Field Court Tax Chambers

FCTC Digest

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Producer: Imran S Afzal

MEMBERS OF CHAMBERS

Patrick C Soares

Patrick Way QC

Philip Baker QC

Imran S Afzal

Peter Vaines

David Bloom QC (Australia)

Philip Goeth

Katherine Bullock

Porus F Kaka (Door Tenant, India)

INTRODUCTORY NOTE

Patrick C Soares

Members of Chambers regularly discuss court cases and tax problems with each other, and that is one of the strengths of our Chambers. We thought it would be a good idea to put our thoughts in writing and share them with our clients and other people we work with, and thus the FCTC Digest was born. We are grateful to Imran Afzal for his work in producing the FCTC Digest.

There are two special features of the FCTC Digest. First, the articles are circulated in Chambers before publication and many contain comments and thoughts from other members of Chambers. Secondly, each barrister will generally be recording a short video expanding on a particular aspect of his/her article, and the videos will be available on our website. We are grateful to Katherine Bullock for organising that. It is hoped that the videos will "bring the articles to life".

The FCTC Digest is an ambitious and exciting project and we look forward to sharing the knowledge and experience of Field Court Tax Chambers with you.

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Please visit www.fieldtax.com/fctc-digest for short videos accompanying the articles.

Disclaimer: The content of the articles contained herein does not constitute advice. The legal position in any given case will depend on the precise facts and circumstances. Nothing contained herein should be relied upon as the basis for any act or omission.

EDITORIAL

Imran S Afzal

The SDLT holiday announced in the Chancellor's statement of 8 July 2020 seems to have brought the residential property market to life and **Patrick Soares'** article *SDLT Holiday* sets out all you need to know and is very opportune. His second article, *IHT and the Family Home,* on how you can give away interests in the family home and continue to live there and avoid IHT (i.e. having your cake and eat it), is a must read for all estate planners.

Following the *Hull City Case* the position on Image Rights and tax has begun to settle down and **Patrick Way QC** "the barrister for the stars" gives some priceless guidance on the dos and don'ts in this very fruitful area.

Philip Baker QC has done a very insightful article on how the advent of BEPS and Brexit have impacted on the way the UK views and negotiates double tax treaties and international tax practitioners will enjoy Philip's article entitled *UK Tax Treaties Post-BEPS and Post-Brexit*.

Due to the coronavirus pandemic some court/tribunal hearings have been conducted by video rather than in person. In my article *Reflections on Litigating by Video* I share my experience of a recent Court of Appeal hearing I was involved in which was conducted by video. If you have a case which will (or might) be heard by video, then hopefully my article will provide some insight into the process.

Peter Vaines in his very opportune article *UK Residence: Exceptional Days* gives some priceless guidance on the difficult area of what days count as presence in the UK, and what days do not, when applying the Statutory Residence Test – very relevant in this time of the coronavirus. Remember that under the Statutory Residence Test one day out might spell disaster.

Katherine Bullock's article on *Family Investment Companies (FICs)* sets out how companies might side-step the IHT settlement provisions so enabling wealth to be passed over to the next generation in an efficient manner. There are many points to consider and Katherine sets these out. The FIC is an essential tool in any financial planner's tool-box.

“SDLT HOLIDAY”

(8 July 2020 – 31 March 2021)

Patrick C Soares

The Chancellor in his 8th July 2020 Statement announced an SDLT holiday which is limited in time and amount.

This holiday reduces the rates of SDLT and will apply for residential property purchases and lease grants in England and Northern Ireland from 8 July 2020 to 31 March 2021.

First time buyers or buyers who had previously owned residential property

If a residential property is purchased between 8 July 2020 and 31 March 2021, SDLT is only payable on the consideration above £500,000 (the threshold is thus raised from £125,000 to £500,000: see FA s55). These rates apply whether the taxpayer is buying his first home or had owned residential property before.

The table of rates is thus:

Property purchase or lease premium amount	SDLT rate
Up to £500,000	Zero
The next £425,000 (the portion from £500,001 to £925,000)	5%
The next £575,000 (the portion from £925,001 to £1.5 million)	10%
The remaining amount (the portion above £1.5 million)	12%

From 8 July 2020 to 31 March 2021 the special reliefs for first time buyers are replaced by the reduced rates set out above which are more favourable.

Example

Mr X buys his first home between 8 July 2020 and 31 March 2021 for £700,000. The SDLT payable is £10,000 (£500,000 at 0% and £200,000 at 5%). A buyer of residential property for £500,000 or more will save £15,000 in the SDLT holiday period.

Purchases of additional properties such as second homes or purchases of residential properties to let

The 3% higher rate for purchases of additional dwellings (e.g. the taxpayer owns a dwelling and buys a further dwelling to let or buys a second home: see FA 2003 Schedule 4ZA) applies on top of the revised standard rates set out above for the period 8 July 2020 to 31 March 2021.

The following rates apply:

Property purchase or lease premium amount	SDLT rate
Up to £500,000	3%
The next £425,000 (the portion from £500,001 to £925,000)	8%
The next £575,000 (the portion from £925,001 to £1.5 million)	13%
The remaining amount (the portion above £1.5 million)	15%

New leaseholds grants of residential property for rents

The nil rate band which applies to the capitalised value of rents (called the net present value of the rent in the legislation) on the grant of a lease of residential property is also increased to £500,000 (this is increased from £125,000: see FA 2003 Schedule 5 para 2).

The following rates will apply from 8 July 2020 to 31 March 2021:

Net Present Value of the Rent	SDLT rate
Up to £500,000	Zero
Over £500,000	1%

Companies

Companies as well as individuals buying residential property for not over £500,000 will also benefit from these changes, as will companies that buy residential property of any value where they meet the relief conditions from the corporate flat 15% SDLT charge (see FA 2003 Schedule 4A).

When the holiday ends

On the 1 April 2021 the reduced rates shown in the above tables will revert to the rates of SDLT that were in place prior to 8 July 2020.

IHT AND THE FAMILY HOME – HOW TO GIVE PART OF IT AWAY AND CONTINUE TO LIVE THERE AND AVOID IHT

Patrick C Soares

If the taxpayer gives her house to her children and continues to live in it that achieves nothing (unless she pays a market value rent to the children) as she would be caught by the reservation of benefit provisions in FA 1986 s102 (GROB) and IHT would be payable on her death even if she survived the gift by 7 years. One cannot give assets away and continue to benefit from them as the legislation "does not allow a taxpayer to have his cake and eat it" (Lord Hoffmann in *Ingram v IRC* [1999] 1 ALL ER 297 at 300).

There is one situation, however, where she can give an interest in her house away and continue to live in it rent free and avoid the GROB (and thus wholly avoid IHT if she survives the gift by 7 years). That situation is found in FA 1986 s102B(4).

SON AND HIS MOTHER

Let us assume that Green Manor is owned by M (mother) and she lives in the same. She is aged 75 years and is in reasonable health. Her son (S) is in his early 40s. He has a flat in London and is there for the working days of the week. M gifts a 50% share of Green Manor to S (so they become beneficial tenants in common) and she continues to pay for the upkeep of the property. After the gift the 2 would occupy Green Manor albeit S has and continues to use his London flat.

THE RELIEVING SECTION (FA 1986 SECTION 102B)

The gift of the undivided share in Green Manor to S will avoid the GROB provisions if two conditions are satisfied:-

(1) the donor and donee occupy the land and

(2) the donor does not receive any benefit, other than a negligible one, which is provided by or at the expense of the donee for some reason connected with the gift.

This provision has effect from 9 March 1999 and the position prior thereto was governed by a Hansard Statement by Peter Brooke of June 10, 1986 col 425 although the legislation is more widely drafted than the Hansard Statement.

ANALYSING THE SECTION

Undivided share

The gifted interest must be a beneficial tenancy in common interest and not a beneficial joint tenancy interest.

Occupation by the donor and the donee

Under the proposal the 2 will occupy the house even though S may only spend weekends or most weekends there and some holidays. S will leave possessions at the property and has his own bedroom and it is open to him at all times. With regards to his London flat he should consider TCGA 1992 s222(5). There is no clear HMRC guidance here but HMRC give a wide meaning to occupation in the pre-owned assets tax (POAT) provisions in FA 2004 Sch 15. Storage and a right to use with minimal actual occupation may well constitute

occupation for those purposes. If the taxpayer has the right to occupy the premises as a 50% owner in common and treats it as his home and is physically present there most weekends and for some holidays and has an earmarked bedroom and study and keeps some of his possessions there and has the keys to come and go as he pleases and is not just a guest or temporary visitor he is in occupation for the purposes of s102B(4). There should be no problems in M living in part only of Green Manor and S doing the same. M may occupy an entire house although her son S has his own room and study. M can enter the rooms as she pleases and store things there and may go into the rooms to hear music or for some quiet time when S is out or to chat to S when he is there. They both occupy the rooms. The old Peter Brooke statement, referred to above, limited the relief to occupation as a "family home." That is not a requirement of the legislation.

If S gives up occupation after the proposal has been implemented the property falls back into the estate of M for IHT purposes. She may only own half of the property but she has reserved a benefit in the part

given to S as the condition in s102B(4)(a) is not satisfied.

No benefit to be provided at the expense of the donee

The outgoings can be shared 50/50 and S must not over-pay his share of the outgoings.

Indeed, the safest course is for M to pay all the running costs - council tax bill, gas and electricity, cleaning, maintenance - and capital outlays. The capital outlays may be a gift in themselves (of those capital outlays as to 50%) and she may have reserved a benefit in these but little may turn on that provided the main prize is obtained i.e. taking half of the gifted land interest out of charge to IHT after 7 years.

The HMRC manual refers to the need for both parties to “share the outgoings” (IHTM14360).

Under the old Peter Brooke statement the sharing of outgoings was envisaged and also each person enjoying separate parts of the house was envisaged; the latter is not relevant to the statutory

requirements and the outgoings can be shared or the donor (M) can bear all of the outgoings.

<u>There must be a gift</u>

M should do a deed of gift in favour of S.

The gift will be a potentially exempt transfer within IHTA 1984 s3A. The half share will form part of the estate of S for IHT purposes. He may thus he chargeable to IHT on his death unless for example he leaves his share to his spouse and the spouse exemption applies.

Note in calculating the loss in value in the estate of M the value of the part retained is discounted to reflect the fact of joint ownership. On M's death this discount is reflected in the value of her estate reducing the IHT payable on her death: a half of a house is worth less than 50% of the total value of the house. A 15% discount would be a safe figure. If the property were worth £800,000 at the date of her death the value of the property for IHT purposes may be £800,000/2 x 85/100 = £340,000 and not £400,000.

The gift by M to S will not give rise to a CGT charge if the principal private residence exemption is available (TCGA 1992 s222).

No SDLT will be payable (FA 2003 Sch 3 para 1). If the property is mortgaged different considerations apply.

PRE-OWNED ASSETS TAX (POAT)

Generally the proposal is within the ambit of POAT but there is an exclusion in FA 2004 Schedule 15 paragraph 11(5)(c) if the property interest given to the son "would fall to be treated as property which is subject to a reservation of benefit" but for s102B(4).

CONCLUSION

This is one of the great IHT reliefs.

FCTC Comments

A number of members have implemented this arrangement successfully for clients one by a mother who gave half the property to her daughter who was living with her and another by a mother

who gave half of the property to her son who spent a lot of time working abroad.

One member felt there is no logical reason why the relief is restricted to gifts of tenancy in common interests and it should be extended to gifts of beneficial joint tenancy interests.

One member felt the relief could be abused in extreme cases and HMRC may seek to apply the GAAR. The author feels this relief may be a loophole of sorts but IHT is a contentious tax between Labour and the Tories and is a tax “which breathes through its loopholes.”

AN UPDATED LOOK AT IMAGE RIGHTS FOLLOWING THE *HULL CITY* CASE

Patrick Way QC

In the Hull City case HMRC seem to have acknowledged that image rights do exist

The starting point is that for some considerable time HMRC have alleged that, as a legal matter, there are no such things as image rights. In the *Hull City* case (*Hull City AFC (Tigers) Limited v. Commissioners for HMRC* [2019] UKFTT 227 (TC)), however, HMRC appear to have given their (implicit) acceptance that image rights do exist after all.

The decision includes the following at paragraph 15:-

> "Both parties to the present appeal accept that in appropriate circumstances payment made by a football club to a third party pursuant to an image rights agreement will be taxed **as such** and not as earnings." [emphasis added]

What are image rights?

The concept of image rights is still evolving. The expression will generally cover the use of the following:-

- name;
- likeness;
- image;
- photograph;
- signature;
- initials;
- voice;
- reputation;
- personal characteristics.

The fact that HMRC appear to be accepting the existence of image rights is helpful and corresponds with the practice generally in this area. In the case of *Irvine & Anor v. TalkSport Limited* ([2003] BCD 140302770 (CA)) the motor racing driver, Eddie Irvine, argued that his image had been used without his permission. Specifically, an advertisement made

it look as if he was listening to and endorsing TalkSport when he was not. Eddie Irvine's action – to defend his image rights in effect – was upheld. This gives rise to the argument, at least amongst some intellectual property lawyers, that image rights could by the time of that case be seen as a definite legal concept.

The Sports Club case

The *Hull City* case is the first case since the case of *Sports Club* (*Sports Club plc v. Inspector of Taxes* [2000] STC (SCD) 443)) to consider the tax treatment of image rights. Although the names of the two players in the *Sports Club* case were anonymised it is fair to say that most people recognised them as being Dennis Bergkamp and David Platt of Arsenal. Indeed, Tolleys Tax Cases shows, in its index, the case by reference to the names of the individual footballers.

The structures in Sports Club

Sports Club involved various promotional and consultancy agreements and a special purpose service company set up on behalf of each player. Each such company contracted with Arsenal, and the players had their own separate contracts with

Arsenal as well. The question was whether payments made from Arsenal to the service companies could be said to be image rights payments or whether they were emoluments of the players or even benefits in kind.

The Special Commissioners (as they then were) held that the payments to the special purpose companies were not by reason of employment, nor were they benefits in kind. Instead they arose by virtue of separate commercial contracts to provide promotional/consultancy services.

So this became something of a lead case in relation to this area although it has to be acknowledged that the position as to whether image rights existed in this context remained unanswered in any definitive sense. Indeed, the Special Commissioners in the *Sports Club* case said as follows:-

> "8. During the hearing, and in the documents, the promotional agreements were sometimes referred to as "image rights agreements". As it was agreed that in England there is no property in a person's image we do not find the expression "image rights agreement" as

> being sufficiently descriptive of the contents of the agreement in issue in this appeal. As the agreements concern promotion, publicity, marketing and advertising we refer to them as promotional agreements except where the context requires a reference to image rights."

US cases

Outside the UK, the concept of image rights in relation to sports stars was evolving in a way that rather left the UK behind. For example, there are two image rights cases involving Retief Goosen and Sergio Garcia. These are as follows:

> Retief Goosen, Petitioner v. Internal Revenue, Respondent (Docket No.23323-09, Filed June 9 2011);
>
> Sergio Garcia, Petitioner v. Internal Revenue, Respondent (Docket No.13649-10, Filed, March 14 2013)

These repay close reading because they set out in a very sensible way how image rights should be treated as a matter of tax law.

The Hull City case

Reverting to the *Hull City* case itself, the importance of the case is that it is a good example of the way in which HMRC consider how purported or actual image rights agreements should be taxed in practice. It reminds us that great care must be used by practitioners in respect of image rights advice. In particular, there must be contemporaneous documentation to evidence the basis upon which the image rights agreement came into being and in particular giving a good explanation of how the payments for the image rights were arrived at.

More particularly, on this front, we can say that one of the key points of which to be aware – when considering image rights – is whether it is justifiable to say that the player in question has any image rights in the first place and if they do whether they have been valued correctly. Often HMRC argue that the player was not sufficiently well known to have image rights as such and if they were then HMRC will argue (almost invariably) that the advisers have overvalued those image rights.

This observation (*does a player have image rights and what are they worth?*) can be identified in the

Hull City case. In that case there was discussion about whether the particular player in that case – Geovanni Gómez ("Geovanni") – was a so-called marquee player who could justify any image rights payments and particularly ones of these magnitude. In the case it was held (perhaps unfairly) that he could not justify being entitled to image rights at all.

Also the case raised the question as to whether Hull City, in 2008, were even in a position to understand how image rights worked. Expert evidence was given to the effect that, broadly speaking, at that time only the top six clubs in the Premier League were capable of effecting image rights agreements. That seems a little unfair given that at the end of the 2007/08 season neither Manchester City nor Tottenham Hotspur (to name but two) were in the top six positions: they certainly would have been in a position to understand image rights agreements, based on my own experience.

Moving on, there were various specific problems with the image rights agreements that were entered into by Hull City and the special purpose company which purported to hold Geovanni's image rights. These issues were highlighted in the case. One such

issue was that the payment for Geovanni's image rights, per season, was exactly one-quarter of his basic wage for the season (£187,200 as against £748,800). This equivalence was "too good to be true". More particularly, it gave the impression that the image rights had not been independently valued but, rather, a proportionate figure had been used which, by implication, which indicated that no valuation exercise was likely to have been carried out. So the question of valuation is an area which always needs to be very carefully considered and documented.

Pausing there, one can immediately see that this is one of the key areas where image rights are concerned. There must be a full discussion between the Club on the one hand and the image rights company on the other as to what the value of the image rights is and there must be good evidence to support that value. Too often in my experience there is no evidence whatsoever. The parties have simply agreed between them that the particular figure "seems reasonable". That is not good enough. The "workings" by reference to how the image rights payments are arrived at is critical.

Another argument in the *Hull City* case was that whilst the image rights company involved (Jonier Limited – incorporated in the BVI) held Geovanni's foreign image rights no company held his UK image rights. In fact, there was no exploitation of his UK image rights at all. This was clearly a major error. Obviously, when Geovanni joined Hull – an English Premier League club – the absence of UK image rights, quite apart from being strange, would have meant that the value to Hull City of his image rights was very much reduced. *Why would an English club whose sponsors are likely to be mainly from the UK be prepared to pay significant amounts for image rights that did not extend to the UK?* The result of all of this was that the payment of £187,200 for image rights was going to be very difficult to justify: it looked excessive to say the least.

Having looked at the *Hull City* case in the round, we can see that the concerns of HMRC were not too surprising. They were arguing, of course, that the payments that were made under the image rights payments should properly be described as earnings for the purposes of PAYE and NICs. By contrast, Counsel for Hull City was arguing that the payments

were separate from Geovanni's earnings and should properly be treated as image rights payments.

HMRC raised three specific issues as follows.

First issue

As per normal, HMRC argued that the burden of proof lay with the appellant and therefore to the extent that it could not be discharged through the evidence which the appellant would establish, HMRC would be bound to win.

Second issue

The second issue was that HMRC invited the Tribunal to take a "realistic view of the payments". This was based on well-understood principles including, in particular, the cases of *HMRC v. PA Holdings Limited* (CA, [2012] STC 582) and the *Rangers* case (*RFC 2012 Plc (in liquidation) (formerly The Rangers Football Club plc) (appellant) v. Advocate General for Scotland (respondent)* (Scotland) (SC [2017] STC 1556) coupled with the Supreme Court decision in *UBS AG & Deutsche Bank Services (UK) Limited v. HMRC* ([2016] UKSC 13). Again, these principles in effect mean that the courts are not "hidebound" by

the way facts are presented nor by the form which the documentation takes. The courts, instead, can take what HMRC like to call a "realistic view" of what is really happening.

It seems as if as part of this the discussions had been as to whether the agreement in question was a sham. Fortunately, HMRC did not push this argument too far. Frankly it was not even necessary to raise the potential sham argument given the modern courts' willingness to apply a "substance over form" argument when looking at transactions and documents particularly when avoidance is involved.

Third issue

The final issue for HMRC was one which they are beginning to argue quite frequently. This is that there had been "mislabelling". In other words, HMRC invited the Tribunal to look at "what was the true agreement between the parties", regardless of the labels involved.

The second and the third issues combined

The Tribunal judge held that the second issue and the third issue were principally the same and

therefore he focused on the argument that the Tribunal should adopt a realistic view of the events.

The experts' view

As part of the decision the judge recited the facts of the case, some of which have been mentioned already. Included amongst these recited facts was the judge's analysis of the expert evidence which is worth repeating, at least by way of precis. Thus, the judge said – on the basis of the expert evidence in relation to the year 2008 – as follows:-

(1) Premier League clubs outside the top six did not generally have the skill to utilise image rights;

(2) 20% of employment earnings could usually be a justifiable amount in respect of a player's image rights in the UK and abroad;

(3) it was possible for a player arriving at the Premier League to have valuable image rights if they were sufficient well known;

(4) the image rights in question had arisen principally from the club's commercial partners wanting to use the image rights

in respect of their own advertising and marketing opportunities;

(5) it was important that negotiations of the image rights sums on the one hand and the earnings on the other were kept quite separate;

(6) a club such as Hull City would not have the relevant experience to deal with image rights; and

(7) historically image rights agreements had been used by some Premier Clubs and players to disguise employment in order to gain tax advantages.

The decision

The decision was, principally, that in the circumstances the amounts paid under the image rights agreement could properly be characterised as being earnings; they were not to be taken as separate image rights payments. The Tribunal in coming to the decision took note of the following facts:-

"(a) no valuation had been given to the image rights in the first place;

(b) there was not sufficient separateness between earnings on the one hand and image rights on the other;

(c) the fact that there were no UK image rights was bizarre;

(d) Hull City was not really in a position to negotiate image rights and therefore it was unlikely that these were image rights; and

(e) the player had not had an image rights contract at one of the "more important" clubs for whom he had played, namely Manchester City."

So, pausing there again, this was probably a "simple" case for HMRC. They did not even need to decide categorically whether image rights did exist as a matter of law. It does seem, however, that that was implicitly accepted.

HMRC's image rights attack generally

In the rest of this article I consider the way in which HMRC typically approach image rights disputes.

Image rights – do they still exist?

Some inspectors may still try and argue that image rights agreements do not exist and I have seen that recently. On the basis of paragraph 15 of the *Hull City* decision, mentioned above, I would hope that HMRC will no longer seek to argue as to the non-existence of image rights.

The overseas image rights company trading in the UK

HMRC often try and argue that the involvement of the player (now a UK resident) is such, in relation to the overseas company which holds the player's image rights, that the player has effective control and management, rather than the named non-resident directors of the company. In other words, HMRC argue that the relevant company has become UK tax resident through the actions of the player. This HMRC contention should usually be countered particularly when the overseas company is well controlled and managed by third party foreign directors.

The transfer of assets abroad rules may apply

HMRC may contend that the arrangements, which involve overseas entities, fall within the transfer of assets abroad rule (specifically ITA 2007, s.720).

Usually, however, the player in question is not UK domiciled with the consequence that the remittance rules apply to overseas income. On this basis, invoking the transfer of assets abroad rules is not usually a fruitful path for HMRC to follow.

In addition, often the player will have had the structure in place at a time before coming to the UK having used it for overseas activities. This should make the motive defence (ITA 2007 s.737) more readily available. Note, however, that the motive defence does need to be claimed each year in the individual player's tax return.

Sales of occupation income (ITA 2007 s.733)

HMRC may seek to argue that there is a charge to income tax under ITA 2007 s.733 when an individual receives a sum for exploiting his income rights: sale of occupation income. However, this can usually be countered because the main object or one of the main objects of the exercise will not be the avoidance or reduction of liability to income tax. This is particularly the case where the arrangements are in place beforehand and it can be demonstrated that the use of a company was necessary, for example, to afford limited liability. In addition, it is

often the case that the particular individuals running the overseas company and providing image rights services are experts in their field. This therefore is demonstrative of their being a sensible commercial decision to engage with the overseas image rights company in the first place.

Transfer of income streams (ITA 2007 s.809AZA)

Here HMRC sometimes argue that there is, in effect, a transfer of a right to receive income (ITA 2007, s.809AZA). This defence, which virtually always applies, however, is that the legislation does not apply if the asset which produces the income is also transferred: the income is not "stripped out" or assigned. By its very nature an image rights contract usually involves the transfer of the individual's image rights "lock, stock and barrel". Consequently, these provisions should not apply.

Transfer pricing

The latest objections which HMRC are beginning to raise are in relation to transfer pricing. HMRC argue that the values involved are not properly justified and they seek to invoke the transfer pricing rules to support their views. For example, they may argue that there was an overpayment for the image rights

up front which means that when the payments for image rights are received HMRC will argue that they should be properly characterised as earnings rather than image rights payments. This needs to be countered by good evidence.

Example

A player sets up an image rights company and sells their image rights to the company for £10m. That is intended to be a capital disposal in consideration of a capital receipt. HMRC may invoke the transfer pricing rules, however, and argue that the correct value is, say, £1m. and that the excess (£9m.) is therefore earnings. They will do so by reference to transfer pricing rules if they can. This HMRC argument will need to be countered (if applicable) by reference to good evidence.

Should I register the image rights in Guernsey or elsewhere?

Now that HMRC acknowledge, or seem to acknowledge, based on the *Hull City* case, that image rights do exist then there may be no particular advantage in having image rights registered as such but I would still advise going to the trouble of registering in Guernsey or elsewhere.

This is because in their manuals HMRC acknowledge that the registration of an image right is helpful. It also seems to me that in building the picture of the image rights being commercial and "real" registration is a sensible step to take.

Spanish situation

It has recently been announced that the Everton manager, Carlo Ancelotti, has been indicted in Spain after being accused of tax fraud in the sum of £1m. The Madrid Community Prosecutor's office said in a statement that Ancelotti had concealed revenues "intending to avoid his tax duties towards the Public Treasury with no justification".

He follows on from other football celebrities who have faced major problems with the Spanish tax authorities in relation to their image rights. As a result, it is absolutely critical that footballers and their UK advisers take good Spanish advice. In my experience (repeating however that Spanish advice should be taken) the best course of action (if image rights are involved) is to set up an image rights arrangement involving a Spanish resident player or manager but, nevertheless, to avoid seeking the Spanish tax advantages in relation thereto unless

and until the position (in respect of image rights) has been agreed with the Spanish tax authorities. I repeat, however, that local tax advice is critical given the appetite the Spanish authorities have for making tax breaches a criminal matter.

Conclusion

In many ways the position in relation to image rights has begun to settle down. The principal Premier League clubs are much more “au fait” with how image rights work. Nevertheless the key points are as follows:-

(a) make sure that there is good evidence to show that the image rights contracts have been separately negotiated from earnings;

(b) make sure that there is real rationale for the values involved. So often these values seem to be “plucked out of thin air”;

(c) make sure, once the image rights are in place, that they are properly exploited. In good cases you will find that the image rights company enhances and embellishes the image rights of the

individual on an almost daily basis. I have experience of a top image rights agent who is in touch with her clients all of the time. She continually negotiates contracts for them all round the world and is constantly in touch with new potential sponsors. This makes it very difficult, in my view, for HMRC to argue:-

(i) that her players' image rights do not exist; and

(ii) in some way the high values which have been attributed to the image rights are illusory;

(d) finally, it is necessary to warn the football club and the player that the utilisation of image rights is still something frowned upon by HMRC and at the very least the advisers (and the player) should prepare themselves for lengthy and sometimes hostile correspondence.

UK TAX TREATIES
POST-BEPS AND POST-BREXIT

Philip Baker QC

Tax treaties are a critical part of any country's tax system, particularly the tax system of a country with high levels of cross-border trade and investment (like the UK). In the post-Brexit era, tax treaties will become even more important for the UK as the provisions contained in a number of European directives – such as the Parent-Subsidiary Directive and the Interest and Royalties Directive – will cease to apply after the end of the transition period, and will need to be replaced by provisions in tax treaties. At the same time, the provisions contained in tax treaties are influenced by international developments, such as the outcomes of the OECD's BEPS Project, some of which are implemented through the MLI – the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS.

This short article examines some of the particular features of the tax treaties concluded by the UK in the

last four years, since the end of the BEPS Project and the referendum vote on Brexit. It focuses on the comprehensive income tax treaties concluded by the UK during this period (though there were also a number of amending protocols, amending existing treaties during those years). An examination of the treaties concluded by a country gives some indication of the position taken by the country in treaty negotiations, and the preferred outcome that the country seeks to achieve. Of course, each treaty is the outcome of a bargain between the two contracting states, and any particular provision may reflect a negotiating aim of the other party to the treaty. However, by examining a number of treaties concluded by a country, one can build up an impression as to the preferred position taken by that country.

Since 2016, the UK has concluded 12 comprehensive income tax treaties, most of them replacing earlier treaties (some of which dated back to the 1950's). Four of these treaties were concluded with the UK's CDOTs (Crown Dependencies and Overseas Territories): replacement treaties with Guernsey, Jersey and the Isle of Man and a new treaty with Gibraltar. In many respects, these treaties come

closest to identifying the UK's ideal outcome since there is an element of commonality on both sides of the negotiations. Two treaties with EU Member States replace earlier treaties: with Austria and Cyprus. There are two new treaties with Latin American countries, where the UK's treaty coverage has traditionally been rather thinner than in other parts of the world: with Colombia and Uruguay. Finally, a miscellaneous group of treaties with Belarus, Lesotho, Turkmenistan and the United Arab Emirates. Some of these treaties have been long anticipated, and the negotiations in some cases may date back several years, to well before the BEPS Project and the changes reflected in the 2017 OECD Model. That may explain why, for example, some of these treaties do not reflect the latest versions of the Model.

It is a truism which tells us relatively little that the UK has generally negotiated treaties that are very close to the OECD Model. At times, however, the UK has been willing to accept measures that are closer to the UN Model: for example, the inclusion of a "services PE" or a positive withholding tax at source on royalties. Not surprisingly, the most recent treaties follow the UK's published position with

regard to the MLI, adopting, for example, only certain of the changes with regard to the definition of a permanent establishment and including provisions for arbitration wherever the other country is willing to agree. Where the MLI reflects an internationally-accepted, minimum standard, there is no surprise to find that reflected in these treaties.

One can identify common features of these new treaties while tracking the order of articles in the OECD Model. In Article 1, there seems to be a preference for including the new paragraphs on fiscally transparent entities (including hybrid entities) found in Article 1(2) of the OECD Model of 2017, and also a "savings clause" based on Article 1(3). The latter would override arguments that a tax treaty could prevent the attribution of income or gains to a UK-resident person under provisions such as the Transfer of Assets Abroad legislation or Section 3 of the Taxation of Chargeable Gains Act 1992 (formerly Section 13 TCGA 1992).

One interesting feature of these new treaties is that virtually all include some form of definition of a "pension scheme", and make explicit provision that ensures that a pension fund – as well as any entity

established for charitable and similar purposes – is to be regarded as a resident of a contracting state for purposes of the convention. Pension schemes and charitable entities enjoy exemptions from tax in many countries, which can raise the issue whether they are "liable to tax" and, therefore, whether they can be resident in a contracting state. The better view is that these entities are liable to tax, since they would be fully taxable if, for any reason, they failed to satisfy the grounds on which the exemption is granted. Nevertheless, it is helpful to clarify that such schemes and arrangements are resident for treaty purposes, and nearly all of the new treaties do so.

It is no surprise to find that virtually all the new treaties apply the tiebreaker in Article 4(3) of the 2017 OECD Model under which, in the case of entities, the determination of residence is by mutual agreement between the competent authorities. The treaty with Cyprus also has some interesting provisions in the protocol on the application of this test, preserving the position of existing, dual-resident companies.

In its position on the MLI, the UK has not accepted all of the proposals with regard to the definition of

permanent establishment in Article 5 of the OECD Model. These new treaties generally reflect this: so, for example, the excluded activities only have to be "preparatory and auxiliary" if they do not fall within any of the "per se" categories, of if they are a combination of different activities. Similarly, the dependent agency provision follows the older version of the definition.

So far as the business profits article is concerned, the new treaties split both ways between the new, "Authorised OECD Approach" and the older form of Article 7. It appears that the UK will try to follow the AOA route with any other country that accepts that approach (or where the negotiators on the other side may not have understood the significance of the new wording in the post-2010 version of the Model).

Many people consider that the "core provisions" of a tax treaty are those dealing with dividends, interest and royalties. These are also some of the articles on which negotiations are likely to focus, and, not surprisingly, the new treaties reflect a number of different patterns. So far as dividends are concerned, with no withholding tax on most dividends the UK has achieved exemption from withholding tax from

the other country in a number of cases. The one exception is distributions from a real estate investment trust, where the UK ensures that a 15% withholding tax is permissible. On interest, the UK negotiators look to achieve exemption from the other country, at least for interest received by various categories of residents of the UK, including financial institutions, and in some cases quoted companies and individuals. On royalties, there is also a clear preference for complete exemption from withholding tax across the board, or at least if certain conditions are satisfied.

The capital gains articles generally follow the standard pattern in Article 13 of the OECD Model, with the general rule being that gains are taxable only in the country of residence of the person alienating the property. All the treaties make provision, however, that disposals of shares (or interests in other entities) deriving the majority of their value from immovable property may be taxed where the property is situated, but exclude shares that are regularly traded on a recognised stock exchange.

The provisions applicable primarily or exclusively to individuals generally follow the OECD Model,

though on pensions there are a variety of different solutions adopted.

Since these treaties all post-date the adoption of UK domestic law which exempts foreign source dividends and the profits of overseas permanent establishments from tax, the articles dealing with "elimination of double taxation" contain a new form of wording now preferred by the UK. Exemption for dividends and PE profits is granted where it is provided for under domestic law; in other cases a credit for the foreign tax is granted, again subject to the conditions under UK domestic law.

Most, but not all of the new treaties contain a provision for mandatory binding arbitration if the mutual agreement procedure fails to resolve an issue within two years. That reflects the UK's position on the MLI, and it seems that the UK aims to include arbitration in its treaties unless the other country takes a policy objection.

In a similar fashion, most of the treaties contain a new article – based on Article 27 of the OECD Model – on assistance in the collection of taxes. Not every one of the new treaties contains this, and one may

speculate that this reflects an assessment by the UK negotiators that, if they were to include such a provision, in the case of some countries it would be unlikely to operate in a sufficiently reciprocal fashion. Some of the treaties that contain provisions for assistance in collection make it clear, generally in a protocol, that this applies regardless of when the tax liability arose.

Finally, virtually all of the new treaties contain an "entitlement to benefits" provision in the form of the "principal purpose test": none of them contains a more elaborate "limitation on benefits" provision.

At this point, it is appropriate to say something about the PPT. It is clear that the UK is strongly committed to including this in its tax treaties (and it may be included in some treaties through the MLI), and it is, of course, a means of satisfying the minimum standard on treaty abuse. By way of reminder, the PPT consists of the following provision:

> (1) Notwithstanding the other provisions of this Agreement, a benefit under this Agreement shall not be granted in respect of an item of income or a

> capital gain if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Agreement.

Interestingly, examining the most recent treaties, the UK also has a preference for including a second paragraph based on the optional additional provision found in Article 7(4) of the MLI. This is as follows:

> (2) Where a benefit under this Agreement is denied to a person under paragraph (1), the competent authority of the territory that would otherwise have granted this benefit shall nevertheless treat that person as being entitled to this benefit, or to different benefits with respect to a specific item of

> income or a capital gain, if such competent authority, upon request from that person and after consideration of the relevant facts and circumstances, determines that such benefits would have been granted to that person in the absence of the transaction or arrangement referred to in paragraph (1). The competent authority of the territory to which the request has been made will consult with the competent authority of the other territory before rejecting a request made under this paragraph by a resident of that other territory.

Purpose-based tests relating to specific articles of tax treaties have been found in the dividend, interest, royalties and "other income" articles of the UK tax treaties for some time. However, there has been no case law (so far as the author is aware) on the interpretation of these purpose tests, and little guidance on their application. Until the PPT, these purpose-based tests have been specific to a particular article and not general. The PPT is, to a certain extent, therefore, a whole new ball game in terms of

access to treaty benefits. It is also a ball game that will be played by two teams, in that different countries may, examining the same bilateral convention, take different views as to whether the principal purpose of the taxpayer was to secure the benefits of the treaty. With limited guidance from prior practice, the OECD Commentary on the PPT may become particularly significant. This is found at paragraphs 169-187 of the Commentary on Article 29, particularly the examples found in paragraphs 182 and 187 of the Commentary. One can make a reasonably confident prediction that we will begin to see litigation on the interpretation of the PPT from a number of countries within a relatively short period of time.

Mention of the OECD Commentaries also invites attention to a novel and slightly unusual feature of several of the new UK treaties. The treaties with Gibraltar, Austria, Guernsey, Jersey, the Isle of Man, and Colombia (i.e. 6 out of the 12 new treaties) all make reference to the use of the Commentaries as an aid to the interpretation of provisions in the relevant treaty which are based on the equivalent provisions in the OECD Model. They all specify that reference should be made to the latest version of the

Commentary, due regard being had to any observations or any other specific reasons for diverging from the meaning contained in the Commentary. This is a new feature; though, to be fair, it is consistent with the OECD's own guidance on the point. It appears sufficiently frequently – and in all the CDOT agreements – that one may presuppose that it is part of the preferred position of the UK negotiators. In part, this may be a reaction to the continuing uncertainty as to the status of the Commentaries as an aid to interpretation, particularly the status of later commentaries amended after the conclusion of a particular treaty. The exact formulation of the statement about reference to the Commentaries is not uniform, presumably reflecting concerns of the other party to the negotiations.

There is something of a point of principle here. According to these statements contained in these new treaties, subsequent changes to the Commentaries will have effect for the interpretation of existing treaties. Those changes are agreed by negotiators in the relevant working party at the OECD, and confirmed by the Committee on Fiscal Affairs. They are not subject to any process of debate

or scrutiny in Parliament. This may change: if amendments to the Commentaries are to have explicit impact on the interpretation of existing treaties (as the wording included in these new treaties indicates) then it is only appropriate that proposals to amend the Commentaries should be subject to a degree of Parliamentary scrutiny. Regardless of this wording in the new treaties, that is probably a development that should be welcomed in any event.

FCTC Comments

One member of Chambers has a case where HMRC are refusing to apply the interest article on the payment of interest by a UK borrower to an Isle of Man company lender unless all the names of the beneficiaries under a discretionary trust which owns the Isle of Man company are declared. HMRC are relying on the PPT provision in the treaty, which applies to interest, to obtain the information.

REFLECTIONS ON LITIGATING BY VIDEO

Imran S Afzal

In recent months there has been a dramatic increase in virtual working, with video meetings the new norm. Video conferences with team members typically work very smoothly and I can see many people sticking with this method in the future.

One point which was on my mind, however, was whether a court hearing conducted by video would be a good substitute for a hearing in person. This will no doubt be a key concern for parties with upcoming hearings, because everyone will want the best and most effective opportunity to present their case. I very recently had a two day video hearing before the Court of Appeal and so I thought I would share my experience. I will not be commenting on the substance of the case, but rather setting out some reflections on the technical process.

One of the great benefits of the oral advocacy system in the UK, as compared to a system of purely or predominantly written submissions, is the ability to engage in dialogue with the judges. If there are

particular points which the judges want to focus on, then they can ask questions about these points and the advocate has the opportunity to persuade the judges. However, one concern I had before my hearing was the extent to which this would be possible over video. Would the judges be able to interject with questions, or would the use of video hinder this? It is preferable to focus one's oral submissions on points which are on a judge's mind, as opposed to spending lengthy time on points in relation to which the court might already agree with you, but would the ability to do this be lost over video?

Fortunately, and contrary to my concern, the process worked brilliantly. The three judges (all of whom were in different locations) were able to interject whenever they wished, and the dialogue with the judges was as natural as it would have been in a courtroom. I doubt the advocates would have been grilled to any different extent in person!

Another issue which might concern parties is that the ability to pass sticky notes, or whisper in counsel's ear will be lost. From counsel's perspective, the ability to get input from the rest of the team is

invaluable and clearly one does not want to lose this. However this remains straightforward even in a video hearing. During the hearing team members can communicate using a messaging service such as WhatsApp, and before/after the hearing and during breaks separate video or phone calls can be set up.

Given that my hearing was an appeal, there were no witnesses. Nevertheless the hearing gave me some insight as to whether one might effectively cross-examine witnesses via video, and whether the ability to see a witness's body language and reactions is lost. My previous inclination had been that video hearings might not be ideal in cases involving witness evidence, but I can see that the process may actually work well. For example, in a live hearing one can often tell from a judge's expression that he or she might like you to pause and elaborate on a particular point, and I found that this was equally possible over video. Similarly, as mentioned above, the interaction between the judges and counsel was as natural and fluid as it would have been in person. That all leads me to think that it should be possible for witness evidence to be given effectively in a video hearing.

Turning to the software the Court of Appeal uses Skype for Business, although other courts may use a different platform (e.g. the First-tier Tribunal (Tax Chamber) uses separate bespoke software). The process of connecting was straightforward. The court sent invitations for the hearing time, and it was easy for participants to connect – there was no need for any pre-existing software subscriptions. At the hearing the judges and advocates connected by video, and other members of each side's teams joined without video.

I would, however, flag one note of advice. I would recommend having a backup device for joining the hearing, ideally using a different type of connection (e.g. mobile data instead of internet). I say that because one of the participants in the hearing suffered some IT difficulties. As one would expect the court and other participants were understanding and sympathetic. IT glitches are out of our control and video hearings are a novel experience. Nonetheless, I can imagine that it is stressful if it is your IT system that is not working, and I could not help thinking *"there but for the grace of God go I"*.

In sum, my overall impression is that the process worked remarkably well. Concerns that I had were alleviated and, at least generally speaking, I do not think parties need to be worried if their hearings will take place by video instead of in person.

FCTC Comments

A member of Chambers has asked me whether virtual hearings are likely to remain an option when things get back to normal.

My reply: Although I do not know what the courts and tribunals will decide in the long term, I can certainly see merit in video hearings remaining an option. As discussed above video hearings work well and in addition they can be convenient and cost-effective. For example, clients who are not based within easy reach of the courts/tribunals can avoid travelling to, and arranging accommodation near, a physical hearing venue.

UK RESIDENCE: EXCEPTIONAL DAYS

Peter Vaines

During recent months there has been a lot of anxiety about the meaning of "exceptional circumstances" for the purpose of the Statutory Residence Test. Many people have been unable to leave the UK because of the restrictions caused by the Coronavirus (either here or in their home country) and these extra days may be crucial in determining their residence position - and their liability to UK tax.

An important question is whether days spent unintentionally in the UK for this reason will be counted in determining their residence under the Statutory Residence Test or whether such days can be disregarded on the basis of exceptional circumstances.

A review of the legislation shows that a degree of anxiety is well founded.

Before 2013 and the introduction of the Statutory Residence Test, there was a Revenue practice contained in their (now infamous) booklet IR20 which said:

> "Any days spent in the UK because of exceptional circumstances beyond your control, for example the illness of yourself or a member of your immediate family, are not normally counted for this purpose".

This general (and obviously flexible) concept found its way into the Statutory Residence Test in Schedule 45 FA 2013 where paragraph 22(4) provides the rather less flexible test that a day will not be counted as a day spent in the UK if:

a) The taxpayer would not be present in the UK at the end of that day but for exceptional circumstances beyond his control which prevent him from leaving the UK, and

b) He intends to leave the UK as soon as those circumstances permit.

Paragraph 22(5) says that examples of such exceptional circumstances are:

a) National or local emergencies such as war civil unrest or natural disasters, and

b) A sudden or life threatening illness or injury.

That is all it says – apart from paragraph 22(6) which provides a statutory limit of 60 days which can be disregarded by reason of exceptional circumstances.

There will be years of debate about what these words mean and it will fall to the courts to provide the necessary clarity in due course. For the moment, we are on our own.

On a strict reading of the legislation it would be very difficult to satisfy the requirements of paragraph 22(4) at all. Unless you are in prison or in a coma it is unlikely that you will be prevented from leaving the UK. Even if there are no flights, you could always get on the Eurostar to France or Belgium, or travel by ferry to lots of places. The rule is not that you cannot get home; the rule is that you are prevented from leaving the UK.

It would be a mistake to assume that days in the UK because of exceptional circumstances may be disregarded wherever it is necessary to count days. That would be much too simple. These rules apply to situations where it is necessary to count the “days spent in the UK” but not for any other day count condition. The complexity is breathtaking. For example, in the application of the automatic UK

residence tests, the rules relating to exceptional circumstances apply to the day count for the first test, but not for the second and third tests. Even more confusingly, exceptional circumstances are relevant to the day count for the tables applicable to the UK Ties – but not to the definitions of the UK Ties themselves (except for the 90 day tie).

The guidance given by HMRC in the Manuals is unsatisfactorily variable. In parts it is excessively strict, introducing additional conditions which are not in the legislation – such as a requirement that the exceptional circumstances do not count if they could reasonably have been foreseen or predicted. In other places, HMRC provide relaxations which are not permitted under the legislation – for example to allow for days to be disregarded where a person is not prevented from leaving the UK but cannot go back to the country of his choice.

There are also idiosyncratic interpretations. For example, HMRC say that it would be an exceptional circumstance if a person has to stay in the UK to deal with a sudden or life threatening illness or injury to his spouse or dependent child - or if they have to come to the UK for this purpose. But this is confined to a

dependent child, and it does not extend to a sibling, nor a parent; nor indeed the illness or injury to the individual himself. The reasoning here is difficult to grasp.

Paragraph 22(5) refers to a sudden or life threatening illness or injury, but does not identify the person who is required to be afflicted. The restrictions imposed by HMRC on the persons who qualify for this purpose seem to be without any justification. Their view is particularly inexplicable when one considers the previous rule under IR20 which applied to "yourself or a member of your immediate family" as this covered not only the individual but his children, siblings and parents.

HMRC suggest that the exceptional circumstances have to arise when you are in the UK and do not apply if you come here voluntarily, for example for medical treatment, and are then stuck here. Whether that is a fair interpretation is a matter of debate – and it will no doubt be tested before too long in the context of the Coronavirus as many people returned to the UK (possibly to *avoid* a sudden or life threatening illness) and were then unable to leave.

HMRC take the view that birth, death, marriage and

divorce are not exceptional circumstances. This too may be open to question on the grounds that most people are only born once, and only die once. On any interpretation anything which occurs only once during a person's lifetime would obviously be exceptional – but again, the person who is born or who dies is not specified by the legislation and is not necessarily the taxpayer. It could mean the birth or death of somebody else. We can go on analysing this point for ever, but it does not get you anywhere because these things do not prevent you leaving the country – unless of course you are the person giving birth or dying.

Relating all this to the Coronavirus, there are clearly many people, who were trapped in the UK and were prevented from leaving by the virus – they may have been in hospital or quarantine. That sounds good - but it would not be enough unless they can prove that they had the intention of leaving as soon as circumstances permit.

There will also be those who travelled back to the UK voluntarily and claim they could not leave again. But people have always been able to leave – our borders have not been closed - and they would been able to go *somewhere*, so they would not satisfy the paragraph

22(4) test; nor would they satisfy the tests set out in the Manuals.

It is highly unlikely that anybody other than a tax professional would have any idea of the strictness and complexity of the statutory rules – or how inconsistent is the guidance provided by HMRC. However they would be anxious and confused, because they would know how important it is; their residence status – and their liability to tax – will depend upon it.

Fortunately, the reaction of HMRC to the current crisis has been to adopt a very helpful approach, just as they did in 2010 when they said that the flight chaos caused by the volcanic ash from Iceland would be regarded as an exceptional circumstances for anybody who planned to leave the country but was unable to do so. That was of course under the previous regime which was purely concessionary anyway and not subject to the constraints of specific legislation.

On 9th March HMRC issued a statement. It provides that if you:

a) *are quarantined or advised by a health professional or public health guidance to self isolate in the UK as a result of the*

virus;

b) find yourself advised by official Government advice not to travel from the UK as a result of the virus

c) are unable to leave the UK as a result of the closure of international borders, or

d) are asked by your employer to return to the UK temporarily as a result of the virus

these circumstances will be treated as exceptional.

Although this statement does not cover all circumstances (and in particular those returning to the UK otherwise than at the request of their employer) it will have been an enormous relief for many people whose careful day count planning would have been completely wrecked by the consequences of the virus.

It is to be hoped that where somebody was trapped here but did not quite fit the terms of this statement, HMRC will adopt their famous light touch.

A further relaxation was announced on 9th April explaining that the Statutory Residence Test is being amended to ensure that any days spent in the UK between 1st March and 1st June 2020 by individuals who were “working on COVID-19 related activities” will not count towards the residence tests.

Quite what is meant by “working on COVID-19 related activities” is unclear except that it will be tightly targeted to minimise the risk of abuse.

This will be a statutory relaxation, unlike the HMRC announcement on 9th March which merely acknowledged that the meaning of exceptional circumstances in Schedule 45 FA 2013 is wider than HMRC had previously suggested.

These are very welcome changes and will do much to relieve the concerns of those who are caught up in this crisis.

The flaws in the legislation relating to exceptional circumstances in the context of the SRT have been clearly exposed by the virus. It is to be hoped that when the crisis is over these flaws will not just be forgotten but that the virus will prove to be the catalyst for some sensible changes which will result in a more reasonable, fair and workable code.

WHY WE NEED TO TALK ABOUT FAMILY INVESTMENT COMPANIES – ARRANGING ACTIVITIES TO ESCAPE CHALLENGE

Katherine Bullock

The revelation of an HMRC unit to investigate the tax risks associated with FICs should be a wake-up call to all FIC shareholders to review the tax efficiency of their structure and whether it remains fit for purpose. The current turbulent stock markets offer an ideal opportunity for tax efficient restructuring.

In April 2019, HMRC established a "secret unit" to investigate the tax risks associated with Family Investment Companies (FICs) with a focus on Inheritance Tax (IHT). This revelation sent ripples of alarm through wealthy individuals and their advisers. The month before the pandemic hit, the headline in the *Financial Times*[1] read, "Secretive UK tax units home in on rich families". Given the popularity of FICs with individuals of all levels of

[1] February 21, 2020

wealth, the length of time that they have been in use and their active promotion as a tax and estate planning tool, it would be more surprising if HMRC did **not** have them under surveillance. What is perhaps more thought provoking is the stated reason for keeping the new unit secret. This is to avoid allowing individuals the opportunity “to arrange their activities to escape challenge”.

There is always a risk of new legislation to protect the UK tax yield from the proliferation of FICs. What should be of greater concern is the wide armoury of tax legislation already at HMRC’s disposal that can be applied to FICs without any legislative change at all.

FICs came into fashion as an alternative to trusts following the changes to the IHT treatment of trusts in 2006. The original idea was elegantly simple - to preserve wealth and mitigate IHT by using a company under the control of the senior generation to pass assets to the next generation. As with all elegant and simple ideas enhancements were added over time.

The anatomy of an FIC

Most FICs are resident in the UK for tax purposes and this is assumed to be the case here. If the company is not centrally managed and controlled in UK, not least the Transfer of Assets Abroad code may be engaged and will need careful consideration.

A simple FIC may be established as follows. The senior generation establish the company with cash, giving shares away to their children on incorporation or alternatively giving cash to the children to enable them to subscribe for shares. No capital gains tax will arise in this scenario and if the senior generation survive seven years the gift should fall outside of their estate for IHT purposes. Any shares retained by the senior generation or by the adult next generation will form part of the relevant individual's taxable estate, but that value may be discounted if it is a minority interest. The senior generation retain control of the investment and distribution policy of the company, by being the directors of the company. The cautious may also retain sufficient voting rights in the company to give a majority, although this may dilute the IHT benefit where additional value attaches to the shares.

The FIC then invests the capital provided, usually in a listed equity portfolio but perhaps in commercial property or other investments. To the extent that dividends on the equity portfolio are exempt, there is no corporation tax to pay within the company. There is additional tax on any profits distributed from the company, although timing and quantum can be controlled. Although capital is not easily extracted, this may well suit the needs of the family who want a savings vehicle where funds can grow tax efficiently and with IHT benefits. Nevertheless, capital may ultimately be realised at capital gains tax rates on liquidation of the company.

To allow flexible and tax efficient extraction of capital by the senior generation in the meantime, many FICs are funded by a combination of share capital and debt, often interest-free and repayable on demand.

FICs can be split broadly into two types. The first is a company designed and used to pass on family wealth to the next generation whilst leaving control with the senior generation. The second is a company designed as a tax efficient investment wrapper. The latter are sometimes distinguished as Personal Investment Companies (PICs). The reality in

practice is often a hybrid as PICs morph into FICs and FICs into PICs. It is this hybrid that can create the unforeseen challenges which are the subject of the remainder of this essay.

The settlement legislation

The settlements legislation in ITTOIA 2005 Part 5 Chapter 5 aims to prevent an individual gaining a tax advantage through arrangements designed to divert income to another person who pays income tax at a lower rate or is not liable to income tax.

Whilst the settlement legislation does not apply to companies, it may apply to arrangements involving companies.

A number of conditions must be met before the legislation applies. The arrangement must amount to a settlement. The definition of settlement is widely drawn to include any disposition, trust, covenant, agreement, arrangement or transfer of assets[2]. As HMRC succinctly put it “Arrangement is a term of

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[2] ITTOIA 2005 s.620(1)

great flexibility"[3]. However, it still requires some element of bounty[4].

If a settlement exists, the individual must retain an interest in the settled property. A settlor is deemed to have retained an interest where any property or any related property in the settlement is, will or may become payable to or applicable for the benefit of the settlor or his spouse or civil partner in any circumstances. Where the legislation applies, the individual making the arrangement may be charged the income tax otherwise avoided.

FICs are particularly vulnerable to attack under the settlements legislation where different family members have subscribed for different classes of shares with similar rights. These are often referred to as Alphabet Shares (individual A holds class A ordinary shares, individual B class B ordinary shares, individual C class C ordinary shares and so on) and are used so that different dividends or disposal proceeds can be distributed to different family members at different times. Is a dividend declared on say the A ordinary shares that leaves insufficient

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[3] Trusts Settlements and Estates Manual para.4105

[4] *CIR v Plummer* [1979] STC 793.

distributable reserves to pay the same level of dividend on say the B ordinary shares a bounteous arrangement? If the B shareholders, who receive the disproportionate dividends, are the adult children of the A shareholder, has the A shareholder retained a benefit?

The answers lie in careful drafting of share rights or management of the distribution policy for each class of shares. As well as avoiding an unexpected charge under the settlements legislation, this should also ensure that HMRC are not able to argue that there has been a gift with reservation of benefit[5] in the relevant shares.

It should be noted that shares transferred to a spouse or minor children may also engage the settlements legislation[6]. Whilst there is an important exception in the case of outright and unconditional gifts between spouses and civil partners, this is only the case where the gift carries a right to the whole of the income (Condition A) and the property given is not wholly or substantially a right to income (Condition B)[7] (contrast the situation in *Young v Pearce; Young*

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[5] FA 1986 s.102
[6] ITTOIA 2005 s.629
[7] ITTOIA 2005 s.626

v Scrutton[8] where dividends paid to wives on preference shares which were substantially a right to income were taxable on their husbands with *Jones v Garnett*[9] where dividends were not taxable on the husband because the wife's shares carried the right to capital as well as income).

A loan by a sole shareholder to establish an FIC lacks an element of bounty and should not be a settlement for these purposes. The shareholder's position considered in the round remains the same[10]. Even if it were argued that an interest free loan to a company in which other family members are shareholders, when viewed in the round, resulted in some element of bounty, it is difficult to see how the lender has retained rights over the funds now invested by the company that give rise to the income.

Transactions in securities

The transaction in securities code[11] is engaged where a transaction or series of transactions is entered into, the main purpose or one of the main purposes of

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[8] [1996] STC 743
[9] *Jones v Garnett* [2007] UKHL 35
[10] *IRC v Levy* [1982] STC 442
[11] ITA 2007 ss.682 - 713

which is to obtain an income tax advantage; condition A (being the more relevant to FICs) or Condition B are met and in consequence of the transaction a tax advantage is obtained.

ITA 2007 s685(2) provides:

> *"Condition A is that, as a result of the transaction in securities or any one or more of the transactions in securities, a relevant person receives relevant consideration in connection with –*
>
> *(a) The distribution, transfer or realisation of assets of a close company,*
>
> *(b) The application of assets of a close company in discharge of liabilities, or*
>
> *(c) The direct or indirect transfer of assets of one close company to another close company,*
>
> *And the relevant person does not pay or bear income tax on the consideration."*

Whilst making a simple loan is not a transaction in securities, a subscription for shares undoubtedly is. Consequently, a loan connected to a subscription for shares **may** fall within the code but to satisfy

Condition A, a person must receive relevant consideration. The definition of relevant consideration includes assets otherwise available for distribution by way of dividend by the company[12] but are loan repayments made from the profits of the FIC really relevant consideration?

Finally, there must be an income tax advantage as a result of the arrangement. It can be argued that where a loan repayment is made by a company out of profits otherwise available for distribution to a shareholder, an income tax advantages arises as the receipt of those profits are not taxed. However, an income tax advantage alone is not sufficient; it must also be the main purpose of the arrangement. Whether or not this is the case will depend upon the facts of each case. The more extreme the facts, the more likely HMRC are to establish the necessary purpose. An FIC established with £100 of share capital and £10 million of debt, where the company receives dividends on its £10 million equity portfolio tax free and the shareholder extracts returns from the FIC as tax free repayment of debt is likely to provoke.

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[12] ITA 2007 s.685

The transaction in securities code will also need to be considered if a decision is taken to liquidate the FIC, particularly to extract profits at capital gains tax rates. The non-payment of dividends followed by the winding up of the FIC after a relatively short period of time is likely to be challenged. Restarting an FIC within two years of a distribution on winding up may also risk engaging the anti-phoenixism TAAR.[13]

Given the potential for the transactions in securities code to apply, taxpayers need to consider whether to seek the comfort of advance clearance. Whether or not to do so is a tactical decision and in light of HMRC's response to date any clearance application requires careful drafting.

Transfer pricing

A loan to an FIC that does not carry an arm's length rate of interest also risks engaging the transfer pricing code. Where the FIC and the lender are related parties, any transaction between the lender and the company must be conducted on arm's length terms. If a non-market or nil rate of interest is charged, the transfer pricing regime imputes a

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[13] ITTOIA 2005 s396B

deemed interest charge taxable on the lender at his highest rate of tax and a corresponding compensating adjustment in form of a deduction for imputed interest in the FIC's corporation tax return.

The transfer pricing rules do not apply where certain exemptions are met, the most relevant to FICs being the exemption for Small or Medium Sized-Enterprises (SMEs)[14]. An SME is defined in accordance with EU provisions set out in Annex to the Commission Recommendations 2003/361/EC of 6 May 2003 which provides:

Article 1

> *Enterprise*
>
> *An enterprise is considered to be any entity engaged in an economic activity, irrespective of its legal form. This includes, in particular, self-employed persons and family businesses engaged in craft or other activities, and partnerships or associations regularly engaged in an economic activity.*

[14] TIOPA 2010 s167

It is open to question whether every individual would meet this definition of an enterprise.

Where the transfer pricing code applies, the legislation and guidance require the terms of the loan to reflect those between an independent lender who would be prepared to lend to the company. This requires an assessment of borrowing capacity and credit worthiness. The conclusion may be that at arm's length a third party would not be prepared to lend to the company and an interest charge is not supportable or alternatively that the company can support a certain level of debt financing but not the full amount provided.

If the company is overly indebted, the excess interest is treated as non-deductible for corporation tax purposes and the excess interest above the arm's length amount as a dividend payment made to the shareholder.

Preference shares are outside the transfer pricing regime and, whilst less flexible than a loan, with careful drafting may offer a viable alternative to the use of debt in these circumstances.

Value shifting

Care needs to be exercised in adjusting the rights attaching to shares in an FIC, where the FIC is controlled by five or fewer participators.

Where an individual exercises his control of the company so that value passes out of shares owned by him or a person connected to him and into other shares in the company, the value shifting code will treat the transfer of value as a disposal for CGT purposes[15]. The value taxed is the increase that is transferred to the transferee, not the amount that passes from the transferor. In the case of changes to rights in a majority holding in favour of minority holdings, these may not be the same.

Similarly, an alteration in the rights attaching to shares or loan capital that reduces the value of a participator's interest in the FIC may give rise to a transfer of value by that participator for IHT purposes. Such a disposition is generally a lifetime chargeable transfer and gives rise to an immediate charge to IHT[16]. Care is therefore required to ensure

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[15] TCGA 1992 s.29
[16] IHTA 1984 s.98(3)

that these provisions are not unintentionally triggered by any reorganisation.

Anti-avoidance

The General Anti-Abuse Rule (GAAR) is unlikely to be engaged in relation to an FIC, which is after all simply a company taxed in accordance with normal rules. Even in the current environment, it is not abusive to set up a company. Many companies undertake an investment business. Gifts are regularly made to children.

However, the DOTAS rules do require careful consideration, particularly in more complex cases, where the rules applicable to the various different taxes may be engaged, including the relatively new extension of the DOTAS regime to IHT.

Conclusion

A properly structured FIC remains a robust tool for the tax efficient management and preservation of family wealth.

There already exists a complex inter-linking web of anti-avoidance provisions that can be applied to FICs that are not so structured.

FICs are more prone than most family companies to a blurring of the line between company and individual. Those that operate FICs as if they were a trust or a personal investment portfolio can easily come adrift within the corporate regime itself without venturing out into any of the territory explored above.

Where the purpose of an FIC has become confused over time, the FIC should be refocused to avoid successful challenge. The silver lining is the ability to modify these structures "to escape challenge" and ensure that they are fit for purpose once more. It is an opportunity that should therefore be seized.

FCTC Comments

One member of chambers is advising on a case where a mother holds all the shares in a property investment company not standing at a gain where new classes of shares are to be created -A,B,C and D- with a view to her giving the A,B and C shares to her 3 children and retaining the D shares which have only the voting rights and nothing else. The aim is to avoid creating a settlement for IHT purposes and doing an effective carve out so avoiding the

reservation of benefit provisions. Another member of chambers notes that where there is no need or desire to extract capital, this may essentially act as a savings vehicle allowing wealth to grow in a more favourable tax environment with IHT benefit.