative sector reliefs

The following changes announced in Budget 2015 are confirmed:

- Reduction in minimum UK spend required to qualify for high-end television relief from 25% to 10% (s 31).
- Expansion of film tax relief so that all films qualify for the rates of film tax relief previously reserved for limited-budget films (s 29).
- Expansion of the legislation for the new children's television tax relief, which was published in draft last December, to include children's game shows and competitions (s 30).

These changes apply from 1 April 2015 (though the film tax relief changes are subject to European Commission approval).

Other corporate tax measures

Some measures published in draft last December are included in the Act, largely unchanged. These include:

- Legislation enabling the implementation in the UK of country by country reporting (the detailed rules to be enacted by statutory instrument) (s 122).
- Repeal of the late paid interest rules for certain connected parties (s 25).
- An increase in R&D credit rates and the restriction of R&D qualifying expenditure (subject to a relaxation for R&D product transferred as waste or for no consideration) (ss 27, 28).

Schedule 10 also includes an anti-avoidance rule announced on, and effective from, 26 February 2015, which prevents plant and machinery allowances being available on the acquisition of plant and machinery from a seller (or connected person) that had previously acquired it without incurring capital or qualifying revenue expenditure. Section 45 also extends the enhanced capital allowances scheme for zero-emission goods vehicles for a further three years to 31 March or 5 April 2018, for corporation tax or income tax purposes respectively. Finally, s 26 restricts relief for internally-generated goodwill transfers between related parties.

The provisions included in draft last December relating to consortium link companies do not appear in the Act, even though it was indicated in the Budget that they would be so included. These were intended to remove, with effect from 10 December 2014, the more restrictive requirements that currently apply in the group relief rules where a consortium link company is resident in the European Economic Area but outside the UK.

Personal taxes

Disguised investment management fees

New 'disguised investment management fee' rules, announced at the time of the Autumn Statement, are amended in s 21 of the Act. The rules will apply where an individual provides investment management services to a collective investment scheme involving a partnership and will apply to sums arising on or after 6 April 2015.

Where the rules apply, an individual will be treated as receiving disguised fee income where they receive any sum from a collective investment scheme (including a loan or allocation of profit) which is not 'carry,' a return or repayment of amounts invested, or a commercial return on amounts invested. The amount will be treated as trading income of the individual where it would not otherwise be taxed either as income from a trade or as employment income (e.g. remuneration via the fund manager vehicle). To the extent that the investment advice is given in the UK, any amounts treated as disguised investment management fees will also be treated as UK source income.

The Act expands the concept of carry; beyond the narrow definition contained in the December draft clauses to include amounts received by way of 'profit related return.' However, such amounts will remain taxable as trading income to the extent that there is no 'significant risk' of receipt. 'Significant risk' is not defined for this purpose and this is likely to be an area where HMRC guidance is key. The Act also includes provisions to allow further amendments to the rules by way of statutory instrument.

CGT for non-residents

The Act includes provisions in Sch 7 to extend the CGT charge to non-UK residents in respect of the disposal of UK residential property with effect from 6 April 2015. The new tax is only intended to apply to gains arising on or after 6 April 2015 and a number of rebasing measures are available for those within the charge whose property was acquired before that date. To the extent that gains on high value residential property are subject to an annual tax on enveloped dwellings (ATED) related capital gain, this will take priority over the new charge. The new charge will, however, take priority over existing anti-avoidance legislation, which attributes gains to UK participators in non-UK resident companies and to settlors and beneficiaries of non-UK resident trusts. It will also take priority over provisions that attribute gains to individuals who return to the UK after a period of non-residence.

The Act includes new provisions for the submission of tax returns covering the charge (NRCGT returns). NRCGT returns must be submitted by the 30th day following completion of the disposal of UK residential property. These must include a calculation of the gain (an 'advance self-assessment') unless the taxpayer has received a self-assessment tax return for that year or a previous year or has submitted an ATED return for the preceding chargeable period.

Where the NRCGT return includes an advance self-assessment, a payment on account of the tax is due at the same time as the return.

New provisions extend holdover and rollover relief to qualifying disposals of UK residential property in certain circumstances for gains which would otherwise be subject to NRCGT.

The Act contains provisions allowing eligible non-resident companies owning UK residential property to make an irrevocable election to form a pooling group. This enables NRCGT gains and losses made by the members of the group to be pooled, and for intra-group disposals of property to be disregarded.

Non-resident individuals and trustees will pay CGT at the same rates as UK resident individuals and trustees (i.e. 18% and 28%) and companies within the charge will pay tax at 20%.

Private residence relief

As expected, the Act also includes changes, in Sch 9, to private residence relief, which provides 100% CGT relief for disposals of an individual's only or main residence.

With effect from 6 April 2015, it will only be possible to claim private residence relief in a tax year for a property in a country in which an individual (or spouse) is resident, or where the individual (or spouse) spends at least 90 days in that property or other properties in the same jurisdiction. The definition of a day spent at the property (previously a 'present at midnight test') has been amended slightly to allow for those who 'stay overnight' at the property without being present at midnight. This may still cause problems for shift workers and HMRC guidance is needed on what is meant by an overnight stay. Where an individual qualifies for the relief for part of the period, only part of the gain will be exempt.

For those who are subject to non-UK resident CGT in respect of their disposal, periods prior to 6 April 2015 will not be counted for the purpose of private residence relief unless the individual meets certain conditions and makes an election.

A principal private residence election is still possible but the interaction between making an election and non-resident periods is complex and will need to be reconsidered before any disposal.

Entrepreneurs' relief

The Act contains a number of updates to entrepreneurs' relief (ER).

Amendments are made to measures announced at Autumn Statement designed to remove ER from sales of goodwill to close companies. Under the amended legislation in s 42, such sales will continue to qualify for the relief where the sale takes place to a close company with which the seller has no connection. These rules, as amended, still apply to disposals on or after 3 December 2014.

Also included in the Act, in s 43, are measures announced at the Budget to restrict the availability of ER for shareholdings in structures involving joint ventures (where the management company is neither a holding company of a trading group nor trading in its own right). ER is also restricted, by s 41, for associated disposals which must now accompany a sale of at least a 5% shareholding in the company or in the assets of the partnership carrying on the business. Legislative clauses to introduce these two restrictions were published at the time of the Budget and apply from 18 March 2015.

As announced at Autumn Statement, there are also measures to allow ER to apply to gains which have been deferred by reinvestment into enterprise investment schemes or social investment tax relief.

Pension flexibility: annuities

New provisions included in the Act build on those made in the Taxation of Pensions Act 2014 in respect of payments of income withdrawal from a drawdown fund on the death of an individual.

The legislation, in Sch 4, sets out when annuities, paid following the death of a pension scheme member, can be paid as an authorised payment to anyone other than a dependent. It also sets out when these payments are taxed against the member's lifetime allowance.

Changes are then made to ITEPA 2003 to provide an exemption from income tax for annuities payable on the death of a person before age 75 in certain prescribed circumstances.

The changes have effect from 6 April 2015.

Other personal tax provisions

The Act includes details of the measure announced in Budget 2015 to ensure that the CGT exemption for certain wasting assets is only available where the assets have been used in the seller's own business (previously it was possible to loan or rent assets to another business and so qualify for the exemption).

The Act also includes the following provisions that were set out in the December draft Finance Bill clauses:

- The remittance basis charge is increased to £60,000 for those who have been resident in the UK for 12 out of the last 14 years, and a new level of charge of £90,000 for non-domiciles resident in the UK for 17 out of the last 20 years (s 24).
- ATED is increased significantly for properties worth more than £2m with effect from 1 April 2015 in line with announcements at the time of the 2014 Autumn Statement. The Act also includes provisions to simplify ATED returns for those claiming relief from the charge in respect of more than one property (ss 70–73).
- ATED related CGT is also extended to properties valued at over £1m with effect from 6 April 2015 and over £500,000 with effect from 6 April 2016 (Sch 8).
- Eligibility is removed for seed enterprise investment scheme, enterprise investment scheme or venture capital trust scheme for companies trading in the subsidised generation of certain renewable energy and for companies once they qualify for social investment tax relief (Sch 6).
- There are measures to counter tax advantages afforded to shareholders by such schemes known as 'B share schemes,' which offer shareholders a choice between income and capital returns on their shares. The Act contains a provision confirming that the legislation applies to sums received on or after 6 April 2015, regardless of when the arrangements were entered into (s 19).
- Amendments to IHT to include an exemption for decorations and other awards (except where purchased) and to exempt from IHT the estates of emergency personnel and certain others whose death is caused or hastened by injuries sustained in the course of their duties. These amendments reflect the expanded scope announced in Budget 2015 (ss 74, 75).

Employment taxes

The employment tax clauses in the Act originate mainly from the chancellor's announcement, at Budget 2014, of four main measures following the Office of Tax Simplification's (OTS) review of employee benefits in kind (BiKs) and expenses.

Trivial benefits in kind

Parliament has decided not to legislate for an exemption for trivial BiKs in FA 2015. This is despite proposals in the Budget of 18 March 2015 for the introduction of anti-avoidance measures to prevent any perceived misuse of the proposed trivial benefit exemption by closely controlled businesses. This means that the draft statutory exemption which would allow employers to identify certain low value BiKs as 'trivial' and hence exempt from income tax and NICs, will not come into force from 6 April 2015 as expected. The measure, subject to conditions and as originally drafted, gave scope to provide multiple trivial benefits in a tax year.

Abolition of the £8,500 threshold

As expected, measures are included in the Act, in Sch 1, to amend ITEPA 2003 and abolish the longstanding £8,500 threshold for 'higher paid employment' meaning that all employees will be taxed on their BiKs and expenses in the same way. Exemptions have been introduced to mitigate the effects of the abolition of the threshold for BiKs for ministers of religion earning at a rate of less than £8,500 and a further exemption has been introduced for employees who work as caregivers in respect of board and lodging that is provided in the home of the person who they are caring for. The relevant NICs legislation has also been amended to align the NICs and the income tax treatments. These measures will take effect from 6 April 2016.

Exemption for paid or reimbursed expenses

The measures regarding the proposed exemption for paid or reimbursed expenses have been included in the Act, in s 11, as originally drafted but with some significant amendments. The measures will allow employers to exempt from income tax, expenses payments and BiKs provided to employees where the employee would have been eligible for a deduction had they incurred and paid an amount equal to the expense themselves. The measures also do away with the current system that allows employers to apply to HMRC for a 'dispensation' in respect of paid or reimbursed expenses where ultimately there is no liability to tax. The processes outlined in the draft clauses which set out the required approval to pay or reimburse expenses at a flat rate remain unchanged in the Act.

However, the payment or reimbursement cannot be provided as part of 'relevant salary sacrifice arrangements.' The definition of such arrangements, whenever made, before or after the employment began, has now been widened from scenarios where an employee simply gives up a right to receive earnings in return for the provision of the benefit, to include scenarios where the amount of earnings received depends on the provision of the benefit.

The measures also now include a targeted anti-avoidance rule. This prevents the exemption from applying to expenses and BiKs which are provided as part of arrangements that reduce the earnings of the employee chargeable to tax and NICs and one of the main purposes of the arrangement is to avoid tax or NICs.

The measures confirm the changes required to abolish the current dispensation regime from 6 April 2016. Parallel changes will also be made to the NICs legislation. However, these measures now include provisions which allow HMRC to revoke a 'pre-commencement dispensation' from a date earlier than 6 April 2016. A 'pre-commencement dispensation' is one which HMRC has given under existing provisions and is in place immediately before 6 April 2016.

Voluntary payrolling

The Act amends ITEPA 2003 to allow HMRC to amend the PAYE regulations to collect income tax on specified BiKs through PAYE with effect from 6 April 2016. The government has decided that, as a first step, a limited number of BiKs can be payrolled; namely those for cars, car fuel medical insurance and gym membership. Once payrolling has been established, the government will consider how other BiKs can be payrolled.

Employment intermediaries: determination of penalties

Section 17 of the Act amends existing legislation in TMA 1970. This allows HMRC to issue penalties, without issuing proceedings before the First-tier Tribunal, where the penalty relates to the late filing of, non-submission of or incorrect or incomplete, quarterly returns by employment intermediaries from 6 April 2015. The first of the employment intermediaries information quarterly return is due to be submitted by 5 August 2015.

Indirect tax

The draft Finance Bill clauses published in December included indirect tax measures relating to:

- Refund of VAT to search and rescue charities and air ambulance charities in relation to their non-business activities.
- Extension of the child exemption from air passenger duty.
- Introduction of a new landfill tax testing regime in relation to waste fines.
- Introduction of an 80% aggregates levy credit for certain aggregate commercially exploited in Northern Ireland.
- Introduction of an alcohol wholesaler registration scheme.
- Tightening of tobacco duty anti-forestalling restrictions.

These clauses appear largely unchanged in the Act.

As announced in the Budget, the Act also provides for VAT refunds to palliative care charities and medical courier charities in relation to their non-business activities with effect from 1 April 2015.

The Budget measure aimed at UK partly exempt businesses which seeks to restrict the recovery of VAT on overhead costs used to support their foreign branches will be introduced by secondary legislation. The draft legislation was published on 18 March. The new rules will have effect for partial exemption tax years beginning on or after 1 August 2015.

Tax administration

Accelerated payment notices

As expected, the Act, in Sch 18, extends the accelerated payments regime to cover circumstances where the company involved in the dispute has surrendered the advantage to another company by way of group relief. This change applies to group relief surrenders whenever they were made, provided that all the necessary requirements for an accelerated payment are met.

This extension of the regime follows the extension of the regime to cover NICs (effective 12 April 2015). Both steps are consistent with Osborne's Budget promise that more accelerated payment notices will be issued to 'those who hold out from paying the tax that is owed.'

Other measures

The following measures were included in the December draft Finance Bill clauses and are largely unchanged:

- Changes to the disclosure of tax avoidance schemes (DOTAS) regime providing HMRC with a power to obtain prescribed information on the users of undisclosed avoidance schemes, increasing the penalty for users who do not comply with their reporting requirements under DOTAS and introducing protection for those wishing to voluntarily provide information about potential failures to comply with the DOTAS (Sch 17).
- An obligation on promoters to notify HMRC of relevant changes to notified schemes and the power for HMRC to publish information about promoters and schemes that are notified under the regime. There are also changes to the power to issue conduct notices to promoters and connected persons (Sch 19).
- A requirement that, while HMRC may publish information about DOTAS schemes, including whether these are on the APN list and whether there is a ruling of a court relating to the scheme, HMRC is then required to similarly publish information about a ruling which finds that the planning in the DOTAS scheme is effective (Sch 17).
- Penalties in connection with offshore matters and offshore transfers (Schs 20, 21).

New measures targeted at serial users of tax avoidance schemes that fail are to be introduced, alongside specific tax geared penalties for cases tackled by the general anti-abuse rule (GAAR), but these measures will be contained in a future Finance Bill. ■

FA 2015 analysis

Diverted profits tax: an overview

SPEED READ The diverted profits tax is a new tax enacted as part of FA 2015. It seeks to target profits which have been 'diverted' from the UK tax net, either by the involvement of entities or transactions lacking economic substance, or through an 'avoided PE'. Taxable 'diverted profits' are assessed by HMRC issuing a charging notice, as opposed to under self-assessment, and are subject to tax at 25% (or 55% in the case of ring fence profits). The legislation is complex and its interaction with the UK's DTTs and EU law obligations, as well as the BEPS programme, is unclear.

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First announced in parliament as part of the Autumn Statement on 3 December 2014, the diverted profits tax (DPT) legislation went through a single iteration on 10 December 2014 before being re-released with FB 2015 on 24 March 2015. It became law with the granting of royal assent to FA 2015 on 26 March. Although an open day for interested parties was held by HMRC on 8 January, comments were invited only on the technical aspects of the legislation, and the revisions at FA 2015 – though largely welcome – therefore did not dilute the controversial nature of the tax. 'Interim draft guidance' was released on 30 March 2015 (www.bit.ly/1Hwp4Fa), revising the guidance that had been issued with the first draft of the legislation in December 2014. As has been stressed both inside and outside parliament during the passage of FB 2015, this legislation has been passed at speed. Given the volume of legislation and guidance that was produced in December, we may assume that DPT had already been under development for some time (and at least since the tax was hinted at during the Conservative party conference in September).

This article gives an overview of when DPT applies and how it is calculated, and of notification requirements and key administrative provisions, while summarising key developments from FB 2015 to FA 2015 and the accompanying guidance (together with the relevant statutory references given its recent implementation). It concludes with a brief discussion of points of interest from the perspective of BEPS, the UK's double tax treaty (DTT) network and EU law.

Charging provisions

Companies may be subject to DPT where they are involved with transactions or entities lacking economic substance (ss 80 and 81) or which avoid creating a UK permanent establishment (PE) (s 86).

Transactions or entities lacking economic substance: Section 80 applies to a company (C) in an accounting period if:

- it is UK resident;
- provision (the 'material provision') has been made between it and another person (P) by means of a transaction or series of transactions;
- C and P are connected under the 'participation condition';
- the material provision results in an 'effective tax mismatch outcome';
- the effective tax mismatch outcome is not an 'excepted loan relationship outcome';
- the 'insufficient economic substance condition' is met; and
- C and P are not both SMEs (within the meaning of TIOPA 2010 s 172).

Section 81 extends s 80, applying it to a foreign company if it carries on a trade in the UK through a UK PE (also called C), which is then treated as a UK resident company under the foreign company's control.

Sections 80 and 81 therefore hinge upon several concepts that require examination.

Transaction or series of transactions: The revised guidance indicates that 'transaction' and 'series of transactions' have the meanings given in the transfer pricing rules at TIOPA 2010 Part 4. Consequently, a series of transactions does not require that two persons are party to the same transaction; the guidance extends the phrase to include arrangements 'through a series of transactions some of which may involve third parties' (see para DPT1115 of HMRC's interim guidance referred to above).

Participation condition: The participation condition in s 106 requires C to be 'directly or indirectly participating in the management, control or capital' of P (or vice versa); or for the same person to do so in respect of both C and P. 'Direct' and 'indirect' participation are also read by reference to transfer pricing legislation. The participation condition generally considers the position at the time the material provision was made or imposed, but is extended to the following six months where financing arrangements are made.

Effective tax mismatch outcome: Reading references to the first party as C and the second party as P, there is an effective tax mismatch outcome under s 107 if the material provision results in:

- allowable expenses of the first party for a 'relevant tax' (CT on income; an amount payable under the supplementary charge in respect of ring fence trades; and IT or non-UK tax on income) and/or a reduction in income that would have been included in computing liability for a relevant tax;

- a reduction in the first party's liability to a relevant tax exceeding any resulting increase in relevant taxes payable by the second party;
- such expense or reductions not being 'exempted' (see below); and
- the increase in the second party's liability to relevant taxes not being at least 80% of the reduction in relevant tax payable by the first party (HMRC considers that this test ensures DPT applies only if tax reductions resulting from the material provision are substantial).

It should be noted that a mismatch could occur even if the first party does not save tax, e.g. because it is already in a loss making position before any deduction for a payment takes place. However, as noted later, this should mean that no actual liability arises under the calculation provisions.

Broadly, results or expenses are exempted if they arise from contributions paid by an employer under a pension scheme, or payments to:

- a charity;
- a person that is tax exempt by reason of sovereign immunity; or
- an offshore fund or authorised investment fund meeting a diversity of ownership condition or where at least 75% of its investors are certain tax exempt persons.

The exempted transactions list was only added in the FA draft. The revised guidance explains that if HMRC considers that exemptions are exploited to facilitate profit diversion, 'HMRC will seek to deny the benefit of the exemption, including where appropriate through use of the General Anti-Abuse Rule (GAAR)' (DPT1180).

Insufficient economic substance condition: Per s 110, this condition can be met if it is reasonable to assume:

- the transaction or series of transactions was designed to secure the tax reduction, unless at the time of the material provision being made it would be reasonable to assume that the 'non-tax benefit' would be greater than the financial benefit of the tax reduction for C and P over the course of the transaction; and/or
- the involvement of a person was designed to secure the tax reduction, unless: (i) a modified version of the 'reasonable to assume' test above applies; or (ii) a majority of the income attributable to the transaction(s) in the relevant accounting period is attributable to ongoing functions or activities of the person's staff.

Excepted loan relationship outcome: An effective tax mismatch outcome will be an excepted loan relationship outcome per s 109, if arising wholly from:

- anything that, if a company within the charge to CT were party to it, would produce debits or credits under CTA 2009 Part 5; or
- a loan relationship and a derivative contract only entered into to hedge risk in connection with that loan relationship.

HMRC's revised guidance clarifies that loan relationships producing an effective tax mismatch outcome do not automatically except the outcome. Rather, the effective tax mismatch outcome must *arise wholly* from the loan relationship/hedging contract (DPT1110).

Avoidance of UK taxable presence: Section 86 applies to a company (the 'foreign company') for an accounting period if during that period:

- it is not UK resident;
- it carries on a trade;
- in connection with supplies of goods, services or other property made by it in the course of its trade, another person (the 'avoided PE'), whether or not UK resident, carries on an activity in the UK;
- s 87 (exception for companies with limited UK-related sales or expenses) does not apply;
- it is reasonable to assume that any activity of the avoided PE, the foreign company or both is designed to ensure that the foreign company does not, as a result of the avoided PE's activity, carry on a trade in the UK for CT purposes (whether or not also designed to secure any commercial or other object);
- the 'mismatch condition' (similar to the rule in ss 80 and 81), 'tax avoidance condition', or both, are met;
- the avoided PE is not excepted by s 86(5); and
- both companies are not SMEs.

Again, several concepts require further examination.

Goods, services or other property: The original draft legislation required there to be a supply of services or goods as a result of UK activity. The FA now applies the s 86 charge to supplies of 'other property', which is clearly designed to catch a very wide range of activities carried on in the UK, including real estate transactions.

Section 87 (exception for companies with limited UK-related sales or expenses): Section 87 disapplies s 86 in respect of the foreign company for an accounting period where it has (including any connected companies):

- sales revenues from 'UK-related supplies' (supplies of goods, services or other property that relate to 'UK activity') no greater than £10m; and/or
- expenses relating to UK activity which are no greater than £1m.

'UK activity' means activity carried on in the UK in connection with supplies of goods, services or other property made by the foreign company in the course of its UK trade. Whilst the sales revenue exemption is helpful, it does not appear at first glance that the expenses threshold will assist many.

The tax avoidance condition: Section 86(3) provides that this condition is met if, in connection with the avoided PE's activity, arrangements are in place, one of the main purposes of which is avoiding or reducing a CT charge.

What is meant by 'main purpose' or 'one of the main purposes' is not defined. HMRC's revised guidance indicates that these expressions are given their 'normal meaning as ordinary English words. They have to be applied objectively, having regard to the full context and facts' (DPT1150). Further, HMRC 'would seek to apply this rule if the company has put in place arrangements that separate the substance of its activities from where the business is formally done, with a view to ensuring that it avoids the creation of a UK PE and it is clear that doing so has resulted in a tax saving'.

Excepted PEs: An avoided PE is 'excepted' under s 86(5) if:

- it is an 'agent of independent status' or party to an 'alternative finance arrangement' under CTA 2010 ss 1142 or 1144, and therefore the foreign company would not be treated as carrying on a trade in the UK; and
- it and the foreign company are not connected in the relevant accounting period, unless it is regarded as an agent of independent status by virtue of the independent broker, independent investment manager or Lloyd's agent provisions of CTA 2010 ss 1145, 1146 and 1151.

Calculating diverted profits

Different methods apply for calculating taxable diverted profits under ss 80 and 81 and under s 86. Profits are estimated when issuing a preliminary notice or a charging notice in a way that is different (see below).

Calculating taxable diverted profits under ss 80 and 81: Taxable profits of a company (or in the case of s 81, a UK PE) are calculated in respect of ss 80 and 81 in one of the following three ways:

- Under s 83, no taxable diverted profits arise if the 'actual provision condition' is met and there are either no diverted profits, or there are diverted profits but the company has made the 'full transfer pricing adjustment', so that all diverted profits (defined here as amounts resulting from a material provision for which the company is subject to CT under the transfer pricing rules) have been taken into account in calculating CT due.
- If the actual provision condition is met, but s 83 does not apply (e.g. because the company has not made the full transfer pricing adjustment), s 84 calculates taxable diverted profits as amounts chargeable to CT after applying transfer pricing, but which were not in fact taken into account in assessing CT. Adjusting CT returns in time may therefore reduce any DPT charge under this head.
- Per s 85, if the actual provision condition is not met, taxable diverted profits are determined by reference to the relevant alternative provision rather than the material provision.

Per s 82(7), the actual provision condition is met if: (i) the material provision results in deductible expenses for the company (ignoring transfer pricing adjustments); and (ii) the 'relevant alternative provision' would have resulted in deductible expenses of the same type as (i), so there is an effective tax mismatch outcome, but no taxable income of a connected company.

The relevant alternative provision per s 82(5) is the provision that it is just and reasonable to assume would have been made instead of the material provision, if tax on income were not a relevant consideration for any person at any time.

Calculating taxable diverted profits under s 86: The FA does not differ greatly from the initial draft in calculating s 86 profits, but sets out more clearly the three ways in which taxable diverted profits can be determined (ss 88–91):

- Where only the tax avoidance condition (and not the mismatch condition) is met, s 89 results in taxable diverted profits being equal to notional profits of the avoided PE. Effectively, these are the profits that would be taxable if there were an actual PE, as calculated under CTA 2009 ss 20–32.
- Where the mismatch condition is met but profits are calculated by reference to the actual provision (because the material relevant alternative provisions would have resulted in expenses of the same type and not relevant taxable income), s 90 also results in taxable diverted profits being equal to the notional profits of the avoided PE.
- Where the mismatch condition is met but the actual provision condition is not met, s 91 requires taxable diverted profits to be calculated by reference to the relevant alternative provision. If the relevant taxable income would have resulted under the relevant alternative provision (and so the actual provision condition does not apply), this is added to the notional PE profits to obtain diverted profits. Otherwise, the taxable diverted profits are the sum of the relevant taxable income and the notional profits of the avoided PE, had the relevant alternative provision been made instead of the material provision. This is expected to cause significant issues for taxpayers, save for very straightforward cases, as it is debatable what the alternative provision would be (particularly given the different ways to assess contributions by staff and non-tax benefits).

Credit for tax already paid: A regrettably vague 'just and reasonable' credit may be given under s 100 for CT or equivalent tax in another jurisdiction, calculated by reference to the profits of the company. Although credit provisions in the FA now include credit for any UK CFC charge (or foreign equivalent), no credit is given for any IT paid on the relevant profits, leaving open the possibility of double taxation.

An unwelcome change is that no credit is given for tax paid after the end of the review period for the charging notice, potentially leading to unfair disallowance of credit, given the different reporting regimes and timetables of DPT and CT.

Notification requirements

The broad scope of DPT notification requirements in the initial draft legislation has been substantially curtailed. Notification is now required if any of ss 80, 81 or 86 apply, each to be read with some modifications and – save where s 86 applies as a result of a (modified) version of the tax avoidance condition – where the tax reduction for the period is 'significant' in relation to the non-tax benefits. Unfortunately, neither the initial nor the revised guidance explores the meaning of 'significant'.

The modifications mentioned above increase the scope of ss 80, 81 and 86 by removing the insufficient economic substance condition. In addition, for notification purposes: (i) s 86 tests whether the foreign company *is* outside the scope of CT as a result of the avoided PE (rather than whether arrangements are designed to achieve this); and (ii) the tax avoidance condition looks at whether the result, as opposed to the main purpose, of the arrangements is a tax reduction.

New exclusions from notification apply under s 92(7), (8) where:

- it is reasonable to conclude that no DPT will arise, ignoring future transfer pricing adjustments;
- HMRC has confirmed, or it would be reasonable to conclude, that no notification is needed because sufficient information has been provided to determine whether a preliminary notice is needed, and this information has been reviewed by HMRC in relation to DPT or otherwise;
- notification was given in the immediately preceding period, or not required because of the 'sufficient information' exclusion, and it is reasonable to conclude there was no change which would be material to whether a charge would be imposed; or
- HMRC directs that the duty to notify does not apply.

It is unclear how much information would be 'sufficient', and in particular whether advance pricing agreements (APAs) would qualify. (Although the revised guidance discusses at DPT1700 how 'APAs in force at 1 April 2015 interact with DPT', this point is not discussed.) A further ambiguity is whether '*immediately* preceding' periods in the third exclusion are mentioned, because notification, confirmation of no notification needed, or sufficient information is given to HMRC every other year.

Despite a query on the point during the Westminster Hall DPT debate (*Hansard*, 7 January 2015, col 83WH), there is no formal clearance mechanism. While HMRC has informally indicated that, post 1 April 2015, APAs may be regarded as de facto DPT clearance, neither legislation nor guidance confirms this point (assuming full disclosure of the relevant facts). The non-statutory clearance mechanism, formerly CAP1, seems to be excluded by DPT1640 of the revised guidance (which states 'HMRC will not provide formal or non-statutory clearances in respect of DPT'); this also indicates that no advance view may be given in some cases and that HMRC does not intend to agree APAs where arrangements are liable to DPT.

Notification must be made in writing within three months of the end of the relevant accounting period. This is softened in the FA, by giving companies with periods ending before 1 April 2016 six months to notify. The information to be provided under s 92(1) is supplemented in DPT2050 of the revised guidance by details of where to send notifications and a notification template.

Estimating diverted profits

When issuing preliminary or charging notices, diverted profits are calculated 'on the basis of the best estimate that can reasonably be made at that time' of the amount calculated as described above (ss 96(2) and 97(2)). Clearly, as HMRC determines this amount, it has wide discretion where only limited information is available.

Additional steps are taken under ss 96(4) or 97(4) for estimating profits if the 'inflated expenses condition' is met, i.e. if:

- the mismatch condition is met;
- the arrangements result in deductible expenses; and
- the expenses result in the mismatch.

If relevant expenses are considered by HMRC to be greater than arm's length equivalents, they are reduced by 30% (ignoring transfer pricing) at this stage.

The revised guidance states that where a company has already made transfer pricing adjustments, 'any reduction in the amount of the deduction would be taken into account in applying the 30% reduction but not so as to reduce the amount below nil' (DPT1139).

Since DPT is aimed at large MNEs, it seems likely they would have robust policies in place, and therefore that HMRC would agree that the 30% reduction should not be applied.

It is unclear how this will be taken into account at preliminary/charging notice stages unless HMRC has already received a transfer pricing analysis, since transfer pricing is not an area in which representations may be made at this stage by taxpayers.

Administrative provisions for charging companies

Unlike notification requirements, the initial calculation provisions were relatively lightly amended in the FA. If ss 80, 81 or 86 are believed to apply, HMRC issues a preliminary notice under s 93, setting out the basis for calculation of the proposed charge. HMRC has two years from the end of the relevant accounting period to produce this notice where duly notified, and four years otherwise.

Section 94 gives companies 30 days beginning with issue (as opposed to receipt, in the FB) of the notice to send written representations, only on:

- arithmetical error;
- the SME condition not being met;
- in the case of ss 80, 81, or where s 86 is said to be met as a result of the mismatch condition: the participation condition test is not met, the 80% payment test is met, or the effective tax mismatch outcome is an excepted loan relationship outcome; or
- in a s 86 case, the exception for companies with limited UK-related sales or expenses applies, or the avoided PE is excepted.

The revised guidance summarises these as 'factual matters that it should be possible to establish relatively quickly' (DPT2100). It is hoped that other similar errors which are not included in the list might also be considered at this stage.

Thirty days after the period for taxpayer representations, HMRC decides whether to issue a charging notice (supplying designated information) or to notify that no notice pursuant to that preliminary notice will be issued. It is possible for a subsequent preliminary notice to be issued. Per s 98, DPT is to be paid within 30 days of issue of the charging notice; 'payment of the tax may not be postponed on any grounds'. The amount charged is then reviewed under s 101 in light of the full provisions for calculating diverted profits. An amending notice or supplementary charging notice may then be issued. In what appears to be an oversight, s 100 (dealing with credits against DPT for other taxes) is not included in the list at s 101(3) of sections which HMRC must consider when ascertaining whether DPT is finally due.

BEPS/DTTs

The chancellor stated in a March 2014 document discussing BEPS that 'international cooperation is the only way to tackle the challenge of tax avoidance in the global economy' (www.bit.ly/NSzEha) and, given the UK's general support for BEPS, it is surprising that it has now sought to pre-empt any outcome with unilateral action. It should also be noted that DPT conflicts with issues addressed by BEPS, such as by incorporating transfer pricing guidelines which are currently the subject of work by the OECD (www.bit.ly/1uBd7uc), as well as affecting the issues being considered on CFCs, information disclosure, IP, hybrids and PEs. Moreover, if the OECD work on BEPS is successfully completed and implemented, then arguably DPT would not be necessary and one could envisage a situation where DPT is eventually withdrawn. This brings into question the timing of DPT and whether its introduction could have waited.

The biggest risk, however, may be that other states decide to follow the UK's lead, leaving the international tax landscape littered with derivative DPTs. It has, for example, been reported that Australia is considering enacting its own version of DPT, albeit that a government body has recently advised against this for reasons similar to DPT criticisms expressed in the UK. A number of measures all circumventing treaty obligations could lead to international tax law reverting to a situation effectively without treaties, exposing taxpayers to the double taxation and other uncertainties which treaties are designed to relieve.

The interaction of DPT with DTTs continues to prove a contentious issue. HMRC appears to be of the following view:

- DPT is neither expressly covered by DTTs, nor a 'substantially similar' tax. Similarly, as actual profits are not taxed but an artificial amount is calculated by reference to profits, treaty benefits do not apply (c.f. *Bricom Holdings Ltd v CIR* (1997) 70 TC 272).
- The OECD commentary does not require states to grant treaty benefits in abusive situations; the 1969 Vienna Convention on the Law of Treaties requires treaties to be interpreted in 'good faith'.
- Tax treaties are only given effect to the extent they do not conflict with UK law (c.f. TIOPA 2010 ss 2 and 6). No treaties have been given effect in respect of DPT; therefore relief from DPT is not part of UK law.

The lack of similarity of DPT to CT and IT is debatable. For instance, calculation of DPT requires the application of transfer pricing principles, and profits taxed by DPT are essentially those which should, in HMRC's view, be subject to CT – reflected by the fact that credit may be given against CT paid. Further, the deliberate engineering of DPT as a new tax for the purposes of sidestepping the UK's DTT obligations itself smacks of artificiality.

Moreover, the descriptions of taxes covered in UK DTTs vary widely but a number of them apply to CT, IT and 'other similar taxes'. The UK/US DTT, for example, applies to 'taxes on income and on capital gains imposed on behalf of a Contracting State irrespective of the manner in which they are levied'. The treaty applies to 'any identical or substantially similar taxes that are imposed after the date of signature of this Convention in addition to, or in place of, the existing taxes'. One could argue that DPT is a 'substantially similar' tax to those listed.

It is also not necessarily the case that a transaction that is caught by DPT is in fact 'abusive' or relies on an interpretation of treaties which is not in 'good faith'. It is quite possible that HMRC itself will have cleared transactions which relied on DTTs or an APA, but which it now considers subject to DPT.

The third point is reminiscent of *Collco Dealings Ltd v IRC* (1961) 39 TC 509, a case in which an Irish resident company argued that an exemption from IT under the UK/Ireland DTT should apply to an abusive scheme, which parliament had legislated against by denying the relevant advantage to 'a person entitled under any enactment to an exemption from income tax'. The taxpayer appealed to 'the comity of nations and the rule of international law' as grounds for reading a specific exception into the statute for treaty rights. While acknowledging the presumption that parliament does not intend to infringe the comity of nations, the court rebuffed the company's argument, broadly on the grounds that as parliament's will is supreme, the treaty only had life to the extent that parliament wished – and it was clear that it did not wish that to be the case.

Whatever interpretation the courts give DTTs in the context of DPT, it is regrettable that the UK has chosen to sidestep bilaterally negotiated rights. The government's approach also raises questions about whether DPT (if outside the scope of DTTs) would be a creditable tax for foreign entities. More generally, it is unclear whether the UK itself is acting in accordance with the principles at arts 26 and 27 of the Vienna Convention, that every 'treaty in force is binding upon the parties to it and must be performed by them in good faith' and that a 'party may not invoke the provisions of its internal law as justification for its failure to perform a treaty'.

Further to the TIOPA 2010 provisions mentioned above, taxpayers can only enforce rights or challenge improper performance of treaty obligations in the UK courts to the extent that they have been implemented into domestic law (save perhaps to a limited extent on legitimate expectation grounds).

Therefore, it appears likely that were any challenge to be made under existing DTTs, it would need to be made by affected contracting states. The US, with a DTT which applies to 'substantially similar' taxes, may be a possible candidate given that many of the intended targets of DPT are US MNEs, but we shall see. At the time of writing, we also understand that the IRS is yet to formally confirm that it considers DPT to be creditable against US taxes.

EU law

DPT's interaction with freedoms of establishment and of provision of services granted by arts 46 and 59 of the Treaty on the Functioning of the European Union (TFEU) is similarly uncertain and could form the basis for its own article (or thesis!).

HMRC's principal response has been and will likely be that, as a measure dealing with tax avoidance, any restriction on freedoms is justifiable and proportionate. Although the CJEU has recognised combating tax avoidance as justification for restrictive legislation, notably in *Cadbury Schweppes* (C-196/04) and *Thin Cap GLO* (C-524/04), the fact that DPT may apply to arrangements that are not wholly artificial and have commercial, non-tax purposes diminishes these arguments. It is also arguable that the modifications made in the FA which are intended to more precisely target artificial arrangements may put DPT at less risk of a challenge on the basis of this line of cases.

Additionally, the CJEU has previously held legislation that does not provide legal certainty to be unlawful, in particular in *SIAT* (C-318/10) and *Itelcar* (C-282/12). Legal certainty demands, per *SIAT*, that 'rules of law must be clear, precise and predictable as regards their effects, in particular where they may have unfavourable consequences for individuals and undertakings'. This objective is arguably not met by DPT because of its reliance on imprecise concepts such as whether it is reasonable to assume a particular fact, the fact that the amount due may not be determined for several years and the lack of an ability in the legislation to fully engage with HMRC or contest the charge at any stage before paying.

At the time of writing, we understand that the European Commission is considering DPT and its compatibility with EU law, though when and how it might respond are currently not known.

Conclusion

Given the various issues outlined above, it is difficult to consider that DPT is anything other than a knee jerk reaction by the current government to adverse publicity. If BEPS is indeed to be the panacea of international tax arbitrage, then DPT is a bit like a disease with no cure.

Points raised in previous articles on issues such as upholding the concept of the rule of law and not further eroding the lines between avoidance, abuse and evasion are relevant here. You do wonder, though, whether DPT would have been rushed through were it not for the recent press coverage on multinational tax affairs and tax's increasing prominence as a topic in the lead-up to the general election. This seems an ill-considered way to legislate and the related uncertainty can only hurt investment into the UK. ■

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FA 2015 analysis

Oil and gas measures

SPEED READ **Mounting pressures from low oil prices, a period of significant cost inflation and a high-tax regime had led UK oil and gas industry experts to express serious fears over the future viability of the sector. Finance Act 2015 sees the introduction of a package of measures intended to support the ailing industry. Key changes include a reduction in supplementary charge from 32% to 20% from 1 January 2015, a reduction in petroleum revenue tax from 50% to 35% from 1 January 2016, and the introduction of an investment allowance from 1 April 2015.**

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For much of 2013, the benchmark Brent crude oil price exceeded $100 per barrel. Nonetheless, the government were sufficiently concerned about the future prospects of the UK oil and gas industry to commission Sir Ian Wood to undertake a review of UK offshore oil and gas recovery and its regulation. The review identified a number of significant challenges facing the sector and made a series of recommendations. Whilst the fiscal regime applying to UK oil and gas activity was not within the scope of that review, it was still apparent that the tax system presented a barrier to investment.

The government consulted with industry during 2014 on changes it could make to the tax regime, with a view to ensuring continued investment in the UK Continental Shelf (UKCS). A crash in the oil price in late 2014 to below $50 per barrel significantly increased the pressure on the already beleaguered sector, and the chancellor reacted with a package of measures in Budget 2015 to reduce the fiscal burden on UKCS activity and support new investment.

The UKCS fiscal regime

Before going into the changes announced at Budget 2015, it is worth starting with a recap of the special regime that applies to oil and gas production activity in the UK and UKCS. Oil and gas producers are subject to three separate taxes on profits:

'Ring fence' corporation tax: So called because the profits that arise from UK and UKCS oil and gas extraction activities are 'ring fenced', and losses from other corporation tax activities cannot be offset against them. While the normal corporation tax rate is 20% from 1 April 2015, a special rate of 30% applies to 'ring fence' profits.

Supplementary charge: First introduced in 2002 at a rate of 10%, the supplementary charge is broadly levied on the same tax base as the 'ring fence' corporation tax except that interest expenses are not permitted. The rate was increased to 20% in 2006, and 32% from 2011.

Petroleum revenue tax (PRT): A field based tax rather than a corporate tax, which applies to the profits of older fields that were given development consent before 15 March 1993. Since 1993, the rate of PRT has been 50%.

PRT is deductible for ring fence corporation tax and supplementary charge purposes, resulting in an effective overall tax rate for a PRT liable field of 81% prior to 31 December 2014. For newer non-PRT liable fields, the effective overall tax rate would be 62%.

The supplementary charge has, since 2009, been subject to a growing array of 'field allowances'. Given the maturity of the UKCS, the largest and easiest to access oil reserves have long since been depleted. A significant proportion of the reserves yet to be produced are small pockets of hydrocarbons, or are challenging reservoirs that can only be recovered commercially as a result of recent advances in technology. Inevitably, such developments are much more costly per barrel, and their commercial viability greatly reduced. Field allowances acknowledge this, by removing a set amount of income generated by a field from the scope of supplementary charge, to the extent the field or project meets specific physical criteria. The basic premise of these allowances was to take investments that were economic before tax but uncommercial because of the standard 62% tax burden, and provide a sufficient amelioration of the tax burden to allow the development to become commercial. Both industry and government would win as a result: industry would profit from a field that otherwise would have gone undeveloped, and government would collect taxes that would not otherwise have arisen.

Finance Act measures

The package of measures enacted in FA 2015 included the following changes:

- the rate of supplementary charge is reduced from 32% to 20%, effective 1 January 2015;
- the rate of PRT is to be reduced from 50% to 35%, effective 1 January 2016;
- an 'investment allowance' is introduced for qualifying expenditure incurred from 1 April 2015;
- a 'cluster area allowance' is introduced for qualifying expenditure incurred in relation to a 'cluster area' from 3 December 2014; and
- ring fence expenditure supplement is extended, with the maximum number of claims increased from six to ten (the additional four claims being available in respect of losses incurred after 5 December 2013).

Rate changes

The Autumn Statement in December 2014 announced that the rate of supplementary charge would be reduced from 32% to 30% from 1 January 2015. The Budget went further, with supplementary charge returning to its pre-2011 rate of 20%. The industry has long argued that the 32% rate of supplementary charge is excessively high in the context of the maturity of the UKCS, and the reduction in rate has provided welcome relief.

The reduction in the rate of PRT came as a surprise to most, with the government having indicated at the time of the Autumn Statement that it was not minded to reduce the rate of PRT. Since the fields within the scope of PRT are the oldest fields, and these tend to be the fields that operate significant pieces of infrastructure that are critical for the transportation of oil from newer fields, the reduction has again been welcomed. It should be noted, though, that the benefit of the PRT rate reduction may represent only a timing difference for many fields rather than an absolute decrease in the tax burden. Relief for the very significant decommissioning cost that arises at the end of field life is given by way of loss carry back, and for many fields any future PRT payable on their remaining profits is expected to be recouped when decommissioning occurs. The rate reduction could thus mean paying less PRT out on profits, to get less back on decommissioning.

From 1 January 2016, the combined tax take from a field subject to PRT falls from 81% to 67.5%.

Despite the significance of the rate reductions, these are by far the simplest of the changes to legislate for within the Finance Act. FA 2015 s 48 deals with the supplementary charge rate reduction together with the consequences for periods that straddle 1 January 2015, and s 52 enacts the PRT rate reduction. However, companies will have to grapple with the deferred tax implications of the rate changes, and in many circumstances this will not be straightforward.

Investment allowance

The government first announced its intention to legislate for an 'investment allowance' at the Autumn Statement, and there followed a very brief period of consultation on the exact mechanics of the allowance. Recognising the practical difficulties that had arisen from the proliferation of field allowances, one of the government's key objectives was to move away from qualification criteria based on physical characteristics towards a simpler measure with basin wide applicability. The investment allowance has thus been structured by reference to three key principles:

- the quantum of the allowance is calculated as a set percentage (62.5%) of 'investment expenditure' incurred by a company;
- the allowance generated in respect of a particular field is capable of being used (or 'activated', in the parlance of the legislation) only to the extent of the revenue from the sale of oil or gas produced from that field in the relevant period; and
- the 'activated' allowance is given as a deduction against the supplementary charge profits of the company.

Moreover, a key part of the design is that any unused field allowances arising under the old regime are to be converted into investment allowance, enabling the repeal of the pre-existing suite of field allowances (with the exception of the onshore allowance introduced in 2014, which continues to apply to certain onshore oil and gas activity).

'Investment expenditure': The first area to consider further is the nature of the expenditure that qualifies for investment allowance. 'Investment expenditure' is defined by the new CTA 2010 s 332BA to be capital expenditure, or expenditure prescribed as 'investment expenditure' under secondary legislation. In the absence of any further definition, 'capital expenditure' has its ordinary tax meaning, which means consideration has to be given to the long history of case law on whether expenditure is revenue or capital in nature. In many cases it will be obvious whether expenditure qualifies as capital, however there are a number of areas where this could be difficult to determine. Expenditure on well workovers, for example, will be incurred with a view to driving an incremental increase in the oil or gas production from a field. However, if the expenditure merely returns the well to its original state, should this be considered a repair rather than capital expenditure in the context of tax law?

The government has indicated a policy objective of ensuring that discretionary spend with an aim of maximising the economic recovery of hydrocarbons from the UKCS is within the scope of investment expenditure. Therefore, s 332BA includes the ability to extend the definition of investment expenditure by secondary legislation to cater for such activity that may fall outside the tax definition of capital. Further discussions with the industry will be held during 2015 in order to validate the scope of the required secondary legislation.

Another area of concern has been the treatment of lease expenditure. Lease payments in respect of assets put to use in capital projects, for example the lease of a drilling rig to drill production wells as part of a field development project, would normally fall to be regarded as capital from a tax perspective and are therefore in the scope of investment expenditure. However, lease payments referable to assets used throughout the production phase, for example the lease of a floating production facility, are arguably revenue in nature for tax purposes. It would be a significant economic distortion if the acquisition of a production facility were to qualify for investment allowance, but the lease of the same production facility would not; consequently, the authors anticipate the secondary legislation will enable such lease payments to qualify as investment expenditure on an appropriate basis.

'Activation' of allowance: As noted above, investment allowance can only be used, or 'activated', where there is income from the relevant field. This mechanism is based on the old field allowance regime, and reflects the broad intention that the benefit of the investment allowance should only be accessed if the investment has resulted in additional taxable income.

This throws up some practical issues. In order for the allowance to be 'activated' by field income, it has to first be attributed to a field. This is not problematic in circumstances where expenditure is incurred wholly for the purpose of producing oil or gas from a particular field. However, expenditure on infrastructure assets that support production from more than one field is to be apportioned between the fields on a 'just and reasonable basis', in accordance with the new s 332C(6). In most circumstances this will represent a necessary compliance exercise without any negative overall impact; however, in particular fact patterns this process could result in investment allowance being either denied or deferred in relation to expenditure that meets the definition of investment expenditure.

Furthermore, this activation mechanism results in unsuccessful exploration expenditure being outside the scope of the allowance. To the extent exploration activity subsequently results in a field development, the investment allowance generated on the initial (capital) exploration expenditure can be activated by the revenue from the ultimate development. However where there is no development, the allowance related to the exploration expenditure is never capable of being activated. HM Treasury recognises this, and may consult separately on specific incentives for exploration activity.

Set off against profits of the company: The fact the activated allowance is set off against the supplementary charge profits of the relevant company, rather than the profits of the specific field, is also consistent with the old field allowance regime. Supplementary charge is levied at the corporate level, and allocating corporate profits down to field level simply to restrict the offset of activated allowance to the profits of the field is seen as both complex and arbitrary. Any activated allowance that cannot be used by the company in the current period, due to an insufficiency of supplementary charge profits, is carried forward to the next period; activated but unused allowance cannot be 'group relieved' to other group entities.

During the consultation period, industry representatives made the point that such a mechanism distorts between groups that hold their producing fields in a number of group companies, perhaps because of banking covenants or historic growth via corporate acquisitions, and groups that carry on all their activity in one single entity. The final legislation has not addressed this concern, and therefore groups may want to consider how they hold their field interests in order to realise the full potential benefit of the allowance.

HM Treasury anticipates that the changes should facilitate upwards of £4bn of incremental investment over the next five years, lifting production by 15%

Transition mechanics: Perhaps the most complex aspect of the legislation introducing the investment allowance is the transitional mechanics. Broadly, the legislation seeks to ensure that no company holding an existing unactivated field allowance from the old regime is left worse off on transition into the new regime. By the same token, the transitional mechanics are drafted in a way that prevents companies benefiting from both investment allowance and field allowance on the same project. This is achieved by excluding expenditure on a project spanning the commencement date from the scope of investment allowance, until such times as the investment allowance generated is equal to the original field allowance that was granted. The following examples demonstrate these principles.

Example 1: Field X, owned by company A, is given development consent on 1 January 2013, and is granted a field allowance of £150m. The capital cost of field development is £600m, and development is complete on 30 June 15. Up to 1 April 2015, expenditure of £500m is incurred; the remaining £100m is incurred after 1 April 2015.

Ignoring the transitional mechanics, company A would be entitled to field allowance of £150m, and also investment allowance of £62.5m (62.5% of £100m).

The transitional mechanics convert the £150m of field allowance into investment allowance (FA 2015 Sch 11 para 7). The first £240m of expenditure after 1 April 2015 is prevented from generating investment allowance (CTA 2010 s 332DA). Therefore, the total investment allowance available in respect of the field development is £150m – equal to the field allowance previously anticipated.

Example 2: Field Y, owned by company B, is given development consent on 1 January 2014, and is granted a field allowance of £150m. The capital cost of field development is £600m, and development is complete on 31 December 2016. Up to 1 April 2015, expenditure of £200m is incurred; the remaining £400m is incurred after 1 April 15.

Ignoring the transitional mechanics, company B would be entitled to field allowance of £150m, and also investment allowance of £250m (62.5% of £400m).

The transitional mechanics convert the £150m of field allowance into investment allowance (FA 2015 Sch 11 para 7). The first £240m of expenditure after 1 April 2015 is prevented from generating investment allowance (CTA 2010 s 332DA). The remaining £160m of expenditure generates £100m of investment allowance. The total investment allowance available in respect of the field development is thus £250m.

As can be seen from the examples, in effect the resulting investment allowance for the transitional project will normally be the greater of the investment allowance on post 1 April 2015 expenditure related to the project and the historic field allowance arising in relation to that project.

A further transitional rule is of key importance in situations akin to example 1. As highlighted, s 332DA prevents the first £240m of investment expenditure from generating investment allowance; this avoids double counting of the original field allowance in respect of the field development project. However, once the initial development that gave rise to the original field allowance is complete, it would be unfair for company A to have to spend another £140m on other projects in the field before it could begin to qualify for investment allowance. Therefore, s 332DB(5) enables the secretary of state to determine a project as 'materially completed', and any investment expenditure incurred after this time is not subject to the transitional restrictions.

There are a number of other complications within the transitional mechanics that apply in specific fact patterns. However remembering the key principles that companies should not be worse off as a result of the transition to investment allowance, and the transition should not result in double counting of field allowance and investment allowance, should lead to the correct application of the transitional rules the majority of the time.

Summary of investment allowance: The investment allowance has been welcomed by the industry. HM Treasury acknowledges that work is still required before the design fully meets its policy objectives, which is somewhat inevitable given the timetable for the introduction of the allowance. The authors are hopeful that incremental changes will be addressed and effected as promptly as possible under the new government.

Cluster area allowance

The so-called cluster area allowance has been trailed over a much longer period than the investment allowance, with its introduction confirmed by Autumn Statement 2014. It operates in a broadly similar manner to investment allowance: qualifying expenditure in relation to a 'cluster area' generates an allowance equal to 62.5% of the expenditure, and the allowance is set off against the supplementary charge profits of the company once activated.

The key difference between cluster area allowance and investment allowance is that the former allowance is activated by income from the cluster area, as opposed to the field. A 'cluster area' is an area defined as such by the Secretary of State, but may include a field as well as surrounding exploration acreage, or possibly more than one field. The primary benefit of being designated a 'cluster area' is therefore that allowance generated within the cluster area can be activated more easily. For example, unsuccessful exploration activity within the cluster area could potentially be activated by income from a separate producing field within the cluster area.

Ring fence expenditure supplement (RFES)

Finally, FA 2015 sees changes made to the operation of RFES. This is an allowance that applies to loss-making oil and gas companies, and enables the company's ring fence trading losses to be uplifted in value by 10% per annum where certain conditions are met. Previously a maximum of six annual RFES claims could be made. FA 2015 Sch 11 introduces the ability for companies to make an additional four claims once the initial six are exhausted, although the four additional claims can only uplift the value of losses incurred after 5 December 2013.

Summary

The changes enacted by FA 2015 have been well received by the UK oil and gas industry. By HM Treasury's own figures, the cost of the package of measures is surprisingly modest – approximately £1.4bn over the next five years – this probably reflects that future tax revenues over that period were estimated to be low because of the current challenges facing the sector. However, HM Treasury also anticipates that the changes should facilitate upwards of £4bn of incremental investment in the UKCS over the same period, lifting production by 15%. If the out-turn achieves this bold prediction, one would imagine both industry and government would be extremely pleased. ■

What's happened to the proposed consortium relief link company provisions?

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The original draft of the Finance Bill 2015 published on 10 December 2014 included legislation that proposed amendments to the consortium relief tax loss surrender rules in relation to what are known as 'link companies'. These provisions were not included in the final draft of the Finance Bill 2015 and are therefore not included in FA 2015.

A 'link company' is a company that is a member of a consortium and also a member of a group relief group. As the name suggests, this company can act as a link between a consortium company (and its group) and the wider group relief group of the consortium member, allowing tax losses to be surrendered between the consortium company (and its group) and the linked group of the consortium member. Under current legislation, such surrenders are only permitted where the link company is either UK resident or established in the EEA and, where established in the EEA, all intermediate group companies are also established in the EEA. Recent EU case law has indicated that such restrictions are contrary to EU law and consequently the original Finance Bill 2015 was proposing that these location requirements be removed. For further details on proposed changes and rationale for these changes, see *Tax Journal*, 26 February 2015.

However, on the day of the Budget 2015, HM Treasury released a document entitled *Overview of tax legislation and rates* which explained that, in recognition of the accelerated parliamentary process applicable to the Finance Bill 2015 by reason of the impending general election, a number of measures included in the original draft of the Finance Bill 2015 were being deferred. The consortium relief link company provisions were identified as one of the measures being deferred.

The Treasury briefing makes it clear that the intention is for these provisions to be legislated in a future Finance Bill. This will obviously be after the general election and so subject to the political position at that time, but given that the intention of the legislation is to address potential incompatibility with EU law, there should be no reason why these provisions will not be legislated in due course.

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FA 2015 analysis

Loss refreshing

SPEED READ **Finance Act 2015 introduces a new targeted anti-avoidance rule which counteracts arrangements under which certain carried forward losses are used to generate other losses or deductions which, for corporation tax purposes, can be used more flexibly. Where a company enters into arrangements meeting the conditions it will be unable to use these brought forward reliefs against profits created by the arrangements in the relevant company. The provisions mark a significant change of approach in relation to arrangements that have previously been seen as relatively benign.**

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Finance Act 2015 contains a new targeted anti-avoidance rule (TAAR) that is designed to counteract arrangements under which certain carried forward losses are used to generate other losses or deductions which, for corporation tax purposes, can be used more flexibly. The new TAAR is found in FA 2015 Sch 3, which introduces a new Part 14B into CTA 2010.

The problem

UK tax legislation often permits tax losses and reliefs, which cannot be used effectively in the period in which they arise, to be carried forward and set against profits arising in a subsequent period. So, for example:

- CTA 2010 s 45 gives relief to a company carrying on a trade for carried forward unrelieved trading losses by set off against profits of the same trade in a subsequent accounting period;
- CTA 2009 s 457 provides for a company's carried forward unrelieved non-trading deficits on loan relationships to be set against its non-trading profits in a subsequent period; and
- CTA 2009 s 1223 provides for the carried forward management expenses of a company with investment business to be set against its total profits in a subsequent period.

With the exception of the new rules for banking companies now in CTA 2010 Part 7A, there are no time limits on the carry forward of losses in this way.

However, the use of these carried forward losses may be restricted in other ways:

- as a general rule, they can only be used by the same company (subject to the provisions applying to transfers of a trade without a change of ownership);
- carried forward reliefs cannot be surrendered or used to create losses that can be surrendered to other group companies by way of group relief in a subsequent period; and
- carried forward trading losses can only be used against profits of the same trade, provided that it is being carried on in the subsequent period.

This position should be contrasted with the relative flexibility afforded to the use of current year trading losses, non-trading deficits and management expenses, which can be set against a wider range of profits and can be surrendered to other group companies by way of group relief. There are therefore benefits that can be obtained if carried forward losses and reliefs can be converted into current year deductions. The new TAAR is designed to address arrangements which attempt to achieve this result.

Scope of the TAAR

The new TAAR will apply only to certain losses and reliefs. In particular, it will only apply to:

- losses which are carried forward under CTA 2010 s 45;
- non-trading deficits which are carried forward under CTA 2009 s 457; and
- management expenses which are carried forward under CTA 2009 s 1223 or are carried forward losses treated as management expenses, in the case of companies with investment business that have ceased to carry on a UK property business.

Conditions

The new TAAR only applies if five conditions are met. These are set out in a new s 730G of CTA 2010.

- **Condition A** requires that the company has relevant profits which arise from tax arrangements from which, in the absence of the TAAR, it would be able to deduct carried forward losses.
- **Condition B** requires that the company or a connected company brings a deductible amount (e.g. current year trading expenses or current year non-trading debits) into account in an accounting period and that 'it is reasonable to assume that neither the company nor any connected company would have brought that amount into account as a deduction for that period but for the tax arrangements'.
- **Condition C** is that the main purpose or one of the main purposes of the tax arrangements is to secure a relevant corporation tax advantage for the company or a connected company. A relevant corporation tax advantage means a corporation tax advantage involving the use of the deductible amount referred to in condition B and the deduction of the relevant carried forward losses from the relevant profits.
- **Condition D** is that, at the time when the tax arrangements were entered into, it would have been reasonable to assume that the tax value of the arrangements would be greater than the non-tax value of the arrangements.
- **Condition E** is that the tax arrangements do not fall within the specific new rules applicable to banking companies in FA 2015 Sch 2 which, inter alia, introduces a new s 269CK to CTA 2010.

It follows from condition B that arrangements which are designed only to transfer group trading profits or an existing group creditor loan relationship to the company with carried forward losses, and in effect accelerate the use of those losses are not caught by the TAAR. They do not involve the generation of new current year expenses or debits. This point is confirmed in HMRC's technical note on the new rules which was issued on 18 March 2015 (see arrangement 4, paras 56–59). The technical note also (see paras 4 and 5) describes and contrasts these kinds of arrangements with loss refreshing arrangements which 'go further' because they involve the creation of new in-year reliefs. It is only loss refreshing arrangements that are the target of the new rules.

Examples

The conditions are perhaps more easily understood in the context of some examples. The technical note contains some examples of when the new TAAR is or is not expected to apply, but the examples below are intended to illustrate the points more simply.

Example 1: In a simple group, company B has carried forward non-trading deficits. It is a wholly owned subsidiary of company A. Company A subscribes additional share capital in company B. Company B uses the proceeds of the subscription to make a loan at interest to its wholly owned subsidiary, company C. Company B claims to set its carried forward non-trading deficits against the profits derived from the interest on the loan to company C. Company C surrenders the deficit created by the interest on the loan from company B to other group companies by way of group relief.

Condition A is met. Company B has relevant profits in the accounting period as a result of the interest accruing on the loan to company C. In the absence of the TAAR, company B would be entitled to deduct the carried forward non-trading deficits from the profits derived from the interest on the loan for corporation tax purposes.

Condition B is met. A company (company C) connected with company B brings a deductible amount (the interest on the loan) into account as a deduction in the accounting period. Company C would not have brought that amount into account as a deduction but for the arrangements.

Condition C is met if the main purpose of the arrangements is to secure the deductible amount for company C and the deduction of the relevant carried forward losses against the interest on the loan for company B.

If so, condition D is also met. The tax value of the arrangements (the two deductions) is greater than their non-tax value. In this example, the arrangements are wholly tax driven and, therefore, produce no economic benefits other than the tax advantages.

Example 2: The second example is the same as the first, except that company C uses the loan from company B to make a commercially driven acquisition of an unconnected holding company (target). Company C surrenders the debits on its loan from company B into the target group.

All of the conditions are met, except perhaps condition D. The arrangements include the acquisition of the target group. That acquisition may produce economic benefits, such as the opportunity to generate additional profits. A similar example is given in the technical note (see arrangement 2, paras 48–51), but it provides no material guidance as to how the economic benefits should be weighed against the corporation tax advantages arising to companies B and C in these circumstances. It is simply noted that the TAAR should not apply where 'the main economic driver of [the arrangement] – and its largest anticipated benefit – is the opportunity to generate additional profits'.

Effect of the TAAR applying

Where the conditions are satisfied and the TAAR applies, the first company is not entitled to a deduction for the carried forward losses from the relevant profits. This does not prevent the carried forward losses being used in the same period or any future period to set against other profits.

In addition, the TAAR has no effect on the tax consequences of the other steps that might be involved in the arrangements; and, therefore, it does not affect the use of the newly generated current year deduction, although that deduction may, of course, be affected by an existing unallowable purpose or other anti-avoidance rule.

Commencement

The TAAR applies to the calculation of total profits of companies for accounting periods beginning on or after 18 March 2015. In the case of any accounting period straddling that date, the new rule applies for the part of that period beginning on that date (with a time based or just and reasonable apportionment of the profits of the period). It does not matter when the tax arrangements were entered into or when the carried forward losses arose.

Why now?

HMRC has in the past been relatively relaxed about arrangements to which the TAAR will now apply. HMRC's manuals refer to arrangements similar to those in example 1 above as 'widespread' and as having 'never been regarded as particularly offensive by HMRC' (see *Corporate Finance Manual* CFM92210). Other arrangements with a similar effect are described in example D5 in HMRC's 2015 GAAR guidance, where the conclusion is that the GAAR does not apply and where arrangements that seek to locate profits arising within a group in a company that has available carried forward reliefs are described as 'well-established corporate house-keeping' (para D5.6.2).

It was therefore perhaps a little surprising that the policy objectives of the new TAAR were described in the relevant tax information and impact notice as '[levelling] the playing field between businesses that enter such arrangements to avoid tax and those who keep within the spirit of the law'. It appeared with no warning and no consultation. This seems a significant change of approach, in relation to arrangements that have previously been seen as relatively benign. ■

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Budget 2015: the impact on multinationals
(Mike Lane, 19.3.15)

FA 2015 analysis
B share schemes

SPEED READ Finance Act 2015 amends ITTOIA 2005 so as to remove the 'unfair outcome' arising from B share schemes. From 6 April 2015, it will no longer be possible for UK resident companies to offer individual shareholders a choice of income or capital treatment on a return of value. This will disrupt a well established practice that many will have assumed was blessed by the GAAR guidance.

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Finance Act 2015 includes measures to prevent companies from returning cash to shareholders in a way that offers a choice between income and capital treatment.

These changes were first announced in the Autumn Statement in December 2014. They came as a surprise and will disrupt a well established practice that many will have assumed was blessed by the GAAR guidance.

Background

A number of factors will influence a company's choice of method to return cash to its shareholders, including tax. One such method, a B share scheme, was originally introduced to enable companies to provide a capital return to shareholders. Over time, B share schemes developed to allow companies to offer shareholders a choice between income and capital treatment, reflecting the fact that UK shareholders may have diverging interests in this regard. Individuals will generally prefer capital treatment, whereas institutional shareholders will often be indifferent, or in some cases may prefer income treatment.

Types of B share schemes: In the simplest case, a B share scheme offering a choice would involve:

- a bonus issue of redeemable shares with a nominal value equal to the amount to be returned, paid up out of 'good' capital (share premium or merger reserve that has not been tainted by subsequent transactions), such that neither the issue of the B shares nor their redemption would be treated as a distribution; and
- either (i) where the shareholder opts for income treatment, the payment of a dividend on the B shares; or (ii) where the shareholder opts for capital treatment, the redemption of the B shares.

There have been many variations to this basic case. Some are intended to minimise the amount of 'good' capital used. For example, a company may issue a different class of shares (often called C shares) with a low nominal value to those shareholders seeking income treatment. Others allow companies to offer a capital return to shareholders even where they do not have sufficient 'good' capital to issue redeemable B shares. For example, a company may issue bonus shares with a low nominal value and make arrangements with a bank to buy those shares *cum div* from shareholders seeking capital treatment.

The new rules

The new rule in ITTOIA 2005 s 396A (inserted by FA 2015 s 19) applies where a person has a choice either to:

- receive a distribution from a company; or
- receive an alternative receipt that has the same or substantially the same value as the distribution and which is not charged to income tax.

It does not matter whether the choice is subject to conditions and 'passive' choices still count. Where the person chooses the alternative receipt, the receipt will be treated as a distribution by the company and charged to income tax under ITTOIA 2005 s 383(1). The distribution will also be treated as a qualifying distribution for the purpose of the rules relating to tax credits.

If a tax other than income tax is charged in relation to the alternative receipt, there is provision for HMRC to make just and reasonable adjustments in respect of that other tax, so as to avoid double taxation.

Scope: Although all variations of B share schemes that offer a choice may fall within s 396A, there are two main limitations to its scope.

First, s 396A only applies to returns received by income taxpayers. This restriction is, however, unlikely to be significant. As noted above, corporate shareholders will often be indifferent as to the tax treatment of the return, so it is doubtful that a company would put in place a B share scheme offering a choice, where individual shareholders could not also benefit from the choice.

Second, s 396A only applies to returns received from UK resident companies. The tax treatment of individuals differs between returns from UK resident and non-UK resident companies. Section 396A does not impact the treatment of returns from the latter. Non-UK resident companies may, therefore, still be able to offer UK individual shareholders a choice between income and capital treatment on a return. Indeed, Paddy Power plc, an Irish resident company, recently announced that it will return cash to its shareholders by way of a B share scheme offering a choice between income and capital treatment.

Changes to the December draft: There are only two changes to the draft legislation published in December 2014.

Commencement. The commencement rules have been amended to clarify that s 396A will apply to any 'things received on or after 6 April 2015 (even if the choice to receive them was made before that date)' (FA 2015 s 19(10)). This was undoubtedly

HMRC's intention from the outset, but the previous drafting left room for argument.

Trustees. Changes have been made to ITA 2007 Part 9 Chapter 3 to ensure that, where a trustee of a life interest trust is deemed to receive income by s 396A, that income is taxed at the dividend trust rate (currently 37.5%), rather than the lower rate that generally applies to dividend income received by such trustees (currently 10%), subject to any tax credit. This is similar to the treatment of the income element of the price on an off-market share buyback (ITA 2007 ss 481(3) and 482).

Changes to the explanatory note: Material changes have been made to the explanatory note. Some statements in the previous draft seemed incorrect or at least confused. Those statements have been amended, but generally not so as to bring greater clarity to the rules. Rather, HMRC appears to have sought to preserve as much flexibility in the application of s 396A as possible.

What values should be compared? When assessing whether the alternative receipt has 'substantially the same value' as the distribution, para 5 of the previous draft of the explanatory note suggested that *post-tax* amounts were relevant. This was clearly wrong.

Shareholders will typically receive the same *pre-tax* amount per ordinary share on a B share scheme (whether by way of a dividend or, say, redemption proceeds), regardless of the tax treatment actually obtained. The post-tax receipt might, in fact, differ considerably: a higher or additional rate taxpayer would pay income tax on the whole receipt, whereas CGT would be payable only on any gain element and after the application of the annual exemption and any losses.

The offending paragraph has been deleted in the revised version of the explanatory note. However, rather than confirming that the pre-tax receipt is relevant, which surely must be the right answer, HMRC has hedged its bets. Para 6 says that the test may be applied 'at either distributing company or receiving shareholder level'. Presumably HMRC thinks that this choice lies with it, rather than the taxpayer.

What is the alternative receipt? Depending on the structure, a shareholder opting for capital treatment might arguably receive *two* alternative receipts: the B shares themselves; and the proceeds received on their redemption or purchase.

Section 396A seems to contemplate that the proceeds on redemption or purchase are the relevant alternative receipt, being the receipt on which CGT may also be charged. (Section 396A(4) refers to another tax charged 'in relation to the alternative receipt'.) This seems right and it is consistent with the need to refer to a receipt 'from a third party' in s 396A(1)(b).

Confusingly, though, the revisions to the explanatory note suggest that HMRC thinks that an issue of the bonus shares could (also?) be the alternative receipt (see para 5, where the words 'the issue of bonus shares or' have been added to the list of possible alternative receipts).

What double taxation is envisaged? If a receipt is charged to income tax, that receipt cannot also be subject to CGT (see TCGA 1992 s 37). No additional rules are needed to achieve this. What double tax charge, then, is s 396A(4) intended to deal with? Paragraph 10 of the explanatory note (which has been tweaked since the original version, but not in a material way) suggests that income tax may be charged on one receipt (the shares) and CGT may be charged on another receipt (the buyback proceeds). Could this be the concern? Even if it were right, though, s 396A(4) would not assist: income tax and CGT would not be suffered 'in relation to *the* alternative receipt'. Rather, they would be suffered on two different receipts.

Removing an unfair outcome?

The explanatory note claims that s 396A will 'support the government's objectives of tackling unfair outcomes in the tax system'. The conclusion – that B share schemes which offer a choice are so unfair that they should be abolished – is bewildering.

B share schemes have been used for a number of years. They are included in the GAAR guidance as examples of 'situations where arrangements have become embedded into tax or business practice in such a way that it would be wrong now to treat them as abusive' (para D2.3 of the GAAR guidance).

Imagine a scenario where a company has fared badly. In order to cut its losses, it sells one of its major assets and returns the proceeds to shareholders. The amount returned is much less than the amount initially subscribed by shareholders. The company implements a B share scheme, so as to give its disgruntled shareholders a choice between capital and income treatment. One might think that income, rather than capital, treatment would be artificial here: in no sense are the shareholders receiving profits of the company. Section 396A would nevertheless apply to treat shareholders as receiving an income return.

A company is generally free to choose whether to make income or capital payments to its shareholders. HMRC's view now appears to be that a company can structure a return so that all shareholders receive income treatment (e.g. a special dividend) or capital treatment (e.g. a 'capital only' B share scheme). However, if a company offers shareholders a *choice*, then that is so egregious that it must be stopped.

Indeed, it is somewhat surprising that s 396A leaves the door open for 'capital only' B share schemes. Should the revised approach to B share schemes that offer a choice be read as a 'keep off the grass' sign for some variants of such 'capital only' schemes, either under the GAAR or otherwise?

Conclusion

While the rationale and timing of s 396A may be surprising, and some points around application are difficult, the intention is clear. It is no longer possible for UK resident companies to offer income taxpaying shareholders a choice of income or capital treatment on a return of value. ■

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Draft FB 2015: B share schemes (Helen Gilbey & Sarah Falk, 22.1.15)

Tax-efficient incentives in the current environment (Andy Goodman, 29.8.12)

FA 2015 analysis

Restrictions to entrepreneurs' relief

SPEED READ Entrepreneurs' relief is a valuable tax relief for those holding equity in the business for which they work. Its relative simplicity gives rise to anomalies, but the FA 2015 changes do not suggest a clear pattern in HMRC's views as to what is acceptable tax planning. Managers with minority equity stakes in joint ventures and companies which participate in partnerships are among those hit by these changes, along with persons disposing of their own assets used by a business and individuals that incorporate businesses carried on in partnership. No grandfathering is available, even for gains accruing before the changes were announced.

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Entrepreneurs' relief (ER) is the latest iteration of a longstanding feature of the capital gains tax legislation, namely a relief for those who develop or invest in a business – typically one in which they work. It follows on from business asset taper relief (BATR) and, before that, retirement relief.

Although the conditions of each of these reliefs differed, reflecting the priorities of the government in power, the essential feature remained the same: for individuals disposing of a business, at least part of the gain would be taxed at lower rate(s). For retirement relief, BATR, and, in its early years, ER, this was achieved by exempting part of the gain from tax.

Reliefs from other taxes pursue the same objective, with business property relief (from IHT) and income tax relief for interest on loans to acquire interests in businesses being good examples. Other reliefs – such as the enterprise investment scheme (EIS) and venture capital trusts – seek to encourage the provision of capital to small businesses, typically by those not involved in the running of the business, or provide rollover relief for certain business asset reinvestments.

> Two concepts – the material disposal of a business asset and associated disposals – were amended by FA 2015

The current relief for business assets

Occupying seven pages of TCGA 1992, ER has been in place since 2008. Readers will be familiar with the basic structure: a 10% rate of tax for gains (of up to £10m of gains, over the individual's life), which are made on a 'material disposal of business assets', and a similar relief for certain disposals made by trustees. Business assets for these purposes include qualifying share disposals by directors/employees. The relief is also available for disposals (of assets) 'associated with a relevant material disposal'.

It is these two concepts – the material disposal of a business asset and associated disposals –which were amended by FA 2015. The first is amended in three respects, the second in one respect. All of these changes restrict the scope for ER, and are the focus of this article.

However, there is some good news. ER is being extended (perhaps, more accurately, reinstated) by FA 2015 s 44 to certain held-over gains which fall back into charge when an investment in an EIS company or in a social enterprise is disposed of, etc. The main point to note about this change is that ER is only available if the gain which was held-over into the EIS company/social enterprise would itself have qualified for ER and would have arisen on or after 3 December 2014.

Qualifying business disposals: the 5% minimum shareholding

Being a relatively straightforward relief, it is inevitable that ER will produce some anomalies. One of the more striking of these is the distinction which the legislation draws between businesses carried on in partnership, and those which are carried on through a company.

In the former case, there is no minimum size threshold to qualify for ER. A very small percentage holding will qualify for relief and, provided that an interest has been held for the 12 month minimum holding period, any gain on the disposal of that interest will qualify for relief. This is the case even if the interest has increased significantly during that 12 month period, such as shortly before an exit.

By contrast, where the individual holds shares in a trading company (or the holding company of a trading group), not only must that individual be a director (or other officer) or employee of the company, but any gain on the disposal of those shares will only qualify for relief if the individual has held at least 5% of the company's equity throughout the 12 months before that disposal. Including such a 'minimum size' threshold for relief can seem particularly anomalous to an individual holding a small shareholding in a trading company, who contrasts the position with that of a similar individual who is a member of a limited liability partnership.

However, this 5% threshold is a refreshingly simple test to apply: what is required is a shareholding which carries 5% of the voting rights and 5% of the ordinary share capital (making the company the individual's 'personal company'). The latter is calculated by reference to the total nominal value of the company. Therefore, any shareholders holding a class of share which has a greater nominal value find it easier to satisfy the

5% threshold than those with shares carrying a smaller nominal value.

Readers familiar with the group relief tests, which are incorporated into other aspects of the chargeable gains legislation, might be surprised by the absence of any economic ownership test. Indeed, in a joint paper on the GAAR, the CIOT and ATT raised the issue of the application of ER to shares with limited economic rights. In practice, the 5% voting rights threshold is an effective safeguard against abuse, because it limits the number of people who can claim ER in respect of any company to a maximum of 20.

Changes to joint venture companies and interests in partnerships

In practice, the limit is often far fewer than 20 individuals, particularly where an outside investor finances or invests in the business. In such a case, the amount of equity available for management shareholders is limited, and the outside investor may want the managers' shareholdings limited to less than 25% of the voting rights in the company.

In such cases, the joint venture company rules in TCGA 1992 s 165A could provide assistance. In theory, they could allow significantly more than 20 individuals to qualify for ER on their shareholdings in a trading company, producing a more level playing field with those investing in a limited liability partnership. In practice, the need to have a workable corporate governance structure placed a lower limit on the number that could qualify.

How did the joint venture company rules work? They allowed managers, or a group of managers, to establish their own 'management' company (Manco), which then held a minority interest in the underlying trading company/holding company of a trading group (Tradeco). Because the 5% threshold is tested by reference to the company in which the manager owns shares, each Manco could be the personal company for up to 20 managers (provided that each had a 5% interest in that Manco and was a director of *that company*). Although the Manco would not itself be carrying on a trade, the joint venture rules – which are similar to those in the substantial shareholdings exemption (SSE) – deemed it to carry on a portion of the trading activities of the Tradeco. The Manco had to hold at least 10% of the Tradeco's shares, and at least 75% of the Tradeco's shares had to be held by not more than five persons. Assuming, as would usually be the case, that the Manco was UK tax resident, the 10% ownership of Tradeco also afforded SSE protection against an additional layer of tax from being introduced. In theory, up to six Mancos might have been possible, but anything more than a single Manco gave rise to commercial issues.

It is these Manco structures from which FA 2015 s 43 removed ER. It did so by introducing, in TCGA 1992 s 169S, a new sub-s (4A)(a), which states that the relevant provisions of the joint venture rules (that is, s 165A(7), (12)) are to be disregarded in determining whether a shareholding qualifies for ER. This change applied from 18 March 2015, without any grandfathering either for shares acquired before then or for gains accruing up to 18 March. This is not unusual for changes to capital gains tax, but it is arguably harsh for a change which applies regardless of whether or not the joint venture structure was put in place to access ER.

A related change is made by new sub-ss (4A)(b) and (c), which prevent a company from deriving its status as a trading company (or trading group) by participating in a partnership which carries on a trade. Again, the change here came into force on 18 March 2015 without any grandfathering and without any reference to the size of the company's interest in the partnership. Although interests in partnerships could be used to combine the (lower) corporate tax rate on retained profits with the absence of a 5% threshold for ER, there will undoubtedly be arrangements which were established in this way for non-tax reasons that no longer qualify for ER.

ER remains a valuable tax relief, but it is not surprising that in an age of austerity HMRC finds Parliament receptive to concerns about perceived abuses

This change carries echoes of the FA 2014 provisions on mixed member partnerships, which also demonstrated HMRC's dislike of taxpayers adopting a mix-and-match approach to the respective tax treatments of partnerships and companies.

Anyone tempted to trigger a disposal after the change was announced (albeit at a cash-flow cost), relying on the three-year grace period after a company ceases to be a trading company (see TCGA 1992 s 169I(7)), will be disappointed by FA 2015 s 43(4). This prevents taxpayers from relying on s 169I(7) if the company ceases to be a trading company by virtue only of the changes made by FA 2015 s 43.

Changes to associated disposals

The 'associated disposal' rule applies to individuals who already qualify for ER in respect of an interest in a partnership, or shares in a trading company/holding company of a trading group. They extend the relief to gains made on assets that the individual holds directly, provided they have been used for at least a year in the business carried on by the partnership/trading company. A classic example is property occupied by a trading partnership, but owned by one of the partners. Another example might now be a piece of art; until the changes made by FA 2015 s 40, such an asset might otherwise have been exempt as a wasting asset.

ER only applies to disposals of such assets as part of the individual's withdrawal from participation in the business carried on by the partnership/company, and the individual must also make a disposal of some of his partnership interest/shareholding.

HMRC's stated concern is about individuals qualifying for ER in respect of such assets where there is no 'genuine' reduction in the individual's participation in the business. Accordingly, it is primarily the requirement that the individual disposes of an interest in the partnership/shareholding which has been made more stringent. FA 2015 s 41 replaces this with a requirement that the individual disposes of at least a 5% interest in the partnership/shareholding in the company in question. For a person disposing of securities, only 5% of the company's total securities must be disposed of. This requirement is set out in three new sub-ss (1A), (1B) and (1C) of TCGA 1992 s 169K, for partnership interests, ordinary shares in a trading/holding company and securities in a trading/holding company respectively.

HMRC's concern is about individuals qualifying for ER where there is no 'genuine' reduction in participation in the business

Significantly, the disposal must be of 5% of the partnership/company, rather than just 5% of the individual's interest in that partnership/company. Therefore, although a member of a partnership does not need a minimum size of interest to qualify for ER in respect of that interest, a 5% partnership interest is required to qualify for ER in respect of privately held assets which are made available to the partnership.

Another change requires that neither this disposal nor the individual's withdrawal occur at a time when there are arrangements under which the taxpayer (or any person connected with the taxpayer) is 'entitled to acquire' a partnership interest (including an increased partnership interest) in the partnership which carries on the business; or – where the business is carried on by (and the individual has disposed of shares in) a company – shares in or securities of either the company whose shares/securities have been disposed of, or any other company in the same trading group (or certain other companies which it is 'reasonable to assume' will become part of that trading group). This is very wide, given that 'arrangements' carries its customarily broad meaning. As well as extending this to connected persons, it is notable that a person who disposes of shares cannot be party to arrangements to acquire securities, or vice versa.

ER is also denied for associated disposal if the disposal of shares takes the form of a capital distribution by the company (as opposed to a sale of shares to a new, or existing, shareholder), unless that distribution is in the course of the dissolving or winding up of that company.

As with the changes to s 169S, these changes took effect on 18 March 2015 without any grandfathering protection.

Changes to transfer of goodwill on incorporation

As ER is available for disposals to connected persons, the 10% tax rate is available to an individual who transfers a business to a company owned by that person.

Clearly, there is a concern about such a transaction, particularly if the company then claims corporation tax relief – at the 20% rate for the same, or a greater, amount – and the outstanding purchase price is used to extract funds from the company without further personal taxation. FA 2015 s 42 addresses the ER position, by inserting a new s 169LA into TCGA 1992. This denies ER for gains attributable to goodwill (but not other assets) which is transferred to a close company by a person who is a 'related party' (using the definition from Part 8) to that company.

There is an exception to this rule, which permits retiring partner(s) to claim ER on the transfer of a partnership's business to such a company, but this exception is limited. Furthermore, ER is only preserved for such an individual if that person is not a participator in the close company (or another company with a 'major interest' in it) and there are no arrangements under which that person could become a participator in the close company.

This new restriction is backed up by a TAAR, which denies ER for gains on disposals of goodwill by a person who is a party to 'relevant avoidance arrangements'. Readers may be depressingly familiar with the width of this TAAR. All that is required is a main purpose of securing that the new restriction does not apply in relation to the goodwill *or* that the person is not a related party in relation to the company to which the goodwill is disposed of.

This change was announced at the Autumn Statement, along with a related restriction on companies claiming the corporation tax relief referred to above under the intangibles regime in CTA 2009 Part 8. It applies to disposals on or after 3 December 2014, rather than the 18 March 2015 commencement date for the other ER changes mentioned above.

Still here, but less generous

ER remains a valuable tax relief, but it is not surprising that in an age of austerity HMRC finds Parliament receptive to concerns about perceived abuses. ■

For related reading, visit www.taxjournal.com

Practice guide: How to optimise entrepreneurs' relief (John Endacott, 6.4.11)

FA 2015 analysis

Goodwill changes

SPEED READ **FA 2015 removes entrepreneur's relief for transfers of goodwill and limits corporation tax deductions for acquisition of goodwill in transactions between companies and related parties. The changes were stated to be made to remove unfair tax advantages on incorporation; however, the changes affect rather more than just incorporations. In particular, family businesses will find that their options for structuring ongoing businesses on the retirement of one generation are limited. Some joint ventures and acquisitions will also need to take care to ensure that they can continue to benefit from corporation tax reliefs on certain acquisitions.**

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Finance Act 2015 brought into law two measures relating to transfers of goodwill from individuals to related companies: removing entrepreneur's relief (ER); and reducing or removing debits under the corporate intangibles rules.

Both measures took effect from the date of the Autumn Statement, 3 December 2014, and were described as correcting 'unintended' tax benefits and making the tax system 'fairer'. 'Unintended' is perhaps an unfortunate description, given that the 'benefits' in question had been in place and clearly known about by government for years (since 2008 in the case of ER; for over a decade in the case of amortisation). The recent financial cost of ER and amortisation relief on goodwill to the Treasury might have been more than estimated, but that's not quite the same thing. 'Fairer' is also something of a misnomer, as the effects of the changes go well beyond that suggested by the HMRC press releases and explanatory notes.

The changes, of course, will affect principally businesses with significant goodwill. Other assets transferred will still attract ER and other intangible assets will continue to be capable of being amortised for tax purposes.

Pete Miller's article (*Tax Journal*, 15 January 2015) set out the changes to the legislation. This article looks at some of the consequences arising from the changes that should be considered in certain situations.

Related parties

Both measures relate to the acquisition of goodwill (and quasi-goodwill in the case of the amortisation measures) by a company from an individual who is a related party of the company. A 'related party' is defined by the corporate intangibles rules (applied by s 169LA(2) for ER), and the amortisation changes are also within the corporate intangibles rules.

CTA 2009 s 835 defines a 'related party' as (inter alia) an individual who:

- controls or has a major interest (i.e. one of two people each with at least 40% interest) in the company (s 835(2)(b)); or
- is a participator or associate of a participator in a close company (s 835(5)(a)).

A 'participator' in a close company includes (inter alia) someone who possesses or is entitled to acquire share capital of voting rights, etc. There is no minimum shareholding required to be a participator (CTA 2010 s 454). However, the 'loan creditor' definition of 'participator' in s 454 does not apply in determining who is a 'related party' within the corporate intangibles rules (CTA 2009 s 841(2)).

An 'associate' includes, inter alia, a linear relative (spouse/civil partner, parent or remoter ancestor, child or sibling) (CTA 2010 s 448).

At the time of the acquisition: The goodwill changes in FA 2015 relate to acquisition from an individual who is a related party at the time of the transaction.

The question of whether an individual is a related party at the time of an acquisition was considered in *HSP Financial Planning* [2011] UKFTT 106 (TC), where the tribunal found that '[o]n the sale agreement being made the partners became entitled to the shares and thereby became participators. What mattered was the entitlement to have the shares allotted and issued not when the allotment or issue occurred.' This followed from the definition of participator which, at CTA 2010 s 454(3), states that:

'a person is treated as entitled to do anything which the person:
a) is entitled to do at a future date; or
b) will at a future date be entitled to do.'

As a result, the order in which events occur is not particularly relevant. An individual is not precluded from being a related party of a company simply because the goodwill transfer occurs before the issue of shares, for example, where they are entitled to the issue of those shares as a result of the transfer.

These are the main circumstances in which someone will be a related party of a company. There are some other circumstances as well (trusts, etc.), but these are not as likely to arise as those described above; they should not be overlooked where they do arise, however.

Removal of ER for goodwill transfers to close companies

This measure (in FA 2015 s 42) is intended to 'remove a tax incentive to incorporate an existing business' (per the explanatory note), but the changes are not limited to transfers on incorporation. There is, for example, no requirement that there be continuing economic ownership of the business being transferred.

The measures apply to deny ER on goodwill sold by an individual to a close company where the vendor is a participator in the company (TCGA

1992 s 169LA(1), inserted by FA 2015 s 42). Technically, the vendor has to be a 'related party'; in practice, with regard to a close company, that means that they will be a participator in the company.

The tax impact summary published by HMRC states that: 'Individuals (including partners) who transfer their businesses to a company which they control in order to claim ER on the gains accruing will be most affected'. These will certainly be affected, but nothing in the legislation restricts the effects to transfers to close companies controlled by the transferor. All that is required is that the transferor be a participator in the close company, which simply requires a shareholding of any size, or an associate of a participator (which requires no shareholding by the vendor).

It is only ER which is removed for the individual; incorporation relief continues to be available where all of the assets of the business are transferred. Alternatively, holdover relief may be available. However, both of these require an ongoing shareholding in the company. They are not available to disposals on retirement, for example, where the vendor takes cash or debt on disposal of the business.

Impact on succession planning: As a result, the measures will limit some succession planning options. If an individual decides to retire and (in order to fund retirement) sells their business to a close family member, such as an adult child, they will have no ER if that child buys the business through a close company, even if market value is paid for the business. The vendor will be an associate of a participator in a close company, being the parent of the owner of the company.

If the child acquired the business from a third party, at the same price and in the same conditions, the vendor would get ER. Where the child chooses to buy the family business, the vendor gets no ER. The parent would be better off selling the business outside the family – or to a non-linear relative such as a cousin – as they would not be an associate. The measures – in this case – appear to create unfairness, rather than removing it.

Retiring partners: ER is preserved for retiring partners, where the continuing partnership decides to incorporate (s 169LA(1)). However, there is still an issue with family succession planning, as this option is not open to partners in family partnerships. In order to get relief, the retiring partner must not be an associate of the continuing partners, other than through being members in the partnership (s 169LA(3)(c)). As above, this limits the options of the ongoing partners or successors to the business, which would not apply in a non-family situation.

Later incorporation – anti-avoidance: In such family scenarios, there might be a temptation to acquire the business and, at some later date, incorporate. Care will be needed with this. It will need to be clear that such incorporation is a separate decision to the decision to acquire the business; otherwise, there is the potential for the anti-avoidance provisions in s 169LA(6) to apply to deny ER for the vendor on the goodwill transferred, if the later incorporation is considered to constitute 'relevant avoidance arrangements'.

Removal of amortisation and changes to realisation treatment for transfers of goodwill and similar assets

In addition to removing ER for the vendor, the purchasing company will almost certainly be unable to claim deductions for any amortisation of the acquired goodwill in the accounts.

FA 2015 s 26 amends CTA 2009 Part 8 in order to disallow 'certain debits relating to goodwill etc. acquired from a related individual or firm'. The explanatory note states that it restricts relief in relation to transfers 'on incorporation' but, as with the changes to ER, the impact of the amendment to the legislation is not limited to incorporations.

The effect of the changes is to remove or limit amortisation deductions on the costs of acquisition of the intangible asset, and to limit debits on any subsequent disposal of the asset. There is some scope for continuing deductions where the relevant asset was originally acquired from a third party and is transferred to the company as part of the transfer of a business (CTA 2009 s 849B(4),(5) as inserted by FA 2015 s 26).

Affected intangible assets: The amortisation restriction applies to the acquisition from a related party of goodwill and a number of marketing related intangible assets, and to the acquisition of licences over such assets. This last element follows logically from the corporate intangibles rules, as a licence is a separate intangible asset for the purposes of those rules.

As these changes apply to more than goodwill, it should be noted that there is no requirement that the transfer be part of the transfer of a business. Some of the assets affected cannot be transferred separately from a business (goodwill and unregistered trademarks), but others can (customer information and customer relationships). Where the intangible asset is transferred on a standalone basis, even if the asset was originally acquired from a third party, no amortisation debits can be brought into account; and, on disposal of the asset, the debit is treated as a non-trading debit, which limits the ability of the company to utilise the debit (s 849B(4),(5) only apply where a business is also transferred; all other acquisitions fall into s 849B(6)).

Sale of company, ongoing involvement: The explanatory note indicates that this change is intended to deal with situations where there is continuing economic ownership of the intangibles assets. This takes too narrow a view of the changes. A person who is a participator in a close company is a related party of that company, but does not necessarily have any continuing economic ownership of the assets, as there is no requirement for a controlling shareholding in order to be a participator.

If a business is acquired by third parties into a close newco, with some shareholding provided to the former owner (e.g. as a form of earn-out, or to retain the owner in the business for a time), then this will be a related party transaction. The company will not be able to claim debits for amortisation of these types of intangible asset if they were generated by the former owner; the former owner will also not be able to claim ER on the sale of the goodwill to the close company.

Acquisition of information, joint ventures: Another scenario that also may not involve continuing economic ownership but would similarly deny corporate tax reliefs arises where a close company acquires a relevant asset (e.g. a customer relationship or licence of customer information) from a shareholder without acquiring any other business assets. Even if the intangible asset was originally acquired from a third party, if the company does not acquire the intangible as part of a business from that shareholder, the company is denied amortisation of that asset. Such a transaction has nothing to do with incorporation, and will not involve continuing economic ownership where the shareholder does not have control of the company.

For example, a joint venture company may enter into an agreement with one of the joint venture parties which licenses to the company the customer information of that party's business. In such circumstances, the joint venture company will not be able to claim any amortisation of the costs of that licence.

Similarly, a licence of an unregistered trademark by an individual to a joint venture (or other such) company in which that individual has an interest could result in a restriction of corporate tax relief. It may be more appropriate to register trademarks where there is any plan to allow the trademark to be licensed to a close company.

Conclusion

It is not clear why the legislation changes go so much further than the incorporation scenarios which were outlined in the Autumn Statement. Even if it has taken some years for the government to decide to limit access to these reliefs on incorporation, it is perhaps not unreasonable to change things in order to ensure that incorporation does not give a further tax benefit, which is not available to those who choose not to incorporate. That does not, however, explain why the rules limit the options for succession planning within families, or remove amortisation for, for example, transfers of customer information or licences of trademarks within joint ventures, in situations where there is no effective continuing economic ownership of a business as such. ■

For related reading, visit www.taxjournal.com

Draft FB 2015: Capital gains and small business incorporation (Pete Miller, 15.1.15)

FA 2015 analysis

The new CGT regime for non-residents

SPEED READ **FA 2015 introduces a new CGT charge for disposals of a UK residential property interest with effect from 6 April 2015. The new charge affects non-resident individuals, personal representatives, partners, trustees, foundations and certain companies. The new regime takes priority over the anti-avoidance rules that attribute a non-resident company's gains to its shareholders (s 13) or a non-resident trust's gains to its settlor or beneficiary (ss 86 and 87); however, ATED-related CGT takes precedence over the new CGT regime and the anti-avoidance rules. There are provisions concerning rebasing, valuations and reporting requirements. Losses are to be ring-fenced; and there are restrictions on the availability of private residence relief.**

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The government first announced its intention to extend the CGT regime to non-residents in the December 2013 Autumn Statement. The government stated then that the changes were intended to improve the fairness of the tax system by addressing the imbalance between the treatment of UK residents and non-residents disposing of UK residential property. After several months of consultation, draft legislation was published on 15 December 2014. The new rules have now been enacted as part of FA 2015, which received royal assent on 26 March 2015, and apply to disposals from 6 April 2015. (References to legislation are to TCGA 1992 unless otherwise stated.)

What is within the scope of the new CGT charge?

The charge applies to a 'disposal of a UK residential property interest', as defined in the new Sch B1 inserted by FA 2015 Sch 7 para 36. Essentially, it applies to the disposal of land that consists of a 'dwelling'. A building counts as a dwelling when it is used or suitable for use as a dwelling. It also includes a building that is in the process of being constructed or adapted for use as a dwelling, but does not include vacant building land (Sch B1 para 4(1)).

The charge covers the disposal of a contract to buy a property off-plan (Sch B1 para 1(3)). There are various exemptions for hotels and residential institutions, such as student halls of residence, boarding schools, care homes, hospitals and prisons (Sch B1 para 4(3)–(9)). Unlike ATED-related CGT, there is no exemption for rental properties and the new charge applies regardless of the property's value. The government has indicated that there is no proposal to extend the rules to commercial property.

Who is within the scope of the new CGT charge?

The new CGT charge affects non-resident individuals, personal representatives, partners, trustees, foundations and certain companies. There is a 'closely held company' test to limit the charge to non-resident companies that are the private investment vehicles of individuals and their families. A closely held company is essentially one which is under the control of five or fewer participators (new Sch C1 para 2 inserted by FA 2015 Sch 7 para 37).

Where UK residential property is sold by a diversely held company, a widely marketed fund or by a life assurance company as part of its assets that provide benefits to policyholders, these entities will be able to claim exemption from the new CGT charge.

Anti-avoidance rules are included to stop people artificially structuring a company so that it is not closely held; for example, when each cell of a protected cell company is treated as a separate company.

Rates of CGT

The new CGT rate for non-resident individuals is 18% or 28%, for trustees is 28% and for personal representatives is 28%. In all cases, the appropriate CGT annual exemption is available. For non-resident companies, the CGT rate is 20%, mirroring the rate of corporation tax for UK companies. Companies can claim indexation allowance.

Interaction with CGT anti-avoidance rules and ATED-related CGT

The hierarchy is as follows: the new CGT regime takes priority over the anti-avoidance rules that attribute a non-resident company's gains to its shareholders (s 13) or a non-resident trust's gains to its settlor or beneficiary (ss 86 and 87). However, ATED-related CGT takes precedence over the new CGT regime and the anti-avoidance rules.

This means that, in some cases, all three sets of CGT charges could apply on a single disposal. For example, where a non-resident company owns a non-investment residential property valued at over £500,000 as at 1 April 2012, ATED-related CGT will apply from April 2016 (FA 2015 Sch 8 para 4). In that case, on a post-2016 disposal, the historic pre-2015 gain will be taxed under the anti-avoidance rules; the new CGT charge will apply to gains accruing in the 2015/16 tax year; and ATED-related CGT will apply to gains accruing from April 2016. This will create a significant compliance burden (see example 1).

Where a non-investment residential property owned by a non-resident company is subsequently rented out (or vice versa), the compliance burden will be even greater. The company could move in and out of the new CGT and ATED-related CGT regimes, with different tax rates and filing obligations applying on a future disposal.

Principal private residence (PPR) relief

The government was understandably concerned that a non-resident could make an election for his UK property to be his main residence and thereby avoid a CGT charge, whilst having no UK CGT liability for his overseas properties. Accordingly, a residence will only be eligible for PPR for a tax year if the person making the disposal is either tax resident in the country where the property is located; or has spent at least 90 days in that property in the tax year: the day count test (s 222C inserted by FA 2015 Sch 9 para 3). The 90 day requirement is reduced pro rata where the property was only owned for part of a tax year. For a day to count, the individual must either be present at the property 'at the end of the day' (which may or may not mean midnight), or he must be there at some point during the day and the next day he stays there 'overnight' (which is similarly undefined and may or may not mean being present at midnight). Clearly good record keeping will be vital.

The new PPR rules are generous in some respects (see example 2). A non-resident individual is still eligible for PPR on his UK property without having to spend 90 days there, provided his spouse or civil partner is UK resident. For the purposes of the day count test, occupation by one spouse counts as occupation by the other, although double-counting is not permitted if both are there on the same day. This is generous in that a couple (where either or both are non-resident) can each spend separately, say, 50 days in the property and claim the relief. The test is also met for a tax year where the 90 days were spent either in the property being sold or in any other properties in the same country owned by the individual or his or her spouse or civil partner.

Previous periods of occupation as an elected or actual main residence before April 2015 can be taken into account on a future disposal by a non-resident. This may be helpful if the individual has made an election for the retrospective basis of computation to apply (see below), or wishes to claim the final 18 month grace period. The FAQs (question 11) provide as follows:

'**Q11.** I lived in the property for 20 years before leaving the UK in 2010 and had met all the conditions for PRR up to that date. Does this mean if I sell the property by 5 October 2016, there will be no CGT liability?

'**A11.** Yes. If you can identify a time prior to 6 April 2015 that the property qualified for PRR then final period relief will be available, i.e. the last 18 months of ownership will be eligible for relief.'

Interaction with the statutory residence test

The day count test means that many non-residents may be unable to claim the relief without becoming UK tax resident, since most people who are non-resident and who own and use a property here would become UK resident under the statutory residence test if they consistently spent 90 days in the UK in a tax year. For many, this would be a case of jumping from the frying pan into the fire. However, the personal circumstances of some non-residents will allow them to spend up to 120 days in the UK without becoming UK resident and so they can safely benefit from PPR. Even those for whom 90 days in the UK would be enough to trigger UK residence, with occupation by one spouse being attributed to the other for the purposes of the day count test, PPR can still be available even though neither of them is here

Example 1: Interaction of regimes

Svetlana is a UK resident, non-UK domiciled beneficiary of an offshore trust. She is the daughter of the settlor and a remittance basis user. She pays income tax at 40% on her UK salary. The offshore trust owns an underlying offshore company. The company bought a UK property for £350,000 in 2007, in which Svetlana lives. It was worth £550,000 as at 1 April 2012. The company sells the property in 2017 for £950,000.

If the trustees made a 2008 rebasing election within the strict time limits, only the post-April 2008 element of the gain is potentially taxable. Since the property was valued at between £500,000 and £1m as at April 2012, it is subject to ATED from April 2016. As to the element of the gain accruing between April 2008 and April 2015, there may be a charge on Svetlana at 28% under the UK's anti-avoidance rules, based on her enjoyment of the property and/or any distribution of the sale proceeds to her in the UK. The new CGT charge will apply at 20% on the gain accruing from April 2015 until April 2016. ATED-related CGT will apply at 28% on the accrued gain from April 2016 until the property is sold in 2017. The total gain will have to be accounted for through Svetlana's own self-assessment tax return (at the rate of 28%), a non-resident CGT (NRCGT) return (at the rate of 20%) and an ATED-related CGT return (at the rate of 28%), all in relation to just a single disposal.

Example 2: Day count test

Vladimir lives in Russia and runs his business there. His wife, Maria, is currently resident in the UK where the children are at school, but she plans to return to Russia in 2017 when the children leave school. Vladimir owns a flat in Mayfair, a house in Wentworth and a Scottish estate. He expects to sell the Wentworth property in 2019. The day count test will not apply for any tax year that Maria was UK resident. Even after she returns to Russia, PPR will be available for any tax year during which *either* Maria *or* Vladimir between them spend 90 days in *any* of their three UK properties.

The day count test applies both to residents and non-residents, so this also has the effect of limiting a UK resident's ability to claim PPR in respect of a foreign property. This may catch out UK residents that own an overseas holiday home, particularly where this is the only home they own.

for 90 days, such that neither becomes UK tax resident.

Rebasing

The new CGT charge applies to all gains accruing since 6 April 2015. There are three options for computing the gain on properties already owned on 5 April 2015 (new Sch 4ZZB Part 2 para 2 inserted by FA 2015 Sch 7 Part 1 para 39):

- rebasing to market value as at 6 April 2015 (the default option);
- time apportioning the gain. For example, if the property was bought on 6 April 2010 and sold on 6 April 2020, half of the gain is taxable. This option is not available if any part of the gain is taxable as ATED-related CGT; or
- the gain is calculated using the original base cost but without any time apportionment. This method is only ever likely to be useful if there is an overall loss.

If the individual previously lived overseas but has moved to the UK before the property is sold, no rebasing can be made. The FAQs (question 20) provide the following example:

'**Q20.** I bought a UK residential property in 2001 whilst I was living abroad. I moved to the UK in December 2015 and sold the property at a gain in March 2018. Can I rebase to 5 April 2015?

'**A20.** No. UK residents are unaffected by the changes and will be subject to CGT in the normal way, i.e. chargeable on the full gain less any reliefs due along with the CG annual exemption.'

Valuations

There is no requirement for a 6 April 2015 valuation until the disposal is made. It is, however, sensible to record, as at 6 April 2015, what condition the property is in and any unusual features, as this will assist with any valuation later on.

In deciding whether to rebase, time apportion or use the original base cost, the most favourable option may not become apparent until the property is sold, which may be many years away. However, affected non-residents would be well advised to arrange a 6 April 2015 valuation in any event, while the evidence is readily available. In practice, that probably means delaying the instruction of a professional valuer for several months until appropriate comparator transactions are available.

Losses

Losses will be ring-fenced for use against gains on UK properties arising to the non-resident in the same tax year or carried forward to later years. If the individual later becomes UK resident, unused UK property losses will be available to be used as general losses against other gains.

A UK resident who becomes non-resident will be able to carry forward unused UK residential property losses for use against future UK residential property gains (FAQs, question 16).

Group companies can enter into pooling arrangements to aggregate gains and losses across a group.

Reporting requirements

The notification of the disposal, and in some cases payment of any CGT due, must be made within 30 days of the disposal. For CGT purposes, disposal of a property on sale is usually deemed to take place when contracts are exchanged. However, in the case of a property sale, the 30 day period will not start running until completion, i.e. the date when title is conveyed. This still gives a tight window, although the seller will have the period between exchange and completion and the further 30 day period to sort out the necessary paperwork and arrange payment. Where the property is disposed of by way of gift, the 30 day period starts running immediately and the individual will, of course, have no cash proceeds with which to pay the tax.

If the individual is already within the UK's self-assessment system, he will still need to report the disposal on a NRCGT return within 30 days, but payment of the tax can be postponed until he makes his normal year end tax payment. (He will also have the option to pay at the time of reporting.) This potentially creates a double reporting burden: the disposal should be reported both on the NRCGT return within 30 days of the conveyance; and again on the self-assessment tax return. Despite this, non-residents may wish to register with HMRC for self-assessment in order to defer paying tax on a disposal until the self-assessment payment date.

PPR nominations are to be made in the NRCGT return. A link to the NRCGT return is available via gov.uk. Amendments can be made within 12 months of 31 January following the end of the tax year when the disposal was made.

Questions remain as to how payment of the tax will be enforced, where a non-resident who has no other UK connections sells a UK property and receives the sale proceeds outside the UK. The government has accepted that third parties such as lawyers and estate agents will have no responsibility for collecting the tax due. It may be that with effective communications between HMRC and the Border Agency, non-payers will find future visits to the UK very costly.

Even if there is no chargeable gain, the disposal has to be reported in any event (FAQs, question 15):

'**Q15.** I have disposed of a property but calculated I have no CGT to pay. Do I still need to report the disposal?

'**A15.** Yes. All disposals must be reported to HMRC irrespective of whether there is a tax liability. The same reporting process will apply regardless of whether there is a chargeable gain, a gain covered by the annual exempt amount, a gain covered by relief such as PRR or a loss. If there is more than one disposal each disposal is to be reported within 30 days of conveyance of the property. Further details will be provided shortly regarding the reporting process.'

Structuring new acquisitions

For new UK property purchases by non-residents, if the property is to be used by the family and PPR will be available, then personal ownership will generally be preferable. However, in the absence of PPR, the position may not be clear cut and CGT on a future sale will be less of a factor in choosing the optimum structure. Indeed, ATED-related CGT will no longer be such a deterrent to buying through a company compared to personal ownership, since the latter will also now attract CGT.

Where ATED does not apply, for example on a rental property, and the owner is non-resident, corporate ownership may continue to be preferable given the IHT shelter and the 20% income tax rate on the rental income. Moreover, a future sale of shares in a non-resident property holding company will avoid SDLT for the buyer and CGT for the non-resident seller.

The FAQs (question 19) confirms as follows:

'Q19. I'm non-resident and sold shares in a UK company. Will I have to pay CGT?

'A19. No. The extended CGT legislation only applies to disposals of UK residential property. The existing capital gains rules continue to apply and as a non-resident there will be no liability to UK CGT on disposals of shares, subject to the usual temporary non-resident rules.'

Ironically, various recent tax changes, such as the very significant rise in SDLT for personally acquired valuable properties and the new CGT regime for all non-residents, may unwittingly encourage the very thing that the raft of penal measures (15% SDLT, ATED and ATED-related CGT) sought to avoid: buying properties in companies.

Possible effects on the property market

Although scarcely qualified to comment on the long-term effects of the new CGT regime on the residential property market, the authors believe there may be a short-term increase in the number of properties owned by non-residents that come onto the market. Although the new CGT rules only apply to future gains and need not therefore precipitate immediate sales, it may be that non-residents do not fully understand the rules or simply do not want to pay any CGT whatsoever.

Alternatively, or additionally, and with an eye to the forthcoming general election, non-resident property owners may fear an increase in CGT rates under a new government. ■

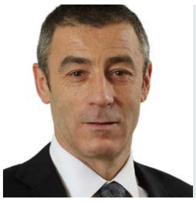
For related reading, visit www.taxjournal.com

Q&A: CGT on non-UK residents: what's proposed? (Andrew Goldstone, 12.12.14)

FA 2015 analysis

New disguised investment management fee rules

SPEED READ ITA 2007 Part 13 Chapter 5E, brought into law by FA 2015 s 21, introduces the new disguised investment management fee (or 'disguised fee') rules for relevant sums arising on or after 6 April 2015. These rules were the subject of draft legislation published in December 2014 and consultation with HMRC between then and publication of the Finance Bill on 24 March 2015. Where they apply, the rules will result in sums arising to investment managers which are disguised fees being taxed as trading income at marginal ordinary income tax rules with self-employed national insurance contributions. The approach to the new rules is similar to that taken in the draft rules, but the detail varies in some important and improved ways.



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Finance Act 2015 s 21 has introduced ITA 2007 Part 13 Chapter 5E, which applies to 'disguised fees' arising to individuals providing investment management services on or after 6 April 2015. Alongside the new legislation, HMRC published a technical note on 25 March (dated 29 March 2015), providing guidance on the rules (the 'guidance'). This article considers the detail of the new rules and the explanation set out in the guidance.

The government sprung a surprise on the fund investment management sector in December's Autumn Statement, when it announced the proposed introduction of rules intended to 'ensure that sums which arise to investment managers for their services are charged to income tax', also stating that the rules were specifically not intended to affect sums 'linked to performance, often described as carried interest, nor to returns which are exclusively from investment by [fund managers]'. While this announcement was not expected, once made the general view was that it would affect only arrangements which sought to treat what were, in substance, guaranteed investment management fees as investment returns rather than ordinary income. As discussed in the authors' article ('Draft FB 2015: Proposed disguised fee income rules', *Tax Journal*, 16 January 2015), the draft legislation published on 10 December 2015 caused more surprise, and considerable consternation, as the rules would have operated to tax a range of standard industry carried interest and co-investment returns as income. This was contrary to longstanding practice acknowledged by HMRC and what appeared to be the government's intention from the Autumn Statement announcement.

Following consultation on the proposed rules, the government has enacted them on considerably improved terms, which address a large number of the concerns raised by the initial announcement.

At risk of repeating what was discussed in our first article, it is important to understand the economics of how fund managers are remunerated for managing funds and what their interests are in a 'typical' fund structure (for which see the simplified structure chart in figure 1) to understand the mischief behind the new rules and how that mischief has been addressed. While not all private funds are structured in this way, it provides a general illustration of how the payments operate.

The carried interest and co-investment elements are intended to align the fund managers' interests with those of the investors and are often required by the investors as a condition to their investment in a fund. They are not, as a general matter, intended to replace or replicate a negotiated annual management fee.

'Carried interest' is a share in the profits of the fund's investment business. It has long been accepted as being subject to tax on the basis of being an investment return, with such recognition being predicated on the fund managers being paid full market rate salaries for their day to day work. Returns from executive co-investments are similarly a share in the profits of the fund's investment business and are subject to tax on this basis; substantively, the managers hold the same economic interest as the investors.

What do the rules do?

The rules, introduced as ITA 2007 ss 809EZA–809EZH, operate so that any sum arising to an individual which is a 'disguised fee' is subject to tax as if it were the profit of a trade carried on by the individual (s 809EZA(1)). That trade is treated as being carried on in the UK, to the extent that the investment management services by virtue of which the disguised fee arises are performed in the UK; and it is treated as being carried on outside the UK to the extent to which the services are performed outside the UK (s 809EZA(2)).

The guidance makes it clear that the rules are intended to tax as ordinary income what is, in substance, the fund managers' annual fee. It refers, in particular, to structures known commonly as 'GPS streaming' and 'GP LLP' arrangements which sought to use the tax transparent nature of limited partnerships and limited liability partnerships to retain in the managers' hands the investment return nature of an investment scheme's receipts, rather than turning them into trading or employment income. These structures are illustrated in the diagrams in figures 2 and 3.

The rules operate using the 'if it's not out it's in' approach, under which everything that arises to the individual fund managers from performing investment management services for the fund is potentially subject to funding income treatment, subject to the exclusion of amounts which fall within the defined categories of acceptable co-investment returns and carried interest receipts.

This approach is the same as that taken in the draft rules, and the general construct of the rules and its shortcomings are discussed in the 16 January article referred to above. Below, we focus on how the rules as legislated differ from those draft rules.

How do the final rules differ from the draft rules?

While the structure of the rules as legislated is, broadly, the same as that of the draft rules, there are some important differences, which have resulted from the consultation process and HMRC reconsidering the unintended consequences of the original drafting. Principal among these are:

- Sums qualifying as 'carried interest' have been broadened. This is to keep payments from a much wider range of industry standard arrangements outside the scope of 'disguised fees'.
- Sums qualifying as 'co-investment' have also been broadened to correct the manifest deficiency in the draft rules. These treated only a return that was comparable to a commercial rate of interest as being an acceptable return.
- The extent to which non-UK resident fund managers who conduct any of their activities in the UK might be subject to UK income tax on their remuneration has been recrafted. This will apply on sensible apportionment terms, rather than the 'all in the UK' approach taken in the draft rules.
- The basis on which affected individuals can claim relief for double tax – which arises by virtue of tax on the disguised fee, and tax on the amount that would otherwise have been taxed as an investment return – have been broadened to work more effectively.

How do the rules work?

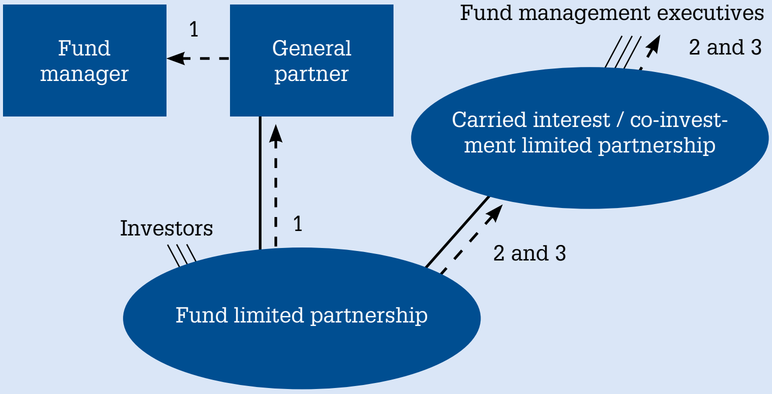
The rules use a number of defined terms, which lead to the identification of the 'disguised fees' as being 'management fees' which are 'untaxed'.

The key concepts in the rules are: management fees; untaxed; investment scheme; investment management services; carried interest; and arm's length return.

An individual receives 'disguised fees' (defined in s 809EZA(3)), which will be subject to income tax in a tax year, if and only if:

- the individual performs investment management services directly or indirectly in respect of an investment scheme under any arrangements;
- the arrangements involve at least one partnership;

Figure 1: Typical fund structure



1. Investors are charged a management fee. This is generally structured as a priority share of the fund's profits and paid to the general partner, which the general partner then pays to the manager as a management fee. This amount is typically calculated by reference to the external investors' investments in the fund. It is this that the new rules are ostensibly seeking to ensure is taxed as employment or trading income in the hands of the individual executives who receive it.
2. The 'carried interest' is a profit share, enabling executives to share in a percentage of the profits of the fund, if an agreed performance target is exceeded.
3. The executives or fund manager itself will be required to make a significant investment (or 'co-investment') in the fund, on broadly the same terms as the investors. Returns will be received from this co-investment.

- under the arrangements, a management fee arises to the individual directly or indirectly from the scheme in the tax year; and
- some or all of the management fee is untaxed.

In that case, the disguised fee is so much of the management fee as is untaxed.

We discuss what is and what is not a 'management fee' below.

A management fee is untaxed, if and to the extent that it would not (apart from the new rules) be either:

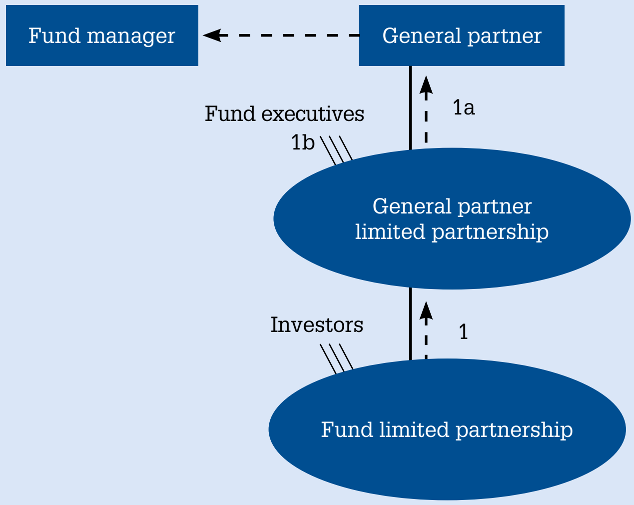
- charged to tax under ITEPA 2003 as employment income of the individual for any tax year; or
- brought into account in calculating the profits of a trade of the individual for income tax purposes for any tax year (s 809EZA(4)). This is unchanged from the draft rules.

The scope of 'investment scheme' has been broadened, and covers (s 809EZA(6)):

- a collective investment scheme, as defined in the Financial Services and Markets Act 2000 s 235; and
- an investment trust, being a company meeting the conditions A to C in CTA 2010 s 1158.

Investment management services has a broad scope which, as stated in the guidance, is expected to cover all of the activities of all managers in a private fund who would be involved in the GPS streaming and GP LLP structures targeted by the legislation.

Figure 2: GPS streaming structure



- The fund limited partnership's general partner is itself a limited partnership, in which the individual fund managers are limited partners.
- The fund limited partnership pays the priority profit share to the general partner limited partnership (1).
- The amount of 1 required to be paid as a fee to the fund manager for the investment management services is paid by the general partner limited partnership to the general partner (1a); and by the general partner to the fund manager.
- The remainder of 1 is received by the individual fund management executives as an investment return from the general partner limited partnership (1b).

Under s 809EZE(1), these activities include seeking funds for the investment scheme from its participants or potential participants; researching potential investments; acquiring, managing or disposing of investments; and acting for the purposes of the scheme with a view to assisting a scheme investment to raise funds.

As mentioned above, the rules continue to take the 'if it's not out, it's in' approach to the concept of 'management fee'. A 'management fee' is any sum (including a sum in the form of a loan or advance or an allocation of profits and including money or money's worth), except so far as the sum constitutes:

a) the repayment of an investment made directly or indirectly by the individual in the scheme;
b) an 'arm's length return' on the investment referred to in (a) (referred to along with (a) as a 'co-investment return' in the rest of this article); or
c) carried interest (s 809EZB(1)).

There are, therefore, three ways in which a sum arising to an individual who performs investment management services for an investment scheme can avoid being taxed on an amount as if it were a disguised fee:

- if the amount is carried interest;
- if it is a co-investment return; or
- if it is sufficiently 'delinked' from the provision of investment management services, so as to not arise directly or indirectly 'from' the investment scheme (as required by s 809EZA(3)(c)).

A return on an investment is 'arm's length' (to fall within the scope of a co-investment return) if:

- the return is on an investment of the same kind as made by external investors;
- the return is 'reasonably comparable' to the return to external investors on such an investment; and
- the terms governing the return on the investment are reasonably comparable to the terms governing the return to external investors on their investments.

This requires that the individual investment managers themselves make an investment that is proportionately equal to that made by external investors. The guidance provides some commentary on the co-investment return exclusion. It states that the aim behind the exclusion conditions is to ensure that 'genuine co-investment' and returns on it are excluded, but to exclude any attempts to provide fees by way of investments only available to managers. By way of example, the guidance refers to arrangements made for managers' capital to receive an excessive return, so paying the annual fee in that way.

The guidance then provides some clarity on what is meant by 'reasonably comparable'. It recognises that the return to managers will not be identical to that to external investors. In particular, it acknowledges that the managers' investment might not be liable for management fees or carried interest (which would, effectively, mean the managers paying themselves), and that such 'no fee/no carry' terms will be reasonably comparable to external investors' terms. The guidance also accepts that where an individual invests capital in a scheme which has been lent to the individual on arm's length terms, 'it can still' meet the requirements for a co-investment return, although in the authors' view this should not need explaining and should certainly not caveating with the 'can still'.

The most significant difference between the new rules and the draft rules is in the definition of 'carried interest'. As discussed in the authors' previous article, the draft rules limited carried interest to arrangements under which the external investors received all of their invested money back, and a preferred return on the invested money of at least 6% per year before amounts were paid on the carried interest. This narrow definition excluded a broad range of industry standard carried interest models, negotiated on arm's length terms between fund managers and fund investors, such as the typical venture capital fund model of no preferred return, or a sub 6% preferred return; the infrastructure fund model of an annual net asset value based return; or the debt fund model of, a least in part, an annual yield based return.

The rules address this serious concern by extending the definition of carried interest to a two limbed test (split into ss 809EZC and 809EZD):

- the first, under s 809EZC, is a general principle 'profit-related return' test (the 'profit-related return test'); and
- the second, under s 809EZD, is a safe harbour on the same 6% preferred return terms as under the draft rules.

To satisfy the profit-related return test, a sum arising to the individual from the relevant arrangements:

- must be by way of 'profit-related return' (s 809EZC(2)); and
- there must be a 'significant risk' that it will not arise (s 809EZC(3)).

A sum arises by way of profit-related return (s 809EZC(2)) if the sum will, or may, only arise if:

- there are profits for a period on, or arising from disposal of, the investments or on particular investments made for the purposes of the scheme (the alternative is to cover both so-called 'fund as a whole' and 'deal by deal' carry);
- the amount which will, or may, arise is variable to a substantial extent by reference to those profits; and
- returns to external investors are also determined by reference to those profits.

'Profit' is defined in s 809EZE(1) as meaning profits, including unrealised profits, arising from the acquisition, holding, management or disposal of the investment, taking into account items of a both capital and revenue nature.

The removal of the requirement for a fixed rate of return to external investors before carried interest is paid, and the inclusion of realised and unrealised profits, means that most commercially negotiated carried interest models, such as no or low-rate preferred return and net asset value based models, should fall within the definition of carried interest.

The guidance explains that the calculation of whether an investment scheme makes profits is based on the same period as that applying to the carried interest arrangements. So, if the decision to pay carry is based on the fund's annual accounts (for example, by comparing net asset value at the end of the year with that at the beginning of the year), then the requirement would be for profits in that year.

While most carried interest arrangements should satisfy the 'payment only if there are profits' element of the profit related return test, careful consideration might need to be given to arrangements for funds which can make a profit on one element of investments and a loss on another. For instance, debt funds will often calculate carried interest by reference to annual income yield. This might cause a concern if carry could be paid for a year by reference to income yield, even if overall the fund generated a (realised or unrealised) loss by reference to the repayment or capital value of the fund's debt investments.

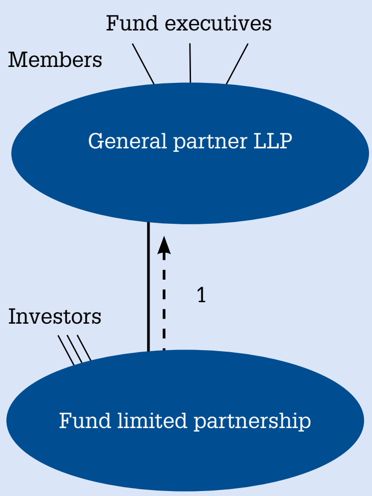
The guidance refers to the requirement for the carried interest payment to vary, to a substantial extent, by reference to the fund's profits and states that the intention is to reflect standard arrangements, under which the carried is a percentage of profits. Such an arrangement would meet the 'substantially variable' requirement.

In addition to these conditions, s 809EZC(3) applies where a sum arises to an individual as a profit related return, but there is 'no significant risk' that at least a certain amount (the 'minimum amount') would not arise. In that case, the minimum amount is not carried interest and is a disguised fee. Section 809EZC(5) provides that the risk of non-payment must be assessed at the latter of when:

- the individual becomes party to the arrangements;
- the individual begins to perform the relevant investment management services; and
- a material change is made to the carried interest arrangements, so far as relating to the sum which will or may arise to the individual.

Section 809EZC(4), (6), (7) and (8) then contain some relatively opaque provisions as to how to determine the risk associated with the receipt of any sum. The essence of the assessment is more clearly explained in the guidance, which states that the intention is that any attempt to apply a 'notional profit link', which is 'really fixed in

Figure 3: GP LLP structure



- The individual fund managers are members of an LLP, which acts as general partner of the fund limited partnership.
- The general partner LLP receives a profit share, rather than a management fee, for managing the fund limited partnership (1).
- The individual fund managers receive their shares of the LLP's receipts as members.

substance', will be ineffective and that the term 'no significant risk' is only intended to catch disguised management fees, being sums which are 'in substance virtually certain to arise'.

Thus, the rules are intended to limit carried interest treatment to returns which are linked to and vary by reference to profits of the investment scheme, in the same way as do the profit element of returns to external investors, and which are not effectively guaranteed by, for instance, linking carried interest to a different pool of investments to the fund's main investment pool where that separate pool generates virtually certain returns. The guidance also emphasises that the test is to the arrangements and not simply the underlying investments. In order to address a specific concern raised during the consultation process, the guidance confirms that a fund manager's track record is not relevant in determining whether there is a significant risk on carried interest returns from a fund.

Where it is applicable, only the 'minimum amount' is treated as a disguised fee (s 809EZC(3)). This is different to co-investment return, where an all or nothing approach is adopted and, if any amount does not represent an arm's length return on a manager's investment, all of the sum received is treated as disguised fee.

The guidance also discusses how dividends received from management companies might be 'de-linked' from the investment scheme so that they would not be a disguised fee. This would, however, require the company to have sufficient substance to justify generating investment returns for its shareholders.

Other elements of the rules

Other elements of the rules worth mentioning briefly are:

a) the apportionment of the deemed trading activities to those treated as carried on in the UK and those carried on outside the UK (s 809EZA(2));
b) the broad anti-avoidance rules (in s 809EZF), which will ignore any arrangement of which the main purpose or one of the main purposes is to secure that the new rules do not apply to an individual;
c) the extension of the double tax avoidance provision (in s 809EZG), noting that an affected individual must make a claim for a consequential adjustment to avoid any adverse double tax consequence of the rules; and
d) the power for the Treasury to amend the definitions used in the rules, including the definition of 'carried interest', by statutory instrument rather than primary legislation (s 809EZH).

On (a), the guidance explains that where a non-UK resident manager is resident in a jurisdiction with which the UK has a double tax treaty with a standard business profits article, any disguised fee arising to that manager would only be subject to UK tax if his or her activities in the UK were carried on through a permanent establishment.

What are the remaining issues?

It is, in the authors' view, unfortunate that the 'if it's not out, it's in' approach was retained for the rules, rather than an attempt being made to clearly define the guaranteed management fee that is at the core of the disguised fee concept. However, HMRC has clearly listened to the concerns raised on the draft rules and the changes, and the guidance, do address the main issues that were identified. Thus, it is now clear what the intention behind the rules is and the extended definition of carried interest should allow all, or nearly all, industry standard models to retain their treatment. In addition, the changes to how investment management activities performed outside the UK are treated (as a trade carried on outside the UK) and to the rules on claiming credit for double tax are welcome.

The main issue for the industry remains how to fund the increasing co-investment obligations that are imposed on fund managers by their investors and which often require a wider range of managers to contribute than in the past. Accepting that this is the case under the new landscape will, however, just mean that fund managers will have to consider how the co-investment can be effectively funded; and, possibly, how the terms of the individual managers' interests might be brought within the scope of carried interest, rather than co-investment return.

The other point to note, for another day, is the power to amend the definition of 'carried interest' by regulation. The concern with this is that – now that 'carried interest' has been defined in primary legislation for the first time – it might be a relatively simple task for it to be further limited under this power. This is notwithstanding the clear statement in the guidance that the new rules are intended to bring into charge to income tax only amounts which are 'in substance' the annual investment management fee, generally based on funds under management, and are not intended to affect the current treatment of carried interest (used as a term of art, rather than in its defined sense).

In this regard, investment managers and their advisers would be well advised to take seriously the statements in the guidance that this power has been introduced to 'allow changes to be made to the legislation to respond quickly to changes in the type of arrangements used by funds, which may be useful in this rapidly changing area' and that HMRC will 'keep the situation in review in future to ensure that all aspects of the tax treatment of funds continue to deliver in equitable result' if they want to ensure that the new distinction between fund managers' ordinary (trading) income and investment returns is conserved. ■

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Draft FB 2015: Proposed disguised fee income rules (Stephen Pevsner & Laura Charkin, 15.1.15)

The AIFMD, fund management LLPs and partnership tax issues (Peter Trevett, 13.9.13)

FA 2015 analysis

Withholding tax exemption for private placements

SPEED READ **FA 2015 provides for a new exemption from withholding tax for private placements, which was originally announced in the Autumn Statement. The legislation is an improvement on the draft published in December and HMRC has clearly taken comments on board. But it remains to be seen what the relevant secondary legislation will look like and it will, in any event, be several months before the exemption comes into effect.**

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As discussed in an earlier article (*Tax Journal*, 22 January 2015), the government announced as part of the 2014 Autumn Statement that it would introduce a new exemption from withholding tax on interest paid on private placements, a form of selective, direct lending to non-individual borrowers. Legislation providing for that exemption has now been enacted as part of FA 2015, although there is still some way to go before it takes effect.

Draft primary legislation and a technical note were published shortly after the announcement. The draft primary legislation sought to impose five conditions for the exemption to apply. First, the interest had to be paid on a security. Secondly, that security had to be issued by a company. Thirdly, the security had to represent a loan relationship to which the company is party as debtor. Fourthly, the terms of the debt had not to provide for the loan relationship to terminate within three years of its coming into existence. And fifthly, the security had not to be listed on a recognised stock exchange. The draft legislation also included a power for the Treasury to make secondary legislation providing for further conditions. The technical note explained what those additional conditions were proposed to look like but did not include a draft of the secondary legislation itself.

A short period of consultation followed, during which HM Treasury and HMRC received comments from, and engaged in discussions with, interested parties. Certain of the points thus made were clearly taken on board, as important changes have been made to the primary legislation.

The legislation enacted

The primary legislation enacted by FA 2015 s 23, which introduces a new s 888A to ITA 2007, imposes only three conditions:

- the interest must be paid on a security;
- that security must represent a loan relationship to which a company is a party as debtor; and
- the security must not be listed on a recognised stock exchange.

The power to make secondary legislation imposing additional conditions remains.

These conditions differ from those in the December draft in two important respects. First, although a security is still required, that security is no longer required to be 'issued'. And secondly, the requirement for the relevant loan relationship to have a term of at least three years has been dispensed with entirely.

The removal of the reference to the security being 'issued' is a response to calls for the exemption to apply not only to bonds but also to debts taking the form of loans – the concern being that, even if a loan can represent a 'security', it is unlikely to be 'issued'. HMRC said in discussions preceding the publication of the amended legislation that they would provide for the exemption to apply to loans as well as bonds and the change is very welcome. Participants in the UK private placement market will use both forms of debt and so certainty that the exemption will apply in each case is important.

The legislation's continued use of the word 'security' is less than ideal, as it is a term which is not always interpreted to include simple loans. However, HMRC has confirmed in correspondence that this will not prevent the exemption applying in relation to loans. It has also suggested that this may be clarified in the secondary legislation. It is to be hoped that the latter sort of clarification is provided, given the need for certainty.

The second change – the removal of the requirement for the loan relationship to have a minimum term of at least three years – is also welcome. Not only was the drafting of the original provision deficient (for the reasons noted in my earlier article), but the three-year rule – which would effectively have disapplied the exemption only in relation to debts with a maturity of between one and three years – seemed arbitrary.

Certain aspects of the primary legislation remain unclear – for example, its application to non-resident borrowers paying UK-source interest, despite HMRC having suggested behind the scenes that such borrowers will be able to benefit from the exemption – but it is in better shape than it was in December.

What next?

The exemption will come into force on a day appointed by the Treasury, once the secondary legislation has been finalised. It seems likely that putting the secondary legislation together will take some time, not least because of the disruption caused by the general election, so it could well be several months before the exemption takes effect.

HMRC has, however, made it clear that it will engage actively with interested parties in order to get the secondary legislation right. It is now unlikely that the scope of the additional conditions will be radically different to the ones described in the technical note – in particular, HMRC is adamant that there must be some lender-related conditions – but the evidence to date suggests that HMRC is prepared to accommodate sensible suggestions where possible (for example, it has shown signs of willingness to dispense with the requirement for the lender to be a regulated financial institution). Interested parties should not only watch this space but also continue to make any concerns known to HMRC. ■

For related reading, visit www.taxjournal.com

Draft FB 2015: Withholding tax exemption for private placements (James Hume, 22.1.15)

Analysis

The international briefing for April

SPEED READ Finance Act 2015 includes legislation for the new diverted profits tax, which has now come into force. The OECD has published three new discussion drafts, including most notably one on action 3 (strengthening CFC rules). In Greece, proposals to introduce new rules restricting the deduction of certain expenses are potentially of concern for businesses with operations there. In Japan, long expected changes to corporate taxation have finally been enacted, including a reduction in the main rates.

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Diverted profits tax changes

At the time of writing my last article, we were awaiting publication of the UK Finance Bill. Since then, the Bill has been published and received royal assent on 26 March. Finance Act 2015 includes the diverted profits tax (DPT) legislation, which came into force in the UK from 1 April 2015. The final legislation contains a number of amendments made following technical consultation on the draft that was published on 10 December 2014. HMRC also published updated guidance on 30 March to take account of these amendments.

Although only a few changes were made to the scope of the DPT charge for UK companies, the wording is now clearer to understand. The amendments have, however, changed the focus for the DPT charge in respect of non-UK companies from 'sales to UK customers' to 'sales which relate to "UK activity"'. UK activity is defined as activity carried on in the UK in connection with the supplies of services, goods or other property by the foreign company in the course of its trade. Where UK activity takes place and the relevant conditions are met, the non-UK company will pay DPT on the profits attributable to the UK activity.

The DPT legislation only applies to arrangements that have 'insufficient economic substance'. The original draft legislation used broad and undefined terms in respect of which arrangements this would apply to. The current legislation is much clearer. Of the three conditions that result in a company having insufficient economic substance, two relate more to business motive than to physical substance, and the third focuses on people functions. A UK company paying royalties to a group company that passively holds intellectual property, for example, is likely to fall within the scope of the DPT legislation where the arrangement is designed to reduce tax via the royalty.

A number of changes have also been made to the notification requirement. The legislation requires companies to notify HMRC of a potential liability to DPT; however, it has been narrowed to reduce the notification requirement in certain circumstances. The notification period has been extended for the first accounting period to six months following the end of the accounting period, while all other notification periods will remain at three months. There will now be no duty to notify HMRC for any accounting period if it is reasonable for a company to conclude that no DPT will arise or if HMRC has confirmed that there is no duty to notify. Also, there is now no requirement to notify HMRC if notification was made in the previous period and there has been no change in circumstances which is material to whether a charge to DPT may arise. Notification was originally required every period, so this should reduce the administrative burden for groups affected.

BEPS

Moving our attention to the OECD's action plan on base erosion and profit shifting (BEPS), we have now entered a further phase of consultation.

Mandatory disclosure rules: The discussion draft in respect of action 12 (mandatory disclosure rules) was published on 31 March (see www.bit.ly/1IPWHk2). This draft outlines the recommendations for the mandatory disclosure regime, so as to ensure consistency across countries of the disclosure of aggressive tax planning arrangements. The OECD requires comments on this draft by 30 April.

Strengthening CFC rules: Then a discussion draft on action 3 (strengthening controlled foreign company (CFC) rules) was published on 3 April (see www.bit.ly/1GakJrJ). The document considers the constituent elements of CFC rules and breaks them into the 'building blocks' necessary for effective CFC rules. The seven building blocks referred to cover the definition of a CFC, threshold requirements, definition of control, definition of CFC income, rules for computing income, rules for attributing income, and rules to prevent or eliminate double taxation. The intention is for the building blocks to allow countries without CFC rules to implement the recommended rules directly; and to allow countries with existing CFC rules to modify their rules to align more with the recommendations.

The document outlines draft recommendations for all of the building blocks, except for the definition of CFC income, where consensus has not yet been reached. Here, instead, it discusses several possible approaches to accurately identifying income that raises BEPS concerns. These include a 'categorical' approach, which would identify the particular types of income that would be attributed, subject to certain exceptions, for example, where the CFC has the necessary substance to support its activities. Another approach is the 'excess profits' approach, which would attribute the profits earned by the CFC that are in excess of a normal return. The concern of some countries with the excess profits approach is that it will include income irrespective of whether or not it arises from genuine economic activity of the CFC and where there is appropriate substance.

The UK government commented at the time of last year's Budget that, having completed its own major reform, it did not anticipate that the UK's CFC rules would require further substantive changes. Although the UK rules seem to fit within the draft recommendations, it is not clear at this stage whether the rules are wholly consistent with the possible options put forward for defining CFC income.

The discussion draft says that some countries have proposed that, in addition to CFC rules, further (or secondary) rules could be applied to that CFC income which does not result in sufficient CFC taxation in the parent jurisdiction. Such secondary rules would introduce secondary taxation in another jurisdiction (for example, the source country of the income earned by the CFC). The Committee on Fiscal Affairs has not yet considered whether to take this high level proposal forward. Working Party 6, however, is currently considering several options for special measures in the area of transfer pricing as part of BEPS actions 8 to 10, which could be implemented as possible secondary rules. This is clearly an area that needs to be monitored.

The OECD has invited interested parties to submit comments on the discussion draft by 1 May 2015 and there will be a public consultation meeting in Paris on 12 May 2015.

BEPS methodologies: On 16 April, the OECD also published a discussion draft on BEPS action 11 (see www.bit.ly/1IRjvTx), which aims to establish methodologies to collect and analyse data on BEPS and the actions to address it.

Global update

Greece – changes to rules for deductions: On 21 March, the Greek parliament passed new rules restricting the deduction of certain expenses. In summary, expenses paid by a Greek entity to any of the following may be not be deductible:

- tax residents in 'non-cooperative' countries;
- tax residents in countries with a 'preferential tax regime', defined as a regime where the tax rate is less than half of Greece's tax rate (currently 26%);
- 'de facto affiliated entities' (not yet clearly defined) unless transfer pricing requirements have been met prior to carrying out the transaction or prior to the issuance of the invoice; and
- suppliers that do not themselves, or via affiliated entities, have the sufficient substance or organisation to perform the relevant transaction.

In order to claim a deduction for such expenses, the Greek entity must pay in advance to the Greek government a 'withholding tax' of 26% on the total amount of the expense. Note that this is not structured as a true 'withholding tax' in the normal sense, as it is not specified that the amount paid to the supplier will be reduced; however, it seems to resemble a guarantee payment confirming the payer's view that the expense qualifies as being deductible. It should be possible to claim back this tax if, within three months of the transaction date, it can be proved that the expense relates to a real and ordinary transaction at current market levels.

> **The new Greek rules appear, on the surface, to be very draconian … This is definitely one to keep an eye on**

At the time of writing, there is very little practical guidance on the manner of implementation of these rules. They appear, on the surface, to be very draconian, with the potential to create a huge administrative burden and cash flow cost for multinational groups. However, the minister of finance is expected to issue a ministerial decision imminently, which should offer further practical guidance and hopefully iron out many of the uncertainties and potential difficulties. This is definitely one to keep an eye on.

Japan – tax reform: I have mentioned proposed changes to the tax system in Japan previously (see *Tax Journal*, 25 July 2014 and *Tax Journal*, 30 January 2015). The tax reform bills have now been passed by the National Diet, and the amended tax laws were enacted on 31 March 2015.

The main change, as expected, is the lowering of the effective corporate tax rate for the next two years. Generally, for a company with a paid-in capital of over JPY100m, the rate was reduced from 34.62% to 32.11% for accounting periods beginning on or after 1 April 2015; and it will reduce further to 31.33% from 1 April 2016.

For a Tokyo based company, the equivalent rate is 33.06% from 1 April 2015, but the 2016 rate has not yet been confirmed.

Also, as expected, to help pay for this reduction there will be an increase in the rate of the size-based business tax which applies to companies with capital over JPY100m.

The key international tax proposals which were anticipated have also now been formally introduced, including a change to the anti-tax haven rules (the Japanese CFC rules) and changes to the Japanese dividend exemption rules. ■

For related reading, visit www.taxjournal.com

The international briefing for March (Chris Morgan, 27.3.15)

VAT focus

Kumon: credit notes and contingent discounts

SPEED READ The First-tier Tribunal in *Kumon Educational UK Company Ltd* decided that a reward payment made by Kumon to its franchisee/instructor should be treated as a contingent discount; and as such was deductible from income for VAT purposes. The FTT took a commercial approach and did not artificially dissect the supplies. The FTT also stressed the importance of substance over form when considering the VAT treatment of payment for services. The decision is of interest to those clients that rely on 'contingent discounts' as part of their business as this could mean a significant VAT saving.

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The First-tier Tribunal in *Kumon Educational UK Company Ltd v HMRC* [2015] UKFTT 84 (reported in *Tax Journal*, 6 March 2015) decided that a reward payment made by Kumon to its franchisee/instructor should be treated as a contingent discount; and as such was deductible from income for VAT purposes.

The facts and issues in this case

Kumon provides educational services for five to 17 year olds which supplements traditional school lessons. Its business model is to offer franchises of its teaching methods to instructors who each pay a 'franchise fee' based on a fixed amount per student. The franchise fee is paid in exchange for training, access to the Kumon teaching methods, workbooks and ongoing support.

Each instructor is assessed annually on his or her performance in accordance with a detailed (but clear) set of criteria which includes: the instructor's ability to retain students; the number of students attaining high levels of achievement; and the instructor's own level of training. Such criteria were outlined in the 'centre development plan' provided to all instructors. Following the assessment, 'rewards' were paid to some 'high-performing' instructors by issuing them with a credit note.

Kumon argued that the 'reward' given to its instructors was a 'contingent discount' linked to the franchise fee, based on the definition in HMRC's published guidance in *VAT Notice 700*, at para 7.3.2(c), which states:

'If you offer a discount on condition that *something* happens later…then the *tax value* is based on the *full amount paid*. If the customer later earns the discount, the tax value is then reduced and *you can adjust the amount of tax by issuing a credit note*' (emphasis added).

It would seem fairly obvious that the reward would be an example of a 'customer later (earning) the discount' to the franchise fee paid, especially given how widely defined the guidance note is, merely requiring that 'something happens later'. Alas, despite over a year's worth of correspondence on this point, HMRC maintained its argument that the reward payment was consideration of a separate supply made by the instructors to Kumon.

The decision

The FTT avoided artificially dissecting the supplies (as per *Pippa-Dee Parties* [1981] STC 495) and considered that the reward was indeed a contingent discount in respect of the franchise fee.

More importantly, the FTT clarified that the form in which a payment is made for services does not affect its treatment for VAT purposes. It did not matter that the reward was not 'deducted' from the franchise fee, and was instead dealt with by way of a separate credit note. Nor did it matter that the reward was not described in any of the agreements between Kumon and its instructors as a 'discount'.

Despite, using the FTT's words, the basis for calculating the reward payable being 'complicated', it was 'based on clear criteria' and was also 'ascertainable in any given case'.

Part of the obligations between the instructors and Kumon was for the instructors to promote the Kumon method of teaching and improve their own teaching skills. The FTT determined that these obligations could not be 'realistically separated from the commercial bargain on which the franchise fee was based'. Relying on the decision in *Everest* [2010] UKFTT 621 (TC), the reward paid to the instructors was for 'enhancing the basic service for which they paid a franchise fee' and was core to their role as instructors.

Why it matters

The FTT focused on the importance of substance over form when considering the treatment for VAT purposes of payments made for services. Therefore, it would be prudent to ensure that regardless of however a contingent discount is described in documentation, it must amount in substance to a contingent discount.

Of wider importance is HMRC's approach to the case. Throughout the correspondence between the parties and in the hearing itself, HMRC provided no explanation as to what the separate supply the rewards related to. In short, HMRC argued: 'The appellant is wrong; but we are not sure what is right'. Unsurprisingly, the FTT was not swayed by this approach. ■

The authors acted for the appellant in this case.

For related reading, visit www.taxjournal.com

Cases: *Kumon Educational UK v HMRC* (3.5.13)


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Ask an expert

Return of capital demerger

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My clients are shareholders in a company which owns two restaurants. My clients have been approached by a prospective buyer to acquire the company but the buyer only wants one of the restaurants (the target restaurant). My clients have asked how the other restaurant business (the retained restaurant) can be extracted from the company prior to the sale in a tax efficient way. They have heard that if it is just transferred to them, there will be tax consequences both for the company and for them as individuals.

They are correct but it should be possible to achieve the desired result in a tax neutral way through a tax efficient return of capital demerger. Clearance from HMRC will be required that the transaction is undertaken for bona fide commercial reasons and not for the avoidance of tax. There are a number of detailed issues to consider and this is only a very brief outline of the key points.

Step 1: A new company (Newco) will be set up to acquire the entire issued share capital of the company in consideration for the issue of shares in Newco to the client shareholders (the share for share exchange). The new shares will be of the same class and have the same rights as the shares in the company, although they will have a higher nominal value. The nominal value of the newly issued shares should be slightly more than the market value of the retained restaurant and so we recommend that a valuation of both parts of the business (including any goodwill or other intangibles) is obtained. In relation to the target restaurant, it may be possible to rely on the price being offered by the buyer for the company, provided we are reasonably confident that it reflects an arm's length price and that there is nothing else in the business which affects the valuation. Similar valuation principles could then be applied to the retained restaurant.

There should be no taxable CGT disposal by the shareholders on the share for share exchange, as relief should be available under TCGA 1992 s 135. No stamp duty should be payable on the share for share exchange, as relief is available under FA 1986 s 75. This will be the case as long as the shares are an exact mirror image. It will also be necessary to check if there is any loan capital, as HMRC has recently taken the view that loan capital should be mirrored as well.

Step 2: The shares in Newco will be reclassified into two classes of share: ordinary shares, entitled to all the profits and assets of the target restaurant; and B ordinary shares entitled to all the profits and assets of the retained restaurant. The nominal value of the B ordinary shares must be equal to the value of the retained restaurant, as accurately as possible, because it will determine the amount of share capital attached to the B ordinary shares which can be returned at step 5. There are no tax consequences as a result of the reorganisation of the share capital. The ordinary shares and the new B ordinary shares will be treated as the same asset for CGT purposes as the original shares in Newco.

Step 3: The business, assets and liabilities of the retained restaurant will be transferred to Newco. Newco must be registered as part of the VAT group. To avoid any argument that a holding company does nothing and cannot be a member of a VAT group, it would be sensible if Newco provides management services to the company on an ongoing basis.

Step 4: A second Newco (Newco 2) will be incorporated with nominal share capital. The initial shares can be held by one of the client shareholders, i.e. Newco 2 will sit outside of the Newco group.

Step 5: Newco will reduce its capital by way of cancellation of the B ordinary shares. The directors will have to make a statement of solvency to support the reduction. The B ordinary shares in Newco will be cancelled pursuant to the reduction of capital. The retained restaurant will be transferred to Newco 2, in consideration for Newco 2 issuing new shares to the client shareholders of Newco. Newco 2 still sits outside the Newco group and now owns the retained restaurant; and Newco still owns the company containing the target restaurant, but only has ordinary shares. Both Newco and Newco 2 are owned by the client shareholders. Provided that the transaction qualifies as a reconstruction for tax purposes, certain reliefs from CGT will be available to both the client shareholders and Newco (TCGA 1992 ss 136 and 139).

If the value of the retained restaurant exceeds the paid up share capital on the B ordinary shares (including any premium), the transfer will be treated as a dividend for tax purposes (under CTA 2010 s 1000(1)) and will result in an income tax charge in the shareholders' hands. However, provided that the nominal value of the B ordinary shares is equalto the market value of the retained restaurant, no dividend should arise.

In considering the clearance, HMRC might take the view that the demerger is only being done to avoid tax on the extraction of the retained restaurant and that this falls foul of the bona fide commercial test. The company could instead just sell the trade and assets of the target restaurant. We have had a number of similar cases where a sale has been in prospect and HMRC has not taken this point. Ideally, the shareholders should only spend money on the legal work for implementing the demerger once clearance is received.

One of the shareholders' main concerns was the impact of all this on their entrepreneurs' relief (ER). This will be preserved through the various stages. The shareholders should also qualify for ER straight away on their shares in Newco 2, as long as they are appointed as directors or employees of Newco 2 before the demerger. This is because of the reorganisation rules, which provide that the new shares (in Newco on the share for share exchange and in Newco 2 on the reconstruction) stand in the shoes of the original company shares.

Where does this leave us?

There will be lots of detail to consider before proceeding with the demerger. If all goes to plan, this gives an excellent outcome. The shareholders are able to sell Newco (with the target restaurant), benefit from ER on the sale, and retain their other restaurant, without having triggered any nasty tax charges at all.

One minute with…

You recently joined Stewarts Law as head of the firm's tax litigation department. What direction do you see yourself taking the team in your first year in the role?
The team is very much focused on complex, high value cases which have moved beyond investigations to litigation, particularly on those which are likely to go to trial. Many tax disputes practices focus on the investigations side of things, which is not our specialism. This also means acting in a significant amount of tax related commercial litigation, as well as the more usual disputes with HMRC.

Aside from your immediate colleagues, whom in tax do you most admire?
I struggle to choose between Sir Alan Moses (Lord Justice Moses, until recently) and Mr Justice Henderson. As Henderson J was picked in a previous edition, I will go with Moses – a fantastic (and fearsome) judge who wouldn't tolerate any nonsense. I always looked forward to our hearings before him, though that might have been different had I been the advocate rather than the solicitor!

What advice would you give to someone new to the profession?
It is a cliché, but the devil is in the detail. Tax legislation is massive, complicated and changes regularly. It often isn't logical (at least on its face). If you enjoy researching a complex point all the way to its conclusion, then you will enjoy practising in tax. If you don't, do something else.

If you could make one change to UK tax law or practice, what would it be?
I would put a long stop deadline on HMRC to conclude enquiries (of, say, six years) and amend the accelerated payment notice (APN) legislation so that one can only be issued after the enquiry has been concluded. There are genuine reasons why some enquiries need to be kept open, but in most cases, six years is more than enough. Once the six years are up, HMRC

David Pickstone
Head of tax litigation, Stewarts Law

could apply to the tribunal for an extension. I am sure it would need greater resources to speed things along and collect any unpaid tax (especially on old avoidance cases); but lack of government resources shouldn't be an excuse for leaving taxpayers in a long period of uncertainty. Using APNs on unconcluded enquiries is not the solution; they solve the cash flow issue for HMRC, but exacerbate the uncertainty for the taxpayer.

You have a very broad range of experience in contentious tax, acting for a variety of clients. Comment on a key challenge you've faced in practice.
It is always a challenge to make sure that your advice is pitched at the right level for your audience. It is very easy to fall into jargon and technicalities and lose sight of the commercial issues which underpin a tax dispute. Some clients are fascinated by technical tax issues and expect a line by line analysis on each and every point. Others simply want to know the bottom line. Because tax affects every company and every individual, you can expect a huge mix of characters. That is a great part of the job, but also a challenging one.

Finally, you might not know this about me but…
My wife recently gave birth to our son, George. So I am happiest spending time with them, in my back garden with the sun shining, preferably having had a good night's sleep. There are some challenges to that at the moment, both from George and from the great British weather…

What's ahead
Dates for your diary

April

28 **Upper Tribunal:** *Carmel Jordan v HMRC* [2014] UKFTT 895 (TC): hearing on income tax appeal re notice under FA 2008 Sch 36 para 1.

30 **OECD BEPS:** Comments due on action 12 (mandatory disclosure rules).
Annual tax on enveloped dwellings: Normal due date for filing an ATED return and making tax payment for ATED period beginning 1 April 2015, although for properties coming within the charge on 1 April 2015 (i.e. those properties valued over £1m but less than £2m as at 1 April 2012) the deadline to file the return is 1 October 2015 and any tax must be paid by 31 October 2015.

May

01 **Consultation:** Comments due on *Travel and subsistence review.*
OECD BEPS: Comments on consultation on action 3 of BEPS (strengthening CFC rules) due by this date.

05 **Upper Tribunal:** *Philip Manduca v HMRC* [2013] UKFTT 234 (TC): hearing on assessment on hedge fund manager.
Consultation: Comments due on *Removal of manual customs declarations.*
CIOT survey: Closing date for survey on taking an appeal to the FTT (see www.bit.ly/1JGEoyg).

06 **Consultation:** Comments due on the Welsh government consultation *Tax devolution in Wales: land transaction tax*, which proposes to replace SDLT in Wales from April 2018.
Upper Tribunal: *HMRC v DPAS Ltd* [2013] UKFTT 676 (TC): HMRC appeal on VAT treatment of supplies of payment plan services to dentists.

07 **Date of general election**

08 **OECD BEPS:** Comments due on consultation on action 11 (improving the analysis of BEPS).

11 **Consultation:** Comments due on *HMRC penalties: a discussion document*, on reform of application of penalties with the increasing digitisation of tax services.
Upper Tribunal: *Pelix Ltd v HMRC* [2013] UKFTT 448 (TC): VAT decision regarding MTIC fraud.

12 **Upper Tribunal:** *Gui Hui Dong v National Crime Agency* [2014] UKFTT 369 (TC): hearing scheduled into taxpayer's appeal on application under TMA 1970 s 55(3) of postponement of tax assessed.

18 **Parliament:** Both Houses return from recess on this date.

For a 'what's ahead' which looks further ahead, see taxjournal.com (under the 'trackers' tab).

Coming soon in Tax Journal:
- Election special.