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Tax and the City Review

In *Royal Bank of Canada*, the Upper Tribunal confirms the Canadian bank is subject to UK corporation tax on payments relating to UK oil which it had received pursuant to the receivership of a debtor. HMT publishes a summary of responses to the call for input on the review of the UK funds regime. HMRC updates its guidance on the meaning of 'substantial' in light of the decision of the Upper Tribunal in *Allam* criticising the previous guidance as being too narrow. The Upper Tribunal confirms the interpretation of the UK's VAT grouping provisions in the *HSBC* case.

Royal Bank of Canada: UK corporation tax in respect of payments received by Canadian bank following receivership of debtor

In *Royal Bank of Canada v HMRC* [2022] UKUT 45 (TCC), the Upper Tribunal (UT) confirmed the decision of the First-tier Tribunal (FTT) that the Canadian bank, RBC, is subject to UK corporation tax on payments linked to an oil field. The payments had been assigned to RBC during the receivership of a Canadian debtor.

RBC had advanced a loan to Sulpetro, a Canadian company, which, together with its UK subsidiary, carried on oil exploration/exploitation activities in the Buchan Field, within the UK continental shelf. At the time when Sulpetro went into receivership the amount outstanding on the loan was CAD $185m. This was written off by RBC as a bad debt. Sulpetro had a right to payments in respect of all production from the Buchan Field. Under a court order, this right to payments was assigned to RBC.

RBC treated the payments received as income of its Canadian banking business accounted for as recovery of the bad debt and did not report them in any UK tax return. Discovery assessments were subsequently made by HMRC on the basis that the payments are subject to UK tax under the ring fence trade regime in CTA 2010, Part 8.

The UT agreed with the FTT that the UK/Canada double tax treaty conferred taxing rights on the UK in respect of the payments. This was on the basis that they were income from immoveable property and that CTA 2009, s1313(2)(b) applied to charge the payments to UK corporation tax because RBC had rights to the benefit of the oil won from the Buchan Field.

RBC argued it should be able to offset the losses incurred by it on the original loan against the payments received but the UT agreed with the FTT that there was no right to offset. There were several reasons for this. The court order for the assignment of the right to the payments expressed the consideration to be $1, not the amount of any unpaid part of the loan. The making of the loan and the assignment of the rights to the payments were two separate transactions. The unpaid element of the loan resulted in losses outside the ring fence which could not be set off against the ring fence income and even if the losses had qualified as an expense of the ring-fence trade, the expense was capital in nature and excluded from deduction (CTA 2009, s53). Additionally, RBC had no permanent establishment in the UK to which any trading loss which otherwise qualified for deduction could be attributed. The loan was made in Canada and any loss in respect of the loan fell to be dealt with in Canada.

This case serves as a reminder for banks to take care when enforcing a security over a loan as assets received in lieu of repayment of the loan may have different tax consequences from a cash repayment of the loan. Consideration should be given to the nature of any payments received and, where appropriate, which jurisdiction has taxing rights.

Review of the UK funds regime: summary of responses

HMT's summary of responses shows that there is plenty of work still to be done before firming up many of the proposals and sets out the order of priority to take things forward. We have highlighted just three areas below:

VAT

The promised consultation on the VAT treatment of fund management fees will be published 'in the coming months'. The consultation will not look at a VAT zero-rate for fund managements fees, however, as this is too costly in the current fiscal climate. Instead, it will be limited to examining other options to improve and simplify the regime.

Tax treaty benefits

There are three issues with the UK's double tax treaty network which the government seeks to address. Firstly, since the Interest and Royalties Directive and the Parent-Subsidiary Directive ceased to apply, UK funds have been suffering withholding tax on payments received from some EU member states. The government seeks to address this in treaty renegotiations, although this will inevitably take some time.

Secondly, if tax exemption for funds were adopted (which is one of the proposals), there are concerns about accessing double tax treaty benefits where tax residence under a treaty is linked to the fund being liable to tax or where the income itself needs to be taxable to benefit from lower rates under a treaty. The government will explore with stakeholders the possibility of an optional tax-exempt regime for authorised funds. This would enable a fund to decide if the benefits of tax exemption outweigh the importance of accessing treaty benefits depending on the investment strategy of the fund.

Thirdly, there is concern that it is not clear or certain whether specific UK fund types and certain investors can access treaty benefits, in particular unit trusts and funds which are not 'taxable persons', such as limited partnerships and authorised contractual schemes. Whether a country classifies a fund as opaque or transparent, or equivalent to or comparable with an EU fund, can to an extent depend on the domestic system of that country. The UK will seek to clarify the status of particular fund structures with partner countries where necessary. The UK will also seek to agree procedures alongside treaty obligations which will assist funds to make claims for treaty relief. This includes updating existing procedures where it appears that they may no longer be working as well as they could.

Long-term asset fund (LTAF) structure

The LTAF rules came into force in November 2021 as a practical solution to the barriers to investment in longer-term, less liquid assets such as venture capital, private equity, private credit, infrastructure, and real estate.

Currently, an LTAF comes within the scope of the existing tax rules for authorised funds. If the LTAF is an OEIC or AUT, however, it must meet a genuine diversity of ownership (GDO) condition in order for it to be subject to the tax rules generally applicable for OEICs and AUTs. The GDO condition ensures that the fund is widely marketed – and cannot be set up to give a limited number of investors a beneficial tax treatment. If the GDO condition is not met, then it can be treated as met where either the LTAF published its prospectus on or before 9 December 2021, or 70% of the units or shares in the LTAF are held by specified institutional investors.

The government is continuing to assess the case for any further changes to the taxation of LTAFs. Some respondents suggested that the government should consider reviewing, for the purpose of an LTAF, the income distribution requirement that applies to all authorised funds, given the investment strategies that an LTAF will pursue. The government will explore this with the funds industry representatives.

Currently, the LTAF can be distributed to professional investors, high net worth individuals and sophisticated retail investors but the FCA will consult this year on potentially changing the restrictions on the promotion of LTAFs to allow distribution to a broader range of retail investors.

The meaning of 'substantial': revised HMRC guidance

The UT's decision in *Allam v HMRC* [2021] UKUT 0291 cast doubt on HMRC's guidance suggesting that, in the context of the definition of 'trading company' in the TCGA, 'substantial' could be taken to mean 'more than 20%'. Although the case itself concerned the definition of 'trading company' for the purpose of what is now business asset disposal relief (and was at the relevant time entrepreneurs' relief), the same definition is also used in respect of the substantial shareholding exemption.

For these purposes, 'trading company' is defined as a 'company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities' (TCGHA 1992, s165A(3)). HMRC's guidance (at the time of the decision) contained a statement indicating that 'substantial' would be taken to mean 'more than 20%'.

This statement was, however, called into question by the UT which stated that 'it is not appropriate to apply any sort of numerical threshold as suggested by HMRC's guidance.' Instead, all of the company's activities have to be identified. Then the significance of the non-trading activities has to be considered in the context of the company's activities as a whole and, in this assessment, physical human activity as well as financial measures of activity should be taken into account. The Upper Tribunal considered that holding investments and collecting rent would be activities for the purposes of the test and that the capital employed in non-trading activities can be taken into account in considering their significance. The end result was that the company did not meet the 'trading company' definition.

HMRC has updated the guidance at CG64090 to remove the statement that substantial in this context means more than 20%. Emphasis is now on the fact that there are a number of factors or indicators that may be useful in establishing whether there is substantial overall non-trading activity without a percentage limit. However, the paragraph provides 'For practical purposes it is likely that from accounts submitted some consideration can be given to the level of non-trading income and the asset base of the company. Where neither of these suggest the non-trading element exceeds 20% the case is unlikely to warrant any more detailed review'.

In most cases it should be clear if a company is a trading company, but where it is unclear taxpayers should be aware of HMRC's move away from the fixed 20% approach.

HSBC: removal of branches from VAT group

HSBC Electronic Data Processing (Guangdong) Ltd and others v HMRC [2022] UKUT 00041 (TC) concerns the removal from the HSBC VAT group of five entities carrying out global group services (the GSCs). HMRC removed them from the VAT group on the basis that they were not eligible, because they did not meet the 'established' or 'fixed establishment' condition in VATA 1994, s43A, or alternatively, that their removal from the VAT group was 'necessary for the protection of the revenue' in the context of VATA 1994, s43C.

HSBC challenged whether the GSCs should be removed from the VAT group at all. If they should be removed, HSBC argued it should not be from the date HMRC gave in the notice (the earliest date for which such a notice was not time-barred), but rather from the later time of the change in HMRC's practice in 2014 (on the basis of VATA 1992, s84(4D)). The UT's decision covers certain preliminary legal issues which were heard directly by the UT. The FTT will now need to determine the substantive appeal.

Eligibility

The UT did not regard the terms 'established' and 'fixed establishment' as having a special meaning in the context of the legislation relating to VAT groups. These terms should be interpreted in a way that is consistent with how they have been used in the context of the Court of Justice VAT cases generally. The concept of fixed establishment in the place of supply rules applies to s43A.

Protection of revenue

The UT decided that the term 'necessary for the protection of the revenue' has a relatively wide application and does not just apply to situations that are considered abusive on *Halifax* principles. The UT considered it would be permissible to introduce measures intended to prevent the objective of avoidance of tax, even where there may be no actual intention on the part of the taxpayer to avoid VAT.

Reasonableness test in s84(4D)

In 2014, HMRC changed its policy as to the criteria for eligibility in relation to group membership. Although the GSCs met the company law test of establishment, as they were branches registered at Companies House, they did not meet the tests of 'established' or 'fixed establishment' under the place of supply rules. The notices reflected HMRC's conclusion that the GSCs are not, and have never been, eligible to be treated as a member of the VAT group.

HSBC argued that it might reasonably have been open to HMRC to decide to terminate the GSCs' membership prospectively, from the date of the new policy, but it was impermissible to terminate it retrospectively. The UT agreed with HMRC that the test in s84(4D) focuses on the reasonableness of the decision reached, not on the process by which it was reached. The test is whether HMRC 'could' reasonably have decided upon the date specified in the notice, not whether it had reasonably done so in the given case. This is an issue of fact left to be determined by the FTT together with substantive appeal on whether the branches of the GSCs are fixed establishments in the UK for the purposes of s43A.

What to look out for:

- The Spring Statement expected on 23 March.
- HMRC's new policy on VAT on early termination payments and compensation benefits, Revenue and Customs Brief 2(2022), commences on 1 April, replacing Revenue and Customs Brief 12 (2020).
- The consultation on the UK's implementation of the global minimum corporate tax rate and the possibility of a domestic minimum tax in the UK closes on 4 April.

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CONTACT

Mike Lane
PARTNER
T: +44 (0)20 7090 5358
E: mike.lane@slaughterandmay.com

Zoe Andrews
PSL COUNSEL & HEAD OF TAX KNOWLEDGE
T: +44 (0)20 7090 5017
E: zoe.andrews@slaughterandmay.com