FIELD COURT TAX CHAMBERS

FCTC DIGEST

13th Edition (December 2022)

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EDITORIAL

Patrick Soares

This is the thirteenth edition of the FCTC Digest and the Christmas 2022 edition.

It comes hot on the heels of the Hunt-Sunak Autumn Statement of 17 November 2022 which in turn had come hot on the heels of the notorious largely discarded Kwarteng-Truss mini-budget of 23 September 2022.

The Autumn Statement is a bit of a damp squid (which is a compliment in tax circles) and contains no major tax changes of substance but is seems to have done the economic trick. It is covered in the first article by the editor.

There is a veritable feast of other articles in this Christmas edition.

The second article also by the editor seeks to answer the question:

> **How do I get land into the family company without paying too much SDLT.**

The third article by **Patrick Way KC ("the barrister of the stars" as he acts for so many celebrities) looks at the tax payable by musicians who sell their recording and publishing rights for a capital sum** and how HMRC can charge the same to income tax. He looks at the areas (albeit narrow areas) where that charge may not be applicable.

The fourth article is by **Peter Vaines** and deals with the determination of market value for tax purposes. **It is sometimes said that "all tax planning is about valuations."** Even in deals between unconnected parties HMRC may argue the transaction was not a bargain at arms' length for CGT purposes (generally market value has a very limited application to SDLT in such cases). A liquidator may get many bids on different terms – which one is the market value. In that situation the editor relies on Vinelott J in *Whitehouse v Ellam* 68 TC 377 where the taxpayers acquired a company debt for £3,000 which had a face value of £124,223.60 from an unconnected lender. It was held that as the lender (vendor) was unconnected the price paid was the best evidence of market value. Vinelott J stated:

> I do not see how any other method of valuation can possibly have had the result of displacing what was actually received in favour of some wholly hypothetical value....

The fifth article is by **Katherine Bullock** and looks at the question of whether multiple trusts can be created for CGT purposes and what the effects are of creating multiple trusts. **Multiple trusts is a difficult area but it must be faced and the planning opportunities must not be overlooked.**

There then follows two articles on the crypto world, the first by **Dilpreet K Dhanoa & Oktavia Weidmann** and the second by **David Southern KC & Oktavia Weidmann** working overtime. **These two articles are <u>a must read</u> for those entering into the crypto world.**

The eighth article is by **"Mr Transfer Pricing" Richard Collier**. His article deals with the provisions in the **Finance Bill 2022-23** concerning the new transfer pricing documentation requirements for large businesses operating in the

UK. The new provisions take effect from 1 April 2023 and the effect of these are to:

> .... expand HMRC's information gathering powers, increase the compliance burden on taxpayers, and are in practice likely to increase transfer pricing compliance/ controversy risks (including potentially tax geared penalties) for MNE groups.

The ninth article by **Rita da Cunha** deals with the case of *AllianzGI-Fonds AEVN* before the Court of Justice of the European Union where it was held that the imposition of a withholding tax on the payment of a dividend by a Portuguese company to a German investment collective was **an infringement on the free movement of capital.** This is important to UK taxpayers:

> As the free movement of capital in Article 63 of TFEU applies to third countries, *undertakings for collective investment in transferable securities* and *undertakings for collective investment in real estate* established in third countries (e.g., UK, US, Brazil) may also be entitled to a refund of the amount of tax withheld in

respect of dividends distributed by Portuguese companies.

The final article is by **Oktavia Weidmann** and is on **the taxation of equity derivatives** held by companies. If you are having to wrestle with this area this article – the first of two – is **a God send!**

Merry Christmas to all our readers from FCTC!

Patrick C Soares

Editor

AUTUMN STATEMENT 2022 –

WHAT IT MEANS TO TAX ADVISERS

Patrick C Soares

The Chancellor of the Exchequer, the Rt Hon Jeremy Hunt MP, delivered his Autumn Statement to Parliament on 17 November 2022.

This article looks at some of the points of interest for tax advisers.

No dramatic changes are proposed and the general rates of CGT – 20% and 28% – remain unchanged.

Basic rate of income tax

This remains at 20%.

Income tax - frozen personal allowance

The Personal Allowance and basic rate limit will be fixed at their current levels up to and including 2027 to 2028 tax year. It will set the Personal Allowance at £12,570, and the basic rate limit at £37,700 for tax years:

- 2026 to 2027
- 2027 to 2028

The Primary Threshold (PT) for Class 1 NICs, the Lower Profits Threshold (LPT) for Class 2 NICs and Lower Profits Limit (LPL) for Class 4 NICs will remain aligned with the Personal Allowance for Income Tax for these years.

The higher rate threshold (the PA added to the basic rate limit) will be £50,270 until 5 April 2028.

The NICs Upper Earnings Limit (UEL) and Upper Profits Limit (UPL) will remain aligned to the higher rate threshold at £50,270 for these years.

Income tax additional rate threshold from 6/4/2023

The income tax additional rate threshold (after the threshold the tax rate is 45%) will be lowered from £150,000 to £125,140 from 6/4/2023.

Dividend allowance

The dividend allowance will be cut from £2,000 to £1,000 (2023) then £500 (2024).

CGT allowance

The CGT allowance will go down to £6,000 (2023) then £3,000 (2024).

No change in CGT rates

What is conspicuous by its absence is any mention of increasing the CGT rates.

There are no fundamental reforms of CGT proposed.

CGT – share exchanges into foreign company shares

There are to be new share exchange provisions which apply to individuals who hold more than 5% of shares and securities in a UK close company and exchange some or all of those securities for an equivalent holding of securities in a non-UK company.

The measure deems securities in a non-UK company acquired in exchange for securities in a UK company to be located in the UK for the purpose of Capital Gains Tax (CGT). Individuals will pay tax on gains or dividend and distribution income received in respect of those securities deemed to be located in the UK in the same way as they would if the securities were in a UK company.

This measure will only apply where the UK company is a close company and non-UK company would be a close company if it were a UK company. In particular, it will prevent UK resident non-domiciled individuals who exchange securities in a UK company for securities in a non-UK company from accessing the remittance basis of taxation on gains realised on the disposal of those non-UK securities or distributions received in respect of those securities.

The measure will have effect for share exchanges or schemes of reconstruction carried out on or after 17 November 2022.

Corporation tax

This will be increased to 25% for companies with over £250,000 of profits from April 2023.

Inheritance tax

The tax-free thresholds and the home nil-rate band taper available for Inheritance Tax will be frozen at their current levels for tax years 2026 to 2027 and 2027 to 2028.

This means qualifying estates can continue to pass on up to £500,000 and the qualifying estate of a surviving spouse or civil partner can continue to pass on up to £1 million without an Inheritance Tax liability.

VAT

The VAT threshold is to remain at £85,000 until 31 March 2026.

OTHER TAX UPDATES

Offshore Corporates Owning UK Property – HMRC letter campaign and Guidance for CIOT members

23 Nov 2022

HMRC have told the CIOT that they will be launching a new campaign in November 2022 to tackle non-compliance linked to offshore corporates owning UK property.

HMRC reviewed data, including from the Land Registry. They identified non-resident corporate owners of UK property that may not have met certain UK tax obligations. Depending on the circumstances, HMRC may issue one of two letters. The letters will be accompanied by a Certificate of Tax Position and a Notice of Intention to Disclose. While the letters are addressed to the corporates, both also recommend that the companies should ask connected UK-resident individuals to ensure their personal tax affairs are up to date in respect of the related anti-avoidance provisions.

One letter will be issued to non-resident companies that own UK property and may need to disclose income received as a non-resident corporate landlord or a liability to the Annual Tax on Enveloped Dwellings (ATED). Under the Transfer of Assets Abroad (ToAA) legislation, UK-resident individuals who have any interest in the income or capital of a non-resident landlord, whether directly or indirectly, may be within the ToAA income charge provisions at s721 and s727 ITA 2007. A UK resident who has not personally transferred assets but benefits from a transfer made by somebody else (e.g., occupation of property) may be within the ToAA benefits charge at s731 ITA 2007. The letter recommends that any such individuals should seek professional advice to ensure their affairs are up to date.

The other letter will be issued to non-resident companies that appear to have made a disposal of UK residential property between 6 April 2015 and 5 April 2019 without filing a Non-Resident Capital Gains Tax (NRCGT) return. Between 6 April 2015 and 5 April 2019, disposals of UK residential property by non-resident companies were subject to NRCGT. Where the company purchased the property before April 2015 and the whole of any overall gain is not charged to NRCGT (or otherwise), then that part of any gain not charged may be attributable to the participators in the company under s13 TCGA 1992 (these rules have since been relocated to s3 TCGA 1992). Additionally, such corporates may also be liable to pay UK tax on rental profits, income tax under the transactions in land rules and/or ATED. Again, the letter suggests that any individual participators should seek professional advice to ensure their affairs are up to date.

GETTING PROPERTY INTO A COMPANY - SDLT

Patrick C Soares

THE PROBLEM

Taxpayers may want to get properties held in their personal names into their family company.

This may involve an SDLT charge at up to 17%.

Can anything be done?

The property will be deemed to have been disposed of at market value.

FA 2003 s53 reads thus:

> **53 Deemed market value where transaction involves connected company**
>
> [(1) This section applies where the purchaser is a company and—
>
> (a) the vendor is connected with the purchaser, or

(b) some or all of the consideration for the transaction consists of the issue or transfer of shares in a company with which the vendor is connected.

(1A) The chargeable consideration for the transaction shall be taken to be not less than—

(a) the market value of the subject-matter of the transaction as at the effective date of the transaction……

Connected is defined in CTA 2010 s1122 and includes cases where the taxpayer or the taxpayer and members of his family control the company.

The article only looks at SDLT.

HOW CAN THE CHARGE BE MITIGATED?

I Part-transfers

The taxpayer may transfer a part interest in the property to the company so the charge is on a reduced figure.

Example

Mr X transfers 1/5th (tenancy in common) of Greenacre to his company – he would expect the 1/5th assets basis value to be heavily discounted for the fact he is transferring a smallish interest to the company.

II Licence to occupy

The grant of a licence properly so-called is free of SDLT (FA 2003 s48(2)(b)).

III Reversion

The taxpayer can keep back a lease and transfer the freehold to the company. The freehold may have a small value at the time – so the SDLT charge is small – but this will increase in time as the lease runs down.

IV Unconnected company

If the taxpayer is not connected to the company market value is not substituted. However, if the property is transferred at less than market value to the company any increase in the market value of the shares may be treated as part of the acquisition price so little may be achieved.

V Transfer to English LLP

This will be see-through for SDLT purposes and general UK tax purposes but for overseas members they will see themselves being members in a body corporate with limited liability and that may be sufficient for their purposes.

VI Six flats or more

If 6 or more separate dwellings are transferred to the company the maximum rate of SDLT is 5% (FA 2003 s116(7)). Note if the company is owned by the tenants (or becomes owned by the tenants) the provisions in FA 2003 Sched 4A (higher threshold interest) must be considered. The ATED may also be in point.

VII Incorporation of a partnership

SDLT may be avoided on the incorporation of a partnership of let properties (see Sergeant & Sims AA3.7 and SDLTM 33750).

VIII Contracts

If property is contracted to be sold to the company SDLT is only in point if the contract is substantially performed or legally completed. If the purchaser for example does not take possession and pays less than 90% of the purchase price the contract will not be substantially performed (FA 2003 s44 and SDLTM07950).

IX Company takes as nominee

If the company takes the property as nominee no SDLT will normally be involved (FA 2003 Schedule 16 para 3).

X Company trustee

If the property is transferred to a company and the company holds the property as trustee in the course of a business carried on by the company that consists of or includes the management of trusts then the market value charge is avoided (FA 2003 s54(2)). There may be scope for avoiding the market value charge depending on the terms of the trust.

XI Revocable interests

The taxpayer may grant a revocable interest to the company so the value of what is added to the company is small but the company can still exploit the interest by letting the same for example.

THE TAXMAN'S TAKEN ALL MY DOUGH

Patrick Way KC

Speed read

Many rock musicians are selling their rights in respect of recordings and publishing rights and the market has become very buoyant.

The receipts, however, are typically treated as income receipts subject to tax at a marginal rate of 45% rather than capital receipts taxable at capital gains tax rates of 20%.

There is little room for manoeuvre but, if possible, planning should be exercised to enable the capital gains tax rate of tax to be due rather than the income tax rate.

Taxation of receipts for sales of music rights

In 1966 the Kinks released their song "Sunny Afternoon". The opening words of the song are as follows:

> "The taxman's taken all my dough
> And left me in my stately home

Lazin' on a sunny afternoon
And I can't sail my yacht
He's taken everything I've got
All I've got this sunny afternoon."

Ray Davies of the Kinks was not alone in being worried about the high rate of tax that was charged in the 1960s. The top rate of income tax on earned income was 83%; and the top rate of tax on unearned income was 98%.

Also, in 1966, George Harrison wrote "Taxman" in which he berated the fact (as he saw it) that the UK Exchequer imposed such a high rate of tax.

Indeed, as an aside, bands at that time (including the Beatles) often entered into forward sales agreements. Missing a lot out these agreements sought to wrap up future rights to income from songs in the form of a one-off capital payment in the hope that a much-reduced rate of tax (or even no tax) would arise.

That scheme (sometimes known as the "Silver Beatles scheme") was stopped by the sales of occupation income rules which are currently found within Income Tax Act 2007, Part 13, Chapter 4 starting to read at s.773. Broadly speaking, the capital receipt in that example would be treated as income.

Moving on to the present day, the market for the purchase of the songbooks of rock bands and rock singers is very hot. This may be because it is so easy to stream music now – thanks to Spotify and others. Or it may just simply mean that a lot of the famous rock groups are reaching the age where it makes sense to cash in their hard-earned legacy.

The question arises, however, as to whether a sale of those rights will produce income or capital.

In the last twelve months I have advised on three multi-million pound sales by famous rock legends.

The position broadly speaking is that if the musician has created the rights themselves then those rights are income or give rise to an income tax receipt; whereas if the rights have been created by somebody else then a disposal of those rights would give rise to capital gains tax.

I should say that I have seen HMRC arguing the opposite and have tried to argue (albeit in a case that collapsed for other reasons) that a sale of a bundle of income rights for a one-off sum should be treated as a capital amount subject to capital gains tax by reference to the case of *CIR v. John Lewis Properties plc* (CA 2002, 75 TC 131).

My reason for saying that the rights are income (and not capital) is by reference to some key cases:

> *Glasson v Rougier* (KB 1944 26 TC 86) – (the *Georgette Heyer* case)
>
> In this case Georgette Heyer entered into certain publishing agreement regarding royalties on books sold. After some years the agreements were cancelled and instead she received lump sums from the publisher for the publishing rights. It was held that the sums were revenue receipts of her vocation. This was on the basis, in effect, that there was a commutation of annual sums.
>
> *Mackenzie v. Arnold (CA 52 33 TC 363) (the "Compton Mackenzie case")*
>
> In this case, Compton Mackenzie sold the copyright of various novels which he had written whilst not resident in the United Kingdom. He was assessed to income tax on

the proceeds and his appeal to the effect that the sale proceeds were capital failed, in due course, before the Court of Appeal. The rights were income.

> *Howson v. Monsell (Ch.d 1950 31 TC 529) (the "Margaret Irwin case")*
>
> In this case Margaret Irwin sold the film rights in two of her books in return for fixed sums which were paid in instalments over a period of several years. The amounts in question were held to be receipts of her vocation and were chargeable to income tax.

Accordingly, based on these cases, and taking account of HMRC's usual practice, the income in question will be treated as miscellaneous income under ITTOIA 2005 ss.687 to 689.

There is an exception where, as mentioned, the sale is by someone who did not produced the rights themselves.

This brings me to the next case:

> *Nethersole v. Withers (HL 1948 28 TC 501) (the "Rudyard Kipling case")*

In this case Olga Nethersole obtained the rights to produce a play based on the novel "The Light That Failed" by Rudyard Kipling. In 1914 Rudyard Kipling further agreed to pay to her one-third of the receipts from any film version of the book or play. He died in 1936 and in 1939 his wife assigned the film rights for ten years for £8,000 to a third party of which – pursuant to the above agreement – £2,666 was paid to Olga Nethersole.

The Inland Revenue issued assessments charging income tax on the £2,666. Olga Nethersole appealed, contending that it was a capital receipt for the sale of copyright. The Court of Appeal accepted this contention and allowed her appeal.

In due course the House of Lords upheld that decision unanimously.

Viscount Simon held that Olga Nethersole had "made a partial assignment of her copyright and ceased to be owner of the portion assigned". This amounted "to a sale of property by a person who is not engaged in the trade or profession of dealing in such

> property". It was a "sum in the nature of untaxable capital [capital gains being untaxed at that time] and not in the nature of taxable revenue".

Conclusion

The distinction in relation to the cases above is that Olga Nethersole played no part in the creation and writing of the relevant book and therefore was "at arm's length" from the creative process. So her receipts were capital not income.

This can lead to oddnesses where the musician has died and the rights have been inherited by the musician's heirs. The heirs then, when they come to sell the rights, will be subject to capital gains tax not income tax.

Taxman – the Beatles

This brings me back to George Harrison's Taxman which he wrote in 1966.

The verses include the following:-

> "Let me tell you how it well be
> There's one for you, 19 for me
> 'cause I'm the taxman

Yeah, I’m the taxman

Should five per cent appear too small
Be thankful I don’t take it all
‘cause I’m the taxman
Yeah, I’m the taxman”

MARKET VALUE

Peter Vaines

Market value is an important concept in determining liability in connection with all the major UK taxes.

Inheritance Tax, Capital Gains Tax, Income Tax, VAT and Stamp Duty Land Tax all impose a charge to tax on the basis of market value in numerous different circumstances.

The main definition of market value is that found in section 272 TCGA 1992 as being:

> 'The price which those assets might reasonably be expected to fetch on a sale in the open market.'

This formulation is used for the purposes of SDLT, with section 118 FA 2003 specifically importing the definition in section 272.

Similarly, section 421 ITEPA 2003, imports the capital gains tax meaning of market value for the whole of Part 7 ITEPA, and this is the same for most income tax purposes.

For inheritance tax there an almost identical provision in section 160 IHTA 1984 that the value of any property is the price it might reasonably be expected to fetch if sold in the open market at that time.

For VAT, open market value is defined in section 19 VAT Act 1994, although market value is only used as a basis for valuation for VAT purposes in rather limited circumstances.

I shall not go through all the various issues which arise in the valuation of an asset – nor all the special features which apply to the valuation of assets for tax purposes. It is perhaps sufficient to say that the value for tax purposes bears little or no relationship to the value in the real world.

For a fiscal valuation there is a hypothetical vendor who is a willing but not an anxious seller who naturally wants the best price for his asset. But he does not have the luxury of not selling and waiting for a better offer. In the main, the relevant transaction taxes place on a certain day and the sale must take place on that day whether the parties like it or not.

We must also consider the position of a hypothetical purchaser who is a willing but not an anxious purchaser. He is a prudent man of business who is appropriately informed about the market; and he does not have the opportunity to walk away either.

All prospective purchasers are assumed to be in the market, including special purchasers for whom the asset will be of particular value. The obvious examples are an asset which will complete a "set" for the purchaser or the purchase of a 5% shareholding by a shareholder with 46% as this 5% will give him control of the company.

There are many more features to consider – but this is probably enough for the moment.

I mention all this by way of background because there have been two recent cases where the meaning of "market value" has been considered by the Tribunals.

In the case of *Close v HMRC TC 8518*, Mr Close (and others) gave some shares in a trading company to a charity and claimed income tax relief under section 587B ICTA 1988 for their market value. (The corresponding relief under the present legislation is section 431 ITA 2007). For the purpose of this provision, market value is determined by reference to the capital gains tax rule in section 272 viz, being the price which the asset might reasonably be expected to fetch on the open market.

Shares in the company were listed on AIM and were dealt in at a price of 53p at about the time of the gift. So that was the price used by Mr Close in calculating his relief.

One would have thought that was pretty conclusive. Unfortunately not.

The expert valuer for HMRC valued the shares at about 8p on conventional valuation bases with all the artificial assumptions required for the valuation of unquoted shares for tax purposes. He could not explain why the AIM figures were so high because such a value could not be justified by the normal analysis of turnover and profits. (Well no. Stock market values are often a mystery, even to experts, but just because you don't understand them doesn't mean they are wrong).

The Tribunal broadly agreed with HMRC and held that the market value should be taken at 12.1p per share.

It is difficult to understand how this conclusion was reached in the face of a value on AIM of 53p. When looking at the definition in section 272 we have to look at the price at which the shares might reasonably be expected to fetch on a sale in the open market.

When the shares are being bought and sold on AIM at 53p it is difficult to see why that is not the relevant price in accordance with the legislation. That must surely be the epitome of an open market.

The FTT simply disregarded the fact that the shares were listed and traded on AIM:

> "There was no evidence before me as to the way in which the AIM market operated, in particular the involvement of market makers and how potential purchasers are matched with potential sellers....In the circumstances I can give no weight to the existence of the market transactions as at 9th December 2003"

The only reasonable conclusion would seem to be that the judge did not trust the AIM price to be sufficiently genuine to override the value which would apply if there were no such AIM transactions.

The second market value case was the decision of the Upper Tribunal in *Pickles v HMRC [2002] UKUT 253* which was concerned with an entirely different situation – the incorporation of a trading partnership involving the sale to the company of the goodwill. This took place in 2011 when Entrepreneurs Relief applied to sales of goodwill to a company in these circumstances.

The goodwill was valued at £1.2m and sold to the company by the partners for that price. They were paid some of the money, but the balance was credited to their directors' loan account.

Unfortunately, the value of the goodwill was ultimately determined by the FTT to be only £270,000 and the whole of the unpaid balance was treated by HMRC as a distribution under section 1020 CTA 2010.

Section 1020(1) says that where an asset is transferred to a company by its members the value of the benefit received by the member (which is treated as a distribution) is the amount by which it exceeds the amount of the consideration given by the member.

Section 1020(3) provides that the value of the benefit received by the member is determined in accordance with market value.

The taxpayer said that the market value of the benefit (to be treated as a distribution – in addition to the excess payments actually received) was the market value of the unpaid consideration. If the value of the goodwill was £270,000 and the company had other assets of only £95,000 the total was £365,000 and the excess was only £95000.

HMRC did not agree; they considered that the amount of the benefit should be calculated on the basis of the face value of the asset transferred.

Quite right said the Tribunal. Market value for this purpose did not mean open market value. In particular it did not have the same meaning in this part of the CTA 2009 as it did in numerous other parts of the CTA 2009. The Tribunal held that market value in this context meant the value placed on the asset by the member at the date of the transaction. That was £1.2m so that is the figure which had to be used.

This is difficult to follow as the whole idea of having a market value substitution provision is to displace the value put on the transaction by the parties which is so obviously open to abuse. The value which is substituted is the market value and however that may be defined, it does envisage some correlation with the market, in other words some independent assessment of the true value.

In this case the parties placed a value on the goodwill which bore no relation to its true value – the reason for which was obvious.

The market value had been determined by the FTT at £270,000 but that was clearly of no relevance if the market value is not to be used.

I respectfully suggest that something has gone awry here.

I would submit that it was not the operation of hindsight (as suggested by the Tribunal) which was the issue here, any more than it is in any other transaction where market value needs to be substituted. The taxpayer sold his goodwill to the company for a figure way in excess of its true value and got rather undone when the FTT determined the market value at £270,000. To the extent that he drew more than that value from the company as consideration for the goodwill, that excess was a distribution and chargeable to income tax. However, the credit to the directors loan account for the price of £1.2m was clearly wrong. It should have been only £270,000, leaving no unpaid consideration – because there was none. Only the excess drawn out would be the distribution.

However, the Upper Tribunal said that this is the wrong analysis and that the taxpayer had to be charged on the full amount that he had said the goodwill was worth.

The taxpayer enquired what the position would have been if the consideration had been £1 billion? Would that have given rise to a distribution of (nearly) £1 billion. No, said the Tribunal because there would have been no genuine intention to pay that amount. (It is a pity that this enquiry was rather overcooked. I wonder what the Tribunal would have said if the consideration had been (say) £10m, an amount which could have been within the range of a genuine intention to pay, because the Tribunal would not have been able to sidestep this rather good question).

Clearly this is a case of burnt fingers but that alone does not necessarily enable the facts to be reconciled with the relevant principles and the legislation.

HOW DO YOU TAKE YOUR CGT?

ONE SETTLEMENT OR TWO?

Katherine Bullock

Can you set up multiple trusts under a single settlement with a single will, or do multiple trusts mean multiple settlements?

Wills and settlements are the cornerstone of many estate and tax planning exercises. When and how one settlement becomes two settlements is, of course, a complex question to which the courts have given detailed consideration over the years. However, the question of whether a settlor creates from inception one settlement containing multiple trusts or multiple settlements, each with their own trust, is far less clear. For lifetime settlements, the answer is usually more straightforward – at the risk of over simplifying, each settlement tends to have its own deed as a starter for ten. However, when it comes to a will, it is hard to offer an easy test. So does a will that creates a nil rate band discretionary trust with the residue on life interest trust for the surviving spouse create one settlement or two? How do you go about drafting a will to account for this issue of multiple settlements?

Whilst this may be largely an academic exercise for IHT purposes as the settlements will be related, for CGT and SDLT purposes, the answer to this question can be far more material.

The Legislation

To lay some groundwork, it might be helpful to begin with some definitions. This is not helped by the easy interchangeable use of the words "settlement" and "trust". For the purposes of this article, I am going to use the word "settlement" to mean a settlement for the purposes of the CGT and IHT legislation and the word "trusts" to mean the set of obligations that may attach to particular property held within such a settlement.

Sadly the word "settlement" is not defined in the CGT legislation; instead its meaning needs to be deduced. It is clearly related to the expression "settled property" as defined by TCGA 1992 s.68 (ie "any property held in trust") but this doesn't get us much further. It extends to cases where property becomes settled property by virtue of a will as well as a lifetime disposition. It is also reasonably clear that "settlement" means the process of holding property on trusts and not the disposition that settles the property on the trusts in question. Whilst it is possible to have distinct trusts with distinct funds and distinct beneficiaries within a single settlement, the legislation provides no further guidance on when these might constitute the same or separate settlements. Thus we turn to the Courts' interpretation.

Case Law

Given the lack of statutory direction on the meaning of "settlement", the Courts generally approach the meaning of "settlement" and "settled property" in the manner explained by Lord Wilberforce in *Roome v Edwards [1982] AC 279*. Lord Wilberforce identified a number of obvious pointers which may help to show whether there is a single settlement. These are:

- Separate and defined property;
- Separate trusts;
- Separate trustees;
- A separate disposition bringing the separate settlement into existence.

However, Lord Wilberforce noted “These indicia may be helpful, but they are not decisive. For example, a single disposition eg a will with a single set of trustees may create what are clearly separate settlements, relating to different properties, in favour of different beneficiaries… There are so many combinations of fact that even where these indicia or some of them are present, the answer may be doubtful, and may depend upon an appreciation of them as a whole.”

In principle, therefore, where these four conditions are met a will may create separate settlements – even though created by a single disposition and held by the same trustees.

The test proposed by Lord Wilberforce is a “practical informed business person test”: “Since 'settlement' and 'trust' are legal terms, which are also used by businessmen or laymen in a business or practical sense, I think that the question whether a particular set of facts amounts to a settlement should be approached by asking what a person, with knowledge of the legal context of the word under established doctrine and applying this knowledge in a practical and common-sense manner to the facts under examination, would conclude.”

A similar test, this time "the practical trust practitioner test", was proposed by Park J in his judgement in *Rysaffe Trustee Co (CI) Ltd v IRC* [2002] STC 872, a case concerning multiple settlements for IHT purposes; his approach and reasoning being warmly approved on appeal. In Park J's view it is not necessary to have a statutory definition to determine whether there is one settlement or more. "Trust practitioners can recognise a separate settlement when they see one, and equally they can recognise a case where there is only one settlement, not several settlements, when that is what they see. Often, fiscal considerations apart, it will make little or no difference in the end whether, for example, a settlor chooses to make one large settlement, or instead to make several smaller settlements. But there is no doubt that as a matter of general principle the two courses are different and create analytically different structures. What kind of structure a particular settlor has created will depend on how he chooses to do it." Noting that the wording of the capital gains tax legislation is not at all the same as the wording of the IHT legislation, Park J continued that, even so, the approach to the question of what is a settlement for the two taxes ought to be the same. "It is the approach of applying the general understanding of trust law and trust lawyers".

Whilst the Court of Appeal has considered whether or not there is a single settlement from the outset for CGT purposes in two decisions, the question of whether a single disposition creates more than one settlement from inception remains unclear. In *Crowe v Appleby* [1976]51 TC 457, where it was argued that a will created several settlements over an undivided share, after expressly noting that his remarks were obiter and provisional, Sir John Pennycuick said:

> "I do not think this is a correct analysis of the position. It is of course competent for the owner of an undivided share in property to make a settlement of that share; and I do not doubt that if he does so, that would be a different settlement distinct from the head settlement which created the undivided share. But where the trusts of each share are declared by the settlor himself, then I think there is a single settlement upon the totality of those trusts and a single trust fund until it

> is broken up by payment out or appropriation."

So far so good, but what is the position where there is no single trust fund and the totality of the trusts apply to each fund separately?

In *Roome v Edwards,* in the Court of Appeal, Templeman LJ also considered the question:

> "If a trust fund is settled on, or appointed to, different beneficiaries in aliquot [undivided] shares, the trustees of the trust fund may treat the whole trust fund for capital gains tax purposes as one settlement; but that is because capital gains tax payable in respect of any dispositions of any of the assets comprised in the trust fund will fall proportionately and equitably on the beneficiaries interested in the whole of the trust fund in different shares. But where a settlement originally, or as a result of an appointment, creates different trusts of different properties, then for capital gains tax purposes, there are created different states of affairs brought about by one or

> more documents and thus creating two distinct settlements."

The Court of Appeal's decision was reversed in the House of Lords. Separate settlements are not created just because separate property is held on separate trusts. Nevertheless, where a single settlor settles separate funds on separate trusts by a single disposition separate settlements cannot be ruled out.

Whilst the remaining body of case law does not address the identification of the number of settlements at inception, they do provide some helpful indicators. For example, in *Bond v Pickford* [1983] STC 517, the test was whether following the transfer of assets, the original trustees still had duties to perform in respect of those assets transferred as trustees of the original settlement. Restating this test for multiple trusts created under a single will, it might be appropriate to ask whether, if you assume different trustees for each trust created under the clauses of the will, would any interaction between those trustees be required once the executors transferred the property? In other words, are they distinct and separate with no possibility of income or capital reverting to the other trusts?

Overall then, it would appear that despite being given a set of indicia of whether a will creates one or several settlements, the facts of the individual case remain of paramount importance. Perhaps, then, it is time to look to the guidance provided by HMRC and see what their position is on the issue and whether that clears up matters somewhat.

HMRC Practice in deciding whether separate settlements arise under a single will

In their manuals at CG33280, HMRC state (my emphasis in bold):

> ***In general you should assume that a single deed or will gives rise to a single settlement, even though there may be several distinct trusts.*** *If it is suggested that there is more than one settlement, you should obtain a copy of the instrument, and ask the trustees why they think there is more than one settlement. It may be helpful at this stage to draw attention to the principles expressed by Lord Wilberforce in Roome v Edwards at 54TC390E, that `the mere existence of separate trusts applying to parts of settled property does not in itself give rise to*

a separate settlement'.

The starting position is therefore that a single disposition may create two trusts but one settlement for CGT purposes. However, almost immediately the waters are muddied as HMRC then note that most cases where there is doubt are trusts created by a will, because it is extremely rare for there to be more than one will.

HMRC extract three factors pointing towards multiple settlements from *Roome v Edwards* (being (i) separate property (ii) separate trustees (iii) separate trusts) but they note, as we did above, that these are indicative only of separate settlements and not conclusive pointers. The questions must be approached in a practical and common-sense manner.

HMRC also note that "the fact that a beneficiary may benefit under several clauses is sometimes a pointer to the trusts declared in those clauses being a single settlement." The position must be considered at the date of death and Inspectors are advised to resist any attempt to start by analysing the position at the present time.

Separate Property

HMRC give the following guidance (my emphasis in bold):

> *It is quite common, particularly in a will, for there to be one or more clauses that deal with specific property, for example a house or a parcel of unquoted shares. The residue is dealt with in one or more further clauses.* ***This is a strong pointer to there being separate settlements, particularly if there is no possibility of the property falling into residue****.*

HMRC contrast this with the situation where the residue is held on two sets of trusts without a direction that the property should be divided into two separate funds and in particular if dealt with as a single block of property. Several funds that share common property is therefore indicative of a single settlement.

Separate Trustees

HMRC note this as "an extremely strong pointer to a separate settlement" unless there is clearly a short term purpose but note that separate trustees in a will are virtually unknown.

Separate Trusts (ie obligations governing beneficial entitlement)

HMRC explain that it is common for a clause in a will to provide that if the preceding trusts fail then the property is held on the trusts of another clause. They state, "in such a situation it could be said that the trusts are not separate." However, they consider that this cannot be regarded as an absolute rule particularly in the case of a will. If the possibility of failure is not remote (and HMRC note that a person failing to reach a specified age or having no children is not remote) and there is specific provision for the property to be held on the trusts of the other clause, there is only one settlement.

If there is only a remote possibility that the trusts of one clause might fail with the result that the property falls into residue, it may be accepted that there are separate settlements. If the will provides for an individual or individuals or a charity to take absolutely under more than one clause "that in no way prevents there being several settlements".

Separate Beneficiaries

In HMRC's view, the fact that the same person may benefit from several clauses does not prevent there from being several settlements. However, interestingly they state that if at least one of these clauses provide discretionary trusts, this may indicate one settlement because the trustees would probably be expected to consider the interests under the other clauses in deciding how to allocate the income of the discretionary fund. If so, they are clearly trustees of the will as a whole.

Other factors not mentioned by HMRC but which are often argued as indicative of multiple settlements are separate dispositions, separate settlors and separate administration. None of these appear to be given weight by HMRC. It is a question solely of construction of the instrument itself.

At HS294 Trusts & Capital Gains Tax (2022), updated 6 April 2022, HMRC in their guidance on completion of the trustees' self-assessment return refer back to their own guidance given previously. They also state that:

> *HMRC accept that it's possible for a will to create several settlements if the property in each is entirely separate from the property in the other(s) and the trusts declared in the will are entirely separate or will merge only in*

totally unexpected circumstances.

This appears to indicate that they consider separation of property and of the trusts as key.

Once again we are left with the impression that although there may be a set of reasonably safe assumptions to be drawn from the indicia set out in *Roome v Edwards*, HMRC does not offer a magic bullet.

Inheritance Tax (IHT)

For inheritance tax purposes, IHTA 1984 s43 suggests that where several dispositions are made in a single instrument it is possible for there to be only one settlement. However HMRC note at IHTM42232 that "where trusts are made at the same time by a single deed or will, they are likely to be separate but related trusts." If the trusts established in the will exist independently of each other they are separate trusts even if the trustees are the same and there is the possibility of the trust property accruing to the other settlement or being added by partial intestacy.

Conclusion

Perhaps at the end of the day, a settlement is rather like the proverbial elephant – impossible to describe and yet we all know one if we see one. The indicia in *Roome v Edwards* provides a useful starting point but every case will turn on its own particular facts and circumstances. Whilst the number of settlements should perhaps be obvious on its face, there is little scope for complacency. As with so many areas of taxation, the optimum outcome is often only achieved by those that plan in advance. Specifically, the matter of whether a single settlement or multiple settlements is created by a will needs to be carefully and thoroughly considered before the drafting and settling process begins so that the desired outcome is achieved. With the lack of a silver bullet solution or a definitive test, the desired outcome must be tailored to the specific circumstances. Certainly, appointing different trustees to different trusts within the same will may be a handy way to sign that "here be dragons".

FROM CRYPTOCURRENCIES TO THE VIRTUAL WORLD:

Cryptocurrencies, NFTs, Skins, Virtual Gaming Items and UK VAT Implications

Part 2: NFTs, Skins and Virtual Gaming Items

Dilpreet K. Dhanoa & Oktavia Weidmann[1]

The time will come when diligent research over long periods will bring to light things which now lie hidden.

-- Lucius Annaeus Seneca, Natural Questions.

This article is the second of two articles dealing with the seemingly peculiar world of cryptoassets. In the first article, we investigated the UK VAT treatment of cryptoassets and NFTs.[2] In this article, we will

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2 Oktavia Weidmann and Dilpreet K. Dhanoa, From Cryptocurrencies To The Virtual World: Cryptocurrencies, NFTs and UK VAT Implications, 12th FCTC Digest (2022), pp. 96 – 130.

mainly focus on the VAT implications in relation to so-called Skins and virtual gaming items purchased and sold in online games. The first article in this series is referred to in the footnote.

An overview of the **direct tax aspects** relating to cryptoassets for individuals and businesses can be found in the articles by David Southern KC and Oktavia Weidmann, 'Cryptoassets: A New Weapon of Massdestruction?', published in the 10th edition of the FCTC Digest.[3] Further articles deal with profit and losses of cryptoassets held by businesses and deal with both accounting and taxation aspects.[4]

The world of gaming is currently an industry projected to reach $330 billion in revenue (excluding

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[3] David Southern QC and Oktavia Weidmann, Cryptoasseets: 'A New Weapon of Massdestruction?' 10th Edition, FCTC Digest, April 2022, 111-140.

[4] Oktavia Weidmann, From Cryptoassets To The Virtual World: To Impair, Or Not To Impair – How To Treat Losses From Cryptocurrencies? 12th FCTC Digest (2022), pp. 64 – 95 and in this issue: David Southern, KC and Oktavia Weidmann, Crypto taxation of businesses: How To Treat Impairment Losses From Cryptocurrencies? 13th FCTC Digest (2022)

hardware) by 2025.[5] It is an industry that has seen an extraordinary rise, and coupled with the increasing sophistication of gaming technology and the ability to play online ‘socially’, it has found an extraordinary following across generations – not just Generation Z.

Understanding the shift in technological change is critical to part of the fundamentals in noting how the technology is used, and importantly, the sorts of transactions that are or could be taking place – the essential component in understanding what should be taxed and who should be taxed.

There are three faces of a fundamentally technological change. The first is mobile, which has grown to generate half of the industry's revenue. Second is the shift from physical to digital, whereby 90% of content is now delivered digitally. And third is the change in business model to monetise gamers differently with free-to-play games - give the games for free and then charge them within the game.

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[5] Bain & Company, Gaming Industry Report: https://www.bain.com/gaming?gclid=Cj0KCQiAsoycBhC6ARIsAPPbeLt6K2BvKaORyPkZ7YwdF-Fi0Yx-Kn37y5n2tHQqwBQS77JMu56e0WwaAi26EALw_wcB (accessed: 2 November 2022).

What does this growth look like geographically?

Half of all gamers are in Asia-Pacific and the rest are roughly evenly split across all the other regions, but in terms of revenue, it follows overall levels of wealth with North Americans and Europeans generating half of overall revenue despite being only one quarter in terms of numbers. The critical thing to remember about geography is that history matters. Wealthier North American, European and Japanese gamers were raised in a console first environment, whereas those in China, India, South America and EMEA are mobile-first countries.

In India, 80% of the population have no other way of accessing the internet other than their phone. So the historical context of how gamers came into this world is critical in understanding the industry and trying to predict the future. This can be seen in the numbers: when you look at the mobile gaming industry, best-selling charts are dominated by casual games for gamers in the west who have their more serious gaming needs met by console and PC, however in mobile-first countries [slide] charts are dominated by higher fidelity, richer storyline and ultimately higher investment games.

In short, if a publisher has a best-selling mobile game in China, for example, they would have to think very carefully about the challenges of selling that same IP to a mobile gamer in the west. And vice-versa – you won't be able to easily sell console-first IP to countries that don't have a high-enough GDP per capita and simple things like 1 or less than 1 television set per person for the people to buy consoles.

1. Gaming: Some History

Part of the issue with taxing the gaming world, is that very often revenue authorities are not entirely sure of what the transaction is and therefore what ought to be taxed. As a result, revenue authorities such as HMRC have (for now) treated most transactions in this universe as 'exempt'.

The authors considered it might be helpful to set out some of the key historical points and terminology in respect of the transactions that take place in the gaming world.

Firstly, where the video industry records reality, games must create reality. Reality is infinitely complex – look at this forest and the millions of components that compose it. The video camera doesn't care about how the trees got there, how they fit with one another, how long are the shadows that the sun casts, what animals live in the shrubs... it doesn't care, it just records what it sees. In a game however, if you want the same visual experience, the computational device must think about all of those things, how they all relate to one another and it must do this every single second because as you move your player, his/her entire perspective on the world changes too.

That is a hugely intensive task and the intensity of that task that will never go away.

Looking at the history of games, it's clear that shifting business models that lower costs and give increased accessibility have always been critical in generating revenue. People mistake Pong as the first game, it wasn't, it was Magnavox's Odyssey system. It didn't succeed because it retailed for $99 and sold only Magnavox stores where staff incorrectly implied it only worked on Magnavox TVs to upsell to customers! So one had high upfront costs.

Gaming company Atari came along and succeeded in placing Pong in arcades, charging only a quarter, and the rest is history as they say. The console wasn't dead however, and the 2nd gen video consoles benefitted from cost reduction on two fronts, falling semi prices and the pioneering cassette system. Once Atari succeeded in separating the console and the game, the razor blade model you see today was born. In a sense that huge growth in free-to-play games you earlier is software version of the hardware razor blade model – give the game for free and then monetise within later within the game. So razor blades on two fronts – hardware and software.

The Japanese focused on character development and story-telling and the Americans focused on gameplay, both bringing a different perspective. Pacman was a novel game because no longer were you simply shooting something, you had chomping face through a maze filled with energy pills and ghosts – it was an experience that was only possible in the world of video games and a completely original concept. So the key lesson here is that novel gaming concepts can radically change the industry – Pacman generated $1 billion in revenue back in the day! – and this is something that we see still see today.

And even back then, everyone knew the importance of monetising IP – you could get Pacman on lunchboxes, t-shirts, pencils, books, and so on. Incidentally, pakku in Japanese means to munch and the romanization of the word led them to brand it as Puckman… when the gaming company Midway were bringing the game over to the US, they changed the name to Pacman because they were well aware how vandals would erase a small part of the p to make it an f.

So the Japanese gave the gaming industry realistic characters but Nintendo ran into a problem with Mario because of a lack of compute power in the 80s – they didn't have the compute power to render hair and its movement realistically when Mario jumped so rather give him unrealistic static hair, they gave him a hat! So technology limitations is why Mario wears a hat!

In today's day and age why would a gamer want to play on the cloud? Well, with increased processing power you should get richer games with better visual fidelity and even greater story lines. Secondly, on the cloud, you can have many more people playing a game at once which is currently limited to about 100 or so given today's servers.

But perhaps most importantly, you can play on any device given all the computation is happening in the cloud. As a gamer, you get much better games on your mobile because of the increased processing power and you can easily continue your progress moving from one device to another. The first of those two points – the much higher quality of games – will be a huge reason why mobile-first countries will be eager to adopt cloud gaming as 5G rolls out – you get an experience in some ways, not all, better than a console but certainly much better than what you get on your phone today, and better monetisation rates of these games will follow.

And it works on the other side the platform too – as a gaming developer, you can focus on building your game on one platform rather than having to repurpose it for mobile from console for example and this is currently a large technical hurdle for AAA game developers to move into mobile.

Such is the value proposition all round that one cannot help but think that this is near some sort of an end-game - the cloud gaming platform winners will close the door behind them and will have a long runway for growth. In some ways, it is the ultimate razor blade model. You have none of the upfront costs of a console and in theory could play a significant number of free-to-play games forever. So if a games developer creates a platform and monetises the publishers through advertising, how can that be truly competitive when seemingly pretty much everything is free and unlimited for gamers.

2. Technical aspects and terminology

Before coming to the taxation aspects, we will briefly remind our readers of the terminology with respect to virtual gaming items and Skins.

Virtual gaming items usually belong to a different category than NFTs (although there are exceptions to NFTs used in games).[6]

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[6] A lot of gamers are children and teenager, which triggers questions of how those children can acquire in-game items and if those purchases are legally valid and if those buying and selling of in-game digital items constitute gambling and thus,

In-game items are usually called **Skins**.[7] Other than being the largest organ of the human body, the gaming world has given another meaning to the word. In short, a skin changes the look of an item in a video game. For example, an object in an online game can have different 'skins' which inevitably make the object look different. They are entirely cosmetic and do not alter the actual game-play nor do they give extra power/strength etc. to the gamer.[8]

Skins can either be purchased in the game's online store, earned within a video game or gamers can open so-called loot boxes (also named cases) where they may find a skin. Of course, they have to pay for the loot box a certain small amount, and it is uncertain which gaming items they find within the

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should be prohibited for children at all. But this is not the concern of this article and we have to accept that gaming and the purchase of in-game items is also popular with for many adults. For this topic, the Royal Society for Public Health Vision, Voice and Practise RSPH) has published a leading article, discussing the notion of gambling: RSPH, Skins in the Game, https://www.rsph.org.uk/static/uploaded/be3b9ba8-ea4d-403c-a1cee2ec75dcefe7.pdf, accessed 20 August 2022.

[7] We will use the terms *digital goods* and *Skins* and *gaming items* interchangeably throughout this article.
[8] See also: Skins & Skin Betting: https://www.videogames.org.au/skin-betting/ (accessed: 4 November 2022).

case. Thus, the gamers are incentivised to purchase many boxes in the hope to find a skins, knifes, gloves stickers etc.

Some skins are rarer than others, and a gamer with a rarer skin may acquire certain recognition in the online gaming world (think the equivalent to haute couture in the real world).

The story does not end there with skins, however. Gamers trade those Skins among each other, and the prices can fluctuate substantially. Skin betting is becoming a popular activity that gamers engage in. This is essentially where gamers use skins as tokens by which to gamble with. For tax purposes, whilst it may be easier to put this under the broad umbrella of 'exempt', it would be entirely inconsistent with how the rest of the gambling industry is treated.

The prices of Skins range from a few pounds to thousands of pounds, depending on their scarcity, and the main trading platform for Skins is Steam.[9]

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[9] There are thousands of articles on the internet on how to buy and sell Skins on Steam, but this article gives a flavour to our readers what it is all about: Tom Senior, 2022, The Best Steam Skins, https://www.pcgamer.com/the-best-steam-skins/, accessed 20 August 2022.

The Skins market was estimated at $40 billion in 2020 and is expected to grow to $50 billion in 2022.[10]

3. VAT on cryptoassets

Before diving into the details of digital gaming items and VAT, we want to remind our readers of the basics of the VAT treatment of cryptoassets in general.

Broadly speaking, VAT is a consumption tax levied on the provision of certain goods and services.[11] The legislative definition of 'goods' and 'services' clearly envisaged a more traditional definition of the same. For example, services are defined as *"anything which is not a supply of goods but is done for a consideration"*.[12]

Cryptoassets like NFTs and Skins could technically be considered goods – but there is no physical

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[10] Janusz Gądek, Skinwallet, Digital goods in computer games and their value: skins, 27 May 2020, https://thcpathfinder.com/digital-goods-in-computer-games-and-their-value-skins/, accessed 20 August 2022.

[11] Value Added Tax Act 1994, section 4.

[12] Value Added Tax Act 1994, section 5(2)(b).

tangible asset, so should they be treated as a provision of services?

The distinction is critical as depending on place, location and who is supplying to who (business to business or business to customer), there is a difference in VAT treatment.

Even HMRC does not quite seem to be able to precisely define cryptoassets. It states: *"VAT is due in the normal way on any goods or services sold in exchange for cryptoasset exchange tokens."*[13]

HRMC considers that the *"value of the supply of goods or services on which VAT is due will be the pound sterling value of the exchange tokens at the point the transaction takes place."*[14] The difficulty with this approach is that it does not clearly identify for the seller precisely which category cryptoassets fall into. That determination is left to the seller, and in the event the classification is incorrect there are invariably penalties.

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[13] HRMC Internal Manual: Cryptoassets for businesses: Value Added Tax (VAT) (CRYPTO45000).

[14] Ibid.

HMRC has previously attempted to provide some guidance on the issue. It makes clear that a supply of goods takes place where the seller passes ‘exclusive ownership’ of moveable items to another person.[15]

A definitional problem with this is: what amounts to a moveable item? In the digital world, it does not necessarily mean physical movement of an item. It goes on to state that a supply of services is something *“other than supplying goods, for consideration”*[16] (thus adopting the broad legislative definition).

Again, the issue arises: if the way in which the cryptoasset is treated by the seller (i.e. they treat is as a good, as opposed to a service), there is a real risk that they will face penalties.

Furthermore, to be within the UK VAT system a supply must be made in the UK. Supplies made outside the UK are, in theory, outside the scope of UK VAT.

However, in the world of cryptoassets and gaming, physical borders are not as rigid. What happens in

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[15] HRMC VAT Guide (VAT Notice 700), para. 4.4.

[16] HRMC VAT Guide (VAT Notice 700), para. 4.5.

circumstances where a gamer (for example) is trading NFTs based outside the UK, but they themselves are physically located in the UK? The place of supply therefore becomes important depending on whether a good or service has been supplied.

HMRC has attempted to keep within the parameters of the VAT legislation (originally drafted almost thirty years ago), and one can see that there will be particular issues that arise with the world of cryptoassets and NFTs that is likely to necessitate a change in how government seeks to tax this arena.

It has stated that for VAT purposes:

> ...bitcoin and similar cryptoassets are to be treated as follows.
>
> Exchange tokens received by miners for their exchange token mining activities will generally be outside the scope of VAT on the basis that:
>
> - the activity does not constitute an economic activity for VAT purposes because there is insufficient link between any services provided and any consideration; and

- there is no customer for the mining service.

When exchange tokens are exchanges for goods and services, no VAT will be due on the supply of the token itself.

It should be noted that for digital services, separate place of supply rules have been established. The onus is placed on the digital platform to account or VAT correctly.[17] Digital services include: radio and television broadcasting services; telecommunications services (including phones, mobiles and the internet); and, electronically supplied services (be that images or text, music, films, games, online content, distance programmes, software etc.). The problem even with these broad categories is that cryptoassets do not fit neatly into one or another – as discussed further below.

The VAT treatment of cryptocurrencies is still heavily influenced by the EU VAT Directives introduced into UK law. Even after Brexit, UK VAT law still relies on those Directives. Hence, looking at the European cases already decided is important, as HMRC

[17] HMRC Guidance, VAT rules for supplies of digital services to consumers.

suggested that it will not apply any changes retroactively.

How do Skins and NFTs differ?

As noted in the previous article, part of the inherent problem in the taxation of NFTs is the language used appears at first blush to be terms we use in common vernacular. However, they are distinct terms of art and have specific meanings in the digital world of cryptoassets. Even HMRC concedes that: *"the terminology, types of coins, tokens and transactions can vary. The tax treatment of cryptoassets continues to develop due to the evolving nature of the underlying technology and the areas in which cryptoassets are used."*[18] Yet the government is still trying to understand what precisely cryptoassets entail.[19]

What this means for an investor in NFTs is that they will be required to check *each individual*

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[18] HMRC Internal Manual: Cryptoassets Manual (CRYPTO10000) – Introduction to cryptoassets.
[19] KANTAR PUBLIC, Individuals holding cryptoassets, uptake and understanding, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1089224/Individuals_Holding_Cryptoassets_Uptake_and_Understanding.odt (February 2022), accessed 30 August 2022.

circumstance for any sale of an NFT and what the current VAT rules are. Due to the nature of the tokens – it might appear that they represent the same or very similar physical assets, but in essence could be very different when considering what the token actually represents.

NFTs are distinct to Bitcoin as the latter is treated as currency, and therefore outside the scope of VAT. However, NFTs go further and represent physical assets of significant material value. Yet on the face of it are tokens which can be exchanged – similar to Bitcoin. However, Bitcoin (and Ethereum) is fungible, whereas NFTs are not as they are not mutually interchangeable.

Yet purchasing or disposing of a NFT is akin to acquiring or disposing of an asset, as opposed to currency. From a VAT perspective, the tricky question of whether this is a good or service arises; and from a direct tax perspective queries of Capital Gains Tax ('CGT'), and what this means for income and inheritance tax will invariably come to bear.

The position adopted by government makes this a difficult horizon to track. HMRC has confirmed that whilst purchasing an NFT with fiat currency will not be considered taxable for the purchaser, it will be liable to CGT for the seller, and purchasing an NFT with cryptocurrency will likely result in a charge to CGT.

Minting NFTs is not considered taxable, but farming NFTs could be subject to CGT or income tax, and gifting an NFT could further be liable to CGT. The USA has adopted a broadly similar approach. The position leaves room for too many variables and alternative methods to avoid taxation, due to a lack of deeper understanding of the nature of these transactions.

In the gaming industry, NFTs are all the range. Whilst the concept may seem novel to many, gamers have in fact been dealing with them (and similar concepts) for some time now (as set out above) – usually in the form of exclusive, rare and one-of-a-kind items. The key difference between an NFT and say, skins, boils down to fungibility. For example, if you gave someone GBP £1 and they gave you USD $1.5 you would, in theory, have something similar or of comparable value. This makes currency fungible (broadly speaking). Non-fungibility of an object lies in its inherent uniqueness: there is no other item quite like it and it cannot be directly replaced (such as is the case with extremely rare works of art, for example). NFTs therefore, are tokens that act as proof of asset ownership.

Proof of ownership is stored in a blockchain – which provides a public ledger with respect to ownership and transactions in connection with the NFT. The distinction with NFTs in game-based items is that the information is not found in blockchains, but rather on the gaming servers themselves. This, in short, significantly decreases their value to almost nil. The value of these virtual goods therefore becomes even more challenging: it feels almost medieval, as it boils down to simply being the value that anyone is willing to pay for them.

4. Conclusion

As in the case of cryptocurrencies, virtual gaming items are invented and they are not likely to be un-invented. Thus, the taxman has to consider how to measure them. As outlined, there are many questions to consider, which are likely to become more virulent in the coming years if the virtual gaming and NFT market keeps growing at the current speed.

Virtual gaming items like Skins go up and down in price although we should always remind ourselves that they are created out of nothing. Thus, the game which introduces those items will win for sure, whereas the gamers have the idea that they can make ‘profit’. It seems almost like the casino in old times if you open a loot box and find a rare Skin or not. Only one thing is sure – the bank always wins.

If your child or another relatives invites you for a game and wants to show you their ‘Skins’, we would invite you to have a look as it may also give you a better perspective how those digital gaming items should be treated for tax purposes.

FROM CRYPTOASSETS TO THE VIRTUAL WORLD:

HOW TO TREAT IMPAIRMENT LOSSES FROM CRYPTOCURRENCIES FOR UK TAX PURPOSES?

***David Southern KC & Oktavia Weidmann*[1]**

We're working to make the UK a global cryptoassets hub. We want to see the businesses of tomorrow, and the jobs they create, here in the UK.

— Rishi Sunak, Twitter April 2022

In the following article, we will bring light to the question of how businesses (companies, partnerships and sole traders) that hold cryptocurrencies as an investment treat cryptocurrency impairment losses for tax purposes.

We will also discuss what the recent US FASB

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decision to tentatively measure cryptoassets at fair value instead of the previous measurement at historical cost less impairment[2] may mean for the accounting treatment of impairment losses under IFRS in the future.

Rishi Sunak, the new UK Prime Minister, proposed in April 2022 ways how the UK could become 'a global cryptoasset technology hub', thereby supporting cryptoasset businesses and those working for them.

Mr Sunak's plan aims to 'ensure the UK financial services sector remains at the cutting edge of technology, attracting investment and jobs and widening consumer choice.'[3]

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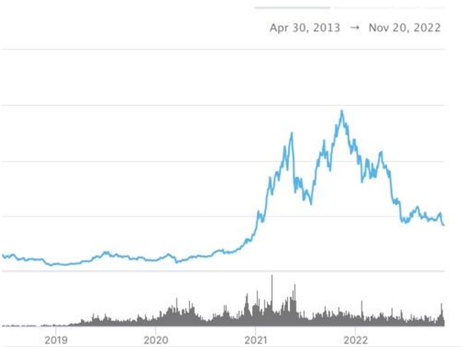
[2] Sherry Ren and Stephen McKinney, Deloitte, FASB Tentatively Decides on Fair Value Measurement of Cryptoassets, https://dart.deloitte.com/USDART/home/publications/deloitte/heads-up/2022/fvm-crypto-assets, accessed 17 November 2022.

[3] Government sets out plan to make UK a global cryptoasset technology hub, https://www.gov.uk/government/news/government-sets-out-plan-to-make-uk-a-global-cryptoasset-technology-hub, accessed 25 October 2022.

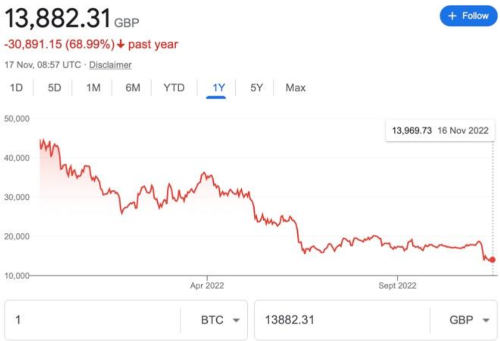
Cryptoassets (virtual or digital assets) are a new asset class. The market mainly consists of cryptocurrencies (with stablecoins pegged to a traditional currency being a subcategory) and (crypto) tokens, which can be further divided into non-fungible tokens (NFTs), security tokens and utility tokens, which all have different economic properties.

Cryptocurrencies have a global market capitalisation of around US$830 billion, despite their decline since November 2021.[4] Still, cryptocurrencies have shown significant volatility within the last year, and Bitcoin has, for example, lost more than 70% from its high on 12 Nov 2021.



Source: Coinmarketcap.com

4 Coinmarketcap, charts, https://coinmarketcap.com/charts/, accessed 17 November 2022.



Source: Google Finance

Thus, UK businesses and companies will likely consider recognising impairment losses for their cryptocurrency holdings in the current tax year.

Hence, a look at the tax treatment of those losses, and we will ask if the companies may recognise those impairment losses not only in their financial accounts but also in their tax accounts. Hence, the topic of this article.

In the 10th FCTC Digest, we discussed the general economic, legal, accounting and tax properties of cryptoassets, including an outline of the HMRC's

Cryptoassets Manual.[5]

Businesses and companies investing in cryptoassets commonly account for them as intangible assets under IFRS 38, in the same way as goodwill, trademarks or patents, as outlined in the 12th FCTC Digest article on cryptoassets accounting.[6]

Based on the classification as intangible assets, businesses and companies can recognise impairment losses for movements below cost but do not account for any movement above cost until the disposal of the cryptoassets in their financial accounts.

Tax compliance has been a concern for governments worldwide. Still, we have yet to see HMRC addressing the utilisation of impairment losses on cryptoassets to offset capital gains generated in other asset classes.

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[5] David Southern KC and Oktavia Weidmann, Cryptocurrency: A New Weapon of Mass Destruction? 10th FCTC Digest (2022), pp. 111 — 140.

[6] Oktavia Weidmann, From Cryptoassets To The Virtual World: To Impair, Or Not To Impair – How To Treat Losses From Cryptocurrencies? 12th FCTC Digest (2022), pp. 64 – 95.

Companies, such as MicroStrategy, show significant impairment losses in their accounts.

For example, as of 30 Jun 2022, the carrying value of MicroStrategy's digital assets (comprised of approximately 129,699 bitcoins) was $1.988bn, which reflects cumulative impairment losses of $1.989bn since acquisition.[7]

The use of impairment losses by some US companies to minimise their profits and gains in their financial accounts may have triggered the recent response of the FASB.

On 12 Oct 2022, the FASB published a tentative board decision made at a FASB Board Meeting, namely that:

The Board decided to require an entity to:

- Measure crypto assets at fair value, using the guidance in Topic 820, Fair Value Measurement.

[7] Rob Griffin, MicroStrategy stock sale: MSTR share issue on cards to buy more BTC as chair Saylor digs in and doubles down, https://capital.com/microstrategy-stock-sale-mstr-capital-raise-btc, accessed 25 October 2022.

- Recognize increases and decreases in fair value in comprehensive income each reporting period.
- Recognize certain costs incurred to acquire crypto assets, such as commissions, as an expense (unless the entity follows specialised industry measurement guidance that requires otherwise).

The Board also considered:

1. Various measurement alternatives for crypto assets with inactive markets and decided not to pursue those alternatives.
2. Whether to provide implementation guidance relative to the application of fair value measurement of crypto assets and decided not to provide additional measurement guidance as part of this project.
3. Whether there should be a difference for private companies for the measurement of crypto assets and decided that the

measurement and recognition requirements should be the same for all entities.[8]

By changing the accounting treatment of cryptoassets from a historical cost measurement less impairment to fair value accounting, the FASB may have also addressed the issue that companies could use impairment losses to offset other gains without disposal of the cryptocurrency holdings.

It remains to be seen if the IFRS Foundation will follow the FASB tentative change of the accounting policy on the measurement of cryptoassets.

1. Summary of the IFRS accounting treatment

The following description is the current treatment of cryptoassets according to the majority view of accounting firms and the IFRS Foundation.

We suggest caution in light of the recent FASB board decision to measure cryptoassets at fair value for

[8] FASB, Tentative Board Decisions, https://www.fasb.org/Page/PageContent?pageId=/meetings/pastmeetings/10-12-22.html&bcpath=tff, accessed 17 November 2022.

holdings held for investment purposes. The current IFRS accounting treatment may change soon, too.

Hence, the tax treatment of impairment losses for UK tax purposes may also change due to a possible change in the accounting treatment for IFRS purposes.

According to the IFRIC, cryptocurrencies are currently classified as intangible assets under IAS 38 unless they are 'held for sale in the ordinary course of a business'; in the latter case, IAS 2 Inventories apply.

The **IFRIC Agenda Paper** cites IAS 38, paragraphs 8 and 12 and maintains,

> The Committee observed that a holding of cryptocurrency meets the definition of an intangible asset in IAS 38 because (a) it is capable of being separated from the holder and sold or transferred individually, and (b) it does not give the holder a right to receive a fixed or

determinable number of units of currency.[9]

For **businesses and companies** that hold cryptocurrencies for investment purposes, there are the following possibilities to measure them: cost model, revaluation model or fair value model.

The **fair value model** will be applied if cryptocurrencies are held in the context of **trading** activity.

For **businesses and companies holding cryptocurrencies** as an **investment**, the cost or revaluation model should apply (as of now).

If the **cost model** is used, intangible assets are measured at cost upon initial recognition. They are subsequently measured at cost, less accumulated amortisation and impairment losses.

If applying the **revaluation model**, intangible assets can be accounted for at a revalued amount if there is an active market for them. The active market

[9] IFRIC Update March 2019, Holding of Cryptocurrencies, Agenda Paper 4, https://www.ifrs.org/news-andevents/updates/ifric/2019/ifric-update-march-2019/#1, accessed 6 May 2022

exists for major cryptocurrencies like Bitcoin. For illiquid cryptocurrencies, this is perhaps not the case. The same measurement model should be used for all assets in an asset class.

Hence, if a business is holding different cryptocurrencies for investment purposes and there is no active market for all cryptocurrencies, those assets should be measured using the cost model.

Thus, businesses measuring cryptoassets at cost may recognise impairment losses through P&L but not any movements above cost until the cryptoassets are sold.

2. Capital Gains and Losses

We will base our tax analysis on the common accounting treatment of cryptocurrencies in the financial accounts.

If a company holds cryptocurrencies as an investment, 'they are liable to pay Corporation Tax on any gains they realise when they dispose of it.'[10]

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[10] HMRC Cryptoasset Manual, CRYPTO 41200, https://www.gov.uk/hmrc-internal-manuals/cryptoassets-manual/crypto41200, accessed 17 November 2022.

A sole trader is liable to pay Capital Gains Tax under TCGA 1992 on any realised gains. In the case of a partnership or limited liability partnership, the partners are either liable to pay Corporation tax if the partner is a company or Capital Gains Tax if the partner is an individual. [11]

If a company or business disposes of cryptocurrencies for less than the allowable costs, it realises a capital loss upon disposal.

In the *Cryptoassets Manual*, HMRC maintains in CRYPTO41300 that

> Section 38 of the Taxation of Chargeable Gains Act (TCGA) 1992 provides for the types of costs which can be deducted. HMRC's view is that these include:
>
> - the **consideration (in pound sterling) originally paid for the asset**
> - **transaction fees** paid for having the transaction included on the distributed ledger
> - advertising for a purchaser or a vendor

[11] Ibid.

- professional costs to draw up a contract for the acquisition or disposal of the tokens
- costs of making a valuation or apportionment to be able to calculate gains or losses.[12]

In addition, some exchange fees are allowable if they satisfy section 38 TCGA.[13]

3. Examples

The following examples will show the accounting and tax treatment of impairment losses.

The accounting issue arises from the tension between balance sheet recognition (historical cost) and upwards or downward revaluation/impairment.

The tax treatment will follow the accounting treatment; hence if an impairment loss is recognised in the financial accounts, it will also show in the tax accounts.

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[12] HMRC Cryptoassets Manual, CRYPTO41300 - Cryptoassets for businesses: Corporation Tax: allowable costs, https://www.gov.uk/hmrc-internal-manuals/cryptoassets-manual/crypto41300, accessed 17 November 2022.

[13] Ibid, see for a list of allowable exchange fees.

Where cryptoassets are held by a company, the normal assumption is that they are held in the course of business.

For accounting purposes, cryptoassets are accounted for as either

- Inventory [IAS 2/FRS 102, Section 13] or
- Intangible property [IAS 38/FRS 102, Section 18].

The classification depends upon whether they are acquired with the intention of selling them within 12 months (stock) or with the intention of holding them for a longer period (intangible property).

Inventory

If held as inventory, they will be valued at the year-end at the lower of cost and net realisable value. That means that there will be the usual stock adjustment at the year-end. Unsold stock is an addback to profit because it represents a cost of the next year's sales, not this year's sales.

Cost of goods sold is (opening stock + purchases – closing stock)

Example 1

At the start of the financial year (1 Jan 2022), X Ltd held cryptocurrency acquired for $400.

In the course of the year, it purchased cryptoassets for $500. And sold assets for $600. At the year-end, its inventory was worth $500.

So its trading profit was

Sales			600
Opening inventory	400		
Purchases	500		
Inventory available for sale		900	
Closing stock		(500)	
Cost of goods sold			(400)
Profit			200

Example 2

At the start of the financial year (1 Jan 2022), X Ltd held cryptocurrency acquired for $400. In the course of the year, it purchased cryptoassets for $500. The cryptocurrency falls in value. It sells the stock for $200. At the year-end, its inventory was worth $100.

Sales			200
Opening inventory	400		
Purchases	500		

Inventory available for sale		900	
Closing stock		(100)	
Cost of goods sold			(800)
Profit (Loss)			(600)

So profit and the impairment of the inventory are recognised for accounting and tax purposes through the stock adjustment, which goes to the income statement. Profit is credited to revenue, and the loss on inventory is charged against revenue. In substance, this is the application of fair value accounting to cryptoassets.

Intangible assets

If the cryptoassets are classified as fixed assets, in the form of intangible property, they come within IAS 38 [FRS 102, Section 18]

Recognition principles for intangible assets other than goodwill are prescribed in IAS 38, paras 21-23/FRS 102, paras 18.4 – 18.8. An intangible asset is recognised as an asset only if

- It is probable that future economic benefits that are attributable to the asset will flow to the entity, and

- The cost or value of the asset can be measured reliably.

Intangible assets normally represent future economic benefits which accrue over a period of time. However, cryptoassets may produce future economic detriments rather than future economic benefits.

They will be intangible assets which have been acquired, not internally created assets. They will usually form part of a fluctuating pool of assets.

Hence the classification as intangible assets stretches current definitions.

Initial measurement is at cost.

IAS 38, paras 74, 75/FRS 102, paras 18.18 – 18,18H prescribe two models for measurement after initial recognition

- Cost model
- Revaluation model

The cost model involves carrying cryptoassets at historic cost until disposal. That means that companies will have hidden profits or losses. The concealment of derivative losses in the 1980s and 1990s caused a number of corporate failures.

That was remedied by the adoption of fair value accounting for all derivative financial instruments.

Cryptoassets are, however, not derivative financial instruments. They do not rest on a contract. They do not go back to anything outside themselves.

Under the revaluation model, the intangible asset is carried at its fair value at the date of revaluation.

IFRS require that certain classes of income or expense should be disregarded when calculating profit or loss and should instead be present in the statement of Other Comprehensive Income (OCI).

IAS 38 generally requires that surpluses arising on the revaluation of intangible non-current assets should be taken to OCI.

This accounting treatment ensures that unrealised revaluation gains are excluded from profit and are not available for payment of a dividend. That will not be reclassified to income in a subsequent period.

However, if the revaluation shows a decrease in value, this must be recognised as an expense when calculating the entity's profit or loss for tax purposes.

This treatment is modified if a revaluation gain reverses a previously realised expense or a revaluation decrease reverses a previous revaluation gain.

A revaluation gain is recognised as income if it reverses a previous revaluation decrease in respect of the same item.

By the same token, a revaluation loss can be debited to the revaluation reserve and not taken to income to the extent that it reverses a previous revaluation gain.

Example 3

Date	Intangible assets (balance sheet)	Revaluation increase (decrease)	Revaluation reserve	OCI	Income
31 Dec 2019	500,000	0	0		
31 Dec 2020	700,000	200,000	200,000	200,000	0
31 Dec 2021	800,000	100,000	300,000	100,000	0

The balance sheet of a company shows the following non-current intangible assets (cryptocurrency). The company uses the revaluation model. It makes no purchases or disposals after 31 Dec 2019. The accounting reference date is 31 Dec.

Example 4

The balance sheet of a company shows the following non-current intangible assets (cryptocurrency). The company uses the revaluation model. It makes no purchases or disposals after 31 Dec 2019. The accounting reference date is 31 Dec.

Date	Intangible assets (balance sheet)	Revaluation increase (decrease)	Revaluation reserve	OCI	Income
31 Dec 2019	500,000	0	0		
31 Dec 2020	400,000	(100,000)	(100,000)		(100,000)
31 Dec 2021	600,000	200,000	100,000		100,000

Example 5

The balance sheet of a company shows the following non-current intangible assets (cryptocurrency). The company uses the revaluation model. It makes no purchases or disposals after 31 Dec 2019. The accounting reference date is 31 Dec.

Date	Intangible assets (balance sheet)	Revaluation increase (decrease)	Revaluation reserve	OCI	Income
31 Dec 2019	500,000	0	0		
31 Dec 2020	400,000	(100,000)	(100,000)		(100,000)
31 Dec 2021	600,000	200,000	200,000	100,000	100,000
31 Dec 2022	100,000	(500,000)	(300,000)	(100,000)	(400,000)

Disposal of a revalued intangible asset

When an intangible asset is disposed of, any revaluation gain included in the revaluation reserve in respect of that asset is taken into income and can be transferred to retained earnings. The transfer is recorded in the statement of changes in equity (SOCIE) and does not affect the statement of comprehensive income.

Example 6

The balance sheet of a company shows the following non-current intangible assets (cryptocurrency).

The company uses the revaluation model.

It makes no purchases after 31 Dec 2018 and disposes of the holding on 31 Dec 2021 for 600,000. The accounting reference date is 31 Dec.

Date	Intangible assets (balance sheet)	Revaluation increase (decrease)	Revaluation reserve	OCI	SOCIE	Income (expense)
31 Dec 2018	400,000					
31 Dec 2019	500,000	100,000	100,000	100,000		
31 Dec 2020	350,000	(150,000)	(150,000)	(100,000)		(50,000)
31 Dec 2021	(350,000)		150,000		250,000	250,000

4. Conclusion

One of the essential characteristics of money, in the form of fiat currency, is that it has a certain fixity of value. This enables it to function as a medium of exchange and store of value. It can serve those functions because it is backed by the productive resources of the national economy and the policy direction of the state.

There is a relationship of mutual dependency between the stability of money and the wider economic and political forces to which it is tied.

As we noted in our April article in the 10th edition of the FCTC Digest, cryptocurrency does not go back to anything outside itself. It is a self-existent component of a virtual universe.

We want to close this article with two quotes by Warren Buffet:

> Cryptocurrencies basically have no value, and they don't produce anything. They don't reproduce, they can't mail you a check, they can't do anything, and what you hope is that somebody else comes along and pays you more money for them later on, but then that person's got the problem. In terms of value: zero.[14]
>
> It's ingenious, and blockchain is important, but Bitcoin has no unique value at all; it doesn't produce anything. You can stare at it all day, and no little Bitcoins come out or anything like that. It's a delusion, basically.[15]

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[14] Warren Buffet, CNBC, February 2020, also, Warren Buffett, Bitcoin is an asset that creates nothing, CNBC, May 2018, https://www.youtube.com/watch?v=LtITDtZPYEw, accessed 17 November 2022.

[15] Warren Buffet, CNBC, February 2019, https://www.youtube.com/watch?v=m4vDTAelhCM, accessed 18 November 2022.

Or put differently, cryptocurrencies are based on a widely distributed computer program that creates – out of thin air – a limited supply of virtual items backed only by the expectation that people will pay more than the current price.

The recent collapse of FTX and wider turmoil in the micro world of cryptocurrencies show the fragility of this expectation and the world which has been created around it.

Whether the emperor has no clothes is not given to us to prophesy.

However, current accounting arrangements would seem to ensure that the general body of taxpayers would subsidise a downward spiral in crypto values through the deductibility of crypto losses. That raises a variety of tax policy issues.

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INTRODUCTION OF TRANSFER PRICING DOCUMENTATION MEASURES

Richard Collier

The new measures

A significant change included in the Finance Bill 2022-23 is the requirement for many large businesses operating in the UK (specifically, those with group turnover over €750m) to comply with specific new transfer pricing documentation obligations. The change will take effect in relation to accounting periods commencing on or after 1 April 2023.

The proposed requirements (the draft legislation and the accompanying notes were published in July 2022) include obligations to prepare and retain a transfer pricing "Master File" and a "Local File". The Master File must contain standardised information that relates to all MNE group members (such as in relation to the nature and organisational structure of the entire business, its use of intangibles, the manner of its financing, and its general tax (including rulings and advanced pricing agreements entered into) and accounting position). The Local File must include standardised information that relates to the activities and transactions of local taxpayer entities (such as the nature of the business and management structure of the local entity or entities, as well as specified information on the financial position of each local entity and information on each material category of related party transactions to which it is a party). More specifically, the Master File and Local File are required to contain all the information requirements set out in Annexes I and II to Chapter V of the OECD Transfer Pricing Guidelines. Those annexes also set out the required form and content of a master file and local file.

This change will bring the UK transfer pricing documentation requirements into line with the full package of standardised transfer pricing documentation recommended by the OECD in the 2015 OECD BEPS Action 13 Report. The UK had previously implemented only the country-by-country minimum reporting standard. (The country-by-country (c-b-c) reporting obligation applies for the largest multinational enterprise groups and the report contains aggregate data on the global allocation of income, profit, taxes paid and economic activity among the tax jurisdictions in which the MNE in question operates).

The UK approach to documentation requirements has previously left greater latitude on the approach to be adopted by taxpayers in relation to transfer pricing documentation other than the c-b-c reporting. This is primarily because the UK already had broad record keeping obligations to keep and retain sufficient records to demonstrate that tax returns are complete and accurate, including those aspects relating to transfer pricing. A policy paper released in July 2022 at the same time as the draft legislation notes that the previous absence of specific transfer pricing documentation requirements, and supporting guidance, has created a degree of uncertainty for UK businesses regarding the appropriate transfer pricing documentation they need to keep, leading to inconsistency of approach. That position is therefore now to be changed by the introduction of a more specific legal requirement to prepare and retain transfer pricing documentation in a designated form.

Whilst the requirement to prepare a Master File and Local File (as well as the c-b-c report that is already required) has been commonly introduced in many states following the BEPS project, another part of the new UK transfer pricing documentation package is entirely novel to the UK. This is the requirement for the preparation of an additional document that is referred to as a “Summary Audit Trail”.

The new document is explained as having two purposes, namely, to encourage businesses to undertake sufficient work to support transfer pricing policies and allow HMRC to "undertake high level quality assurance on the transfer pricing documentation" with a view to providing a better focus on higher risk areas during enquiries.

HMRC has released a draft of the proposed Summary Audit Trail document for consultation. The draft of the Summary Audit Trail document includes around 30 specific questions about the steps that have been undertaken to prepare the Local File document. The thrust of questions is to establish the main actions that were taken and the issues that were considered in compiling the transfer pricing documentation.

This package of transfer pricing documentation requirements is being introduced following a public consultation on transfer pricing documentation in the Spring of 2021. That consultation addressed the question whether there should be included in the transfer pricing documentation package an additional requirement to prepare an International Dealings Schedule (which would have involved the mandatory reporting to HMRC of transactional data in a structured format, allowing HMRC to analyse and interrogate that data as part of its risk assessment activity). The 2021 consultation also considered the need for what was referred to as an "evidence log" to support the facts in the local file. However, the requirements for both the International Dealings Schedule and the Evidence

Log have now been dropped in favour of the new "Summary Audit Trail" document, which is intended to be a more limited documentation obligation.

Under the new approach, the relevant transfer pricing documentation should be prepared in advance of a company filing its UK corporation tax return, a point that is reinforced by changes to the legislation on penalties in Schedule 24 to Finance Act 2007.

The current position is that the draft legislation for inclusion in Finance Bill 2022-23 and the accompanying notes were published in July 2022. The main revisions are those which are being made to paragraph 21 of Schedule 18 to Finance Act 1998 and section 12B of the Taxes Management Act 1970. New powers are being built into each of these pieces of legislation to enable regulations to specify certain transfer pricing records which must be kept and preserved. A draft Statutory Instrument, The Transfer Pricing Records Regulations, identifies these documents as the master file, the local file, and the Summary Audit Trail questionnaire.

Significance of these new measures

There are various reasons why these new measures merit attention by MNEs operating in the UK.

The changes reflect the high priority given by HMRC to scrutinising related party transactions and arrangements. Significant HMRC resources are devoted to this area and transfer pricing enquiries have yielded and continue to yield very high returns. They also often lead to challenges in other related areas such as in connection with PE and DPT issues. HMRC enquiries concerning transfer pricing approaches and documentation are therefore very common. They are also often lengthy and highly detailed.

Further, the draft legislation makes it very clear through amendments to Schedule 24 Finance Act 2007 that failure to comply with these new transfer pricing documentation obligations or failure to produce the relevant documentation when requested to do so by HMRC will lead to the presumption that any inaccuracy by a taxpayer is 'careless' for the purposes of any tax penalty assessment imposed by HMRC. That presumption would be displaced only by the taxpayer providing the documents and showing that the underlying transfer pricing information had been prepared in advance of filing the relevant tax return, or otherwise showing that reasonable care was taken. Thus, in the absence of preparing and maintaining this documentation there is clearly an increased risk of tax-geared penalties if further tax becomes payable because of a transfer pricing adjustment.

It is also notable that the relevant transfer pricing documents can be requested at any time and irrespective of whether there is an ongoing enquiry. Further, the rules are not restricted to those situations where the documents are in the "possession or power" of the UK entity in question but as a result of changes to Schedule 36 Finance Act 2008 can operate when they are in the "possession or power" of another person within the multi-national group.

The new Summary Audit Trail document is framed to allow HMRC to understand the strength of support underpinning the approach taken in the transfer pricing documentation. The questions in the draft Summary Audit Trail are evidently designed to help HMRC make a risk assessment – and in particular identify key risk areas that might be further probed – for example, by reference to the responses to questions in the draft Summary Audit Trail that ask for the identification of cases where there is no inter-company agreement, and of cases where a full functional analysis has not been carried out, and of cases where a full functional analysis has been carried out but there has been no subsequent check for material changes in the business, and of cases where the functional analysis has been carried out but without interviews with the relevant business personnel being conducted, etc. The Summary Audit

Trail document may therefore highlight gaps in the available data, or in the process that has been followed in compiling the transfer pricing documentation or gaps or issues in prevailing group transfer pricing policies.

It is notable that the draft Summary Audit Trail document also focuses on UK headcount and job roles, with a question whether such information has been used to determine the price of the relevant controlled transaction. For those commonly involved in transfer pricing disputes this is a predictable – and difficult – area of controversy. Technical issues relating to the character and consequences of the actions of senior employees in particular are raised not only in the ongoing controversy about how the new transfer pricing approach to the "control of risk" framework should most appropriately work,[1] but a consideration of the role of senior employees in this context also routinely leads to other points of controversy such as whether PE or DPT issues are engaged. The identification of this area in the draft Summary Audit Trail document suggests there is unlikely to be any let up in HMRC's focus on these issues.

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[1] See further On The Breakdown Of The OECD Transfer Pricing Guidelines – Richard S Collier, Field Court Tax Digest 10th edition

Not surprisingly, the draft Summary Audit Trail also includes a focus on financing transactions. This is another area in which disputes commonly arise.

In summary, the new measures expand HMRC's information gathering powers, increase the compliance burden on taxpayers, and are in practice likely to increase transfer pricing compliance/ controversy risks (including potentially tax geared penalties) for MNE groups.

‘UNDERTAKINGS FOR COLLECTIVE INVESTMENT’ ENTITLED TO A REFUND OF TAX WITHHELD ON DIVIDENDS DISTRIBUTED BY PORTUGUESE COMPANIES

Rita da Cunha

1. The Court of Justice’s ruling in *AllianzGI-Fonds AEVN*

In *AllianzGI-Fonds AEVN*,[1] the Court of Justice of the European Union (“Court of Justice”) held that the imposition of a withholding tax on dividends distributed by Portuguese companies to an *undertaking for collective investment in transferable securities* established and tax resident in Germany infringes the **free movement of capital** provided for in Article 63 of the Treaty on the Functioning of the European Union – “TFEU” (as dividends paid by Portuguese companies to *undertakings for collective investment* established and tax resident in Portugal are not subject to withholding tax).[2] For the Court of Justice, it was not relevant whether the dividend

[1] Case C-545/19, *AllianzGI-Fonds AEVN v Autoridade Tributária e Aduaneira,* judgement on 17th March 2022 (preliminary reference from the Tax Arbitration Tribunal in case 93/2019-T). The judgment is not available in English.
[2] Article 22(1), (3) and (10) of *Estatuto dos Benefícios Fiscais* (“EBF”).

income is taxed in the hands of the recipient in its State of residence, or whether the domestic withholding tax rate (25%) is reduced by a tax treaty.

As of November 2022, the domestic special tax regime for *undertakings for collective investment in transferable securities* and for *undertakings for collective investment in real estate* has not been amended: only *undertakings for collective investment* established in Portugal and governed by Portuguese law are exempted from withholding tax on dividends distributed by Portuguese companies. It follows that Portuguese law continues to discriminate against *undertakings for collective investment* which are established in other EU Member States, and in third countries (e.g., UK and US).

2. Refunds of tax withheld on dividends distributed by Portuguese companies

Undertakings for collective investment in transferable securities and *undertakings for collective investment in real estate* may request a refund to the Portuguese tax authorities regarding the amount of tax withheld on dividends in the previous **four years**. The Portuguese tax authorities tend to refuse these refunds (even after the Court of Justice's ruling in *AllianzGI-Fonds AEVN*). Where the tax authorities refuse the refund, or fail to issue a decision within four months, tax arbitration proceedings may be commenced (arbitration is the fastest route to a final decision on the matter). An arbitration award is expected to be issued within 6 months to a year.

Tax Arbitration Tribunals have consistently ordered the tax authorities to (i) refund the amounts withheld regarding dividends distributed by Portuguese companies to *undertakings for collective investment*, and (ii) pay interest on the amount withheld (4% per annum). As of November 2022, only *undertakings for collective investment* established in **Germany**, **Luxemburg**, **Ireland** and **Belgium** have commenced arbitration proceedings with this purpose and been recognised the right to a refund by Tax Arbitration Tribunals. The following table shows the arbitration proceedings which led to these refunds:

Entity classification and jurisdiction	**Tax Arbitration Tribunal - Case number**	**Amount of tax refunded**
Undertakings for collective investment	93/2019-T[3]	€ 34 305,31
	90/2019-T[4]	€ 11.958,96
	528/2019-T[5]	€ 262.570,00
	548/2019-T[6]	€ 8.979,10

[3] Award issued on 17th June 2019.
[4] Award issued on 23rd July 2019.
[5] Award issued on 27th December 2019.
[6] Award issued on 26th June 2020.

(constituted by contract) established in **Germany**	68/2020-T[7]	€ 38 417,76
	32/2021-T[8]	€ 80.937,50
	133/2021-T[9]	€ 253.262,13
	547/2019-T[10]	€ 34.190,40
	97/2019-T[11]	€ 49.399,12
	625/2020-T[12]	€ 146.431,25
	92/2019-T[13]	€ 17.471,12
	627/2020-T[14]	€ 82.241,78
	100/2019-T[15]	€ 53.167,34
	549/2019-T[16]	€ 29.528,14
	570/2020-T[17]	€ 48.239,71
	132/2021-T[18]	€ 190.012,92
	190/2019-T[19]	€ 34.288,85
	134/2021-T[20]	€ 187.146,00
	717/2021-T[21]	€ 30.173,62
	91/2019-T[22]	€16.921,48
	135/2021-T[23]	€ 198.313,75

7 Award issued on 25th January 2021.
8 Award issued on 5th November 2021.
9 Award issued on 21st March 2022.
10 Award issued on 24th March 2022.
11 Award issued on 24th March 2022.
12 Award issued on 28th March 2022.
13 Award issued on 5th April 2022.
14 Award issued on 12th April 2022.
15 Award issued on 12th April 2022.
16 Award issued on 20th April 2022.
17 Award issued on 20th April 2022.
18 Award issued on 26th April 2022.
19 Award issued on 26th April 2022.
20 Award issued on 26th April 2022.
21 Award issued on 27th April 2022.
22 Award issued on 27th April 2022.
23 Award issued on 30th April 2022.

	566/2020-T[24]	€ 35.448,80
	567/2020-T[25]	€ 18.891,85
	130/2021-T[26]	€ 276.863,85
	546/2019-T[27]	€ 48.383,18
	86/2019-T[28]	€ 22.570,43
	576/2019-T[29]	€ 17.464,79
	28/2021-T[30]	€ 612.951,57
	558/2020-T[31]	€ 487.181,75
	623/2021-T[32]	€ 18.528,13
	529/2019-T[33]	€ 21.560,82
	550/2019-T[34]	€ 30.844,04
	622/2021-T[35]	€ 38.285,01
	621/2021-T[36]	€ 41.278,90
	98/2019-T[37]	€ 10.031,69
	641/2020-T[38]	€ 11 612,50
	115/2022-T[39]	€ 261.649,81
	721/2019-T[40]	€ 58.646,90

[24] Award issued on 3rd May 2022.
[25] Award issued on 3rd May 2022.
[26] Award issued on 3rd May 2022.
[27] Award issued on 4th May 2022.
[28] Award issued on 6th May 2022.
[29] Award issued on 8th May 2022.
[30] Award issued on 18th May 2022.
[31] Award issued on 23rd May 2022.
[32] Award issued on 24th May 2022.
[33] Award issued on 26th May 2022.
[34] Award issued on 26th May 2022.
[35] Award issued on 31st May 2022.
[36] Award issued on 2nd June 2022.
[37] Award issued on 14th June 2022.
[38] Award issued on 13th July 2022.
[39] Award issued on 13th July 2022.
[40] Award issued on 14th July 2022.

	620/2021-T[41]	€ 28.429,63
	121/2022-T[42]	€ 57 212,18
	99/2019[43]	€ 31.221,75
	64/2020-T[44]	€ 20.723,43
	624/2021-T[45]	€ 13.475,00
	83/2022-T[46]	€ 20.023,24
	640/2020-T[47]	€ 8.500,00
	135/2022-T[48]	€ 152.477,54

Undertakings for collective investment (corporate form) established in **Luxemburg -**	926/2019-T[49]	€ 372 339,08
	922/2019-T[50]	€ 191.250,91
	127/2021-T[51]	€ 851.407,10
	817/2021-T[52]	€ 1.210.129,48
	734/2021-T[53]	€ 60.669,34
	129/2022-T[54]	€ 205.676,71
	716/2020-T[55]	€ 185.625,27

41 Award issued on 14th July 2022.
42 Award issued on 15th July 2022.
43 Award issued on 22nd July 2022.
44 Award issued on 25th July 2022.
45 Award issued on 8th August 2022.
46 Award issued on 21st August 2022.
47 Award issued on 3rd October 2022.
48 Award issued on 19th October 2022.
49 Award issued on 19th October 2020.
50 Award issued on 11th January 2021.
51 Award issued on 8th April 2022.
52 Award issued on 18th May 2022.
53 Award issued on 7th June 2022.
54 Award issued on 28th June 2022.
55 Award issued on 29th June 2022.

Société d'Investissement à Capital Variable (SICAV)	816/2021-T[56]	€ 764.185,39
	746/2021-T[57]	€ 868.076,82
	128/2022-T[58]	€ 296.945,75

Undertakings for collective investment (constituted by contract) established in **Luxemburg**	215/2021-T[59]	€ 94.165,26
	593/2021-T[60]	€ 868.471,55
	821/2021-T[61]	€ 461.279,11
	543/2019-T[62]	€ 46.871,86

Other *undertakings for collective investment* established in **Luxemburg**	214/2021-T[63]	€ 73.465,63
	368/2021-T[64]	€ 771.712,47
	370/2021-T[65]	€ 46.504,48

Undertakings for collective	11/2020-T[66]	€ 167.357,94
	166/2021-T[67]	€ 159.447,51

56 Award issued on 28th July 2022.
57 Award issued on 10th October 2022.
58 Award issued on 26th September 2022.
59 Award issued on 16th December 2021.
60 Award issued on 26th April 2022.
61 Award issued on 26th April 2022.
62 Award issued on 25th July 2022.
63 Award issued on 7th April 2022.
64 Award issued on 28th April 2022.
65 Award issued on 23rd May 2022.
66 Award issued on 6th November 2020.
67 Award issued on 5th November 2021.

investment established in **Ireland**	202/2019-T[68]	€ 134.442,34

Undertakings for collective investment (corporate form) established in **Belgium**	345/2021-T[69]	€ 141.065,36
	711/2021-T[70]	€ 93.080,01

As the **free movement of capital** in Article 63 of TFEU **applies to third countries**, *undertakings for collective investment in transferable securities* and *undertakings for collective investment in real estate* established in third countries (e.g., UK, US, Brazil) may also be entitled to a refund of the amount of tax withheld in respect of dividends distributed by Portuguese companies. In a third country scenario, it is relevant whether the jurisdiction in which the *undertaking for collective investment* is established has a tax treaty (or a tax information exchange agreement) with Portugal enabling the tax authorities to

[68] Award issued on 27th April 2022.
[69] Award issued on 1st February 2022.
[70] Award issued on 22nd July 2022.

verify the information transmitted by the *undertaking for collective investment*.[71]

3. Wider repercussions

The Portuguese special tax regime for *undertakings for collective investment* may also be incompatible with EU law requirements in that it discriminates against **interest income, rental income and capital gains** arising in Portugal to *undertakings for collective investment* established in other EU Member States and third countries (where received by *undertakings for collective investment* established in Portugal, these categories of income are not subject to corporation tax and benefit from a withholding tax exemption).[72]

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[71] See Case C-190/12, *Emerging Markets Series of DFA Investment Trust Company v Dyrektor Izby Skarbowej w Bydgoszczy* (judgment on 10th April 2014), concerning an *investment fund* established in the US and receiving dividends from Polish companies. Also: in a case where the Tax Arbitration Tribunal had to consider the extension of the domestic special tax regime for *undertakings for collective investment* to interest paid by a company resident in Portugal to an *undertaking for collective investment* established and resident in **Mauritius**, the Tribunal held that not applying the said domestic special tax regime in the case at bar constituted a justified restriction to the free movement of capital provided for in Article 63 of TFEU, as Mauritius is a jurisdiction blacklisted by the Portuguese Government, and there is no tax treaty (or a tax information exchange agreement) between Portugal and Mauritius. CAAD – Tax Arbitration Tribunal, P547/2020-T (30th November 2021).

[72] **Regarding the tax treatment of income from real estate investments carried out by *undertakings for collective investment***: in Case C-342/20, *A SCPI v Veronsaajien oikeudenvalvontayksikkö* (judgment on 7th April 2022), the Court of

The Portuguese special tax regime for ***venture capital funds***[73] also raises doubts as to its compatibility with EU law: only income and capital gains derived by *venture capital funds* established in Portugal are exempted from Portuguese corporation tax.

These issues are yet to be settled.

Justice held that the free movement of capital in Article 63 of TFEU precludes a national legislation from excluding non-resident *alternative investment funds* from the income tax exemption provided for resident *alternative investment funds* in respect of (i) rental income, and (ii) profits arising from the disposal of immovable property or of shares in companies owning immovable property.

[73] Article 23(1) of EBF.

THE TAXATION OF EQUITY DERIVATIVES HELD BY COMPANIES – PART 1

Oktavia Weidmann[1]

The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear. Central banks and governments have so far found no effective way to control, or even monitor, the risks posed by these contracts. In my view, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.

— Warren Buffet on Derivatives, Excerpts from the Berkshire Hathaway, Annual Report 2002

Although derivatives have not vanished since 2002, one has not only experienced the financial crisis of 2008/2009, partly driven by the wrong evaluation of credit risks by banks but mainly fuelled by a crumbling US housing market that was only the

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expression of the Great Recession occurring between 2007 and 2009.

These days seem long forgotten. Nevertheless, one should be cautious amidst a global economic downturn, which will most likely lead to crumbling house prices in the UK and elsewhere due to rising interest rates and a simultaneous household income decline due to difficult overall economic circumstances.

But this should not be the topic of today's article, and I will certainly not play Cassandra as Warren Buffett – rightfully – did in 2002.

My task is much more straightforward. It concerns the beautifully complicated, at times mind-bending yet – in most instances – masterfully drafted UK tax legislation.

Hence, the topic of this piece is the taxation of equity derivatives in the UK. Due to the extent and complexity of the topic, the article has two parts – with part two following in the next digest.

For guidance and reference, I suggest to consult David Southern KC's magnificent book on the taxation of loan relationships and derivatives – now already in its 10th edition.

1. The Equity Bias in tax systems

Business activities can be financed through equity or debt. David Southern KC gives an excellent summary of this distinction, stating:

> The distinction between debt and equity is best expressed in the German terms *Fremdkapital* ('external finance') and *Eigenkapital* ('internal finance'). The distinction is between proprietors' capital and creditors' capital. Debt is capital provided by third party lenders, while equity is capital provided by shareholders .[2]

In the same way, one can distinguish income: dividends arise from equity, whereas interest is paid as income on debt.

Some jurisdictions privilege equity capital gains for tax purposes – through exemption or preferential tax

[2] David Southern, Taxation of Loan Relationships and Derivative Contracts, 10th edition,

rates. Others privilege dividends compared to interest but treat equity and debt capital gains alike.

This equity and debt taxation dichotomy also influences the taxation of equity derivatives. Or, put more generally:

> If a tax legislator privileges equity over debt, frictions are likely to arise if capital gains from the sale of equities are exempt, but gains from the settlement of equity derivatives are not. Tax legislators may also treat equity derivatives differently on their form of settlement. Gains from physically settled equity derivatives may be tax-exempt when exercised because the gains from the disposal of the equities are exempt. In contrast, cash-settled equity derivatives would be subject to tax at the full rate. Thus, taxpayers may choose a form of settlement which provides them with favourable tax treatment.[3]

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[3] Oktavia Weidmann, *Taxation of Derivatives*, Wolters Kluwer, 2015, p. 25.

In legal practice, one has previously seen tax structuring attempts that used the put-call parity formula to convert one category of income into another without changing the economic essence of the combined products.[4]

C - P = S - PV(K) – PV (D)

Whereas

C is the call option price

P is the put option price

S is the value of the underlying asset

PV (K) is the present value of the strike price or the value of a zero bond with the notional amount of K.

PV (D) is the present value of the pay-out return of the underlying minus costs.

Understanding the nature of equity derivatives means understanding that derivatives can be replicated in relation to their payoff, using other derivatives, traditional financial instruments like shares and bonds (the so-called underlying assets), and cash.

[4] A detailed discussion of the financial terms of the put-call parity can be found in: John Hull, Options, Futures and Other Derivatives, 9th edition, 2018, p. 268 ff.

Or put more technically:

> A derivative can be replicated by entering into other financial instrument(s), if at maturity of the derivative, the financial instrument(s), which replicate the derivative, have in sum the same *payoff* as the derivative, meaning the sum of all cash flows of the financial instrument(s) used in the replicating portfolio must have the same present value as all cash flows of the derivative itself.[5]

That means that the sum of all cash flows of the instruments used for the replication equals the value of the replicated derivative contract.

Taxpayers have in the past (since the late 1980s) used the put-call parity and its reformulations to cover income that is fully taxed into other income that is subject to a preferential tax rate of tax-exempt.

Thus, tax arbitrage schemes may allow taxpayers to receive (tax-privileged) income or equity capital gains, thereby avoiding non-privileged debt capital gains or interest. Vice versa, taxpayers may be able to

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5 Weidmann, *Derivatives*, p. 11-12.

structure transactions to achieve fully deductible debt capital losses instead of non-deductible equity losses.

That is, however, only possible if equity capital gains and dividends are privileged over debt capital gains and interest AND if no comprehensive anti-avoidance and disclosure regimes are in place that prevents this outcome.

Before embarking in detail into the taxation of equity derivative contracts, it is worth noting that the EU is currently addressing the discrepancy between equity and debt taxation in a new EU Directive proposal concerning the so-called 'equity bias'.

The Directive proposal supports the financial neutrality of a tax system by limiting the tax deductibility of exceeding borrowing costs beyond a so-called debt-equity bias reduction allowance (DEBRA).[6]

The proposal aims to deal with the disparity between equity and debt financing by (1) introducing a tax-

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[6] European Commission, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12995-Debt-equity-bias-reduction-allowance-DEBRA-_en, 11 May 2022, accessed 22 November 2022.

deductible allowance for equity investments and (2) further limitation of the ability to deduct the interest.

It will be tied to the existing interest limitation rule under Article 4 of the EU's Anti-Tax Avoidance Directive.[7]

Even after Brexit, the proposal is relevant to UK companies as the rules apply to taxpayers subject to tax in one of the EU Member States, which includes permanent establishments of non-EU head offices.

2. Understanding equity derivatives in general

John Hull defines a derivative as 'a financial instrument whose value depends on (or derives from) the value of other, more basic, underlying

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[7] COUNCIL DIRECTIVE (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016L1164&from=EN, accessed 22 November 2022.

variables.'[8] Derivatives can be traded on exchanges or over the counter (OTC).

In my book, Taxation of Derivatives (2nd edition forthcoming 2023), I have outlined that derivatives can be categorised according to their type and the underlying asset/ variable.[9]

One can broadly distinguish options, futures, forwards and swaps in terms of types of derivatives.

Traditional underlyings of derivatives are the prices of equities, bond and debt instruments, commodities and currencies (FX) and credit.

Hull sums it up as follows:

> Very often, the variables underlying derivatives are the prices of traded assets. [...] However, derivatives can be dependent on almost any variable, from

[8] John Hull, *Options, Futures and Other Derivatives*, 9th edition 2018, p. 23.

[9] Weidmann, Derivatives (2015), chapter 2.

> the price of hogs to the amount of snow falling at a certain ski resort.[10]

Thus, the underlying is not the equity but the price of the equity. Typically, equity derivatives exist on single stocks, stock baskets and equity indices.

In recent years, one has seen cryptoassets emerging as a new asset class.[11]

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[10] Hull (2018), p. 23.

[11] For a discussion of the new asset class and the issues in relation to cryptoassets see:

David Southern KC and Oktavia Weidmann, Cryptocurrency: A New Weapon of Mass Destruction? 10th FCTC Digest (2022), pp. 111 — 140. In this article, we have, among other topics outlined that cryptoassets are not derivatives themselves but a new asset class.

Oktavia Weidmann, From Cryptoassets To The Virtual World: To Impair, Or Not To Impair – How To Treat Losses From Cryptocurrencies? 12th FCTC Digest (2022), pp. 64 – 95, discussing impairment losses.

Oktavia Weidmann and Dilpreet Dhanoa, From Cryptocurrencies To The Virtual World: Cryptocurrencies, NFTs and UK VAT Implications, 12th FCTC Digest (2022), pp. 96 – 130, discussing VAT aspects of cryptoassets.

In this article, I will focus only on equity derivatives, namely on derivatives with the price of equities as underlying variables.

This article will not deal with derivatives that have the income stream of equity derivatives as underlying, i.e. dividend swaps, as the topic of dividend swaps is a topic in its own right that deserves a separate article.

3. Taxation of equity derivatives

The UK tax legislation has a set of rules that deal with the taxation of derivatives – unlike some other countries that also apply the general taxation rules to derivatives.

CTA 2009, Part 7 deals with the taxation of derivatives. CTA 2009, s 571 (1) states that 'all profits arising to a company from its derivative contracts are chargeable to corporation tax under CTA 2009. Part 7.

Rule number one: Derivatives income/ profits arising to a company are generally taxed as income.

Rule number two: distinguish between derivative contracts entered into for trading and non-trading purposes.

Rule number three: gains from certain derivatives are subject to a capital gains taxation regime within CTA 2009, Part 7.

Insofar as rule number three is an exception to rule number one and an expression of the traditional equity/debt divide mentioned above.

Before one applies rule number three, one must always remember to check rule number two (trading/non-trading).

Rule number one in detail:

The underlying policy of the taxation of derivatives is that the UK tax regime follows, in principle, the accounting regime under UK GAAP or IAS/IFRS. [12]

Based on FRS 102/IFRS 9 determines that all financial assets, including derivatives, are recognised at fair value at inception (classification).

Rule number two in detail:

Banks and other financial traders typically enter derivative contracts for the purposes of a trade. For

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[12] Southern, Loan Relationships and Derivatives, p. 396 ff; for details: Weidmann, Derivatives (2015), chapter 6.

other companies, it depends on the intention of the parties.[13]

Ultimately, one has to determine what a trade is by resorting to case law and the famous 'badges of trade'.

Provided a derivative contract is attributed to a company's trade under CTA 2009, Part 3, all credits and debits are taxable as trading receipts.[14]

Rule number three in detail:

This rule provides that a capital gains taxation regime applies to certain derivative contracts if certain conditions are fulfilled.[15]

In the following, I will provide more details on how rule number three operates.

A contract can be qualified as a derivative contract only if the following three conditions are met:

a) **Condition One:**

[13] Weidmann, Derivatives (2015), p. 274.

[14] CTA 2009, s 573 (2).

[15] Weidmann, Derivatives (2015), p. 282.

The contract must be a 'relevant contract'. CTA 2009, s 577 describes a relevant contract as an option, future of contract for differences. CTA 2009, s 581 says that the term 'futures' includes forward contracts.

Confused?

For people in the banking world, it seems natural that a forward contract is an OTC contract which is the basis for any futures contract.

Futures are – simplified – exchange-traded forward contracts that use a margin system.

But the tax world is different. Thus, forward contracts are a subset of futures for UK tax purposes.

'Contracts for differences' are again something different than one would expect if one is familiar with the banking terminology.

There are swaps that are traded OTC (over the counter), usually between professional counterparties and sometimes between normal companies and banks.

And then there are CFDs – contracts for differences that are sold commonly to individuals and give them exposure to the price movement of underlying assets.[16]

So what are 'contracts for differences' – CFDs for tax purposes?

CTA 2009, s 582 (1) defines CFDs as

> A contract for the purpose or pretended purpose of which is to make a profit or avoid a loss by reference to fluctuations in
>
> 1. The value or price of property described in the contract, or
> 2. An index of other factor designated in the contract.

One understands from that definition that it is quite wide. The author of this article believes that the definition includes cash and physically settled

[16] Corporate Finance Institute, Contract for Difference, https://corporatefinanceinstitute.com/resources/derivatives/contract-for-difference-cfd/, accessed 22 November 2022.

CFDs.17 But the Corporate Finance Manual is silent on this aspect.[18]

Southern disagrees with me and suggests:

> FRS 102, paras 12.4-12.5 distinguish between (a) options, forwards and swaps which are to be settled by delivery, and (b) contracts where no delivery is intended. The former are not financial instruments. Hence, options and forwards which are intended to result in delivery of the underlying subject matter will be outside of FRS 102, Section 12 and so will not be derivative contracts, unless they are relevant contracts, which, although not classified as derivative financial instrument for accounting purposes, are, by way of exception to the general rule,

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[17] Weidmann, Derivatives (2015), p. 45.
[18] HMRC, CFM50380, https://www.gov.uk/hmrc-internal-manuals/corporate-finance-manual/cfm50380, accessed 22 November 2022.

See for the discussion of this aspect: Weidmann, Derivatives (2015), p. 45.

> brought within the derivatives contract rules.[19]

The author of this article believes that the distinction between cash and physically settled derivatives does not make sense as both have – economically speaking – the same intrinsic value, i.e. the same price.

Only the mode of payment is different. Thus, it seems plausible that the legislator did not intend to exclude physically settled derivatives from the derivative contracts regime in the same way as the legislator did not intend to exclude equity options.[20]

Condition one is narrowed down by conditions two and three.

b) Condition two:

A relevant contract needs to meet 'any of the accounting conditions for the accounting period (see section 579)', CTA s 576 (1) (b).

'Accounting conditions' are further defined in CTA 2009, s 579 (1) (a) to (c) and (2).

[19] Southern, Loan relationships and derivatives, p. 402.
[20] See arguments below – accounting conditions.

Broadly speaking, we can determine three sub-conditions:

CTA 2009, s 579 (1) (a): Derivatives are also derivatives for tax purposes if they also qualify as derivatives for accounting purposes.

CTA 2009, s 579 (1) (b): Derivatives that are brought back into the derivative contracts taxation regime although they do not fulfil the accounting definition of derivatives under FRS 102/ IFRS 9.

CTA 2009, s 579 (1) (c) and (2): Certain derivatives are treated as derivatives for tax purposes by virtue of their underlying subject matter if they are a relevant contract within CTA 2009, s 576.

Thus, 'Categories (b) and (c) do not require the derivatives transaction to qualify as a derivative under FRS 102 [IFRS 9]'.[21]

For CTA 2009, s 579 (1) (a) one will first have to test if FRS 102/ IFRS 9 is fulfilled, CTA 2009, s 579(1).

A derivative is defined in IFRS 9 (Appendix A) as

[21] Southern, Loan Relationships and Derivatives, p. 403.

a financial instrument or other contract within the scope of IFRS 9 with all three of the following characteristics:

a. its **value changes in response to changes in the so-called 'underlying'**, i.e. the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (in case of a non-financial variable, the variable must not be specific to a party to the contract)
b. it requires **no initial net investment or an initial net investment that is smaller** than would be required for other types of contracts with a similar response to changes in market factors.
c. it is **settled at a future date**.

CTA 2009, CTA 579 (1) (b):

Derivatives that fall outside CTA 2009, s 579 (1)(a) are brought back into the regime and nevertheless qualify as derivatives for tax purposes if:

> the relevant contract—
>
> (i) is not so treated just because of not meeting the requirement in paragraph 9(b) of Financial Reporting Standard 26 issued in December 2004 by the Accounting Standards Board (requirement for no initial net investment or smaller initial net investment than comparable types of contract), but
>
> (ii) is or forms part of a financial asset or liability for accounting purposes.

Thus, in relation to equity derivatives, pre-paid forwards and deep-in-the-money options will fall within the scope of CTA 2009, Part 7.[22]

Further, equity options held by a company meet condition two.

If one applied FRS 102, para 12.3. (e) literally, these rules would only qualify for the issuer of equity options but not for the holder of the same.

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[22] Southern, Loan Relationships and Derivatives, p.402.

The result would be absurd: the long position holder of equity options (i.e. the buyer of equity options) would fall outside the tax definition of the derivative contract regime of CTA 2009, Part 7.

The author of this article believes that this has not been the intention of the legislator. Southern agrees and explains this aspect of the law as follows:

> FRS 103, para 12.3(e) takes equity instruments out of the scope of financial instrument treatment as regards the issuer but not as regards the holder. This is not intended to exclude equity options from derivative financial instrument treatment.[23]

Thus, in summary, equity forwards, equity futures and equity options fall within the scope of the accounting test and require fair value accounting.

This article's author believes this is not only the case for cash-settled equity derivatives but also for physically settled derivatives, as a distinction

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[23] Southern, Loan Relationships and Derivatives, p. 402.

according to the mode of settlement seems inappropriate.

Of course, equity derivatives over equity indexes are commonly cash-settled only. In contrast, equity derivatives over a single stock or a basket of stocks can be both cash and physically settled.

c) Condition three:

Relevant contracts can fall out of the derivative contract regime as **excluded contracts by virtue of their underlying subject matter**, CTA 2009 ss 589-593.

The third condition is the so-called **underlying subject matter test**.

CTA 2009, s 583 (1) to (5) define the underlying subject matter positively in relation to a derivative contract.

For example, the underlying subject matter of an equity option is the price movement in the equity, an equity basket or an equity index.

Condition three, the underlying subject matter test, is a piece of legislation that shows the complexity of the entire derivative contracts legislation, and thus needs further analysis.

CTA 2009, s 589 (1) states that

> A relevant contract is not a derivative contract for the purposes of this Part if its underlying subject matter—
>
> (a) consists wholly of excluded property (see subsections (2) to (5)), or
>
> (b) is treated as consisting wholly of such property.

CTA 2009, S 589 (2) (b) defines excluded property – among others – as 'shares in a company other than shares within subsection (3),' but these exceptions are rather narrow.

Southern lists all those exceptions in para 13.32 of his book.[24]

A detailed explanation of the excluded subject matter: shares can be found in Ghosh, Johnson and Millers on the Taxation of Corporate Debt and

[24] Southern, Loan Relationships and Derivatives, p. 404.

Derivatives.[25] A discussion of those would go far beyond the scope of this article.

Those excluded subject matters will be 'chargeable assets for the purpose of the charge to corporation tax on chargeable gains: CTA 2009, *ss 661, 662*.

Once all those three conditions are met – and the contract is **a) relevant, b) fulfils** – in whatever manner, CTA 2009, s 579 (1) (a), (b) or (c) – **the accounting conditions**, and **c)** is not an excluded contract by virtue of CTA 2009, ss 589-593, derivatives can be taxed as income under Part 7, or as capital under CTA 2009, Part 7 Chapters 7 and 8.

In principle, certain embedded derivatives that have a chargeable asset as an underlying subject matter and that can be bifurcated will fall under a capital gains regime within Chapters 7 and 8.

David Southern dedicated the complete chapter 15 to the topic of embedded derivatives.

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[25] Julian Ghosh, Ian Johnson, Paul Miller, Ghosh, Johnson Miller on the Taxation of Corporate Debt and Derivatives, Issue 20, October 2019, [E2.432]-[E2.470].

Therefore, the discussion of this important topic is – like a cliffhanger in a good TV series – left to part two in the next FCTC Digest.

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