FIELD COURT TAX CHAMBERS

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CONTENTS

Title	Page
Editorial Katherine Bullock	5
Deductibility Of Debts For IHT Purposes Patrick C Soares	7
Stale Or Simply Out Of Date? A Consideration Of HMRC's Discovery Procedures Patrick Way QC Dilpreet K Dhanoa	26
An Introduction To State Aid And Taxation, And To The New System Of Control Of Fiscal Subsidies Philip Baker QC	48
Notional Transactions – An Alarming Trend Peter Vaines	73

IHTA 1984 Section 39A And The Amazing Nil Rate Band 83

Katherine Bullock

Loan Transfers 97

David Southern QC

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EDITORIAL

Katherine Bullock

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

In the broad range of topics covered in this edition, the underlying theme that emerges is the principle that practical opportunities are secured through precise analysis and disclosure of facts and law.

Our first article is definitely one to pin above your desk. **Patrick Soares** provides 13 principles that solve a complex and perennial problem for private client practitioners in his article, *Deductibility of Debts for IHT purposes*.

With the Supreme Court judgement in *HMRC v Tooth* hot off the press, **Patrick Way QC** and **Dilpreet Dhanoa** consider together the principle of staleness, where this leaves us on discovery and the critical importance of those white space entries. See their article, *Stale or simply out of date? A consideration of HMRC's discovery powers*.

We have left the EU and with it State Aid. In his article, *An introduction to state aid and taxation and*

to the new system of control of fiscal subsidies, **Philip Baker QC** compares EU State Aid and the new UK replacement of fiscal subsidies, an area that will be core to many tax practices going forward.

In the article *Notional transactions: an alarming trend,* **Peter Vaines** considers the implications for the rule of law, when the actual transaction that a taxpayer undertakes is not the transaction on which he is taxed and argues that there are signs that the Government's card is marked.

I look at how a different approach to legacies of business property may create unexpected opportunities for family businesses to mitigate IHT. Can you 'create' a nil rate band of £3,250,000? See my article: *IHTA 1984 section 39A and the amazing nil rate band*, **Katherine Bullock.**

In his first article for the FCTC Digest, **David Southern QC** explains the wide ranging and surprising tax consequences of the transfer of syndicated loans. See the article: *Loan Transfers*.

Happy reading!

DEDUCTIBILITY OF DEBTS FOR IHT PURPOSES

Patrick C Soares

Practitioners are frequently asked whether a debt is deductible for IHT purposes.

The writer sets out below his checklist on the matter.

The recent changes in the law[1] determining the location of debts for IHT purposes do not affect the principles governing the deductibility of debts for IHT purposes.

PRINCIPLES ON DEDUCTIONS FOR IHT PURPOSES

Principle 1 Liability actually incurred

The debts and liabilities of a person are deductible for IHT purpose if that person is liable to discharge them (IHTA 1984 s5(3)) and there is no provision which disallows a deduction.

[1] IHTA 1984 Schedule A1

Thus unless there is a principle which disallows a deduction, the deduction will be allowed.

Principle 2 Full consideration given for the liability

Debt are not deductible however if they are not incurred for consideration in money or money's worth (IHTA 1984 s5(5)). So, if X enters into a deed stating he encumbers out of natural love and affection his land by mortgage by £5m in favour of his son no IHT deduction is created. If X on the other hand enters into a debt obligation to repay his son £5m, his son having lent X that sum full consideration will have been given for the obligation and Principle 2 will not be a problem.

Principle 3 The payment must not be reimbursed

If a liability is to be reimbursed or is reimbursed it is generally not deductible (s162(1)) as the borrower has not borne the liability.

Principle 4 Value the liability at the relevant time

If a liability is to be taken into account at say day 1 but it is to be discharged on day 300 it is to be valued (to determine the amount deductible) on day

1 (s162(2)). Thus if at the time of death £10m is payable in 5 years' time and it is worth £8m on the death only £8m is deductible.

HMRC state thus:

HTM28110 - Liabilities: investigating liabilities: future debts

If a liability is not due to be discharged until a future date it is taken into account at a discounted value rather than the amount eventually to be paid, IHTA84/S162 (2). So debts payable at a future date that do not carry interest (or with interest at less than the market rate) should be discounted. The rate of discount will vary according to market conditions.

<u>Principle 5 Take debt first against encumbered property</u>

If a particular property is encumbered by a debt (e.g. the property is mortgaged) the debt reduces the value of that property as a general rule (s162(4)).

<u>Principle 6 Debt to non-resident</u>

If the debt is owed to a non-resident and is

encumbered on UK property, the general rule is the debt will reduce the value of the UK property (s162(5)).

<u>Principle 7 Debts are not deductible if they finance the acquisition of tax relieved property</u>

IHT relief for debts may be restricted if the debts are incurred to finance "relievable property" (e.g. agricultural property or relevant business property) as specified in IHTA 1984 s162B.

<u>Principle 8 the relief is restricted if excluded property is purchased</u>

Relief for debts is restricted when UK properties are charged to fund the purchase of excluded property under IHTA 1984 s162A (e.g. non-UK located property is purchased by a non-UK domiciled individual and he charges his UK property to raise the borrowings).

<u>Principle 9 Debts must generally be paid off on or after death (with exceptions)</u>

There is a general rule (with exceptions) that debts are not deductible unless they are discharged on or

after death (s175A).

Principle 10 Debts created from one's own monies are not deductible

A debt will be disallowed if the borrowed monies comprise property derived from the deceased (FA 1986 s103).

Principle 11 Artificially created debts are not deductible

Artificial debts will not be deductible (*WT Ramsay v IRC* [1981] STC 174).

Principle 12 GAAR debts are not deductible

Debts may be disallowed under the GAAR (FA 2013 s206 et seq.).

Principle 13 Loans which are in reality outright advances

HMRC may not like the terms of a loan but if it is a loan properly so it will be deductible. If the lender had no power to make the loans (*Esdaile v CIR 20 TC 700*) or was not authorized to make the loans (*Jacobs v CIR 10 TC 1*) the position may be

different: such loans may amount to outright advances.

EXAMPLE OF THE 13 PRINCIPLES IN OPERATION

Mr D (UK resident but non-UK-domiciled under general principles) borrows £3m from F (a settlement of which he (D) was not the settlor) to buy a house in the UK and mortgages the same in favour of F. Applying the above rules on the death of D the loan is deductible from the value of the UK house for IHT purposes. D was the debtor (Principle 1) and the debt was incurred for full consideration (Principle 2): D received the £3m from F to pay the purchase price of the property. The monies were not reimbursed (Principle 3). The house has been charged and there was no financing of relievable property (Principles 5 and 6). The anti-avoidance provisions in s162A do not apply as the monies were borrowed to buy UK property (Principle 8). The debt must be discharged on or after death as a general rule (Principle 9) but that may not be a problem in practice. Also as F provided the monies out of its own funds (and not from those provided

by Mr D) Principle 10 is not a problem. Principles 11 and 12 will have no application and as the loan was a loan properly so called. Principle 13 is not relevant. Disallowing a loan is a major matter. If Mr X borrows £10m to buy a house for £10m his estate may be worth nil. If the loan is disallowed for IHT purposes it is worth £10m for IHT purposes but nil in reality and the tribunals and courts will want to ensure the tax analysis follows reality.

ADDITIONAL COMMENTS ON PRINCIPLES 12 AND 9

Comments on Principle 12 – When can a debt be disallowed under the GAAR?

The double reasonableness requirement of the GAAR will ensure the GAAR has limited application in this area (FA 2013 s207(2)). The GAAR counteracts tax advantages obtained from abusive tax avoidance transactions. FA 2013 s207(2) states:

> (2) Tax arrangements are "abusive" if they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the

relevant tax provisions, having regard to all the circumstances including —

(a) whether the substantive results of the arrangements are consistent with any principles on which those provisions are based (whether express or implied) and the policy objectives of those provisions,

(b) whether the means of achieving those results involves one or more contrived or abnormal steps, and

(c) whether the arrangements are intended to exploit any shortcomings in those provisions.

The 2 loan examples in the GAAR guidance[2] show how the GAAR will have little application in this area.

D28.2.1 gives the following example:

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[2] HM Revenue and Customs (HMRC) General anti-abuse rule (GAAR) guidance (Approved by the GAAR Advisory Panel effect from 11 September 2020)

D28.2.1 The trustees of an excluded property settlement buy a property in the UK and hold it directly. At the ten year anniversary, the UK property (in the absence of any other arrangements) will be subject to inheritance tax at a maximum of 6%. Shortly before the ten-year anniversary, the trustees borrow funds from a bank and secure the debt on the property. The cash is paid out to the settlor on the understanding that the money will be returned. Shortly after the ten-year anniversary, the settlor adds the funds back to the trust and the trustees use it to repay the loan, freeing the UK property from its charge.

The second area dealt with in the GAAR is where the borrower seeks to effectively borrow his own monies to obtain a deduction for IHT purposes.

The GAAR D31 reads thus:

D31 Lending to fund UK real estate by foreign domiciliary This example shows how standard tax planning may have increasing levels of abnormality attached to it. A number of the alternatives are, nonetheless, clearly on the

non-abusive side of the GAAR boundary. However, the example aims to show at approximately what point that boundary is crossed, although this will always be highly dependent on the facts. The example also aims to demonstrate a situation (option 7) where the arrangements might fail a single reasonableness test, but be saved by the double reasonableness test. D31.1 Background D31.1.1 Inheritance Tax is charged on the worldwide assets of someone who is domiciled in the UK, and on the UK assets of someone who is domiciled abroad. Similarly, property situated abroad and held in a trust that was set up by someone who was domiciled abroad is excluded from charge, whereas UK assets owned by such a trust are subject to Inheritance Tax. D31.1.2 Foreign domiciled individuals, and the trusts created by them, may therefore consider using borrowing when acquiring UK real estate, particularly where residential property will be occupied by the individual or their family. Borrowing is now more likely because the alternative strategy to

reduce Inheritance Tax by property ownership through a corporate structure may trigger Annual Tax on Enveloped Dwellings and potentially also Capital Gains Tax. D31.2 The arrangements D31.2.1 R is domiciled abroad and wishes to buy a valuable house in the UK for his occupation. He has a number of options: 1. R buys the house in his own name, using his own cash resources to fund the purchase. 2. R settles cash from his own resources into a trust that purchases the house. R is a beneficiary of the trust. The reasons for using a trust may be partially non-tax related and may include a desire for confidentiality, to avoid complex probate procedures, or to provide an automatic succession plan on R's death. 3. R, even if he could have funded the purchase from his existing resources, chooses to borrow from a bank to fund a large part, say 70%, of the purchase price. 4. R (as in 2, above) partially funds the trust. The trustees (as in 3, above) then borrow the remainder of the purchase price from a bank. OFFICIAL 5. R deposits

foreign investments with a bank thereby enabling the bank to lend a greater amount (say 95%) to fund the purchase of the property. The borrowing is again secured on the property. 6. R having funded a trust to the value of, say, 5%, of the purchase price of the house, agrees to guarantee the trustees' borrowing. This enables R's trust to borrow the remainder of the purchase price from a bank. The borrowing is again secured on the property. 7. R has an existing substantive discretionary trust which he settled many years ago. R is a beneficiary of the trust, but his adult children are also beneficiaries and they have all benefitted from the trust over the years. The trustees previously owned a UK house, but sold it a couple of years ago. The trustees have been looking around for a new UK property suitable for R and his children to use as each of them visit the UK for a few weeks a year. The trustees could afford to buy the new house using existing resources but instead they accept an offer from R to lend them the purchase price via an offshore

company that is wholly owned by R. The loan is interest free and repayable on demand. The company owned by R secures the loan on the house. 8. R settles cash from his overseas resources into a newly established trust which then lends it back to him through an underlying company for the purchase of the house in his own name. 9. R adds cash from his overseas resources to a trust, known as the Loan Trust, of which he is settlor and beneficiary. His spouse, or other relative, sets up another trust, known as the Property Trust, which is funded with, say, £1000 cash. R adds no funds to the Property Trust. The Loan Trust forms an overseas company into which the cash is transferred, and the company lends the cash to the Property Trustees who acquire the UK property that R wishes to occupy. The loan is repayable on demand and may be interest-free, interest-bearing or index-linked. The Property Trustees incur no personal liability as the lender may have recourse to the house only. D31.3 The relevant tax provisions • sections 48(3)(a) and 162(4) IHTA 1984 •

sections 102(3) and 103 and para 5(4) Sch.20 FA 1986 • para 11 Sch.15 FA 2004

Comments on Principle 9 - Debts must generally be paid off on or after death

IHTA 1984 s175A provides thus:

175A Discharge of liabilities after death

[(1) In determining the value of a person's estate immediately before death, a liability may be taken into account to the extent that—

(a) it is discharged on or after death, out of the estate or from excluded property owned by the person immediately before death, in money or money's worth, and

(b) it is not otherwise prevented, under any provision of this Act, from being taken into account.

(2) Where the whole or any part of a liability is not discharged in accordance with paragraph (a) of subsection (1), the liability or (as the case may be) the part may only be

taken into account for the purpose mentioned in that subsection to the extent that—

(a) there is a real commercial reason for the liability or the part not being discharged,

(b) securing a tax advantage is not the main purpose, or one of the main purposes, of leaving the liability or part undischarged, and

(c) the liability or the part is not otherwise prevented, under any provision of this Act, from being taken into account.

(3) For the purposes of subsection (2)(a) there is a real commercial reason for a liability, or part of a liability, not being discharged where it is shown that—

(a) the liability is to a person dealing at arm's length, or

(b) if the liability were to a person dealing at arm's length, that person

would not require the liability to be discharged.

....

This section has the effect of disallowing a deduction for a debt unless it is "redeemed after death."

Dymond's Capital Taxes provided thus at 25.333:

25.333

The Revenue Manual makes the following additional points:

1. If the personal representatives are aware that a liability is not going to be repaid they should not deduct it;

2. "There is no need to make any enquiries to establish that liabilities which are clearly commercial and arm's length have been repaid, as it is more than likely that the creditor will want to recover the money owed to them". The examples given include utility bills; credit card bills and outstanding tax. Of

course in the event that a liability is not repaid a corrective account will be required;

3. In the case of liabilities incurred to family members (and trusts or family companies) the Manual indicates that the Revenue will ask for evidence that the liability has been discharged out of the estate (e.g. a copy letter enclosing a cheque to the creditor or confirmation by him that he has been paid and a bank statement showing monies paid out of the estate). It goes on to say "where the PRs do not repay a liability during the normal administration of the estate ... you should disallow the deduction and ask for the tax to be paid". It appears that the Revenue intend to be proactive in monitoring the repayment of connected person debts. The legislation does not provide a time period within which a debt must be repaid but the Manual suggests that HMRC are looking to impose such a limit in cases where repayment has not occurred during the normal administration;

4. It appears that a liability which is not contractually due for repayment until a future date (and the death has not triggered an early repayment obligation) is not within s.175A. (my emphasis)

At 25.334 and 25.335 it is provided thus:

The "real commercial reason" let out

25.334

The disallowance does not apply (so that the liability will be taken into account in calculating the tax bill) if:

1. There is a real commercial reason for it not being repaid;

2. A main purpose of leaving the liability unpaid must not be to secure a tax advantage;

3. It must not be disallowed under any other provision in the legislation.

The Manual comments that "this may be the case where a business is being taken over by the beneficiaries and the bank is prepared to

allow any lending and overdraft facilities to continue". The Manual contains the following examples.

Example

David's estate includes a house valued at £800,000. There is a commercial mortgage of £200,000 from a family trust charged against the property. David leaves his house to his son, Roger. The trustees are content that the house can be transferred to Roger provided that Roger takes over the mortgage and continues to make the repayments. (my emphasis)

Clearly these provisions must be considered but note the 2 emphasised (underlined) ameliorating factors.

STALE OR SIMPLY OUT OF DATE?

A CONSIDERATION OF HMRC's DISCOVERY PROCEDURES

Patrick Way QC

Dilpreet K. Dhanoa

"You can have a God, you can have a king, but the man to fear is the tax collector."[1]

Complete Power to Discover?

One of the key issues in discovery cases is how soon HMRC must raise the discovery assessment after a discovery has been made by an HMRC Officer. One of the dictionary definitions of the word 'discover' is, *"to find something for the first time, or something that had not been known before."* It inherently implies an element of 'newness' – discovering something which was not known before. The critical question is: how long does HMRC have before the discovery becomes old or stale, and crucially, is there even a requirement for HMRC to act promptly at all?

[1] Proverb, Ancient Mesopotamia (3100 BC).

The discovery assessment legislation is a contentious area. Although the provisions are relatively brief, they are broadly drafted resulting in significant case law before the courts and tribunals over the years. This article will focus on discovery assessment legislation as it applies to individuals in the Taxes Management Act 1970 ('TMA'), section 29. For the sake of completeness, it is noted that the discovery rules for companies (as contained in the Finance Act 1998, Schedule 18, paras 41-45) are broadly similar.

This article also considers what factors should be borne in mind in respect of discovery assessments, whilst considering some of the recent case law that has discussed this concept further – in particular, the recent Supreme Court judgment in *HMRC v Tooth*[2], where their Lordships ruled that 'staleness' is unsustainable as a matter of ordinary language. In drawing a firm line under the debate that taxpayers have previously tried to argue, the Supreme Court held that there is no place for the idea that a qualifiable discovery should cease to do so by the passage of time. Their Lordships considered this an untenable proposition based on the ordinary

[2] *HMRC v Tooth* [2021] UKSC 17.

language and in conflict with the statutory framework which sets out a series of limitation periods within which assessment to tax should be made.

<u>What is required to make a 'discovery'?</u>

HMRC's power to make discovery assessments is a powerful one, which enables it to assess additional tax liabilities that may arise from tax return errors – provided certain conditions are satisfied. Section 29(1) of the TMA is engaged when an HMRC Officer (in respect of the taxpayer) 'discovers' that income or gains have not been assessed; or that a tax assessment has become insufficient; or, that excessive relief has been given. Certain requirements must be satisfied in order for such discovery assessments to be valid, and there are two alternative conditions:

i. The loss of tax was brought about carelessly or deliberately (*per* section 29(4), TMA).
ii. Alternatively, when HMRC's tax return enquiry window closed (or when the enquiry into the taxpayer's return was completed), the HMRC Officer could not

have been reasonably expected to be aware of the relevant loss of tax, based on the information provided and made available to them before that time (*per* section 29(5), TMA).

‘Careless’ or ‘Deliberate’? Are they really the same thing?

Previous iterations of section 29(4), TMA referred to fraudulent or negligent conduct. This has now shifted to ‘carelessness’ as being the test to be satisfied.

In the relatively recent case of *Bubb v HMRC*,[3] the taxpayer’s self-assessment returns for 2009/10 and 2010/11 contained several errors. They amounted to mistakenly omitting his state pension, understating his occupational pensions and employment earnings, and overstating tax deducted. HMRC issued discovery assessments for both tax years, and when appealing the taxpayer asserted that he had encountered various difficulties when compiling his tax returns.

[3] *Bubb v Revenue and Customs* [2016] UKFTT 216 (TC).

The First-tier Tribunal ('FTT') satisfied itself that the requirements under section 29(1) of the TMA were met in relation to both years. The Tribunal noted that:

> "HMRC clearly "discovered" that there was income that had not been assessed for both years in or shortly before April 2013. As made clear in a number of cases,… this is concerned with the inspector's subjective view and does not require any new facts to emerge. It is enough that the inspector satisfies himself or comes to a conclusion."[4]

The Tribunal made clear that in respect of the conditions to be satisfied (in this case section 29(4), TMA relating to carelessness), the burden of proof was on HMRC to establish carelessness. Noting the wording of section 29(4), the FTT stated that:

> "…HMRC must therefore demonstrate that the appellant's careless behaviour brought about the underassessment. If they can establish that then there is

[4] *Bubb v Revenue and Customs* [2016] UKFTT 216 (TC), para. 29.

> power under the closing words of s 29(1) to make an assessment in the amount or further amount which in the officer's opinion ought to be charged "to make good to the Crown the loss of tax"."[5]

The Tribunal also noted that whether a taxpayer is careless is a question of fact, which is to be determined having regard to all the circumstances.[6] It was this latter part that was critical to the outcome in *Bubb*. In the Tribunal's view, it came to the conclusion that HMRC had not established that the errors were in fact caused by any careless behaviour on the taxpayer's part (apart from the omission of the state pension income). Accordingly, HMRC was not permitted to raise assessments to recover a loss of tax that it had been unable to establish was attributable to the taxpayer's purported careless behaviour. The taxpayer's appeal against the discovery assessments were permitted, and it was held that they were not made validly under section 29, TMA.

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[5] *Bubb v Revenue and Customs* [2016] UKFTT 216 (TC), para. 33.

[6] *Bubb v Revenue and Customs* [2016] UKFTT 216 (TC)., para. 34.

It is therefore critical that taxpayers and their advisors always check carefully to ensure that valid discovery assessments have been made; and when in doubt, to seek further advice. Despite the broad ranging power that HMRC has under section 29, TMA, *Bubb* serves as a useful reminder that HMRC does not simply have a general power to raise discovery assessments under the provision, and there is a statutory mechanism to be carefully followed and adhered to.

The more recent case of *Tooth* again considered discovery, and the issues around the validity of HMRC raising a discovery assessment.

Facts in *Tooth*

Pursuant to section 9A of the TMA, HMRC is entitled to open an enquiry 12 months after a return is filed. Schedule 1A permits HMRC to open an enquiry into a claim which is not included within the taxpayer's return. HMRC subsequently opted for this route stating that it was looking into the loss relief being claimed. Following the Supreme Court's decision in Cotter in 2013, in which it was held that HMRC was correct to withhold repayment of tax pending an enquiry following a claim made for a carry back of

loss relief, HMRC issued an assessment to Mr Tooth pursuant to section 29, TMA for 2007/08. The reasons given were that Mr Tooth's return was inaccurate and the mistake was deliberate. In claiming deliberateness, HMRC was able to rely on section 36(1A), TMA which grants them the ability to raise a discovery assessment – but with a 20 year time limit.

The taxpayer appealed to the FTT arguing that HMRC had not made a 'discovery' and the assessment was out of time as there was no deliberate inaccuracy. The FTT agreed with Mr Tooth, and HMRC subsequently appealed to the Upper Tribunal ('UT'). Again, the UT held there was no inaccuracy and the appeal was dismissed – although the UT did consider HMRC's arguments on discovery. Once again, HMRC appealed to the Court of Appeal with the two main issues being: (i) whether there had been a discovery; and, (ii) if there had been, whether the taxpayer had deliberately brought about a situation where an assessment to tax was insufficient. In applying the 2012 decision of *Charlton & Others* to the first question, the Court held that for there to b e a discovery of insufficient tax (for section 29(1)(b), TMA purposes), it was not enough for HMRC to state

that it had found a new reason for contending an assessment insufficient. Accordingly, it held that HMRC had not established that there had been a discovery and the assessment was invalid. As regards to the second question concerning deliberate inaccuracy, HMRC tried to draw a distinction between an inaccuracy in a document and an inaccurate document and that the losses in the partnership pages of Mr Tooth's return amounted to an inaccuracy in his tax return.

Two of the three Court of Appeal judges (Males LJ and Patten LJ) concurred with this, stating that there was inaccuracy 'in' a document even though the inaccuracy was corrected elsewhere in Mr Tooth's return. Floyd LJ however dismissed this contention, stating that the individual parts of a document had to be read in the context of the document as a whole – thus concluding that there had been no inaccuracy in Mr Tooth's return. All of them agreed however, that if there was an inaccuracy it was deliberate and once that was established intention was irrelevant. However, owing to the taxpayer's success on the first point HMRC appealed to the Supreme Court, whilst Mr Tooth sought to restore the conclusion arrived at by the FTT and UT.

The Supreme Court's Judgment in *Tooth*

In a carefully considered judgment, the Supreme Court has recognised the tension between section 29(4) and section 118(7), as *"pull*[ing] *in different directions"* when read independently. In concurring with HMRC, the Supreme Court has taken the view that section 118(7) does open the way to discovery assessments with 20-year time limits by reason of conduct by the taxpayer – even in circumstances where such conduct may be hard to describe as fraudulent. In considering the meaning of 'deliberate inaccuracy', the Supreme Court held that firstly the natural meaning should be considered, and that there is a degree of intention attached to the statement. This in turn, is the *"gateway to the taxpayer's exposure to a 20-year period for the making of a discovery assessment"*. Without intention, even taxpayer's making honest but inaccurate statements (or being careless) would be caught by this gateway.

In rejecting the argument that persuaded the majority of the Court of Appeal as to what constitutes 'in a document', the Supreme Court stated that context of the overall circumstances should be given

due and proper consideration. The fact that Mr Tooth's self-assessment income tax form was being read by a machine was not necessarily his choice. Rather, he made use of the 'Additional Information' sections to provide that information where he could. In short, in noting that HMRC could not have its cake and eat it, their Lordships have held that: *"If they sensibly include ample white spaces in their approved form of online returns so as to ensure that the taxpayer is not constrained by the limitation of the boxes for figures from making a correct and complete return, then they cannot thereafter assert, for the purpose of advancing a non-contextual interpretation of one or more boxes, that their computer cannot read what is written on the white spaces."* In describing HMRC's approach as artificially separating the return and applying *"tunnel-vision"* to one part of the document whilst ignoring the rest, the Supreme Court has clearly restored the findings of the FTT and UT in this regard and reinforced that a document must be read as a whole.

Accordingly, the Supreme Court has concluded that there was no deliberate inaccuracy made by Mr Tooth (and the FTT and UT were correct in their

conclusions on this point). In rejecting HMRC's arguments as to Mr Tooth having filled in the boxes incorrectly, the Supreme Court has taken the view that "[t]*he solution which Mr Tooth adopted had…the considerable merit of showing the correct overall figure at which he self-assessed his liability to tax.*" In other words: substance over form was critical. Importantly, their Lordships emphasised in their conclusion on this point that, *"for there to be a deliberate inaccuracy in a document within the meaning of section 118(7) there will have to be demonstrated an intention to mislead the Revenue on the part of the taxpayer as to the truth of the relevant statement or, perhaps,…recklessness as to whether it would do so."* The Supreme Court has thus made it crystal clear that mere discovery of an inaccuracy is not enough to amount to a deliberate inaccuracy, which will be critical for taxpayers, their advisers and HMRC to all bear in mind.

<u>Discovery & Staleness</u>

Although 'staleness' of a discovery assessment was not the central issue in *Tooth*, HMRC clearly saw the appeal before the Supreme Court as a way to test the concept. Judicially, there was a strong divergence of

views in this case, and it was been heavily contested in the lower courts.

The FTT found that HMRC had made a discovery in 2014, and not as per the taxpayer's argument that they had made that discovery in 2009 (when HMRC first considered the return). In applying *Charlton v HMRC*[7] the UT reversed the FTT's decision on timing of the discovery. Specifically, the following was relied on from *Charlton*:

> "The requirement for newness does not relate to the reason for the conclusion by the officer, but to the conclusion itself. If an officer has concluded that a discovery assessment should be issued, but for some reason the assessment is not made within a reasonable period after that conclusion is reached, it might, depending on the circumstances, be the case that the conclusion would lose its essential newness by the time of the actual assessment."[8]

[7] *Charlton v HMRC* [2013] STC 866.
[8] *Charlton v HMRC* [2013] STC 866.

The UT thus took the view that if two different HMRC Officers independently made the *same* discovery but at different times, then only the first discovery qualified as a 'discovery' for the purposes of section 29(1), TMA. The UT went further to say that if no assessment was issued whilst the discovery was new, then it was in effect permitted to become 'stale'. The Court of Appeal unanimously upheld the UT's decision on this discovery issue.

The Supreme Court, however, pointed to the fact that in the earlier cases[9] considering discovery there was no reference to the concept of 'staleness'. Their Lordships took the view that the UT in *Charlton* has misinterpreted and misapplied Viscount Simonds' words in *Cenlon* when he referred to discovery as covering *"and case in which…it newly appears that the taxpayer has been undercharged."* Their Lordships in *Tooth* took that to mean that this was a reference to the HMRC Officer's state of mind when they make the discovery, to whom it 'newly appears' that an assessment to tax seems to be insufficient. Specifically, they stated:

[9] See for example: *HMRC v Mackinlay's Trustees* [1938] SC 765, or *Cenlon Finance Co Ltd v Ellwood* [1962] AC 782.

> "In our judgment…there is no place for the idea that a discovery which qualifies as such should cease to do so by the passage of time. That is unsustainable as a matter of ordinary language and, further, to import such a notion of staleness would conflict with the statutory scheme. That sets out a series of limitation periods for the making of assessments to tax, each of them expressed in positive terms that an assessment "may be made at any time" up to the stated time limit."[10]

Their Lordships therefore did not consider that the taxpayer would be unprotected, as the statutory framework had built-in protections and time limits, along with possible relief via judicial review proceedings.

Their Lordships also rejected the submission that once a discovery is made by one person, another could not make the same discovery. Upon establishing that there was no inaccuracy in the taxpayer's return, their Lordships did not need to

[10] *HMRC v Tooth* [2021] UKSC 17, para. 76.

consider the concept of staleness and whether the discovery was a qualifying one. The views set out in the judgment are therefore *obiter dicta*, but powerful enough that it will prompt taxpayers and their advisers to proceed carefully when asserting that a discovery is stale or out of time.

Patrick Way comments

Overall the decision in the *Tooth* case is something of a relief. It was, to say the least, quite extraordinary that HMRC would seek to run the very unattractive argument that there had been a deliberate inaccuracy in Mr Tooth's tax return when the software involved prevented him from reporting the position in the relevant employment section leaving him no option but to report the position elsewhere in the return. Mr Tooth should not have been at risk on that basis.

Further, the wording which Mr Tooth used in his white space entry made the position very clear indeed. It certainly should have alerted anyone reading it to the particular issues and to the reason why the relevant information had been included in the "wrong part of the return". The final wording was extremely candid and stated as follows:-

> "I wish to make it clear that the deduction I am claiming on my return is not what you regard as a Loss for this tax year set-off against other income for 2007-08 – for all these reasons I assume you will open an enquiry."

It is also something of a relief that the Court of Appeal's decision has been overturned. After all, it is clear that there was no intention to mislead and the taxpayer had taken very full steps to explain his actions. Nevertheless the Court of Appeal had found that completing the partnership pages rather than the (non-existent) employment pages was an inaccuracy. It clearly was. They then decided that that inaccuracy was deliberate. It clearly had been. But then extremely alarmingly the Court of Appeal elided those two concepts ("inaccuracy" and "deliberate") to say that there had been a deliberate inaccuracy which in effect is the same as fraud.

This troublesome decision of the Court of Appeal has now been overturned on the basis that in the circumstances for there to have been deliberate conduct there would have had to have been an

intention to mislead HMRC as to the position and patently that was not the case here.

The Supreme Court decision is also to be welcomed since it investigates the history of discovery assessments and (unlike some other decisions below it) it seeks to recognise the difference between the old system (prior to self-assessment) by which the Inland Revenue made the assessment and the self-assessment system by which the taxpayer makes the assessment himself or herself. Self-assessment was introduced with effect from 1996 and whilst the previous wider power to issue discovery assessment was restricted by the new law nevertheless the basic definition of what constituted a discovery (so as to bring into play TMA 1970 section 29) has remained unchanged.[11] I make this point because some of the early decisions (after the introduction of self-assessment) seemed not to appreciate the difference that ought to prevail between the old system where the assessment was made by the Inland Revenue and the new system where it was made by the taxpayer. Certainly this change must impact upon the very nature of discovery itself as the rules ought to be

[11] *Hankinson v Revenue & Customs Commissioners* [2011] EWCA Civ 1566.

different where the assessment is now done by the individual himself or herself rather than being done the Inland Revenue has used to be the case.

The Supreme Court's decision so far as staleness is concerned does strike me, however, as unfortunate. It is unfair, to state the least, that different inspectors can make "fresh" discoveries from time to time as the file is passed to each of them in turn. The taxpayer should not be subject to the lengthening of the process which results in these circumstances but that will be the outcome of the *obiter* view of the Supreme Court.

The Supreme Court were satisfied that the taxpayer would still be protected because of the relevant time limits within the legislation which would apply (see TMA 1970 sections 29, 34 and 36). However, in my view, the taxpayer is not usually protected in these circumstances.

After all, in my experience (and no doubt those of other readers) HMRC very often issue "protective assessments" without really knowing what the position is and then (based on the relevant wording of the *Tooth* judgment – which wording was *obiter*) can now take an unlimited time before issuing a

discovery assessment. So, in my view, there is not the statutory protection which the Supreme Court seemed to think there was. In any event, it is unfortunate, in my view, that the concept of staleness has now gone. As recently as the *Mehrban* case the First-tier Tribunal thought that it would be an absurdity to say that the concept of staleness does not exist.[12]

COP9

In the context of deliberate behaviour as it applies across the board (including, for example, in relation to COP9 enquiries) it is helpful that the Supreme Court have stated, as mentioned in the main article, that for an inaccuracy to be deliberate there would have to be an intention to mislead HMRC.

Practical advice

The position has now been reached in relation to self-assessment returns where a taxpayer should certainly consider making a full white space entry where there is any doubt as to the steps which the taxpayer has taken and therefore the contents of the return. This will always be the case where tax

[12] *Mehrbahn v HMRC* [2021] UKFTT 53

avoidance is involved simply because HMRC will almost invariably argue that the avoidance has been unsuccessful with the result that if HMRC are otherwise out of time for raising a "simple assessment" they will then seek to raise a discovery assessment if at all possible.

By including a well-worded white space entry the taxpayer should avoid penalties that might otherwise arise if, after all, the planning proves to be unsuccessful.

In respect of the sort of wording which practitioners might use the Supreme Court agreed that the relevant test at section 29(5) in relation to the second condition is objective. As such it is always good practice to picture, when drafting a relevant white space, an actual human being reading the wording to see whether he or she would really understand what was involved. As mentioned above, the white space entry in *Tooth* was very candid and the sort of wording to be recommended.

Finally

A final point to make is that it is something of a relief that the Supreme Court considered the discovery provisions on their own merit in isolation from the

consideration of the underlying tax scheme. Very often courts below the Supreme Court tend to look at the relevant tax scheme first and if the taxpayer would “otherwise get away with it” will then be more inclined to uphold the validity of a discovery assessment regardless of the position taken in isolation from the avoidance involved. In the *Tooth* case that did not happen notwithstanding, no doubt, their Lordships disapproval of the scheme which was at the heart of the case.

AN INTRODUCTION TO STATE AID AND TAXATION, AND TO THE NEW SYTEM OF CONTROL OF FISCAL SUBSIDIES[1]

Philip Baker QC

I've been practising as a barrister for 30-odd years. If somebody had said to me at the beginning of my practice that in 30 years' time I'd be spending a third or so of my working time on state aid and taxation, I think I would probably have responded like Eliza Doolittle and said "nah"! Then I probably would have said "what on earth is state aid and taxation?" In a sense it shows how tax practice changes and new issues come up, because 30 years ago I don't think anybody would really have thought about state aid and taxation. Now it's something that we need to be aware of. It impinges on some people's practice much more than others. In this short article I introduce taxation and state aid, and also explain a new area of development in relation to the UK: that is the question of fiscal subsidies and the new system of subsidy control that the UK is putting in place to

[1] This is based on a talk given on 26th May 2021.

replace EU state aid law. We have left the European Union and so EU state aid law is not directly applicable any longer in the UK. However, we have to replace it with a new system of control of subsidies, particularly fiscal subsidies.

A basic introduction to EU state aid law

EU state aid law derives from the part of the Treaty on the function with the European Union which deals with competition, and it is concerned with maintaining a level playing field for businesses throughout Europe. One of the realisations of the draftsmen of the original treaties back in the 1950's was that you wouldn't have a level playing field if the German Government could give assistance to German companies or the Irish Government to Irish companies and so on. They introduced from the very start a prohibition on state aid to particular businesses by governments. The main provision is Article 107 of TFEU (the Treaty on the Functioning of the European Union). It is a remarkably short provision.

"Save as otherwise provided in the treaties, <u>any aid</u> granted <u>by a Member State or through state resources</u> in any form whatsoever which distorts or

threatens to distort competition by favouring certain undertakings or the production of certain goods shall insofar as it affects trade between Member States be incompatible with the internal market."

I have underlined the key elements there. It has to be an aid. It has to be granted by a Member State or through state resources (and in the tax context we are always concerned with government action). It has to have a distorting effect on competition. It has to favour certain undertakings or the production of certain goods. It has to effect trade between Member States (so if it only impacts on one country it is not caught by this prohibition).

Under Article 108 TFEU, there are certain types of aid that are compatible. Some are automatically compatible with EU law: aid having a social character, aid to make good damage caused by natural disasters (so aid to remedy the consequences of very severe weather conditions or flooding would be automatically compatible).

There is also a very wide category of aid that may be compatible; the decision as to what is compatible rests primarily with the European Commission. If an EU government wants to introduce aid, for example

to promote the economic development of areas where the standard of living is low or there is serious under-employment, then the government concerned should take the aid in advance to the European Commission and seek clearance from the European Commission. If they don't do so, then they run the risk that the Commission can come along subsequently and investigate whether the aid is incompatible. We will see below what happens when the Commission comes and investigates and find out that it aid is incompatible.

The European Commission's Directorate General for Competition is the policeman of this part of the treaty. It keeps under review all systems of aid so that governments are under the review of the Commission who will challenge any particular aid. If the Commission carries out an investigation and finds that the aid is incompatible with the internal market then it must decide that the state concerned shall abolish or alter such aid. So, the Commission can order a Government to change its law and get rid of an impermissible aid.

There is also a required procedure for governments to notify in advance aid that they are planning to

introduce. There is a standstill obligation until the Commission has given its approval or six months have passed during which the government is not allowed to introduce that aid.

An introduction to fiscal state aid

Turning from state aid in general to fiscal state aid: we can first rephrase Article 107 to show that there are essentially four elements that need to be proven in order for the Commission to establish that there is state aid. There has to be an advantage, that is a financial advantage; it has to come out of state resources; it has to be selective (and it is the key element of selectivity - the element of favouring certain undertakings or the production of certain goods); and it has to distort competition between the Member States.

In tax cases the second and the fourth elements are usually pretty clear. It involves taxes, so it involves state resources: if a business ends up paying less tax than its competitors or less tax on certain products, that will distort competition. So, the key elements in tax cases are usually: is there an advantage (is there an enterprise that is better off)? And is it selective? Sometimes those are put together, and the question

is asked whether there is a selective advantage. So in the cases we will consider, the key question has been really whether there was a "selective advantage".

In tax matters, as distinct from many other types of aid, an important point is that the aid is usually negative: it is an exemption from a tax that would normally be due. If on thinks in terms of the ordinary type of aid, where the Spanish Government, for example, gives a grant of funding to a factory that's in financial difficulties or orders a warship and pays over the odds for the warship, the Government is actually shelling out money. However, in tax cases it is usually negative in the sense that the beneficiary is paying less tax than they would otherwise be paying. So the fiscal aid is granted "out of state resources" in the sense that the government is collecting less tax than it would under the normal tax system.

Hence a key element in tax cases is identifying the normal tax charge. This is sometimes referred to as the derogation approach, where you start by identifying the ordinary or the normal tax charge: what would be the normal tax that would be paid. Then you see whether there is a selective advantage by a derogation from that normal tax system. This

involves defining a reference system – the normal tax regime that would otherwise apply – and then considering whether there has been a derogation from the reference system. The government then has the possibility of responding and justifying any exemption by showing that the reduction in tax is part of the nature and general scheme of the tax system.

If the European Commission discovers that there has been unlawful state aid, then recovery is mandatory. The government concerned has no choice; they must be ordered to recover the aid, and the order can go back up to ten years.

A short history of fiscal state aid investigations

With that background, it is possible to outline the history of fiscal state aid. Up until the late 1990's there was little discussion about state aid and taxation. A few state experts noted that it could have an impact on tax, but most tax practitioners were oblivious of the whole idea about state aid.

In December 1997 Mario Monte, who was the European Commissioner at the time responsible for taxation, pushed through a package of measures. One of those measures was a code of conduct on

business taxation, and that code of conduct is still applicable at the present moment (it is currently being redrafted, but it is still the 1997 code of conduct that applies). That code mentioned really for the first time for some of us the idea that state aid could apply in the tax context.

That was followed by a notice issued by the Commission on the application of state aid rules to direct business taxation. The Commission had recognised that as governments realised they could not make direct grants to failing businesses or companies they wanted to encourage, they might be tempted to achieve the same result by giving particular businesses a tax exemption. So, the Commission started to turn its attention to tax, and in the early 2000's they targeted a range of special tax regimes that had been operating in some cases for decades in certain European countries. The Commission considered that these regimes were all preferential harmful regimes and they constituted state aid. One by one the Commission picked off these regimes, so the German control and coordination centres, the Luxembourg coordination centres, the French coordination centres, etc. - these regimes no longer exist largely because the European

Commission targeted them, found in their decisions that these were unlawful state aid, and ordered the governments concerned to cease and desist. On one of those regimes, the Belgian coordination centre, the case went up to the European Court of Justice and the Court upheld the position of the Commission in that case. The case is called Forum 187 and in a sense it was the European Court confirming that the Commission was correct in targeting and seeking the abolition of these various special regimes.

The second phase of state and taxation begins around 2013/2014 and it runs parallel with the OECD BEPS project. The Commission noticed that information was coming out – partly through Lux leaks, partly through Parliamentary hearings – that a number of large multinationals were receiving rulings from various Governments (the Dutch, the Belgian, the Luxembourg governments) and that those rulings might well be confirming a preferential tax treatment. This second phase has been focused on rulings given by governments.

The Commission updated its Notice on State Aid in 2016 and drafted a specific working paper (which it has never quite finalised) on the particular area of tax

rulings. Multinationals that had a tax ruling have been on notice since 2016/2017 that the Commission is very alive to the possibility that these rulings could be unlawful and that the Commission is ready to challenge them.

The process of a state aid investigation

So, how does a challenge take place? What happens when there is a state aid challenge? The Commission here acts in a peculiar position in that, in a sense, it is investigator, jury, judge and, if you like, executioner as well. The Commission officials at DG Comp take up a case, they investigate it, they decide whether it is unlawful, and they order the government to desist and recover the aid. So the Commission carries out a variety of roles. It is under the supervision of the European Court, but beyond that it is a power to itself. The Commission staff may trigger off an investigation on pretty much anything that comes to their attention. They may read from the press that there is a report that a particular company appears to be getting some aid. They will receive complaints from competitors, so if one company considers that a competitor is getting fiscal aid they can complain to the Commission (this is

something that is picked up again when we come to the new UK system). Initially, the Commission will informally ask for information from the government concerned as a starting point, but if they come to a conclusion that there is enough information to merit a formal enquiry, then they will formally issue a public decision that they are enquiring into a particular aid. When they do that, competitors and others are invited to submit information. A period of perhaps a couple of years may follow while they are gathering information about the potential aid.

The Member State concerned, and the company or companies that may have benefitted, are invited to make written observations. This ultimately leads to a decision by the Commission and it is the decisions in Amazon, Starbucks, FIAT and the others that have led to the recent string of cases. Decisions that there is unlawful aid are referred to as negative decisions because they mean that the aid is incompatible with the internal market.

If the Commission concludes that there has been a grant of unlawful state aid, then the Member State that has granted it has a mandatory obligation to recover that aid for up to ten years going back from

the start of the investigation. There are very limited exceptions when recovery will not be ordered; by and large if you are found to have received unlawful aid you will have to pay it back. If the government or the company or both of them doesn't agree with the decision, then the matter may be taken to the European Court. There is a judicial review type challenge, first before the General Court (it used to be called the Court of First Instance – it is the administrative court in Luxembourg) and then an appeal on points of law to the main Court of Justice.

The recent fiscal state aid investigations

The recent fiscal state aid cases have hit the headlines. The first two that really hit the headlines were Starbucks and Fiat. The negative decisions were issued by the Commission on the same day (21st October 2015). The Commission found that Starbucks had received aid from the Netherlands and Fiat had received aid from Luxembourg. Starbucks and the Netherlands, Fiat and Luxembourg each challenged the negative decisions and went to the General Court. Almost two years ago now the General Court issued two judgments on the same day, one against the Commission and one for the

Commission. They found that in Starbucks the Commission had got it wrong and that Starbucks had not received aid or at least it hadn't been proven that they had received aid. On the other hand Fiat had received aid from the Luxembourg Government. Fiat and Ireland – Ireland intervened in the case – disagreed with the General Court and appealed to the Court of Justice. On 10th May 2021 there was a hearing in Luxembourg on Fiat and Ireland's challenge.

What were the two cases about? Starbucks was a ruling given by the Dutch tax authorities; it is a transfer pricing case. There were two elements to the case: on the one hand, Starbucks apparently does its roasting and grinding in the Netherlands, they buy the beans from a Starbuck subsidiary in Switzerland. The price that they paid for the coffee was said by the Commission to be too high. The Commission challenged the transfer price. Secondly, the Dutch company paid to a UK partnership a somewhat "unusual" royalty. The royalty was linked to the profits of the Dutch company, and left the Dutch company with a small margin taxable in the Netherlands and all the rest of the profit was paid out to the UK. The Commission said this was a very

unusual royalty; it was really a way of just drawing out the profits and making certain that they were not taxed. They were also not taxed in the UK because the UK treats a partnership, of course, as transparent, so the UK saw it as flowing through and was not taxable. Both aspects were confirmed by rulings form the Dutch revenue authorities.

The Commission challenged the transfer pricing, but failed to show that the transfer pricing was wrong. The Commission did not present a report from outside experts. They raised a number of challenges to the basis upon which the pricing was fixed, but the General Court (which is now becoming quite expert in transfer pricing) said that the Commission had failed in their burden of proof to undermine the basis of the transfer prices.

In the other case, Fiat, the Commission was successful. Fiat essentially ran an internal bank in Luxembourg. The financing to various Fiat companies around Europe was provided by this Luxembourg subsidiary acting as a form of private bank. The question was: how do you determine the profits of a private bank? Fiat had a ruling from the Luxembourg authorities which analogised the Fiat

private bank to a retail bank, using various indicators for the capital base of the bank and the return on each part of the capital base. On this the Commission was more successful. The General Court found there was no basis in Luxembourg law for the ruling; the ruling provided for Fiat to have a preferential tax regime and that was held to be state aid. That judgment has been appealed to the Court of Justice. There should be a judgment later this year.

Those were the first two cases. McDonald's is the only case where the Commission has opened an investigation and then dropped it. They decided that McDonald's, who had obtained a ruling from Luxembourg, were actually not receiving state aid. Essentially, McDonald's had a structure that used a mismatch between the understanding of permanent establishment in Luxembourg and the US. A royalty was paid out of a Luxembourg company via a Swiss branch to a US branch. For Luxembourg purposes it was treated as paid to a branch in the US of the Luxembourg company; the royalty was deductible with the result that there was a little profit left for tax in Luxembourg. One might expect the royalty to be taxed in the US where it ends up. However, there is a mismatch between Luxembourg law and US law.

Luxembourg regards the branches as permanent establishments and exempt from tax in Luxembourg under the exemption system. The US does not use the PE concept, and the US regarded the royalty as not being derived from a US trade or business. Hence, the US did not tax the royalty. Thus there was a deduction in Luxembourg but no taxation on the receipt of the royalty either in Luxembourg or the US. The Commission eventually came to the view that that was the correct view of the law and they held that there was no state aid.

The Belgian excess profits ruling case(s) involve a series of rulings issued to 35 companies. For technical reasons the Commission's initial decision was found to be wrong. The Commission has now reopened that with 39 separate investigations.

In Apple, the Commission's negative decision finding that Ireland had granted aid to Apple was in 2016. Ireland and Apple challenged that, and in July 2020 the General Court found that Ireland and Apple were right and the Commission was wrong. The Commission has appealed to the Court of Justice. Ireland and Apple are defending the challenge before the Court of Justice.

Of other recent cases, Amazon and Engie were again negative decisions. On 12th May 2021, the General Court did the same as it did with Fiat and Starbucks: they found that the Commission was wrong about Amazon but right about Engie. We are now waiting to see whether there are going to be appeals from those decisions.

Amazon was essentially another transfer pricing case. Amazon in Luxembourg had a ruling that they were paying a royalty ultimately to the US, and the quantum of the royalty was covered by a transfer pricing ruling. The General Court found that the Commission had failed to undermine that ruling. On the other hand, Engie was using a ZORA, a form of hybrid instrument, that is a loan which was convertible to equity. This gave them a deduction for interest on the one hand, but a receipt of shares on the other had which was not taxable. Thus they had achieved a deduction but a non-taxable receipt of shares. The General Court concluded that the ruling confirmed state aid because it left only about 1% of the profits taxable in Luxembourg.

Finally, in connection with rulings there are ongoing enquiries relating to IKEA, Nike and Huhtamaeki.

Some comments on fiscal state aid investigations

One may ask what is objectionable about all of this? Arguably it is a good idea that we should have the Commission investigating whether governments are giving an unfair advantage to particular companies. However, there are a number of critical points one might make.

First, there is sense that the Commission is following a political agenda. It seems not incidental that many of these companies are US groups, and that there may be a political motive behind it (as a way of encouraging the US to reform its taxation of multinational enterprises).

Secondly, some of what the Commission is doing clashes with what the OECD has been doing about transfer pricing in the BEPS project. There is certainly a clash with the Commission's tax proposal for a common consolidated tax base (now being rebranded as the new BEFIT proposal on a common tax base).

Thirdly, in bringing these cases the staff in the Commission who are not tax people but competition people have some rather unusual views about taxation. Most have no tax or transfer pricing

expertise and so far they have not commissioned reports from outside experts (which is one of the reasons why they may have failed in a couple of their cases). They are challenging national tax administrations and saying, for example, to the Luxembourg revenue authorities that they are misapplying their own tax law.

Fourthly, this is creating uncertainty because multinationals, who thought that they had rulings are their position was clear, suddenly discover that their position is being reopened. This can lead to a recovery for up to ten years. If there is recovery and if, for example, you are a US group it is not clear that what is recovered is creditable against US tax. So there is a whole range of problems inherent in what the Commission is doing.

The new UK system of subsidy control post-Brexit

I turn now to consider the new "state aid" system after Brexit; this is new and still very much in formulation so it is possible to see some of the material on it, but we won't really know until later this year the form that this is going to take. Just before Christmas 2020 the UK signed the TCA, the Trade and Cooperation Agreement, with the

European Union. This new agreement is the basis for the future trading relationship with the European Union. The European Union was perhaps suspicious that the UK was going to giving aid to our companies to compete against European companies. So they insisted that in the TCA there would be a state aid part. It was clear that in this future trade relationship the UK was going to have to introduce its own form of state aid regulation. That is also going to be true of other trade agreements that we conclude with Australia or Japan or whoever: they are all likely to involve an element of a control over subsidies to stop the UK Government benefitting UK companies to the disadvantage of Australian companies, Japanese companies and so on.

In the TCA there is a chapter, under the level playing field title, that deals with the control of subsidies. In that chapter, a subsidy means financial assistance which includes “the forgoing of revenue” so not collecting tax can also be a subsidy. The subsidy has to confer an economic advantage: we saw that this is one of the elements of EU state aid. A subsidy has to be “specific” insofar as it benefits certain economic actors in relation to the production of certain goods. So “specificity” is the equivalent of “selectivity”. They

have used a different term in the TCA, but it is basically the same idea of advantage and selectivity. Instead of "selective advantage" we now have "specific advantage". A subsidy also has have an effect on trade between the UK and the European Union; if it affects trade then it can be a subsidy.

Those who drafted the TCA provisions on subsidy control were obviously thinking about tax, because they put into the TCA definitions of when a tax measure will be specific. This includes any reduction in the tax liability that would otherwise have been borne under the normal tax regime. This is equivalent to the derogation approach and the normal tax regime: they have lifted the same ideas from EU law on fiscal state aids. They have defined the normal tax regime by its internal objective, its features, tax base, tax person, taxable event and an authority which autonomously has the competence to design the tax regime. It will be necessary to ask, for example, whether the Northern Irish legislature is competent to design its own tax regime and it creates a normal tax regime in Northern Ireland which might be departed from for particular companies.

So they have essentially redrafted the EU fiscal state aid rules into the TCA.

Similarly, just as under the EU state aid system a government can justify aid if it is part of the design of the general tax system, so a government can do that under the subsidy control system. There has to be an inherent principle, like the need to fight fraud or evasion, avoidance of double taxation, tax neutrality or progressivity reflecting a taxpayer's ability to pay. Quite a lot of thought seems to have gone in to what are permissible tax advantages given to particular businesses.

It is reasonable to assume that, going forward, when the UK in a budget or in the Finance Bill introduces any form of tax advantage, any tax expenditure, or any departure from the normal tax system, we are going to see much more detailed explanations of the rationale. The Treasury will know that they are going to potentially have to justify these advantages to the European Commission or to the Courts to show that they are inherent in the design of the general tax system.

The new approach to subsidies is a principle-base approach. This is not just for tax, but for all matters.

A government who is challenged for having granted a subsidy, there are a number of principles that are applied. Does it pursue a specific public policy objective? Is it proportionate? Is it designed to change economic behaviour? Is it an appropriate policy instrument? Does it make a positive contribution? It is worth repeating that we should end up with clearer statements of principle behind UK tax legislation, particularly legislation that gives any form of tax expenditure.

We do not yet know how this new subsidy system is going to be operated. There is likely to be an equivalent to the European Commission. There is discussion that the Competition and Markets Authority will take over the control of the subsidy area, but the courts are also to play an important rule. It will be possible for cases to be brought to the UK Courts to review the granting of subsidies to impose remedies, including recovery. Just as the European Commission can order recover, the UK courts will be able to order recovery. The courts will also be able to hear claims from interested parties, including competitors, who may argue that they have been disadvantaged by the grant of a subsidy.

One can imagine a situation quite easily coming up where a client says that competitor businesses are receiving a subsidy through the tax system. It will be possible to challenge this by going to court and bringing a claim to review the decision to grant the subsidy. It will also be possible to make a complaint, not now to the European Commission (unless it is a competitor in a European country) but probably to the Competition and Markets Authority.

Note that the European Commission has the right to intervene before a UK court. If say a French company is complaining that its UK competitors are getting a tax advantage then they could also get the European Commission involved. We may see cases going forward where the European Commission instructs UK lawyers to participate in a challenge before the UK courts.

How are these provisions in the TCA going to be put into domestic law? At the moment the UK Government is consulting on this. There was a consultation document and a consultation up to March 2021. The consultation document was called "Subsidy Control - Designing a new Approach" In the Queen's Speech in March 2021 it was announced that

one of the legislative measures for this year is a Subsidy Control Bill. It is not yet published but it will contain measures to ensure support for businesses. It will implement a domestic form of subsidy control, creating the UK's own subsidy control system. It will allow the UK to meet international commitments. In all probability it will put into law the principles set out in the TCA.

This is something to watch out for later this year.

30 years ago I would never have expected that a third to a quarter of my time would now be spent on state aid. I will predict fairly confidently that a significant part of the practice for tax advisers in the future may well be advising clients on fiscal subsidies . This will include whether a particular tax benefit that they are receiving is potentially subject to challenge as a subsidy, or whether a benefit to a competitor (whether in the UK or in Europe) is something that could be challengeable under either the UK system or the European system for control of fiscal subsidies or state aid.

NOTIONAL TRANSACTIONS

An Alarming Trend

Peter Vaines

It has traditionally been the case that tax is charged on the basis of transactions and activities undertaken by the taxpayer. The proper legal effect of the transactions is analysed and the tax tends to follow that analysis.

This was illustrated recently in the case of *Boston Khan v HMRC [2021] EWCA Civ 624* where the precise legal analysis of the transactions was fundamental in determining the tax consequences, with most unfortunate consequences for the taxpayer.

This places a premium on taxpayers being clear about the transaction and all the relevant details – such as the parties, the subject matter and the consideration (if any). Every professional adviser will have experience of clients misunderstanding all three, particularly where trusts and companies are involved.

Sometimes the analysis can be quite subtle – but that is no more than an acknowledgement that precision is

necessary when it comes to the charging of tax.

An example would be where an asset is sold (usually a business) for a consideration which includes an earnout – a lump sum on completion with further consideration payable later subject to the satisfaction of various targets. The House of Lords showed us the way in *Marren v Ingles 54 TC 76* that this was a disposal for a composite consideration being the immediate cash sum and the value of the right to receive the future consideration – subject to the statutory constraints in Sections 48 and 48A TCGA 1992. This is often confusing to taxpayers – but the reasoning is clearly unimpeachable.

Things become more complicated when you introduce deemed disposals and where a transaction giving rise to a capital gain is charged to tax as income. It gets worse with the various fictions which apply for inheritance tax. When it comes to share valuation and the "dim world peopled by the indeterminate spirits of fictitious or unborn sales" (per *Holt [1953] 32 ATC 402*), the artificial assumptions upon which a valuation must be made become almost completely separated from reality.

I do not suggest here is anything wrong with these

complications – they just demonstrate the indisputable truth that tax is complicated.

However, an alarming trend seems to be developing that taxpayers are being taxed on the basis of purely notional transactions.

I am thinking of situations where the taxpayer enters into a valid, legitimate, genuine and binding contract with another person to do something. However, the legislation says that we must ignore that contract and assume that there was another contract with another party or parties on different terms and it is that notional contract which will form the basis of the taxpayer's liability to tax.

This reasoning may not have originated with *Ramsay*, but that is a good place to start.

This is not really a problem of purposive interpretations; they are (or are said to be) merely the proper way to interpret the arrangements undertaken by the parties. The tax is charged on the real transaction as correctly interpreted.

However this principle has been developed and refined over the years (and finds a resonance with some decisions of the GAAR Panel) to the effect that if

you start at point A and end up at point B, the way you got there can be ignored if it gives rise to a lower tax liability than if you had chosen a different route. The government can charge the higher amount of tax by effectively recharacterising the transaction.

Let us say I want to travel from London to Paris. I am passionately opposed to Airline Passenger Tax so I go by train. The main purpose for choosing to travel on Eurostar is specifically to avoid the Airline Passenger Tax. I leave London and I arrive in Paris at broadly the same times as if I had gone by air – but I avoid the tax. Why should I not be charged the APT anyway?

This has all the hallmarks of a scheme to avoid tax. I have deliberately chosen this course of action and have contrived these circumstances for the express purpose of avoiding the tax. I have arrived at exactly the same place – but without having to pay the tax.

Of course this sounds absurd – but these are exactly the words and reasons which are used when seeking to nullify arrangement undertaken by a taxpayer to save tax in real life situations.

Let us consider the IR35 legislation. An individual may present TV programmes and do other entertainment-related activities. He operates through

his own company which contracts with third parties to provide his services. The company contracts with Channel X to provide his services on specific terms and for a specific consideration. There is a genuine binding contract which reflects the precise contractual intentions of both sides. There is nothing artificial or in any way improper about this arrangement. However, it may not be the basis upon which tax is charged.

The IR35 legislation requires us to consider what the contract would have been if it had been between different parties on similar terms (not necessarily the same terms) and what the relationship between these different parties would then have been. Tax can then be charged on this basis notwithstanding that the parties did not enter into this notional contract nor did either of them wish to do so. In fact, if they had been told that this is what the contractual obligations would have been, neither would have entered into the contract at all. Nevertheless, that is the basis upon which the tax will be charged.

And what about Stamp Duty Land Tax and Section 75A Finance Act 2003 which was enacted (as is clear from the headnote "*Anti-avoidance*") to prevent the

avoidance of tax. However, the tax avoidance motive did not find its way into the statute beyond the headnote and we know from *Project Blue [2018] UKSC 30* and the Supreme Court's careful analysis of the legislation that no tax avoidance motive is necessary for its application.

If the transaction undertaken by the taxpayer gives rise to a lower liability to SDLT than an alternative notional transaction, then the higher amount of tax which would have been paid on the notional transaction can be charged. This is notwithstanding that nobody entered into the notional transaction; it is purely a figment of the imagination of the legislature – but nevertheless the liability stands.

There are increasing number of examples where a liability to tax arises in respect of a transaction if certain conditions are satisfied – but the legislation goes on to say that even if the taxpayer does not satisfy the conditions, the tax liability will arise anyway.

I would suggest that all this is exceedingly dangerous. When the government starts charging citizens to tax on the basis of things they have not done and did not intend to do, where does it stop?

Parliament is Sovereign and can pass any laws it likes

– but if the Government can literally make up the rules and impose taxes without regard to the facts, this is a slippery slope which will end in tears – and not for the first time.

A while ago, attempts by the State (i.e. the Crown) to suspend or dispense with laws in its own interests caused a bit of a problem. It was eventually put right in 1689 when the power for the Sovereign to raise taxes without the consent of Parliament was abolished and it was declared that the "levying taxes without grant of Parliament is illegal".

We are now moving to the position where Parliament is allowing the government (rather than the Monarch) to raise taxes without any real restriction.

What has happened to the rule of law?

It could be said that if the government follows the terms of the legislation then they are respecting the rule of law. However this is much too disingenuous. The government with a majority in Parliament makes the law – and if they make the law enabling them to have a discretion about who and what they tax, the rule of law is merely a fig leaf because in reality it denies the citizen any chance of a remedy.

We can all point to countries whose government passes laws to make sure that they stifle any dissent allowing them to imprison or execute anybody they choose and confiscate their property. We rightly say that this is not a proper lawful process – this is an abuse of the rule of law and condemned in robust terms.

However when it comes to the confiscation of property (which is of course what taxes are) we are moving worryingly along that road. This ought to be recognised before it goes too far – because no government wants their wishes being frustrated .... by the citizens, for goodness' sake - or worse, by the courts. There is an increasing amount of the tax code where the taxpayer has no right of appeal and the well published wish for the government to restrict the opportunities for Judicial Review points clearly in the same direction.

It is no defence to chant slogans about people paying the right amount of tax when the right amount of tax is the amount those chanting say it is. Such a Humpty Dumpty approach is an offence to a legal system as important as ours which is the envy of the world. Allowing this erosion of the rule of law will undermine

and eventually destroy the reputation of English Law earned over centuries – and which we would repent at our leisure.

However, maybe there is hope on the horizon. In *Boston Khan* the Upper Tribunal explained:

> "[Mr Khan] is to be taxed in accordance with the transaction that he did enter into and not by reference to the transactions that he was about to enter into (but did not) even if they might have left him in the same economic position"

And on appeal, the Court of Appeal made specific reference to the following statement by Lord Greene MR in *Henriksen v Grafton Hotel Ltd* [1942] 2 KB 184

> "... this was not the contract which the parties chose to make. It frequently happens in income tax cases that the same result in a business sense can be secured by two different legal transactions, one of which may attract tax and the other not. This is no justification for saying that a taxpayer who has adopted the method which attracts tax is

> to be treated as though he had chosen the method which does not or vice versa."

It may be too much to hope that these principles will immediately be taken on board by the government – but it may be the first step in the right direction.

IHTA 1984 SECTION 39A AND THE AMAZING NIL RATE BAND

Katherine Bullock

What if I told you that the nil rate band (yes, the limit that suffers a 0% rate of Inheritance Tax) was not £325,000 but £3,250,000? Now that would be exciting, wouldn't it? This article is about the unusual results that can arise due to the interaction of the rules governing the calculation of Inheritance Tax (IHT) on partially exempt estates and agricultural and business relief. It therefore involves some obtusely drafted legislation, maths (and I mean grossing up) and, most probably a wet towel. I therefore shamelessly dangle a carrot to keep you incentivised. Stay with me and all will be revealed.

The Question

For partially exempt transfers made after 17 March 1986 where any part of the value transferred benefits from business relief (BR) or agricultural relief (AR), special rules govern how that value is allocated between the exempt and chargeable gifts. These rules are contained in IHTA 1984 section 39A (1) to

(7) and the process is known as interaction. In broad terms, these rules have the following effect:

- A specific gift of relevant business or agricultural property is deemed to be reduced by the available BR/AR
- Where the relevant business or agricultural property is not left via a specific gift, the BR/AR is spread across the whole of the estate and reduces the exempt and non-exempt gifts proportionately.

As a result, received wisdom is that a testator should make specific gifts of assets qualifying for BR/AR to chargeable beneficiaries to avoid 'wasting' BR/AR. The relief, it is argued, is wasted where it will pass or be allocated to an exempt beneficiary, who is not going to suffer tax in any event. If Mr A has an estate of £3million of which £1million qualifies for 100% BR and his NRB of £325,000 is intact, he could leave £1.325million to his children, which is sheltered by BR and his nil rate band, and the residue of £1.675million to his wife, which is sheltered by the spouse exemption. His estate would pay no IHT. There is then £1.675million which may potentially suffer IHT on his widow's death. If he leaves £325,000 to his children, which is sheltered by the

nil rate band, and the residue of £2.675million to his wife, sheltered by the spouse exemption, regardless of whether BR is available or not, again his estate would pay no IHT. However, on the second death £2.675million is potentially exposed to IHT and the risk of BR no longer being available. The result is that the opportunity to remove £1million from the combined estates to the children tax free has been wasted.

Is there a way to utilise the interaction rules that is more advantageous for a family in the round where a family business is concerned? Can we, in effect, give away non-business assets with a value far exceeding the Nil Rate Band and also take full advantage of the BR/AR available?

The purpose of s39A

Section 39A was introduced to correct an anomaly in the partial exemption rules in IHTA 1984 Chapter III. Whilst these rules meant that the overall value of a transfer of value was reduced by BR/AR, they did not require the relief to reduce specific gifts, whether or not made out of qualifying business or agricultural property. This could work for or against the taxpayer but with appropriate gifts, a taxpayer

could make a specific gift to his wife, which would be exempt under the spouse exemption, and leave the residue to his children with the full benefit of all the available BR/AR against the chargeable residue. The position was the same whether or not the business or agricultural property was specifically gifted to the wife. This meant that the value passing to the chargeable beneficiaries was considerably increased at the expense of HMRC's share.

Express rules were therefore introduced in Finance Act 1986 section 105, adding section 39A to IHTA 1984, to govern the interaction of BR/AR and the partial exemption regime for transfers of value made after 17 March 1986.

Section 39A

Section 39A provides thus:

> *(1) Where any part of the value transferred by a transfer of value is attributable to -*
>
> > *(a) The value of relevant business property; or*
> >
> > *(b) The agricultural value of agricultural property,*
>
> *then, for the purposes of attributing the value transferred (as reduced in accordance*

with s104 or s116 below) to specific gifts and gifts of residue or shares of residue sections 38 and 39 above shall have effect subject to the following provisions of this section.

(2) The value of any specific gift of relevant business property or agricultural property shall be taken to be their value as reduced in accordance with section 104 or 116 below.

Subsection (2) therefore ensures that any specific gift of relevant agricultural or business property is reduced by the BR/AR available, regardless of whether or not the beneficiary is exempt.

(3) The value of any specific gifts not falling within subsection (2) above shall be taken to be the appropriate fraction of their value.

Subsection (3) provides that where the relevant business or agricultural property falls into residue, any BR/AR is apportioned between the exempt and chargeable gifts by reducing any specific gifts not qualifying for AR/BR by the appropriate fraction.

The appropriate fraction is set out in subsection (4):

(4) In subsection (3) above "the appropriate fraction" means a fraction of which

(a) the numerator is the difference between the value transferred and the value, reduced as mentioned in

subsection (2) above, of any gifts falling within that subsection and

(b) the denominator is the difference between the unreduced value transferred and the value before the reduction mentioned in subsection (2) above, of any gifts falling within that subsection;

And in paragraph (b) above "the unreduced value transferred" means the amount which would be the value transferred by the transfer but for the reduction required by sections 104 and 106 below."

Accordingly, the appropriate fraction is:

$$\frac{\text{(Value of the estate reduced by AR/BR)} - \text{(Value of specific gifts of agricultural/business property reduced by AR/BR)}}{\text{(Value of the estate unreduced by AR/BR)} - \text{(Value of specific gifts of agricultural/business property unreduced by AR/BR)}}$$

Where there are different funds in the estate, for example the free estate and the settled estate, the fraction applies only to the values of the fund out of which the specific gifts are made.

IHTA 1984 section 42(1) defines a specific gift for these purposes. A specific gift does not include a pecuniary legacy satisfied by the appropriation of business property nor does it include one paid out of business property.

To give an example of section 39A in practice and returning to Mr A above, if Mr A left a specific pecuniary legacy to his children of £1.5 million and the residue to his wife, the children's specific legacy would be reduced to £1million being £1.5million x (£2million estate after BR - £nil) x (£3million before BR - £nil). IHT would be paid at 40% on the amount exceeding the NRB of £325,000, giving tax of £270,000. The balance left to the widow would be reduced by BR of £500,000, but this would not matter as this gift benefits from the spouse exemption. The position is the same whether the executors distribute the business to the children or the spouse. It is the same whether the specific gift is made to the spouse or the children.

The 'amazing Nil Rate Band': an alternative hypothesis

What if Mr A decided to leave a specific gift to his children of the maximum amount that can pass free

of IHT and the residue to his widow? Such a will does not result in a specific gift of the business property. Applying the appropriate fraction to the partially exempt transfer of Mr A's estate, a specific gift of £325,000 would result in a chargeable gift of £216,667 (£325,000 x £2million/£3million). Further funds therefore need to be added to meet the requirements of the legacy. A legacy of £487,500 is required and is calculated by grossing up the nil rate band as follows: £325,000 x 3/2. The IHT on the nil rate band legacy is £nil as it falls within Mr A's NRB, once it has been reduced by BR. IHT on the widow's residue is nil due to the spouse exemption.

Clearly the greater the proportion of business assets to non-business assets the greater the value of non-business assets that could be removed from Mr A's estate.

What about the poor widow?

The value of the family business may alter dramatically, less so the available nil rate band (although there is of course the issue of any transferable nil rate band and possibly the residential nil rate band). The amount of the pecuniary legacy is therefore unpredictable and it is

quite possible to imagine a scenario where the residue left to the spouse is less than intended or possibly nothing at all.

One solution is therefore to leave the pecuniary legacy to a discretionary trust for the benefit of the surviving spouse, the children and other family members. Of course, the ongoing IHT and other costs of operating such a trust would need careful consideration and management.

Having our cake and eating it

But hold on, you may say. The BR has still been 'wasted': the business has passed to the surviving spouse. There must be a significant risk that the family business will not qualify for BR on the death of the surviving spouse.

That is true, dear reader. However, IHTA 1984 section 120(2) deems the surviving spouse to meet the occupation and ownership conditions for AR/BR on the death of the testator. The relevant assets will therefore qualify for relief in her hands from the moment she inherits and she can give them away to the next generation without IHT, whenever she so chooses. If the gift is made close to the first death, there should be little CGT liability. There should be

no SDLT payable by the Trustees. There may even be further bites of the cherry yet to come. There does remain a risk of a claw-back of the relief if the widow dies within seven years of the gift.

Commercially passing such assets to the trust might be useful where the business is likely to grow significantly. For example, our family business might float on a recognised stock exchange.

The Nil Rate Band and the Residential Nil Rate Band

It will be important to balance the use of the nil rate band on the first death against the loss of the ability for the surviving spouse to claim a nil rate band increased by the proportion unused on the death of the first spouse (the transferable nil rate band). As the transferable nil rate band is calculated on the basis of the nil rate band applying at the time of the second death, the advantage of any increase between the two deaths will be lost.

The Residential Nil Rate Band (RNRB) will also need to be considered. Whilst it would be tempting to calculate the specific gift using this larger number, many estates with business or agricultural property may exceed the £2million tapering threshold over

which the RNRB is not available. Where the RNRB does apply, it still may be more sensible to pass the family home to the surviving spouse, allowing the RNRB and the carried forward RNRB to be claimed on the second death. Where the family home is specifically gifted to the surviving spouse, section 39A will still apply to reduce the value of that gift.

Some thoughts on valuation

To apply the appropriate fraction, the whole estate must be valued, regardless of whether or not the majority is exempt. In their Inheritance Tax Manual at M26105, HMRC previously stated that they would exercise "sensible discretion" in such cases, particular in smaller estates or where the amounts chargeable or the property qualifying for relief was small in relation to the whole estate. That text has been removed because of exemptions in the Freedom of Information Act 2000.

If the value of business or agricultural property ultimately agreed with HMRC differs significantly from that submitted by the taxpayer, the denominator in the appropriate fraction will change and depending on the circumstances the IHT liability may increase or decrease. As a result, the

Share Valuation Division may not agree the value of the shares in the family business even though it is agreed that these will qualify for 100% BR.

A word on charities

This article is focussed on the family business and how interaction might work where the exempt beneficiary is the surviving spouse or civil partner. The same rules may also apply where the exempt beneficiary is a charity. Charitable legacies in these circumstances require careful consideration and the rules may operate to a different effect.

Where an estate could benefit from the reduced 36% rate of IHT, the calculations are particularly complex. In essence, the calculations must be done in two stages. The conditions for eligibility must first be calculated using the values of any specific charitable gifts unreduced by the appropriate fraction. Once eligibility has been determined, the six stage calculation for interaction must be carried out using the 36% rate rather than the 40% rate.

Conclusion

In summary, the application of section 39A can produce advantageous and disadvantageous results.

It is therefore critical to consider the full circumstances in each case, including the future intentions of the surviving spouse as regards business and agricultural property. There is no hard and fast standard rule and no good and bad wills where these rules apply. Indeed, section 39A may give a highly advantageous result where the surviving spouse wishes to remain in control of or involved in the business going forward and the testator wishes to give significant pecuniary legacies to his children.

So let's return to my 'carrot'. Let us suppose we have a family business worth £9million and non-business assets worth £1million, giving a total estate of £10million and Mr A has an available nil rate band of £325,000. He decides to leave the maximum amount he can give away tax free to a discretionary trust of which the beneficiary is his wife and children and to leave the residue to his wife. In these circumstances, the pecuniary legacy left to the trust tax free will be £3,250,000 (being £325,000 x £10million/£1million) because when the appropriate fraction is applied (being the estate after BR of £1million divided by the estate before BR of £10million), the reduced value of the specific gift

subject to tax is £325,000. This amount is fully covered by the nil rate band leaving no IHT payable in respect of it. Ladies and gentlemen, I give you the amazing Nil Rate Band!

LOAN TRANSFERS

David Southern QC

Introduction

In a syndicated loan, a number of banks make separate loans on the same terms to a single borrower. Individual banks, which belong to the syndicate, will regularly vary their participations by transferring part of their participation to another bank or even a non-bank. This will commonly be done to reduce risk-weighted assets to accord with capital adequacy requirements. Other motives will the aim of a bank to diversify a loan portfolio, or the perception that a loan may be carrying a heightened credit risk.

The banking arrangements for these debt transfers are well established. The tax consequences are less certain. This article addresses in outline the tax consequences of loan transfers.

Syndicates

Bank syndicates may be 'true' syndicates, in which

each bank has a direct debtor-creditor relationship with the borrower. There will be a lead bank (or arranger) and a number of participant banks, each of which provides a specified proportion of the overall loan. Alternatively, there may be a 'participation' syndicate, in which the lead bank ('the grantor') transfers part of its share of the loan to another bank (a 'participant') without ceasing to be the direct creditor of the original borrower. This is what is meant by 'sub-participations'. The effect of loan transfers may be to convert a true syndicate in whole or in part into a participation syndicate.

Loan transfers

Clause 24 of the London Market Association (LMA) agreement on syndicated loans provides from loan transfers. A loan transfer involves an agreement between the lead bank (the grantor) and the new lender (the participant).

There are four recognised methods of debt transfer.

1. Assignment
2. Novation

3. Sub-participation

4. Risk participation

The tax consequences are as follows.

Assignment

The lead bank assigns to the participant all or part of his rights under the loan agreement, plus the pro rata benefit of the loan agreement. If notice of the assignment is given to the debtor, this will convert an equitable into a legal assignment: Law of Property Act 1925, s 136. Whether the assignment is equitable or legal, the assignee (participant) will acquire a direct contractual relationship with the original debtor, and an equitable assignment will have the same effect as a legal assignment for accounting purposes and capital adequacy effect (see below).

For the creditor the assignment will constitute a 'related transaction' within Corporation Tax Act 2009 ('CTA 2009'), s 304 and the assignor will realise a profit or loss on his loan relationship. As regards the debtor the original loan relationship remains in place.

If the assignment is an intra-group transaction, the 'group continuity rule' in CTA 2009, ss 335-346 will usually ensure that a no gain/no loss tax treatment applies as regards the assignor.

If, as is invariably the case in international loans, there is a tax grossing-up clause (increased cost clause) in the original loan agreement, the assignee will have the benefit of that provision.

If, however, the effect of the assignment is to increase the costs of the borrower, e.g. because the borrower was not required to deduct withholding tax on interest paid to the original lender, but would be required to deduct withholding tax from interest paid to the proposed assignee, and the borrower would have to gross up the interest payments as compensation, that is likely to invalidate the assignment: *Tollhurst v Portland Cement* [1902] 2 KB 660.

The syndicated loan scheme (SLS) enables treaty relief to be given from withholding tax on UK source interest payable to lending members of the syndicate where HMRC are satisfied that there is a negligible risk that an application for treaty relief

would fail. The borrower and the lenders must be unconnected and the transaction must be on arm's length terms. Interest payable to an assignee will equally come within the SLS.

Novation

The benefit of a contract can be transferred by assignment but the burden can only be transferred by novation. A novation involves the discharge of the original debt and the substitution of a new debtor for the original debtor. This will constitute a related transaction within the loan relationship rules as regards both the original debtor, the substituted debtor and the creditor.

However, if the original debt contract contains a debtor substitution clause, the creditor will not make a disposal of his creditor loan relationship. Where a debt contract contains a debtor substitution clause, the novation is not regarded as a disposal of the loan relationship by the creditor, because it is provided for under the terms of the original agreement.

If there is no debtor substitution clause, there may be a variation of rights clause whose terms are sufficiently wide for it to be pressed into service for this purpose.

In practice most novations take place in groups, so that the no gain/no loss treatment will apply to both the original debtor and the creditor.

Accordingly, when involved in the novation of a debt, the first thing to check is the existence or otherwise of a debtor substitution clause, and its potential scope.

The same withholding tax issues may arise as with an assignment.

Sub-participation

In both assignments and novations the participant has direct rights against the borrower. Sub-participations are quite different and introduce a third tier into the lending: hence the term 'sub-participation'. The participant places a deposit with the grantor in the amount of his participation. The grantor agrees to pay the participant amounts equal to his share of payments which he receives from the

debtor. If the grantor receives nothing from the debtor, he has no obligation to transfer anything to the participant. The participant thus holds conditional debt.

The participant will acquire a creditor loan relationship, the debtor being the grantor. The grantor will not enter into a related transaction, giving rise to a profit or loss on the original loan relationship. That stays in place. He will enter into a new loan relationship with the participant, represented by the deposit which the participant has contributed to the grantor.

In a sub-participation the participant has a double credit risk. He is exposed to the insolvency both of the original debtor and of his grantor.

That problem was addressed in a LMA Report of 2010, 'Funded Participation – Mitigation and Grantor Credit Risk'.

The credit risk for the participant will be reduced if he has a proprietary interest in the original documentation or the benefit of Ancillary Rights and Clauses. The point is that this gives the

participant a preferential interest in his deposit in the event of the insolvency of the grantor. Otherwise he is simply an unsecured creditor.

This issue was addressed in *Lloyds TSB Bank plc v Clarke* [2002] UKPC 27. This involved a syndicated agreement for the issue of securities rather than a syndicated loan. However, similar principles apply. The question was whether a sub-participation agreement entered into between banks in a Eurobond issue, conferred upon a sub-participating bank any proprietary interest in the underlying bonds or their proceeds, in a case where the grantor had become insolvent. The Privy Council concluded that the money received by the grantor from the original debtor was simply the measure of the payments to the participant, rather than the source of the payments.

This shows the importance of the drafting of the sub-participation agreement. It is also a factor which will be taken into account if the participant's loan asset is fair valued.

Tax grossing-up clauses in the original loan agreement will not carry over into the sub-

participation agreement, because this will be a new loan agreement.

If the grantor is UK-based, and the participant is resident outside the UK, withholding tax may have to be applied to interest which the grantor passes on to the participant.

As the grantor has agreed to account for interest which he receives from the debtor pound for pound to the participant as soon as he receives it, and has no power to dispose of the interest, for tax treaty purposes the grantor may cease to be 'beneficial owner' of the interest payable by the debtor. In that case he would not be able to claim the benefit of being able to receive interest free of withholding tax under the interest article of a double taxation agreement. This would in turn trigger the tax grossing-up clause in the loan agreement.

It was held in *Indofood International Finance Ltd v JP Morgan Chase Bank* [2006] STC 1195 that 'beneficial ownership' has an autonomous meaning – an international fiscal meaning - in double taxation agreements.

In market type sub-participation agreements, market practice will have a role in the application of double taxation agreements, and there is an argument that the grantor retains beneficial ownership of the interest in both domestic and international law.

Risk participation

In a risk participation the participant agrees to guarantee payment obligations of the debtor. The participant gives a guarantee to the lead bank of a portion of the debt owed by the borrower to the lead bank. The participant does not provide funding to the lead bank.

Guarantees are commonly found within groups of companies, where one company will guarantee the borrowings of another company in the group.

There is no disposal of the loan relationship by the grantor because the participant as guarantor only has a contingent liability. This will be recorded in the notes to the accounts. The fees received by the guarantor will be general commercial income, not profits on loan relationships.

If the guarantee is called on, the amounts paid by the guarantor will not as such give rise to losses on a loan relationship, because the guarantor has no creditor loan relationship. However, under the doctrine of subrogation the participant may be able to step into the shoes of the grantor. Subrogation acts as an equitable assignment to the participant by operation of law of the lead bank's payment rights as against the debtor. The participant will then be able to include its payments under the guarantee as loan relationships debits.

Within a group of companies, the guarantee by one company of the loan obligations of another group company may have transfer pricing implications.

Since the introduction of the corporate interest restriction (CIR) rules in 2017, the practical importance of arm's length principle (ALP)-based transfer pricing rules has greatly diminished. However, the CIR rules contain no specific rules relating to guarantees and guarantee payments, so the CIR still leaves room for ALP-based transfer pricing rules to apply to the guarantee.

In relation to the group ratio percentage and the computation of the qualifying net-group interest expense (QNGIE), the use of guarantees to provide indirect financial support has a number of aspects. The provision of a direct financial support to a member of the world-wide group (WWG) by a company which is not a member of the WWG might have the effect of making the lender into 'related party' within TIOPA 2010, ss 462-465, with the consequent dilutive effect on QNGIE. However, the use of guarantees can forestall this possibility, while producing the same commercial result.

Accounting aspects

The essential aim of the transferor is normally to secure derecognition of the financial asset.

Derecognition of financial assets is regulated by FRS 102, Section 11; IFRS 9 [IAS 39]. The transfer of a financial asset is derecognised only if the transferor either transfers the contractual rights to receive the cash flows of the financial asset (this is an assignment or novation) or (in the case of a sub-participation) the transferor retains the contractual rights to receive the cash flows of the financial

assets but assumes a contractual obligation to pay those cash flows to a recipient. This arrangement must satisfy three conditions:

- the transferor has no obligation to pay amounts to the recipient unless it collects equivalent amounts from the original asset (sub-participations always so provide);
- the transferor is prohibited from selling or pledging the original asset other than as security to the recipients for the obligation to pay it cash flows; and
- the transferor must remit any cash flows it collects to the recipient without material delay. The transferor is not entitled to reinvest the cash flows, except for investment in cash or cash equivalent during a short period. Interest earned on the investments must be passed to the recipient.

Stamp duty

Stamp duty should never be overlooked in

documentary transactions, but instruments transferring loan capital are generally exempt from stamp duty: Finance Act 1986, s 79. This exemption will not apply in the case of convertible debt.

Conclusion

The tax effects of loan transfers are wide-ranging and can be surprising. The essential starting point will always be a detailed analysis of the banking documentation giving effect to the transaction.