FIELD COURT TAX CHAMBERS

FCTC DIGEST

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EDITORIAL

Imran S Afzal

Welcome to the third edition of the *FCTC Digest*.

The question of whether a company is, or is not, resident in the UK is one that many tax practitioners have to grapple with. Read **Patrick Soares'** article *Ensuring your company is not resident in the UK* for a summary of the relevant principles and a helpful checklist of steps to take.

Patrick Way QC, who appeared as counsel for the taxpayer in *Ardmore*, discusses the *Source of interest following the Ardmore case*. The article notes that the source of interest is found by applying a multifactorial test, and explains how that test is to be applied.

In *A curious (and incorrect) judgment* **Philip Baker QC** discusses the CJEU's decision in *Impresa Pizzarotti*. The key question in that case was whether the application of Romanian legislation, which gave effect to the Authorised OECD Approach by imputing a notional market rate of interest on an interest-free loan from branch to head-office, was compatible with the freedom of establishment. Read Philip's article for more details about the case – although you can guess his views about the outcome from the title of his article!

As the member of Chambers most regularly involved in litigation, I have prepared an article called *Winning in the First-tier Tribunal: the crucial role of the List of Documents* (**Imran S Afzal**). In my article I have given some tips in relation to the preparation of a List of Documents, and I hope to give other litigation tips in future articles!

The basic building block of the main residence exemption is that a property must be a *residence*. For an overview of cases in which different outcomes have been reached on this important question, read **Peter Vaines'** article *Main residence exemption: clarity or confusion?* Having read Peter's article you might agree with his conclusion that we *"urgently need some definitive guidance from the superior courts"*.

A critical question in relation to transactions in land is whether there is an investment or trade. **Katherine Bullock** discusses the case of *Hopscotch* in which there was an interesting role reversal – the taxpayer argued that it was carrying out a property development trade, since it was seeking relief from the ATED charge on this basis. Read Katherine's article *Hopscotch: trading or investing land – the rules of how to play* for details about what was decided.

Happy reading!

ENSURING YOUR COMPANY IS NOT RESIDENT IN THE UK

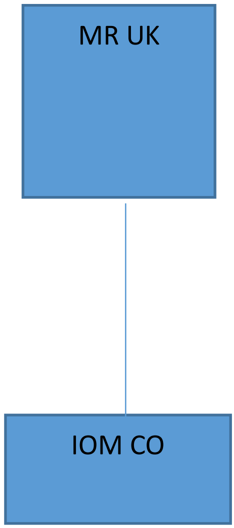
Patrick C Soares

It is often necessary to convince HMRC that a company is not resident in the UK. The fact that a company is owned by a UK resident does not make the company resident in the UK.

In some case the taxpayer may be happy HMRC determine a company is resident in the UK. For example, if a company is non-UK resident the income may be assessed on the transferor who set up the company at 45% under ITA 2007 s720. If the company is resident in the UK the income can only be assessed to corporation tax on the company at 19%. Note the loans to participator provisions only apply to UK resident companies and that may be a reason (among others) for ensuring a company is not resident in the UK (CTA 2010 s455).

There is set out below the principles to be taken into account in determining the residence of a company together with a checklist.

Ownership of a company's shares tells you little about the place of residence of a company



GENERAL RULE

The residence of a company for UK tax purposes, assuming it is not incorporated in the United Kingdom, is determined by the place where the central management and control of the company actually abides and that is the place "where the directors meet and where they transact their business and exercise the powers conferred upon them" (*De Beers Consolidated Mines Ltd v Howe (Surveyor of Taxes)* 5 TC 195).

If the directors are in the UK and Jersey and they hold a telephone board meeting that is a meeting partly in the UK and partly in Jersey (even though there is a governing majority in Jersey). The UK director must fly overseas to attend the board meeting. It is better to have no UK directors at all.

USURPATION

If a person, for example, the controlling shareholder usurps the functions of the board of directors so as to bypass the functions of the board of directors then the company will be resident where the usurper exercises its powers (*Unit Construction Ltd v Bullock (Inspector of Taxes)* 38 TC 712).

Except in a case where a shareholder usurps the functions of the board the company is not resident where the controlling shareholder resides and it is not resident in an offshore jurisdiction just because it happens to be incorporated in that jurisdiction.

ADVISERS NOT DICTATORS

If a person who is not a member of the board advises the board or influences the board or proposes matters to the board this has no bearing on the residence of the company unless that person dictates the decisions taken by the board (*Wood v Holden* (2006) STC 443 at 460 [27] and [41]).

Thus, if the board invariably takes the advice of professional advisers, for example, because their reasoning is sound or the advice of a parent company because the reasoning of the parent company is sound (*Untelrab Ltd v McGregor (Inspector of Taxes)* (1996) STC (SCD) 1) this has no bearing on the residence of the company.

On the other hand if the outsider determines matters and the board automatically complies with the same so that that person may be said to be a dictator for the purposes of these provisions the company may be resident where the dictator makes his decisions.

TYPICAL CHECKLIST

Typical checklist in this area would be as follows:-

(a) The name of the company and the provisions of its constitution can be relevant;

(b) Hold regular board meetings in the overseas country in question outside the UK;

(c) Properly minute the board meetings and preserve these;

(d) Give full consideration to any proposals put to the board: do not adopt them as a matter of course;

(e) Question requests as appropriate and obtain any further information that the directors feel is needed to enable them to reach a decision;

(f) It must be made clear that requests will not be agreed to by the board if the request is improper, unreasonable or contrary to the law of the country in which the company is registered;

(g) Keep all company documents and records outside the UK;

(h) Draft and execute any company documents outside the UK;

(i) Ensure that there is nothing in the company's constitution which conflicts with the above;

(j) Do not be dictated to by shareholders or others;

(k) Make it a term of the constitution that board meetings must be held in the relevant jurisdiction such as in Jersey in the case of a Jersey company owned by a UK resident who is also one of the directors of the company – he or she will need to fly overseas to attend board meetings;

(l) Keep the necessary document in anticipation of an HMRC enquiry;

(m) A company which invests in a portfolio which is left with a bank to manage under a discretionary contract is easier to establish as resident in a country other than where the assets are not held or where the shareholder resides than a company which buys and sells widgets let alone one which makes and sells widgets in a particular country.

SOURCE OF INTEREST FOLLOWING THE *ARDMORE* CASE

Patrick Way QC[1]

The main issue

This article considers the source of interest in circumstances where borrowings have been made, typically by a UK borrower from an overseas lender: is the borrower obliged to withhold income tax on the payments of interest to the creditor?

In brief, there will be an obligation to withhold tax in these circumstances if the provisions of Income Tax Act 2007 ("ITA 2007") s.874 are triggered.

The legislation

The relevant parts of s.874 are as follows:-

> "*Duty to deduct sums representing income tax*
>
> **874 Duty to deduct from certain payments of yearly interest**
>
> (1) This section applies if a payment of yearly interest arising in the United

[1] Patrick Way QC was Counsel for Ardmore in the Court of Appeal case.

Kingdom is made –

...

(d) by any person to another person whose usual place of abode is outside the United Kingdom.

(2) The person by or though whom the payment is made must, on making the payment, deduct from it a sum representing income tax on it at the basic rate in force for the tax year in which it is made.

(3) But see

(a) sections 875 to 888 as to circumstances in which a duty to deduct a sum under this section is disapplied."

Pausing there

In a nutshell the question is: what is the source of the interest? Or, more particularly, does the interest arise in the United Kingdom?

Multifactorial test

The source of the interest is found by applying a multifactorial test. This is important. It is not a simplistic matter (certainly not initially) of asking what the origin of *the money* is. If it were as simple as that one would just look to see where the bank account was located from which the interest was paid.

Nevertheless we can see from the *Ardmore* case ([2018] EWCA Civ 1438) that when applying the multifactorial test the fact that the borrower had funded the interest from its UK business was relevant in determining what the source of that interest was. The Court of Appeal in *Ardmore* held that principally the money to pay the interest had emanated from a UK business and therefore that, to a large extent, governed the source of the interest: also in the UK.

The test, however, as stated, looks to a variety of factors and this is based on the well-known case of *Westminster Bank Executor and Trustee Co (Channel Islands) Limited v. National Bank of Greece* ([1971] AC 945, (the "*Greek Bank case*") especially within the speech of Lord Hailsham at 956-957E).

Aim of this article

This article considers therefore how the multifactorial test is applied.

This is of particular relevance where UK landlords borrow money from overseas lenders to fund the purchase of UK properties to be let or where property is acquired in the UK to be developed and sold using overseas funding: is the interest subject to withholding tax? Is the source, more particularly, in the United Kingdom?

Is it short interest?

Before we start, however practitioners need to consider whether the interest is *short* (payable for less than a year). If it is short then the concerns under review do not apply: the interest is not *yearly*.

The law in more detail

Having identified ITA 2007 s.874 as the key section we should also look at the principle of territoriality.

This is key and in this respect the relevant section to consider is Income Tax (Trading and Other Income) Act 2005 ("ITTOIA 2005") s.386(2) which reads as follows:-

> "(2) Income arising to a non-UK resident is chargeable to tax under this Part only if it is from a source in the

United Kingdom"

The statutory provision above emanates from the well-known words of Lord Herschell in the case of *Colquhoun v. Brooks* ((1889) 14 App Cas 493). He said the following, at page 504:-

> "The Income Tax Acts, however, themselves impose a territorial limit, either that from which the taxable income is derived must be situate in the United Kingdom or the person whose income is to be taxed must be resident there."

So, why should a foreign lender suffer UK tax in the first place?: answer, only if the interest has a UK source.

The Greek Bank case

The key to understanding the situation in general and the *Greek Bank case* in particular is to consider the speech of Lord Hailsham. The relevant wording of this speech is set out now, in full, because it is so important:-

> "I have come to the conclusion that the source of the obligation in question was situated outside the United Kingdom. This

obligation was undertaken by a principal debtor which was a foreign corporation. That obligation was guaranteed by another foreign corporation which, as was conceded before us, had at no time any place of business within the United Kingdom. It was secured by lands and public revenues in Greece. Payment by the principal debtor of principal or interest to residents outside Greece was to be made in sterling and either at the offices of Hambros Bank or Erlangers Ltd. or (at the option of the holder) at the National Bank of Greece in Athens, Greece, by cheque on London. Whichever method of payment was selected, it was pointed out before us that, whatever use were made of the option, discharge of the principal debtor's obligation would have involved in the ordinary course either a remittance from Greece to the paying agents specified in the bond or, at the option of the holder, a cheque issued within Greece though drawn on London, and presumably payable there out of funds remitted by the debtors from abroad. It was also pointed out that the bond contained no provision for payment by the guarantor at any particular place or in any particular country.

The only circumstances relied on by the Appellants as supporting their contention that the obligation was located inside the United Kingdom were as follows. Although the original guarantor had no branch in the United Kingdom, the present Appellants had acquired one on their universal succession in London. Moreover, it was urged that, since discharge of the obligations under the bond in Greece had been caught by the moratorium enacted by the Greek Government, it followed that the only place at which the obligation could have been discharged or enforced was in London. Speaking for myself, I do not see how an obligation originally situated in Greece for the purposes of British income tax could change its location either by reason of the fact that one guarantor had

> been substituted for another, or by reason of the fact that the second guarantor so substituted subsequently acquired a London place of business, or by reason of the fact that the Government of Greece had by retrospective legislation altered by moratorium and substitution of a new guarantor for the purposes of Greek law the obligations imposed upon the principal debtor and the guarantor. The Appellants acquired no obligation different from that of the original guarantors, and that was the obligation imposed on the original guarantors by the terms of the bonds. In my view, the bond itself is a foreign document, and the obligations to pay principal and interest to which the bond gives rise were obligations whose source is to be found in this document. [1971] AC 954H-955"

It has to be said, respectfully, however, that it is not the simplest wording to understand and indeed it seems that towards the end of the speech that there is some confusion as there are references to the bond rather than interest, for example. It is the source of the interest which is at stake; not the location of the debt.

Having said that, what is interesting is that Lord Hailsham refers to "the bond itself is a foreign document". I raised in the Upper Tribunal in *Ardmore* the fact that in my submission the nationality of the relevant documentation was foreign and I referred to Lord Hailsham's wording in this respect. However, the Upper Tribunal held that this was not that helpful because in ascertaining the "nationality" of the document one would be applying a similar multifactorial test to that which had to be carried out anyway. Nevertheless, in my view, this wording of Lord Hailsham should have more relevance than it does: the nationality of the governing document, it seems to me, should be taken into account but that is not something with which the courts would agree.

Multifactorial test

Having ascertained that there is a multifactorial test one can say that the key factors to consider are as follows although I should sound a warning that not all of these are given equal weight by HMRC. These key areas are as follows:-

- debtor;
- creditor;
- proper law;
- exclusive jurisdiction clause;
- security;
- location of debtor's bank account;
- location of creditor's bank account;
- and now, following *Ardmore*, how is the interest actually funded.

Elephant in the room

There is also one other factor which should be borne in mind and this is what I call "the elephant in the room". By this I mean simply is the structure under review one that is a "plain vanilla" commercial transaction in which case, frankly, the multifactorial test will be applied "benignly"? Alternatively, has the whole structure been contrived to attempt to make what would otherwise be UK-source interest into foreign interest? The sort of example I have in mind here is whether the relevant documentation has been worded (and the relevant steps have been taken) in such a way as to make what is essentially a UK arrangement into an offshore arrangement. A typical example would be where an overseas exclusive jurisdiction clause is incorporated into the transaction even though it has no obvious connection with that transaction. Another such "giveaway" is where the debtor sets up an overseas bank account merely for the purpose of receiving and then paying on monies for the interest when in "normal" circumstances the payments would emanate directly from a UK bank account.

None of these "add ons" will have any bearing when one looks at the "elephant test": *is there are a contrivance*?

The Ardmore decision

The relevance of the *Ardmore* decision is principally that the *National Bank of Greece* case is difficult to apply because the speech of Lord Hailsham (respectfully again) is not the clearest.

We therefore can look to a large extent to the judgment given by Lady Arden (as she is now) in the *Ardmore* case. The paragraph numbers below are taken from her judgment.

Paragraph 37

Lady Arden confirms that the correct approach is to apply a multifactorial test but particularly to ask "whether a practical person would regard the source as in [the United Kingdom] [*bad news*] or elsewhere [*good news*]".

That, it seems to me, is the most important consideration and it is from here that I get the somewhat flippantly named "elephant test".

Paragraph 38

Lady Arden refers to the judgment of Lord Atkin in the Privy Council case of *Liquidator, Rhodesia Metals Limited (in liquidation) v. Commissioner of Taxes* ([1940] A.O 774; [1940] 3 All ER 422). And from this she concludes that the important stance is to have regard to "the underlying commercial reality". Lady Arden goes on to say that these words are appropriate to a case such as the one involving Ardmore where there was a commercial transaction. She also said, however, that in other types of transaction one would identify the source "from a practical or realistic point of view".

Pausing there, it is this "realistic point of view" that needs to be emphasised in *all* modern tax litigation, and not just merely litigation or disputes involving the source of interest.

The multifactorial test

Lady Arden refers to the multifactorial test and says that she would add that the correct approach is the practical approach and that it is not merely multifactorial but also acutely fact-sensitive. She says that the Court or Tribunal must examine all the available facts both singly and cumulatively.

Paragraph 42

The immediate search, says Lady Arden, is for the source of the interest rather than a search indirectly for the source of the loan.

In the *Ardmore* case the funds that were paid over as interest derived from funds generated in the UK.

The activity of lending (from overseas) became passive once the loan was made; whereas the business of *Ardmore* was actively conducted to produce those funds to pay the interest.

Further, on the basis that there was no default, it followed that the exclusive foreign jurisdiction and overseas governing law clauses (which had been inserted by the parties) would matter only if there was default. In the absence of any default Lady Arden's view was that these provisions could be ignored. As an aside, this seems to me to be an odd conclusion which does not seem to be shared by HMRC: these clauses are relevant but only if they are genuinely drafted in the first place.

Lady Arden also states that in relation to enforcement of any judgement (following a default) this would be principally by reference to UK assets.

In Lady Arden's view, in the *Ardmore* case, there was also an insubstantial nature of any connection with Gibraltar (which was where the exclusive jurisdiction lay) and this is why, in *Ardmore*, the particular circumstances could be distinguished from other cases such as the *Rhodesian Metals* case already referred to where there were genuine links to particular jurisdictions.

Paragraph 43

Lady Arden approves the approach of the Tribunals which had considered the *Ardmore* case before the Court of Appeal. Those tribunals had looked to substantive matters rather than theoretical matters such as causative link and governing law and had applied a practical approach.

Accordingly, Lady Arden found that the interest arose in the United Kingdom: that was the result (broadly) of applying a practical approach to the multifactorial test and not being "blinkered" by the use of provisions which (in her view) had no rationale on applying such a practical basis.

So where are we?

In many ways the *Ardmore* case throws us back to the position that has long since maintained, from before the *Ardmore* case. The approach, therefore, is to apply a multifactorial test but to do so on a practical basis applying, in my words, "a common sense" approach.

A brief history

It may be helpful now to set out a brief history of how HMRC (and the Inland Revenue before them) have sought to apply the *Greek Bank case* in the past and now to apply *Ardmore* itself.

In their Tax Bulletin 9 (November 1993) (well before *Ardmore* obviously) the Inland Revenue stated the correct test was multifactorial and particularly said as follows:-

> "Although the Greek Bank case was concerned with income which turned out not to have a UK source, inferences can be drawn from that case about the factors which would support the existence of a UK source and we regard the most important as
>
> - the residence of the debtor, i.e. the place in which the debt will be enforced
> - the source from which interest is paid
> - where the interest is paid, and
> - the nature and location of the security for the debt.
>
> If all of these are located in the UK then it is likely that the interest will have a UK source."

In the current version of the Savings and Income Manual (which has been updated following the *Ardmore* case) is found the following at paragraph 9090:-

Whether or not interest has a UK source depends on all the facts and on exactly how the transactions are carried out. HMRC consider the most important of factors in deciding whether or not interest has a UK source to be

- the residence of the debtor and the location of his/her assets. This will influence where the creditor will seek to enforce any judgement following default;
- the place of performance of the contract and the method of payment. Here we are looking at the substantive (not immediate) origin of the funds out of which the interest was paid;
- the competent jurisdiction for legal action and the proper law of contract;
- the residence of the guarantor and the location of the security for the debt.

This list of factors is derived from the leading case on the source of interest, Westminster Bank Executor and Trustee

> Company (Channel Islands) Ltd v National Bank of Greece SA (46 TC 472) and this approach was reinforced by the Court of Appeal in Ardmore Construction Ltd v Revenue and Customs Commissioners (2018) EWCA 1438. These cases have confirmed that in applying this multifactorial, fact-sensitive test where different factors give different answers, the question of source should be looked at from a practical, or realistic point of view.
>
> Additional factors need to be considered for companies. See SAIM9095.

The above is interesting because although it highlights the relevance of the debtor, it no longer states specifically that the debtor's residence is the most important factor. This is a useful approach and a change in practice which, to some extent, reflects the *Ardmore* decision where the multifactorial test was applied across the board coupled with what you might call a more realistic approach to matters: as mentioned – *have steps been contrived*?

The relevance of the creditor

One of the oddnesses about the multifactorial test as it is applied is that not enough weight (in my opinion) is given to the place where credit is provided. In other Commonwealth jurisdictions the place where the lender resides is of significant importance.

Commissioner of Inland Revenue v. NV Philips Gloeilampenfabrieken [1955] NZLR 868 (NZ CA)

In that case Gresson J said, at 884:-

> “That was the view taken by Watermeyer, CJ in the South African case of IRC v Lever Brothers that “source” does not mean the quarter whence the moneys come, but the originating cause of the payment being made – the quid pro quo which the recipient of the money gave to entitle him to receive payments from time to time; that in the case of a loan, the lender provides money for the borrower, who, in return, pays interest until such time as he makes repayment.” [page 883]

A practical approach

So, having given the background to all of this, the real question is: *how do you ascertain the source of* *the interest*?

The starting point is to ask yourself whether, in essence, the monies in question have been borrowed on a normal commercial basis in circumstances where, as mentioned previously, there is no contrivance in relation to the documentation or the steps by which it is intended "artificially" to shift the source of the interest abroad.

Based on what Lady Arden has said, one has to apply a practical test rather than one based purely on legal concepts and rules.

Having ascertained, let us assume, that the transaction is one that has not been amended to "push" the interest artificially abroad, then the multifactorial test can be applied relatively benignly. Then, the next step is to look at the relevant tests.

These can be said to be as follows:-

> the most important aspect is probably to look at the situation overall with a practical eye and ask oneself how the moneys to fund the payment of the interest have come into being. The difficulty therefore is in a great many circumstances this would be from UK-source rent and that is why a

common sense test, nevertheless, needs to be applied in the first place: just because UK rent is involved it does not automatically mean that the source of the interest is in the United Kingdom. There are other factors to take into account and in particular, in my view, a common sense approach needs to be adopted. Although each case will be fact-sensitive my view is that if, on a practical basis, the monies have been borrowed genuinely from abroad by reference to a foreign document (and other foreign circumstances apply) then my view is that it should generally be satisfactory to say that the interest is also foreign-source;

the residence of the debtor – this still remains important but the reason for this is based, in my view, on a misunderstanding. The relevance of the debtor's residence, in past tax cases, has arisen because that is where an action for recovery of non-paid interest would start. If, however, there is a genuine exclusive foreign jurisdiction provision then the relevance of the debtor, by and large, disappears. In any event, HMRC seem to have moved away from their "fixation" with the residence of the debtor;

the next consideration, in my view, is to look at the residence of the creditor – this requires a common sense argument based on the Commonwealth cases which are referred to in the Court of Appeal judgment in *Ardmore*. It should be pointed out that HMRC will not readily agree with this approach (as to the importance of the creditor) even though I consider them to be wrong and I always emphasise the importance of the creditor's residence. It clearly is a very important factor to bear in mind;

the place of payment and the place of receipt – in the past the place where the payments were actually made and whether they came from UK or from foreign bank accounts was important: this is less so;

the proper law – that is less important now;

the exclusive jurisdiction – this should have more significance than it has and it would certainly be relevant provided, of course, that a non-UK jurisdiction has been chosen for genuine reasons;

security – this is an issue and therefore to the extent that there is overseas security that must help. But again one can see this is not, by any means, straightforward. In a modern situation, security may be over a number of assets some of which are in the UK and some of which are elsewhere. What happens if the security changes? (Probably, the residence of the interest, to some extent, changes and that is why security (unless there is a single secured asset) is not a particularly helpful factor.)

Conclusion

My approach is to focus on the commercial reality and to ask myself whether I consider that the reality is that we have an overseas arrangement or an onshore arrangement. I appreciate that is not quite what the case law says but it is a very good starting point.

Having ascertained that, I then look to see whether there has been any contrivance to artificially shift the interest abroad.

I then settle down on the different factors and reluctantly I apply a little bit more weight to the debtor than I think is appropriate and a little bit less to the creditor than I think is appropriate. I also look to see how the monies are earnt to pay the interest appreciating that in the rental situation that will not necessarily produce a sensible outcome and in those circumstances I, to a large extent, rely on a commercial/practical approach.

Broadly, I ask myself whether the reality is that in my view the surrounding circumstances are foreign. If that is the case then in my view the interest is also foreign source and therefore no obligation to withhold tax arises.

A CURIOUS (AND INCORRECT) JUDGMENT

Philip Baker QC

It may seem strange, or even bizarre or perverse, to write a note on a judgment of the Court of Justice of the European Union ("CJEU") related to the Romanian tax of a branch of an Italian company and to include that in the Digest of a set of tax chambers in London. However, the author of this article thinks the case is important, of potentially wider significance, and – most important – wrong.

The case is Case C-558/19, Impresa Pizzarotti & C SPA Italia Sucursala Cluj v National Tax Administration Office – Directorate-General for the Administration of large-scale taxpayers, Romania, judgment of the Sixth Chamber of 8th October 2020. As speakers of Romanian will immediately recognise, this is concerned with the taxation of the branch in Cluj in northern Romania of the Italian company Impresa Pizzarotti. That company is a construction and civil engineering company with its headquarters in Parma in Italy; in the years in question (going back to 2012 and 2013) it operated in Romania through a branch in Cluj. During the course of a tax audit, the

Romanian Revenue noted that the branch in Cluj had made two loans, one of €11.4 million and the other of €2.3 million to its "parent company". By "parent company" it appears that this referred to two "loans" to its head office in Italy. The loans were interest-free. The Romanian Revenue authorities decided that parties at arm's length would not have lent the funds interest-free, and determined a notional amount of interest to be added to the profits of the branch in Cluj, resulting in a tax charge of €72,400. [1]

The legal basis under Romanian tax law for this adjustment and addition to the taxable income of the branch was Articles 11(2) and 29(3) of the Romanian Tax Code. The latter of these provisions states that "The taxable profit of a permanent establishment shall be calculated by treating that establishment <u>as a separate person and in accordance with the rules on transfer pricing</u> used to determine the market price of a transfer between a foreign legal person and its permanent establishment" (emphasis added). Article 11(2) contains a simple transfer pricing

[1] Paragraph 10 of the judgment refers to an "additional taxable amount" of approximately €452,595 and a "tax increase" of approximately €72,400. Presumably the first of these is the additional income and the second is the actual tax imposed on that, though the details are not precisely clear.

provision under which the tax authorities may adjust the income or expenditure of a taxable person to reflect the market price of the goods or services supplied. On the basis of these two provisions combined, the Romanian Revenue authorities treated the branch as a separate person, and determined that such a separate person would have charged a market rate of interest on the loan, and the additional income attributed was that deemed interest.

Aficianados of these issues will immediately recognise that Romanian law appears to have adopted the Authorised OECD Approach or "AOA" under which a permanent establishment is treated as a functionally separate enterprise and transfer pricing rules are applied by analogy to the dealings between that functionally separate enterprise and its headquarters. Under the old, pre-2010 approach to attribution of profits to a permanent establishment, the OECD commentary was absolutely clear that there was no warrant for attributing deemed interest between a permanent establishment and its head office, except in the case of financial institutions (and one assumes that the branch of a civil engineering company was not characterised as such).[2]

Between 1998 and 2010 the OECD carried out a lengthy project on the attribution of profits to permanent establishments. This project resulted in the development of the AOA, which is fundamentally different to the approach previously adopted. Under the AOA, the permanent establishment is hypothesised (i.e. an artificial construction is created) as a functionally separate enterprise, and all dealings between that enterprise and the other parts of the company, including its head office, are then identified. If the terms of those dealings do not reflect the arm's length principle, then the OECD Transfer Pricing Guidelines are applied by analogy. Thus, for example, if the first stage of the analysis for the AOA identifies a permanent establishment as having economic ownership of intellectual property, and that intellectual property is made available to the

[2] Thus, for example, paragraph 41 of the 2008 Commentary on Article 7 of the OECD model states: "except for financial enterprises such as banks, it is generally agreed that such internal 'interest' need not be recognised." That was said in connection with a deduction for deemed interest, but the same would have been true with regard to the deeming of an interest charge where none was actually made.

head office, then a dealing should be recognised in the form of a licence from the permanent establishment at the head office. In respect of that dealing, a notional “royalty” should be charged by the permanent establishment to the head office, which would constitute taxable income for the permanent establishment, and a deductible expense for the head office. In this case before the CJEU, the issue was not a deemed “royalty” for the use of intellectual property, but rather deemed “interest” for the use of a loan.

As many people will know, the AOA project of the OECD has been very largely a failure. It has not attracted widespread support around the world. The number of countries that have adopted legislation to give effect to the AOA is probably less than a dozen. Bizarrely, and for reasons that no one appears ever to have enunciated fully or debated, the UK seems particularly wedded to the AOA. A few years ago, Germany adopted complex legislation which gives effect to the AOA. A much larger group of countries have rejected the AOA: in particular, the UN Committee of Experts, which focuses on the tax interests of developing countries, has rejected the AOA.

There are several reasons why the AOA has been rejected. It is extraordinarily complex, with many unclear issues, and often produces no more reliable a result than under the much simpler, older, pre-AOA approaches to attribution. To fully support the AOA, a country really needs to renegotiate all its tax treaties to contain the wording in the 2010 OECD Model. It results in a shift of income between the country of the head office and the country of the permanent establishment, often to the disadvantage of developing countries.

To take a simple example of that: assume a situation where intellectual property is economically owned by the head office and made available to a permanent establishment without any royalty being charged. The application of the AOA requires the recognition of a notional, arm's length royalty, which is deductible against the profits of the permanent establishment and should be recognised as income in the hands of the head office. If this was an actual royalty paid, for example, by a subsidiary in the country where the permanent establishment is located, then one would expect that the royalty would be deductible in that country, but there would be an amount of withholding tax imposed on the royalty which would ensure that this was not a straightforward base erosion for the country where the subsidiary is located. However, in the case of deemed royalties under the AOA, because this is a deemed payment and not an actual payment, no withholding tax is applicable. Thus the country where a permanent establishment is located sees a deduction which erodes its tax base, but cannot impose a withholding tax: it is not really surprising, in those circumstances, that developing countries have rejected the AOA.

Curiously, it seems that in 2003 when it adopted its Tax Code, Romania decided to adopt the AOA. One intends to make no aspersions about the quality of tax policy advice in Romania, but one does wonder whether the Romanian legislators knew exactly what they were doing.

The list of disadvantages of the AOA continues. One consequence of adoption of the AOA is that a company can be required for tax purposes to recognise a taxable profit, when no actual profit has been realised. Thus, for example, if a company has a manufacturing facility in Paris, but a sales office in Milan, under the AOA the transfer of stocking trade from Paris to Milan would have to be treated as a sale at arm's length, and the Paris part of the company required to recognise a profit, taxable in France, even if the inventory was not sold by the Italian branch by the end of the year (and, in principle, even if the Italian branch never sold the inventory). This gives an indication of one of the problems with the AOA which has been identified since it was first invented by the OECD, and that is its compatibility with European Union law.

Now one is coming closer to the issues in the Impresa Pizzarotti case. If products are manufactured in a factory in Paris, and then they are shipped to Marseilles for sale, there is no question of recognising a taxable profit for French law on the transfer internally within the country. By contrast, if the products are manufactured in Paris and shipped to Milan for sale, then a taxable profit is recognised on the transfer of the inventory. This is clearly a difference in treatment between the purely domestic situation and the cross-border situation in Europe and that reflects a potential restriction of the exercise of European freedoms.

Before getting into the details of the CJEU judgment, it is worth standing back a moment from the facts of Impresa Pizzarotti. It appears that funds were held by the branch in Cluj. There is no suggestion that the Cluj branch had borrowed the funds and then made them available interest-free to the head office: one may assume, therefore, that the funds that were made available were, in all probability, retained earnings of the branch in Cluj. As retained earnings, they would have been available to all parts of the company, whether in Italy or in Romania. Thus, for example, if the branch in Cluj had simply remitted the profits to the head office bank account in Parma, there would have been no loan and no notional interest.[3] Presumably for internal commercial reasons, the retained earnings were not actually remitted to the head office but were shown as an internal, interest-free "loan". In real tax terms, that should have been a tax nothing: no deduction in Italy for any notional "interest"; no income in Romania on the receipt of a notional "interest"; and no withholding tax. However, because of this artificial

3 It is not known whether there may be a branch repatriation tax in Romania, or, if there is, how compatible that is with European law.

approach of the AOA, the Romanian Revenue authorities attributed a notional interest receipt to the branch in Cluj.[4]

With this background it is appropriate now to turn to the judgment of the CJEU.

The taxpayer appealed against the additional tax charge in Romania, and argued that the national provisions which deemed it to receive income infringed Articles 49 (Freedom of Establishment) and 63 (Free Movement of Capital) of the Treaty on the Functioning of the European Union ("TFEU"). The Regional Court of Cluj was not certain what the answer to that question was and referred the following question to the CJEU:

> "Do Articles 49 and 63 [TFEU] preclude national legislation such as [Articles 11(2) and 29(3) of the Tax Code], which provides that a bank transfer of money from a company branch resident

[4] It is unknown whether the Italian Revenue would have made an adjustment and allow a deduction against Italian tax for the notional interest.

> in one Member State to the parent company resident in another Member State may be reclassified as a revenue-generating transaction, with the consequent obligation to apply the rules on transfer pricing, whereas, if the same transaction had been effected between a company branch and a parent company, both of which were resident in the same Member State, that transaction could not have been reclassified in the same way and the rules on transfer pricing would not have been applied?"

The CJEU concluded that it could answer this question without an Advocate General's Opinion, which is unfortunate: an AGO might have allowed the Court to identify further possible arguments, and the CJEU might, in that case, not have got the wrong answer.

One of the first questions that the CJEU asked itself was whether the applicable freedom was Article 49 or Article 63. It concluded that this case concerned the creation and ownership by a legal person situated in a Member State of a permanent establishment situated in another Member State, and that fell within the scope of Article 49. To the extent that the legislation in question had restrictive effects on the free movement of capital, "such effects would have to be seen as an unavoidable consequence of any restriction on freedom of establishment and they do not justify an examination of that regime in the light of Article 63 TFEU". This is in line with accepted jurisprudence, but it is still worthwhile asking briefly whether this was correct. Article 49 is concerned with freedom of establishment, that is the establishment and operation of a permanent establishment of a company of one Member State in another Member State. The making available of retained earnings by way of a "loan" to the head office had very little to do with freedom of establishment. It is much more closely related to a movement of capital – the making of a loan from Romania to Italy. In this particular case, it wouldn't have made any difference because Italy and Romania are both members of the European Union and the application of Article 49 and Article 63 would have been unlikely to result in a different conclusion. However, that is not the case if, for example, the branch had been located in the United Kingdom, no longer a member of the European Union. Article 49 does not apply to the establishment of a branch in the United Kingdom, but Article 63 does apply to a movement of capital to or from the UK. It is reasonable to speculate that, in the not too distant future, the CJEU may be asked to examine more carefully, and with perhaps greater rigor, the relationship in particular between the freedom of establishment and the free movement of capital.

All that being said, the CJEU concluded that it was the freedom of establishment in Article 49 that was applicable and it concluded that the Romanian branch of a non-resident company enjoyed less favourable treatment than that enjoyed by a branch of a resident company carrying out similar transactions with its parent company. Put simply, if a branch in Cluj had made funds available to its head office in Bucharest, no tax charge would have arisen: by contrast, because the permanent establishment was in one Member State and the head office in another, a tax charge arose. As explained above, this is exactly the consequence of the application of the AOA in the European Union context.

Again in very standard terms, the CJEU concluded that the imposition of this tax charge was liable to constitute a restriction on the freedom of establishment: the parent company in Italy might be deterred from acquiring, creating or maintaining a branch in Romania because of the tax burden imposed in a cross-border context on transactions entered into on non-arm's length terms. So, there was a potential restriction of the freedom of establishment. The next question, therefore, was whether a tax measure was permissible either because it relates to situations which are not objectively comparable, or if it could be justified by overriding reasons in the public interest recognised by EU law. The CJEU spent no time on objective comparability: the treatment of a branch in another Member State is clearly objectively comparable to the treatment of a branch in the same Member State.

So far as justification was concerned, the CJEU held that it was justifiable to have such a rule on the basis of the balanced allocation of the power to tax between Member States. This is not at all surprising: the effect of the rule was to maintain the balance of taxation between Italy and Romania. It is permissible for a country to adopt and maintain in force transfer pricing legislation to adjust transactions between associated entities in different countries so that the taxable profits reflect the amounts that would have arisen on an arm's length, market basis. That is well established with regard to separate but associated companies, and it is not particularly surprising that a justification of balanced allocation was also applied to dealings between a branch and a head office.

It is not enough, however, for a restrictive measure to be justified on the basis of one of the overriding reasons in the public interest that has been recognised as part of EU tax law. It is also necessary that the measure should be proportionate. This, however, with respect, is where the CJEU went wrong.

For a restrictive measure to be proportionate it is necessary that it is appropriate for ensuring the attainment of the objective in question (in this case the balance allocation of taxing rights) <u>and does not go beyond what is necessary to attain that objective</u>.

The CJEU considered proportionality by reference to its previous case law in relation to transfer pricing and artificial arrangements designed to grant a gratuitous benefit from one company to another.[5] On that basis, the CJEU held that the national legislation must provide for a consideration of objective and verifiable elements to determine whether a transaction represented an artificial arrangement, and whether the taxpayer is given an opportunity, without being subject to undue constraints, to provide evidence of any commercial justification for that transaction. Additionally, where the consideration of those elements leads to the conclusion that the transaction goes beyond what companies would have agreed under market conditions, the corrective measure should be confined to an adjustment to the market value level.

That test of proportionality was, with respect, wrong in two respects.

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[5] In particular, the <u>SGI</u> case, Case C-311/08, judgment of 21st January 2010.

First, there was no evidence here of this being in any way an artificial arrangement. A branch had made what are assumed to be retained earnings available to its head office, and it had made them available by way of a loan on interest-free terms. There is no suggestion that this would have given some tax advantage to the branch or the head office. It is inappropriate, therefore, to apply proportionality criteria that are essentially designed for anti-avoidance measures to an application of the AOA to deem the branch to have received income.

Second, and this is much more important: it is an essential element of the principle of proportionality that a restrictive measure must not be adopted if there is an equally effective measure which is <u>less restrictive of the enjoyment of the EU freedoms</u>. Put another way, was there an alternative way in which Romania could have taxed the profits of the branch without potentially restricting exercise of the freedom of establishment: that is, without imposing a tax charge on a cross-border situation when none would have arisen in a domestic situation? Asking that question cries out for the answer: yes. The pre-AOA situation was equally effective (it was in place for decades between countries and is still in place for the vast majority of countries in the world) and it would not have had this restrictive effect. As explained above, in the pre-AOA situation, no interest would have been deemed to arise (except in the case of financial institutions). Countries have lived with that for years, and it is only the introduction of the AOA approach that gives rise to this restriction.

This argumentation was never presented to the CJEU. Apparently, all of the governments that intervened did so to support the Romanian Government, as did the Commission, and an argument based upon proportionality and the AOA does not appear to have been made before the CJEU. The case was crying out for that argument, and it was not made. If it had been made, then there are good reasons to assume that the CJEU would have decided the matter differently. Quite simply, the case is decided *per incuriam*.

No doubt this case will be regarded as the case that concluded that the AOA was compatible with EU law. It is quite wrong to draw that conclusion. The most significant issue in this case – the proper approach to proportionality – was missed.

Perhaps by way of conclusion, one should say a little bit more about the alternative to the AOA. Sadly, because the OECD is still deluding itself that over time countries will begin to adopt the AOA, little work is being carried out on the alternative. However, there was always an alternative. The AOA may be regarded as the "separate entity approach": treating the branch as a functionally separate enterprise, and applying the Transfer Pricing Guidelines by analogy. However, a number of countries in the past have applied the "single entity approach". Under that approach, the company as a whole, including all its permanent establishments, is treated as a single entity, entering into transactions with other companies and deriving profits from those transactions. No profits are regarded as arising unless there has been a sale to an outside party (which, incidentally, is consistent with the ability to pay principle). Various approaches may be adopted to attribute the profits of this single entity to its different parts. This may include, for example, internally maintained management accounts, if those are reliable and have not been manipulated. Alternatively, some form of profit level indicator can be used to determine the profits of a particular part of the enterprise. For example, if all parts of the enterprise are engaged in similar activities, then it might be possible to obtain figures for the capital employed at the head office and the capital employed at the branch and use that as a formula for allocating profit between the different parts. Other allocation keys might be the wages bill of the different parts, or the costs incurred more broadly by the different parts. These are much simpler ways of attributing profits. Most importantly, they do not result in the imposition of a tax charge on a mere notional dealing between one part of the enterprise and another.

All of these are issues that should have been ventilated in the Impresa Pizzarotti, and that might have happened if there had been an Advocate General's Opinion. In the absence of that, it is important to recognise that this case is a defective judgment, and should not be regarded as the final word on the consistency of the AOA with European Union law.

WINNING IN THE FIRST-TIER TRIBUNAL: THE CRUCIAL ROLE OF THE LIST OF DOCUMENTS

Imran S Afzal

One of the early steps in litigation before the First-tier Tribunal ("FTT") is that an appellant (and indeed HMRC) must serve a list of documents ("LOD") on which it is intended to rely in the proceedings.[1]

In terms of timing the general position (although this might be changed) is that HMRC must serve its Statement of Case ("SOC") within 60 days[2] after the FTT sends it the Notice of Appeal, and the LOD must be served within 42 days after the date HMRC send the SOC.

It can be seen that the time period between an appellant filing a Notice of Appeal with the FTT, and the usual deadline for serving an LOD, is not long. Put another way, there will generally be a fairly

[1] See Rule 27 of the First-tier Tribunal (Tax Chamber) Rules.
[2] This applies in relation to a Standard or Complex case other than an MP expenses case. The time limits are different in other categories of case. See Rule 25 of the First-tier Tribunal (Tax Chamber) Rules.

lengthy period between the LOD being served and the ultimate hearing before the FTT.

Because of the foregoing timing there is a danger that the appellant will not be in full “litigation mode” at the time the LOD has to be served. Notwithstanding this, however, it is important that the LOD is given full attention and that it is compiled with care. The LOD is a critical document because, broadly speaking, it will set out the entirety of the documentary evidence on which the appellant can rely in seeking to win the appeal.

There is some scope for further documentary evidence to be adduced subsequently but it is limited. In particular, documents are sometimes exhibited to witness statements, but as a general matter (a view will need to be taken in each case) I consider it preferable to serve documents on the LOD rather than exhibiting them to witness statements. The reason is that typically the time period between serving the LOD and filing witness statements is not long (i.e. there may not be much to gain by holding the documents back), but on the other hand it avoids scope for dispute as to whether the documents should have been served earlier.

Of course if a document only comes to light after the LOD has been served, then one might try to exhibit it to a witness statement, or seek permission to disclose the document late. But as a general proposition it is preferable to include all relevant documents on the LOD.

Given the importance of the LOD, and bearing in mind that it has to be served fairly early in the litigation process, I have the following tips.

The first tip is that the arguments to be presented in the case should be carefully considered some time in advance of the LOD being prepared. The skeleton argument, in which the detailed arguments are set out, will not be prepared until approximately one month before the hearing. However, it is important to know the nature of the arguments before the LOD is prepared (even if the arguments are subsequently refined), because the arguments to be advanced will have a direct impact on the documents to be included on the LOD: if the appellant is going to argue X, then documentary evidence which helps prove X should be included in the LOD.

The second tip is to set aside sufficient time for the preparation of the LOD. The precise amount of time needed will vary from case to case depending on factors such as the number and nature of the issues. As a general rule the earlier one can start the better, e.g. it might be that the process is commenced even before the Notice of Appeal is filed with the FTT. The process can take a fair amount of time because there are a number of steps involved in the process, such as the following:

- Thinking about the arguments that will be presented in the case, and considering what documents might be used to support the arguments.

- Carrying out a search to identify such documents.

- Reviewing the documents found and determining whether to include them on the LOD.

- Sometimes the documents found can lead to thoughts as to further documents which one might want to include on the LOD, and in turn such documents will need to be located, reviewed etc.

Overall, the key point is to not underestimate the importance of the LOD. As with many things in life, if one has the proper tools at one's disposal, it makes the completion of a task much easier. In the present context, if an appellant can fight an appeal armed with as much helpful evidence as possible, then that should, all else being equal, improve the prospects of success.

MAIN RESIDENCE EXEMPTION: CLARITY OR CONFUSION?

Peter Vaines

Everybody is familiar with the capital gains tax exemption for the only or main residence in section 222 TCGA 1992. There are lots of technical issues which arise with the exemption but I am concerned here with the basic building block for the exemption: that the property must be a *residence*.

Although that sounds straightforward, all sorts of difficulties seem to arise.

The starting point in all the authorities on this matter is always the judgment of Lord Widgery in *Fox v Stirk [1970] 3 All ER 7* who said that "a residence" means

- The place where a man is based or continues to live;
- Where he sleeps, shelters and has his home;
- Something other than temporary accommodation;

- There is some expectation of continuity with a degree of permanence.

This has been considered by the Courts many times.

Decisions of the Courts and Tribunals are published so as to assist the citizen in understanding the law on a particular subject. Decisions may differ having regard to the particular facts of the case – but the legal principles ought to be clear.

When it comes to the decisions on the exemption for the main residence, clarity seems to be in short supply.

Let us start with the case of *Susan Bradley v HMRC TC2560*. Mrs Bradley lived in a house which she owned jointly with her husband. She also owned another small house which was normally let. She decided to leave the matrimonial home and moved into the small house when it became vacant in April 2008, making various improvements and generally making it her home. Although the property was on the market, the market was very poor and she expected to live permanently in the property. However, Mr and Mrs Bradley later became reconciled and she moved back to the matrimonial home in November 2008. She sold the small house in January 2009.

So during the period April 2008 to November 2008 she lived in the small house and she might have felt confident that the property would qualify, not only as her residence, but as her main residence.

The Tribunal decided that the property was not Susan Bradley's residence at all. They said that she never intended to live permanently in the property; it was only ever going to be a temporary home and it was therefore never her residence.

The Tribunal was heavily influenced by the Court of Appeal judgment in *Goodwin v Curtis [1998] STC 475* where it was held that the occupation of the property must show some degree of permanence and some expectation of continuity – which were two of Lord Widgery's tests in *Fox v Stirk*. However, in *Goodwin v Curtis* the taxpayer had separated from his wife and family, stayed in the property as temporary accommodation – and after only two days he completed the purchase of another property which he intended to be his private residence.

It was a bit of a stretch to suggest that Mr Goodwin occupied the property as his residence; it was obviously the most temporary of accommodation. This is a long way from the situation of Mrs Bradley who moved into a perfectly suitable home, took steps to make it more of a home and lived there from April to November without any intention of moving out unless the house were to be sold which was unexpected.

Mrs Bradley may have thought herself a bit unlucky with the outcome of her case – but maybe she accepted that she was not really there long enough for it to be her residence. However she would have been seriously enraged by reading the case of *David Morgan v HMRC TC 2596* which was published only three weeks later.

Mr Morgan was getting married. He was in the process of purchasing a property which would be the matrimonial home. He was living with his fiancée's family but unfortunately two weeks before the purchase of the intended matrimonial home, the relationship ended. So he went to live with his parents. Nevertheless he carried on with the purchase of the property and moved in for two weeks specifically to prepare the house for renting and then moved back to live with his parents. The property was let and then sold. He claimed the exemption – to which many might have thought: You Cannot be Serious! However, the Tribunal decided that Mr Morgan had lived in the property for two weeks and this was enough to qualify it as a residence.

Then we have the case of ***Piers Moore v HMRC TC 2827***. Mr Moore also had matrimonial difficulties and moved into another property taking furniture with him from the matrimonial home. He took all his clothes knowing that he would never return. He lived there from November 2006 to July 2007 spending pretty much every night there except when he was away on business. The Tribunal found that he did not occupy the property with a sufficient degree of permanence for it to be a residence. It was only temporary accommodation.

Then we have the case of *Dutton Forshaw v HMRC TC 4644*. Mr Dutton Forshaw had owned and lived in loads of properties. In the end the issue was whether the property in which he had lived for seven weeks was a residence. In these circumstances, one might have thought that HMRC were on strong ground in claiming that this was not a residence at all but merely temporary accommodation. However, the Tribunal took the view that if this was not the taxpayer's residence for that period he would have had no property which was his residence and they thought that would be surprising. Accordingly they decided that there was sufficient permanence or continuity for his seven week period of occupation for it to be his residence and his main residence.

Susan Bradley would by now have disappeared into a slough of despond. There she would probably have found Piers Moore – and also Mr Yechil.

Mr Yechil had claimed the exemption too: *Yechil v HMRC TC 6829*. He bought a property in September 2007 with the intention it would be the family home for him and his fiancée. It needed significant work and while this was going on they lived in a one bedroom flat elsewhere. They got married but in January 2011 the marriage came to an end and in April 2011 he moved into the intended property. In October 2011 the property was advertised for rent and sale; in December he moved back to live with his parents and sold the property in August 2012.

There was no dispute that Mr Yechil lived there although the accommodation was rather unsatisfactory. It had a bedroom, a kitchen and a bathroom and he slept there every night between April 2011 and July 2011 although it is not clear what happened after July. He did not cook there (he did not cook at all it seems) and had meals at his parents' house or had a takeaway. He had meals at his property, sometimes standing up, sometimes in his car and sometimes in bed. He received post at the property but took his clothes to his parents for washing; (this rings a distant bell).

The Tribunal said that as well as occupation and an intention to occupy for a time with a reasonable degree of permanence, the quality of his occupation must be determined by what he actually did in the house. They considered that to have the quality of residence, the occupation of the house should not only involve sleeping, but also periods of cooking, eating meals sitting down and generally spending some periods of leisure there. It is not clear where the authority for these additional conditions comes from.

Clearly Mr Yechil's living arrangements were unsatisfactory compared with people in rather better circumstances, but the fact that he ate his takeaway meals in bed or standing up seems a rather bizarre criterion on which to base whether he was living in the property. The Tribunal members might have thought "you cannot live like that" but some people have to.

They eat their meals in bed or standing up because they cannot afford a table – or perhaps not one which is big enough for all the family.

With all the above in mind, I turn to the case in October of *Core v HMRC TC 7917*.

Mr and Mrs Core bought a property in Green Lane. They did not move into Green Lane immediately because they were doing building work. They moved into the property in March or April 2014 and they were soon approached by somebody who made an offer for the property. They rejected the offer– and did so again when the offer was repeated. However, about a month later, the purchaser made a higher offer which Mr and Mrs Core decided to accept. They had occupied the property for 6 weeks and the Tribunal found that this was enough to represent a residence, as they had moved into the property expecting to live there for an indefinite period.

I could go on. There are many other cases on this subject.

In any kind of litigation, there always opposing views, but the idea is a coherent body of authority is built up to assist our understanding of the meaning of complex legislation. Nowhere is this more important than in taxation where the State has a legislative right to deprive citizens of their money.

It is really unhelpful (and wasteful) for confusion to exist. If HMRC and the taxpayer both have a long list of authorities on their side because of the contradictory nature of Tribunal decisions, this merely promotes litigation. The taxpayer will clearly be encouraged to fight his case when he has loads of similar cases which directly support his claim – and you cannot blame HMRC for opposing him if they have loads of cases which directly support their position. And as can be seen, the outcome is utterly unpredictable.

We urgently need some definitive guidance from the superior courts here. As things stand one might question the value of publishing First Tier Tribunal cases – particularly as they do not have any precedential authority anyway.

HOPSCOTCH: TRADING OR INVESTING IN LAND – THE RULES OF HOW TO PLAY

Katherine Bullock

For the purposes of taxation generally and of land in particular, there is a fundamental distinction between land and buildings held as an investment and land and buildings held and developed in the course of a trade. The chief difference being that as a rule of thumb, and in the absence of anti-avoidance provisions, gains made on the former are taxed as capital gains, while profit made on the latter are taxed as income.

There are of course pros and cons to both for the taxpayer, and which is most beneficial ultimately comes down to individual circumstances. Nevertheless, the first step is to determine which will apply to any given property transaction and it is a dangerous step to leap over. Whilst this is a question of law, it is determined by the facts, which require detailed and forensic examination and make appeal difficult as has recently become apparent in the case of *Hopscotch v HMRC*[1].

Accordingly, how parties describe, record and account for transactions in land can be critical to their ultimate tax position. The label that they attach to their activities can be less helpful. In particular "development", which can apply to both investment and trading activities.

Is there a trade?

Trade is defined as "any venture in the nature of a trade" for both the purposes of income tax and corporation tax[2]. There is very little further statutory guidance. HMRC's Business Income Manual[3] pragmatically concludes that "trade cannot be precisely defined, but certain characteristics can be identified which are normally those of trade, and other characteristics can be found which preclude a profit from being that of a trade."

The Royal Commission on the Taxation of Profits and Income in 1955 identified six badges of trade and

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[1] [2020] UKUT 294 (TCC); [2019] UKFTT 288 (TC)
[2] Income Tax Act 2007 s.989; Corporation Tax Act 2010 s.1119
[3] HMRC BIM20051

these were expanded in *Marson v Morton & Others*[4] to nine. Whilst the court was clear that the list was neither exhaustive nor would apply in every case and although judicial approach has varied, these badges remain a useful and influential starting point. With regard to land transactions, there are two badges in particular that seem to merit significant weighting; intention and the level of activity undertaken.

However, there are also more evidential considerations that may also sway the balance. The value of a credible witness, alive and well with exceptional recollection by preference, cannot be understated. The structure of the transaction can also be influential. Care is needed here in land transactions where the ease of administering VAT for multiple parties may inadvertently create the appearance of trade or change of intention. Clear and contemporaneous minutes and records of a transaction can be a critical differentiator. Accountancy treatment – whether land is held as a capital item or trading stock and its movement between the two – can be very significant, although any label must reflect the underlying reality.

4 [1986] 59TC 381

The intended purpose of a given activity, specifically whether there is an intention to make a profit, is the key indication of trade. The crucial point at which to assess intention is normally the time of acquisition. Land acquired by way of gift or inheritance has been held not to be acquired with an intention to trade[5]. Any planned development on acquisition would clearly be relevant. However, the intention at point of purchase is not where this determination ends. It is possible, and in some cases even probable, that the intention will change during ownership. Take for example, the farmer owning farmland which with planning permission can be developed as housing stock. At what point and how much activity is required to evidence a change in intention that moves a long-term asset used for the purpose of a trade to an asset being developed in the course of trade? Improving an investment property in order to realise the maximum return on that investment is not carrying on a trade but at what point and how much activity is required to tip the scales?

Here the amount of work done to the land or building may be influential. As always, the position is more

[5] McClelland v TC of C & A [1971] 1 All ER 969; William v Davies 26 TC 371

nuanced, and a multitude of other factors may influence whether such activity is either commencement of a trade or realisation of the full value of an investment. *Hopscotch* suggests that it is not purely the quantity or extent of activity or change that is key. In addition, there is not a valid distinction between expenditure to expedite a sale (investment) and expenditure to increase sale proceeds (trade). The body of case law indicates that if the taxpayer has an extensive history of buying properties and selling them at a profit or is generally involved in property transactions (as an estate agent, surveyor, builder etc, adding a new dimension to the old adage "know your client") that will support the view that their intention is to trade the property. If the transaction takes a form which is widely recognised for property transactions or follows a well-defined and practiced process, that will suggest that the disposal is also a trading activity. It is interesting to consider the position of land held in trust. Does ownership by trustees of itself lend weight to the argument in favour of investment?

Hopscotch v HMRC

The facts in *Hopscotch* are reasonably straightforward and were not contended. Hopscotch

Limited (Hopscotch) was a BVI company that purchased a residential London property in 1993 for £1.25m for investment purposes. Over the next fourteen years, the property was occupied intermittently and had some minor developments made to it until, with its use declining and the property occupied solely by domestic staff, it was put up for sale in 2011 for an asking price of £13.5m. Unsold for two years, the Appellant changed estate agent. Their new agent suggested that the property be redeveloped to a "near new building" so as to make it more attractive to prospective buyers. They suggested the addition of space, functionality and technology, improvements to its lighting and the addition of an elevator. Board minutes following the meeting recorded that the property presented itself as a redevelopment opportunity which would result not only in sale but in additional profits from the development. The board was of the opinion that there was an opportunity to create substantial additional value through that process. The board minutes also recorded that the company had been provided with comparable data which showed that whilst the highest value today might be less than £13 million, redevelopment could make the property worth significantly more.

Hopscotch engaged architects, a conservation architect and structural engineers, taking a significant degree of professional advice. Planning permission was granted on 15 December 2015. Work began in April 2016 and ended in September 2017. In the end, the redevelopment cost approximately £1 million, £1.75 million less than the estimate for the construction work. Hopscotch borrowed to finance these costs. The property was listed for sale in October 2017 at an asking price of £15.9 million. As of the date of both the First Tier Tribunal (FTT) hearing and the Upper Tribunal hearing, it still had not been sold. It was noted that Hopscotch had never sought to register as liable to corporation tax or filed company tax returns.

In 2013 the Government introduced the ATED, charging an annual tax on any residential dwellings held by a company worth over £500,000. From 2013 to 2016, Hopscotch dutifully paid the ATED charge on the then value of the property without claiming any relief. However, in 2017 and 2018, the company claimed relief under Finance Act 2013 s.138 on the basis that it was carrying out a property development trade. HMRC disagreed. Hopscotch brought their appeal to the FTT and were unsuccessful. They appealed to the Upper Tribunal which reaffirmed the FTT's decision.

The First Tier Tribunal

The parties agreed that the work carried out on the property between April 2017 and September 2018 amounted to the development of the property. However, they disagreed as to whether that development amounted to a property development trade and whether the company held its interest in the property exclusively for the purposes of that trade. The company argued that the property which had been held as an investment on capital account should be regarded as having been appropriated to trading stock as a result of its decision to redevelop the property. Unfortunately, as Hopscotch was a BVI company, it was not required to and did not produce accounts.

HMRC submitted that before establishing a property development trade, the company had to establish whether it was trading at all, which it had failed to do. The company was doing no more than any other owner of an investment who wished to maximise the value of the investment before sale. There had always been an intention to realise a profit from the investment the only difference was that the company had decided to adopt a different means to realise that profit. The mere fact that the redevelopment work was substantial and that the company had taken professional advice did not mean that it had begun to carry on a trade.

Hopscotch argued the there was a distinction between carrying out work to make an asset more saleable and carrying out work to maximise value on a subsequent sale. An investor would be merely looking to ensure recovery of the cost of refurbishment work in the eventual sale proceeds. A trader would be looking to maximise its profits from the assets. Hopscotch argued that because it had carried out a comprehensive and carefully thought out plan to redevelop the property it had gone beyond merely realising the value of the property and had instead begun a scheme to make profit.

The FTT acknowledged that the badges of trade did not all point in one direction and some were simply irrelevant. The badges that pointed towards a trade included the fact that the company borrowed to carry out the redevelopment and the work was done on the property for the purposes of sale prior to being remarketed. The badges that pointed towards investment were the one off nature of the transaction, the transaction did not relate to a trade which the company already carried on, the property was capable of being held as an investment on capital account and the fact that the property remained essentially a single large dwelling with limited appeal.

It was possible to hold a property as an investment and to decide at a particular point in time to hold the same property for a trading purpose and at that point to appropriate the property from capital account to trading account. However, did that happen here? The transaction was not typical of a trade of property development. The FTT considered it striking that the minutes of the board meeting at which the trade was alleged to have started did not mention the expected costs, the amount of profit expected to arise or the relationship between the two, omissions which it felt were inconsistent with a company embarking on a new trade. There was no evidence of any trading accounts or business plan showing the level of profit to which the development activity was expected to give rise. The discrepancy between the estimate received for the costs of development and the actual costs was massive and yet there was no paperwork to evidence the reason for the difference or the impact of that underspend on the realisation of value and anticipated profit. The absence of this level of financial planning, which would have been indicative of a trade, pointed instead towards steps taken to maximise the value of the company's investment.

The Upper Tribunal

The Upper Tribunal finding in favour of HMRC drew the following principles from the authorities:

1. An asset can be held as trading stock or for non-trading purposes as an investment for capital appreciation, income generation or otherwise.
2. An asset is either held for trade or it is not; there is no intermediate status.
3. The fact that an asset is acquired for one purpose does not preclude the asset from being subsequently held for another purpose.
4. Steps taken to enhance the value of an asset are capable of being either steps taken for the

purposes of a trade or for the purposes of a non-trading activity.

5. In determining the question of whether an asset is held for the purposes of a trade, it is relevant to consider whether the asset is brought into use for the purposes of a pre-existing trade.
6. Where there is no pre-existing trade, there needs to be evidence that a trade has been newly set up that demonstrates more than the taking of steps simply to enhance the value of an asset. In particular, precision is required before finding that an asset has changed its status. As a matter of principle, if an intention has changed where the intention has such significant fiscal and other consequences, there must be evidence to bear out the change.

The final point is particularly useful in stressing the importance of persuasive evidence to show such a fundamental change of intention. Whether or not a trade exists before or after a change of intention depended on all of the relevant facts including a comparison of those before and after the change.

The Tribunal agreed that there was no need to consider the particular tests of a property development trade for the purposes of the ATED charge unless the activity was a trade in the first place; if it were not a trade, it inevitably could not be a trade of a particular kind.

In the Tribunal's view there was a common misapprehension that the tax legislation distinguishes between trading companies and investment companies. To reason that a company as a result of its corporate status must carry on a business and that because the business was not one of investment it must be a trading business was unsound. Simply because Hopscotch was not holding the property to generate an income return and was therefore not carrying on an investment business did not mean that the company must be carrying on a trade.

Conclusion

Whilst *Hopscotch* concerned relief from the ATED charge, it is a decision likely to have a far wider relevance in its analysis of the distinction between trade and investment where the development of land is undertaken and particularly where the intention of the landowner changes. The novel and unexpected role reversal in the usual argument between taxpayer and HMRC may assist taxpayers arguing for capital treatment after undertaking significant steps to enhance the value of land pre-sale. Who knows? Perhaps, we shall see HMRC hoisted on their own petard - (apparently) a small bomb like device.