THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

December 2024

MODULE 2.09 – UNITED KINGDOM OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

To: The board of German Kitchens Ltd
From: Tax Adviser

Tax deductibility of interest expense

As a general rule, interest expenses incurred by a company can be deducted for the purposes of calculating the profits chargeable to UK Corporation Tax. However, this general rule is subject to a number of restrictive rules that may limit the amount of interest that can be claimed as an expense for Corporation Tax purposes.

The main rules to consider are summarised below.

Transfer pricing

The UK transfer pricing legislation is within Part 4 of TIOPA 2010. The UK transfer pricing rules are broadly consistent with the OECD's approach and the OECD Transfer Pricing Guidelines are a key interpretative text.

The rules apply to intra-group transactions including financial transactions. There is no motive test and so the purpose for entering into a specific transaction is irrelevant for transfer pricing purposes.

Given that the SME exemptions for transfer pricing will not apply, the loan from Deutsche Kitchens Financing Ltd is within scope of the transfer pricing rules regardless of whether there is a commercial motive for taking out the loan.

The transfer pricing rules, when applied to financing transactions, seek to ensure that company borrowing and lending conform with the arm's length principle. It should be noted that the UK transfer pricing rules are not only concerned with the interest rate applied but take into account all other factors affecting the interest expense including the amount of debt (s.152 TIOPA 2010). Unlike some other jurisdictions, there are no "safe harbour" or prescribed formulae rules within the UK transfer pricing regime for interest deductibility.

Therefore, in addition to considering whether the interest rate and all other terms and conditions of the loan are at arm's length, we will also need to consider whether German Kitchens Ltd is "thinly capitalised" by applying the arm's length principle. A company is considered to be thinly capitalised if has more debt than it either could or would borrow at arm's length.

I note that debt financing makes up most of the company's capital structure and most of the debt is intra-group, so thin capitalisation may be a concern for HMRC, the UK tax authority.

The board may wish to consider applying for an Advanced Thin Capitalisation Agreement (ATCA). This is an agreement with HMRC that sets out in advance how the UK transfer pricing rules will apply to a specific financing transaction(s). Applying for an ATCA would likely involve greater upfront compliance costs but would bring greater certainty. However it should be noted that an ATCA would only provide certainty on the transfer pricing treatment of the loans and not the other areas of potential risk covered below.

Unallowable purpose

The unallowable purpose rule is set out at s.441 and s.442 CTA 2009. The rule is a targeted anti avoidance rule and applies where a loan has an unallowable purpose. An unallowable purpose is defined as a purpose that is not amongst the business or other commercial purposes of the company.

The legislation specifically provides that where one of the main purposes of a loan is to secure a tax advantage for the taxpayer or any other person, such a loan will be within scope of the rule. For loans within scope of the rule, no tax deduction is available for any part of the interest attributable to the unallowable purpose.

There are demonstrable commercial purposes to taking out the loans, namely to provide working and start-up capital for the new UK business. However, these commercial purposes would not preclude the unallowable purpose rule from applying if an additional unallowable purpose for taking out the loans is identified. The preference for debt financing over equity financing may raise concerns with HMRC that the financing structure was at least partly motivated by a desire to secure a tax advantage in the form of excessive interest deductions. Likewise, if the loan is structured in a way that results in the interest not being subject to tax in Malta, HMRC may view this as an indication of a tax avoidance motive. This may lead HMRC to make an unallowable purpose challenge which could involve a costly and time-consuming investigation and, if successful, result in some or all of the interest expense being disallowed for UK CT purposes.

The board should therefore closely consider the rationale for the financing structure and ensure the decision making in relation to the financing is clearly and comprehensively documented.

Hybrid mismatch rules

The UK's hybrid mismatch rules are contained within Part 6A TIOPA 2010 and are mostly based on Action 2 of the OECDs BEPS project.

Broadly speaking, the rules apply where the use of entities or instruments with hybrid features results in either:

- A double deduction (D/D) mismatch (two tax deductions for the same expense); or
- A deduction/non-inclusion (D/NI) mismatch (a deduction without a corresponding taxable receipt).

I note there is some doubt over whether the interest expense on the intra-group loan will generate a corresponding taxable receipt for the financing company in Malta. This suggests the possibility of a deduction/non-inclusion mismatch depending on the legal form of the loan instrument used. If there is such a mismatch and this results from use of a hybrid instrument (or any entity with hybrid features), the hybrid mismatch rules will apply. The practical result will be that any part of the interest deduction not matched by a corresponding taxable receipt in the Maltese entity will be disallowed for UK CT purposes.

The loan instrument would be a hybrid instrument (and within scope of the rules) if, for example, it fell to be treated as debt for UK tax purposes but as equity (or quasi-equity) for Maltese tax purposes.

It should be noted that the hybrids legislation is drawn very widely and does not contain a motive test meaning that even wholly commercial transactions are potentially within scope of the rules. I would therefore strongly recommend that the board reviews the legal form of the loan instrument to be used and obtains advice on the Maltese tax treatment of the interest. It will be important for the board to review all aspects of the intra-group loan structuring in detail, with appropriate tax technical advice, to ensure it isn't within scope of the rules.

Corporate interest restriction

In addition to the rules summarised above, the UK has a corporate interest restriction ("CIR") regime that places restrictions on the amount of interest UK companies can deduct. The rules are included in Part 10 TIOPA 2010 and are based on Action Point 4 of the OECD BEPS project.

The CIR rules are complex. In most cases, the rules cap allowable interest to 30% of the group's UK taxable earnings. However, a higher percentage can be allowable for worldwide groups that are highly geared.

It seems likely that the company will have to consider the impact of the CIR, especially as the £2m CIR de minimis threshold for UK net interest expense is likely to be exceeded and there is no motive test for the CIR to apply. Provided the £2m threshold is exceeded, the group will have to prepare and file a CIR return with HMRC.

Any restriction on interest under the CIR will be calculated by reference to actual earnings and so it is not possible to say for certain what the effect of the CIR will be on interest deductibility in advance.

Profits of the Irish permanent establishment

The general rule is that UK-resident companies are subject to UK Corporation Tax on their worldwide profits (s.5 CTA 2009), which would include profits of the Irish PE.

However, the business profits article of the OECD Model DTA provides that profits attributable to an Irish PE may be taxed in Ireland. Note that this article does not preclude the UK from also taxing profits of the PE.

This creates the potential for double taxation as the UK and Ireland may both seek to tax the profits of the Irish PE. To alleviate this, the UK company should be able to claim double tax relief for the Irish tax suffered on PE profits under article 23 of the OECD Model DTA. However, such relief will be limited to the Irish tax suffered. As the Irish tax rate is lower than the UK tax rate this would mean some UK tax would still be payable on Irish PE profits.

An alternative would be to make an election under s.18A CTA 2009 to exempt profits of a foreign PE from UK Corporation Tax. Such an election is irrevocable and needs to be made before the start of the first period to which it relates. The effect of such an election would be to exclude profits of all PEs of the UK company from the UK Corporation Tax computation meaning that PE profits would not be subject to UK tax.

It would seem sensible to make such an election, especially considering the following factors:

- the Irish PE will be profit making;
- the Irish tax rate is lower than the UK's tax rate meaning double tax relief will not fully relieve UK tax on PE profits; and
- the UK company only has one PE so won't have to consider the impact on other PEs (as the election applies to all PEs of a UK company).

Withholding tax

As a general rule, UK companies are required to withhold income tax on certain payments. Withholding tax requirements for the intra-group payments are summarised below:

Interest

Under UK domestic law, companies are required to deduct withholding tax at the basic rate of income tax (20%) from payments of interest with a UK source, subject to a number of exceptions. This rate can be reduced or eliminated completely under the terms of DTAs negotiated by the UK.

Payments of interest to UK banks are excluded from the requirement to deduct withholding tax so no withholding tax will be deducted from interest payable to the bank.

It is possible that the UK company will have to deduct withholding tax on the intra-group loan interest as the interest will have a UK source.

The OECD Model DTA provides that countries can withhold tax at a rate of up to 10% on interest provided the recipient is the beneficial owner of the interest.

Even though the relevant DTA does not prevent the UK from deducting withholding tax on interest, it may still be the case that no withholding tax is due if an exemption applies (for example if the loan instrument takes the form of a quoted Eurobond).

Royalties

Under UK domestic law, companies are required to deduct withholding tax at the basic rate of income tax (20%) from royalty payments arising in the UK relating to brand names and many other forms of intellectual property.

However, the OECD Model DTA provides that no withholding tax can be deducted by the UK on royalties arising in the UK as long as the recipient is the beneficial owner of the royalties. Therefore, German Kitchens Ltd will not be required to deduct withholding tax from the royalties paid to Deutsche Kitchens IP AG as long as the latter is the beneficial owner of the royalties.

Dividends

There are no provisions within UK domestic law that require tax to be withheld on dividend payments. Therefore, the dividends paid by German Kitchens Ltd will no be subject to UK withholding tax.

Payments for goods

There is no domestic law requiring income tax to be withheld on payments for goods, so German Kitchens Ltd will not be required to deduct withholding tax from these payments.

Kind regards
Tax Adviser

Question 2

To: Luis
From: Tax Adviser
Date: December 2024

Dear Luis,

Thank you for your correspondence regarding the UK tax implications of your UK secondment. I have laid these out below however please let me know if you have any queries or would like to discuss in more detail.

UK tax residence

The Statutory Residence Test (SRT)

An individual's UK tax residence is determined by the Statutory Residence Test ('SRT'). UK tax residents are subject to UK tax on their worldwide income and gains and UK tax non-residents are subject to tax on their UK sourced income and UK property gains.

The SRT is split into three parts: the automatic overseas tests, the automatic UK tests, and the sufficient ties tests which must be applied in order. The tests that apply depend on whether the individual is a 'leaver' (UK tax resident in at least one of the prior three UK tax years) or an 'arriver' (UK tax non-resident in all of the prior three tax years).

As you have never previously visited the UK, you will be an 'arriver' and we may therefore disregard the first automatic overseas test as this only applies to leavers. The second automatic overseas test states that you would be non-resident if you spent fewer than 46 days in the UK during the year. As you will spend over 46 days in the UK from 1 January to 5 April 2025, this test is not met.

The third overseas test (Full Time Work Abroad) has four conditions which must all be met in order to be considered as UK non-resident:

- you spend fewer than 91 days in the UK during the year;
- you exercise fewer than 31 workdays in the UK during the year;
- you do not have a significant break from overseas work; and
- you work sufficient hours overseas.

As you are expected to exercise more than 31 workdays in the UK during 2024/25, this test is not met.

We therefore consider the automatic residence tests. The first automatic resident test is met if you spend more than 183 days in the UK during the year, which will not be met for 2024/25.

The second UK test is the home test which states that you will be resident if we can find a 91-day consecutive period, only 30 of which need to fall in the tax year in question, where you have a UK home and are present in it for at least 30 days during the tax year and you either:

- do not have an overseas home; or
- have an overseas home but is present in it for fewer than 30 days in the tax year.

As you will be living in temporary accommodation during the 2024/25 tax year, you should not have a UK home and therefore this test is not met.

The third UK test is the full-time work in the UK test. This requires there to be a 365-day consecutive period, only one day of which needs to fall in the tax year, where you exercise at least 75% of your working time in the UK with no significant breaks. You are expected to spend 100% of your working time in the UK from 1 January 2025 for a three-year period and we therefore expect you to be considered as UK tax resident under this test.

Split Year Treatment

As you are arriving in the UK partway through the 2024/25 tax year, we must consider whether you are eligible for 'split year' treatment to split the tax year into a period of UK tax residence and UK tax non-residence. There are 5 cases under which an individual can split the tax year when arriving in the UK. The one relevant to your circumstances is case 5 'Starting Full Time Work in the UK'. The conditions of this are:

- you are UK tax resident for the year;
- you were non-resident in the prior year; or

- you start to meet the third automatic UK test from a point in the tax year.

Prior to this date, you do not meet the 'sufficient ties' test.

You will meet the above from your first UK workday (assumed to be 1 January 2025) and this will be your first day of UK tax residence. You should not have any ties to the UK prior to 1 January 2025 and were non-resident in 2023/24 so the above conditions are met.

You will therefore be subject to UK tax on your worldwide income and gains from 1 January 2025 and the UK tax treatment of each element of your employment income is as follows.

UK taxation of employment income

Salary

Your salary from 1 January to 5 April 2025 (£30,000) is taxable in the UK as you are UK tax resident. As you exercise your employment wholly in the UK, no relief can be considered.

Bonus

Payments with defined earnings periods such as bonuses are taxable based on the individual's residence status and working pattern during the earnings period. As you were not UK tax resident for the earnings period during the 2024 calendar year, the bonus is not taxable in the UK.

Temporary Accommodation

When an individual relocates for their employment, qualifying relocation costs up to a value of £8,000 are exempt from UK tax.

The relocation is qualifying if the following conditions are met:

- the employee is starting a new job with the employer or changing their place of work within the organisation;
- the employee's new home is reasonably close to their new workplace and their old home is not; and
- the costs are paid before the end of the second tax year following the employee's relocation.

Temporary accommodation, where the employee intends to move to permanent accommodation to complete the relocation, is qualifying expenditure. Therefore the excess above £8,000 (£4,000 in this case) is taxable in the UK.

Return trips to Brazil

Certain travel costs that are met by an employer may be exempt from UK tax under Sections 373 – 375 of ITEPA 2003. The trips must be between the country outside of the UK in which the individual lives and any place in the UK where employment duties are performed.

The following conditions must also be met:

- the employee is not domiciled in the UK;
- the cost of the travel is met by the employer; and
- the journey takes place within five years of the employee's 'qualifying arrival' in the UK.

If these conditions are met, the costs for an unlimited number of journeys by the employee is exempt from UK tax.

In addition to the above, if the employee is present in the UK for a continuous period of at least 60 days for the purpose of performing their employment duties and they are accompanied by their spouse and/or dependent children (younger than 18), the costs of up to two return trips per year for the employee's family are exempt from UK tax.

As such, the portion of the flight costs relating to you are exempt from UK tax however the costs relating to your family are exempt for only two trips per year.

I trust the above provides you with additional information regarding the UK tax system to support you with deciding whether to accept the UK secondment however please let me know if you require anything further.

Yours sincerely
Tax Adviser

PART B

Question 3

To: The directors of Garden Innovation Ltd
From: Tax Adviser
Subject: Corporate residency changes

I am writing to you to set out how the planned relocation of the company's headquarters to The Netherlands may affect the company's residency status for UK Corporation Tax ("UK CT").

Corporate residency

For UK CT purposes, a company is resident in the UK if it is incorporated in the UK and/or centrally managed and controlled in the UK.

As a general rule, UK resident companies are chargeable to UK CT on their worldwide profits (s5 CTA 2009).

Current corporate residency status

As the company was incorporated in the UK, it will be considered resident in the UK under UK law (as per s14 CTA 2009). For completeness, the company also appears to be centrally managed and controlled in the UK; the board meetings take place in the UK and there is no suggestion that strategic decisions affecting the company are taken outside the UK.

Given the above, it is unlikely that other countries would currently view the company as resident in their jurisdiction.

Future corporate residency status

It seems likely that following the proposed changes on 1 January 2026, The Netherlands will view the company as resident there as it appears the central management and control/place of effective management will shift from the UK to The Netherlands.

This raises the possibility of the company being considered dual-resident as the company would still be considered resident under UK law (under the incorporation rule).

Article 4(3) of the OECD Model Tax Treaty aims to prevent such dual-residency scenarios. The multi-lateral instrument ('MLI') included within the Model Tax Treaty outlines that any company which may be deemed as dual resident should seek agreement (via the Mutual Agreement Procedure) between the two Competent Authorities (in this case the UK and Netherlands) as to which country the company shall be deemed to be resident in under the treaty. In seeking to reach agreement on this point, the MLI states that the competent authorities should consider place of effective management, place of incorporation "and any other relevant factors".

The place of effective management ("POEM") test is very similar to the concept of central management and control and takes into account the location of board meetings, where the senior executives carry out the core business of the company and where the headquarters of the business are located. Based on the facts of the case, my view is that the competent authorities would likely conclude the place of effective management of Garden Innovations Ltd would be located in The Netherlands from 1 January 2026 as this is where the directors of the business will hold board meetings and make the strategic decisions affecting the company.

It is noted that UK-based personnel will still oversee the operations of the UK factory until closure, but this likely won't affect the POEM being in the Netherlands as long as such personnel act under the oversight of the board of directors and aren't seen to exercise strategic control over the company. The nationality of the directors is not relevant as long as the directors do not make strategic decisions affecting the company in the UK.

For the UK competent authorities to agree that the company is effectively managed in The Netherlands, the company needs to be able to demonstrate that this is where the substantive decisions are made rather than just where decisions made elsewhere are "rubber-stamped". It will therefore be important to maintain an audit trail to demonstrate the board's decision-making process.

It is important that the UK and Netherlands competent authorities agree on a single country of residency. It should be noted that while contracting states are encouraged to seek agreement, there is no binding arbitration clause in the model treaty, raising the possibility that the Mutual Agreement Procedure does not result in an agreed position on residency.

In the absence of such an agreement, the company would be seen as "dual-resident" (resident in the UK and in The Netherlands under both country's respective domestic laws). Such dual-resident companies are not entitled to treaty protection and may as a result suffer from unrelieved double tax.

Therefore, the board are advised to tread carefully and ensure that following the move in headquarters, there is no scope for the UK competent authorities to argue the company is being effectively managed from the UK.

If, having scrutinised the plans in greater detail, there is any real risk of the UK competent authorities claiming the company is still effectively managed in the UK, it may be worth the board considering other options such as transferring the business to a new company incorporated in The Netherlands.

UK Corporation Tax consequences of a change in residency

If Garden Innovation Ltd becomes "treaty-resident" in the Netherlands, the company will need to consider "exit charges' as it will effectively be disposing of its assets resulting in potential chargeable gains and profits / losses arising on loan relationships, derivative contracts, corporate intangibles, trading stock and capital assets. Any assets continuing to be within scope of UK Corporation Tax would not be subject to an exit charge.

It must also notify HMRC of its intention to cease to be resident and migration time, provide a statement of its tax liabilities, make arrangements for the settlement of these liabilities in due course and obtain HMRC's approval of the arrangements.

The company will no longer be treated as UK resident for UK CT purposes. As a non-UK resident company, it will only be subject to UK CT on profits attributable to a UK Permanent Establishment (as per article 7 of the UK-Netherlands DTA).

It is likely the company will have a Fixed Place of Business UK Permanent Establishment (PE) under UK domestic law (s1141 CTA 2010) and under the terms of the DTA (Article 5), both of which specifically provide that a "Fixed Place of Business" includes factories. Profits attributable to the UK PE will be taxed in the UK. Double Tax Relief should be available to the extent that UK PE profits are also taxed in The Netherlands.

More information will be needed to determine whether the company will continue to have a UK PE following closure of the factory in 2028.

Since 1 April 2019, any gain made on disposal of UK land by non-resident companies is chargeable to UK CT. Therefore, any gain realised on the sale of the UK factory will be subject to UK CT regardless of whether this occurs in 2028 or at a later date.

From 6 April 2020, non-UK resident companies are chargeable to UK CT on profits of a UK property business (having previously been subject to UK income tax). Therefore, if the company instead decides to rent out the UK factory, it will be subject to UK CT on any rental income received regardless of whether the company still has a PE in the UK (for UK tax purposes, a UK property business does not constitute a trade, so the rules relating to trading through a UK PE are irrelevant).

Kind regards
Tax Adviser

Question 4

Part 1

Domicile is a UK common law concept which can impact the basis on which an individual is subject to UK income tax, capital gains tax, and inheritance tax, and the availability of certain UK claims and reliefs. An individual must be domiciled somewhere and cannot have more than one domicile at one time.

Domicile status is determined by the following:

- Domicile of origin: an individual acquires a domicile of origin at birth based on the domicile of their father if their parents were married, or their mother if not.

- Domicile of dependence: an individual's domicile status follows that of their parents until the age of 16 at which point the individual is said to have legal capacity to not require dependence on another person.

- Domicile of choice: an individual may acquire a domicile of choice in a country different to their domicile of origin/dependence if they are both:

    - resident in that territory subject to a distinctive legal system of 'municipal law'; and
    - intend to reside there indefinitely.

A change in an individual's domicile status is not irrevocable however since a domicile of choice can only be acquired through an intention to reside in a territory indefinitely, it is not common for an individual's domicile status to change multiple times.

As Susannah was born in Norway to Norwegian parents, she will likely have a domicile of origin in Norway. As she and her parents lived in Norway until her adult life, her domicile will not change via a domicile of dependence. She is unlikely to acquire a domicile of choice in the UK despite her UK employment since she only intends to reside in the UK for 3-5 years before returning to Norway. As such, Susannah should be considered as domiciled in Norway.

Part 2

The default basis of UK taxation is the Arising Basis whereby UK tax residents are subject to UK tax on their worldwide income and gains as it arises. Alternatively, as a non-UK domiciled individual, Susannah is eligible to claim the Remittance Basis of taxation for the 2024/25 UK tax year which enables her to be taxed on her UK sourced income and gains as they arise but only on her non-UK sourced income and gains to the extent that she remits (brings) the proceeds to the UK. The claim is typically made on her UK tax return.

HMRC's definition of a remittance is:

> "any money or other property which is, or which derives from, your offshore income and gains which are brought to, received or used either directly or indirectly in the UK for your benefit or for the benefit of any other relevant person."

This includes a transfer of money from a foreign bank account to a UK bank account but also includes instances where a service is provided in the UK by the individual or a relevant person and the cost of that service is met by funds from the non-UK income/gains.

Non-UK sourced income refers to personal income from non-UK sources (for example her Norwegian rental income), and the portion of her employment income relating to non-UK workdays (i.e. 20% of her £75,000 UK employment income relating to her non-UK duties).

Individuals claiming the Remittance Basis are not entitled to the Personal Allowance or Annual Exemption however for individuals with unremitted income and gains below £2,000, the Remittance Basis applies automatically and the Personal Allowance and Annual Exemption are not lost.

As Susannah's non-UK income totals £35,000 (£20,000 Norwegian rental income plus £15,000 employment income relating to non-UK workdays), it will be beneficial for her to claim the Remittance Basis to exclude this income even though the Personal Allowance is lost.

Personal income

Susannah's Norwegian rental income can be excluded from UK tax under the Remittance Basis provided that the profits are not remitted to the UK. It is therefore advisable that she receives this income into a non-UK bank account from which she does not remit any income to the UK to clearly demonstrate that the funds have not been remitted.

It is recommended that she open a new non-UK bank account (or clear an existing non-UK bank account) to start to receive her Norwegian rental income from 1 January 2025. This is so the Norwegian rental income received while UK tax resident is not paid into an account containing income earned while UK non-resident (clean capital)which can be freely remitted to the UK.

Her £50,000 of savings are clean capital as it has been earned prior to becoming UK tax resident and should therefore be ring fenced as it can be freely remitted to the UK without any tax consequences.

Employment income

20% of Susannah's employment income can be excluded from UK tax under Overseas Workday Relief which is a relief available to Remittance Basis users for the first 3 years of their UK tax residence. Since employment income including UK and non-UK sourced amounts are paid into the same bank account, it can be complex to determine the makeup of the account whenever a remittance or transfer is made. These are called the 'mixed fund' rules and must be assessed whenever a remittance or offshore transfer is made to determine whether a taxable remittance has occurred.

HMRC allow individuals to apply the 'special mixed fund rules' which treat all UK remittances made during the year to have been made on 5 April followed immediately by all offshore transfers. This is a favourable and simplified method of analysis however the individual must have a 'qualifying account' for this to be available.

The conditions of a qualifying account are:

- The account must be an ordinary bank account held by the individual (it can be held jointly)
- An individual can only have one qualifying account at a time
- The account must be nominated to HMRC by 31 January following the end of the tax year.
- The account can only receive employment income, proceeds from certain employment related securities and interest arising from the account.
- The account must have less than £10 on the 'qualifying date' which is the date that the account first receives employment income in a 'relevant' tax year which is a year in which the individual receives employment income consisting of UK and non-UK sources.

If Susannah has such an account and her employment income from 1 January 2025 is paid into it, provided that she retains at least £15,000 in the account, she can exclude this from her UK taxable income.

Following these rules, Susannah's UK taxable income for 2024/25 would be £60,000 however the personal allowance would not be available when computing the UK tax due on this income.

PART C

Question 5

Part 1

The UK's Digital Services Tax ("DST") came into force on 1 April 2020. The rules are contained in Part 2 FA 2020. DST is applied at a rate of 2% to (gross) revenue attributable to UK users arising from any of the following three digital services activities:

- A social media service where the main purpose of the service is to promote interaction between users (including interaction between users and user-generated content) where making user generated content available to other users is a significant feature of the service.

- An internet search engine (excludes facilities on websites that only enable a person to search for material on that website and closely related websites).

- An online marketplace where at least one of the main purposes is to facilitate the sale by users of services or goods (or enable users to advertise such items for sale or hire).

The DST is designed to apply to large groups deriving significant revenues in the UK from digital services activities. As such, the DST only applies to groups exceeding the following thresholds:

- £500m digital services revenues; and
- £25m UK digital services revenues (i.e. digital service revenues attributable to UK users).

Effectively, groups within scope are subject to DST at a rate of 2% on all UK digital services revenues above £25m. Although the DST is calculated for the group as a whole, the actual charge is allocated to each member of the group based on their proportion of UK DST revenue.

Groups can make an "Alternative Charge Election" to calculate their DST liability using a formula based on operating margins. Such an election may be beneficial for groups generating low profit margins or losses from the digital service activities in the UK.

There is no specific tax relief against the DST charge and no specific rules determining the deductibility or otherwise of DST against any other tax liability. For UK Corporation Tax the normal rules concerning whether expenditure is an allowable deduction should be considered. Therefore, it is likely that DST will be deductible when calculating profits chargeable to CT as the DST expense is directly related to the earning of its revenues and is a legal obligation of performing that trade (so should be deductible on first principles).

Part 2

As a whole, the UK's DST is broadly consistent with the underlying principle that businesses should be taxed in the countries in which they create value.

The introduction of DST was first announced at Autumn Budget 2018 as an interim response to the perceived limitations of the existing international corporate tax framework in relation to the digital economy. Specifically, the announcement reflected a growing global consensus that global businesses (and especially digital platform businesses) can generate substantial value in a country (through the participation of an active online user base) without having a taxable presence in the country.

Prior to the introduction of the DST, trading profits of non-resident companies were only subject to UK tax to the extent they were attributable to a permanent establishment in the country. The UK recognises two types of permanent establishments: Fixed Place of Business ("FPOB") PEs and Dependent Agent PEs ("DAPE"). Both types of PE require the business to have some form of physical presence in the UK. Unlike some other countries, the UK does not recognise "digital PEs". The commentary to the OECD MTC states that an internet web site does not itself constitute tangible property so does not have a location that can constitute a "place of business". Furthermore, the UK's established view is that a server cannot of itself constitute a FPOB (a view not shared by some other countries).

Digital business models (such as those within scope of the DST) allow multinational businesses to generate significant revenues in a country without the need to establish a physical presence in the same country.

In introducing the DST, the UK sought to ensure that digital businesses generating significant value in the UK from certain digital service activities could be brought within scope of UK tax regardless of whether they had a physical presence in the UK or not.

Online users/customers based in the UK do create value for digital businesses which is not reliant on having a physical presence in the UK. Such activities would not create sufficient nexus to allow the UK to tax such activities under the existing CT/PE rules. The DST rules recognise the value of a "digital presence" and work on the basis that a "digital presence" in the UK can constitute sufficient nexus to allow the UK to tax income attributable to the digital presence. In this way, the DST can be seen as an attempt to align tax with value creation.

However, given the DST is a tax on gross revenue, it may be argued that the UK's DST is not consistent with the principle that profits should be taxed in the countries where value is created (as revenue is not necessarily an accurate reflection of profits related to user-based value). It should be acknowledged that while DST is a tax on gross revenue, some companies within scope of DST can make an "Alternative Charge Election" which does take into account profit margins.

It should also be noted that the scope of the DST is fairly limited, only applying to certain large groups and to certain digital service activities that monetise users' engagement with online platforms. Therefore, some digital businesses may derive significant value from UK-based online customers without triggering a DST (or UK CT) charge. An example may be the direct sale of online content by businesses that own or have the rights to distribute the content. The DST is therefore not a comprehensive solution to aligning tax with value creation.

The US authorities appear not to agree with the proposition that unilateral DST's such as that introduced by the UK are a reasonable approach to aligning tax with value creation. The US view such measures as contrary to international tax principles and discriminatory towards US-based companies operating in the digital economy.

Question 6

Transfer pricing rules

The UK's transfer pricing rules are set out in Part 4 TIOPA 2010. The OECD transfer pricing guidelines are a key interpretative text in relation to the UK transfer pricing guidelines, as explicitly referenced by S164 TIOPA 2010.

Generally speaking, transactions between associated enterprises are within scope of the rules if:

a) the terms of the transaction (or "provision") differ from the arm's length position (i.e. the terms that would have been agreed between independent enterprises) and

b) the divergence from the arm's length position results in a potential UK tax advantage.

Where the rules apply, the actual provision is substituted by the arm's length provision for the purposes of calculating UK Corporation Tax.

Dormant companies, along with Small and Medium Enterprises (SMEs) are generally exempt from applying the transfer pricing rules. Neither of the exemptions appear to apply to Toys UK Ltd as the group is actively trading and is required to file CbCR returns, something only required of large businesses with revenue of at least €750 million.

Therefore, Toys UK Ltd is within scope of the UK transfer pricing rules in respect of its transactions with associated enterprises.

Review of transactions

Purchase of components and materials from Toys (Shenzhen) Ltd

These transactions will be within scope of the rules as Toys (Shenzhen) Ltd is an associated company of Toys UK Ltd.

Sale of finished products to independent UK retailers

Not within scope of the transfer pricing rules as the sales are not to an associated enterprise (i.e. the participation condition is not met).

Sale of finished products direct to individual customers across the world

Not within scope of the transfer pricing rules as the sales are not to an associated enterprise (i.e. the participation condition is not met).

Sale of finished products to group companies outside the UK

These transactions will be within scope of the rules. It is noted that Toys UK Ltd achieves a higher margin on sales to independent enterprises. This may be picked up as a risk by HMRC. There may be valid reasons for the difference (e.g. product or market differences) which means that at arm's length, the company would achieve a lower margin on sales the companies outside the UK. However, Toys UK Ltd should ensure it documents the reasons for the difference in margin.

Purchase of plant and machinery from Factoryparts (China) Ltd

Not within scope of the transfer pricing rules. Although the group does hold shares in Factoryparts (China) Ltd, it only holds 5% of the company's shareholders. Therefore, the participation condition is not met.

Provision of IT support to other group companies

Within scope of the transfer pricing rules as provision of services to associated enterprises. Note cost plus 5% seems appropriate for what is likely to be a low value-added service (although further information is needed to confirm this).

Borrowed £100m from the UK branch a multinational banking organisation.

Not within scope of the transfer pricing rules as the bank isn't an associated enterprise.

Lent £20m to Toys (Germany) GmbH, a group company resident in Germany.

Financial transactions are within scope of the transfer pricing rules and the transaction is with an associated enterprise, so the transfer pricing rules will apply to the loan to Toys (Germany) GmbH. The lack of interest on the loan presents a transfer pricing risk because at arm's length, lenders would normally require a return in the form of interest (so the actual provision differs from the arm's length provision). On the face of it, there is also a potential UK tax advantage from the arrangement as Toys UK Ltd would bring any interest charged on the loan into account as taxable income in the UK. Therefore, it seems likely that a transfer pricing adjustment will be required.

As well as the interest rate, the company should ensure that all other aspects of the transaction (as accurately delineated) including the amount of loan and other terms and conditions attached to the loan conform to the arm's length standard.

Transfer pricing documentation

From 1 April 2023, certain UK companies are required to retain a standardised master and local file in accordance with the OECD transfer pricing guidelines. These documentation rules apply to members of groups meeting the CbCR threshold with at least one "material controlled transaction". Transactions (or category of transactions) exceeding £1m are material controlled transactions for these purposes.

The group meets the CbCR threshold and has several material controlled transactions, so will be within scope of the new documentation rules.

Practically, this means the group must prepare and retain a standardised Master and Local File which accords with the OECD transfer pricing guidelines.

As per the OECD guidelines, the Master File should provide an overview of the multinational group's global business operations, including its transfer pricing policies and strategies as set out in Annex I to Chapter V of the transfer pricing guidelines. This should include information such as the group's organisational structure, its intangible assets, and its financial and tax positions.

The Local File should provide detailed information on the transfer pricing arrangements of Toys UK Ltd as set out in Annex II to Chapter V of the OECD TPG. In summary, the Local File should include a functional analysis of the UK company, benchmarking studies, and other information that supports the transfer pricing arrangement between Toys UK and its related parties.

The Master and Local File must be reviewed annually and updated to reflect any significant changes.
HMRC guidance states that these records should be made available to HMRC within 30 days of a request.

A penalty of up to £3,000 may be charged for failing to keep or preserve adequate records to support a tax return including the specific transfer pricing records detailed above.

Furthermore, the changes to UK law applying from 1 April 2023 mean that if the company's tax return is found to contain an inaccuracy relating to transfer pricing and has not maintained the specified transfer pricing documentation, there will be a presumption of careless behaviour for the purposes of calculating behavioural tax penalties.

Question 7

Overview of the rules

The International Movement of Capital (“IMOC”) rules are contained in Sch 17 FA 2009. Groups with a UK presence must report certain cross-border transactions to HMRC within 6 months of the transaction taking place. Transactions within scope of the rules must be reported if they have a value over £100m. Series of transactions are aggregated when determining the value for IMOC purposes.

Reportable transactions include:

- the issue of shares or debentures by a foreign subsidiary;
- the transfer of shares or debentures in a foreign subsidiary; and
- a foreign subsidiary becoming or ceasing to be a controlling partner in a partnership.

However, many transactions are excluded from the IMOC reporting requirements. The following transactions are specifically excluded from the IMOC provisions:

- transactions carried out in the ordinary course of a trade;

- transactions where all the parties to the transaction are resident in the same territory (at the time the transaction takes place);

- transactions consisting of the giving of security to the bankers of a foreign subsidiary by reason of any transaction entered into with it by them in the ordinary course of their business as bankers;

- transactions consisting of the giving of security by a foreign subsidiary to an insurance company for any payment due from the subsidiary to the insurance company by reason of any transaction entered into in the ordinary course of the insurance company business by way of investing funds; and

- other transactions specified in regulations.

Regulations have been issued excluding several further transactions from the IMOC reporting requirements including the issue of shares by the foreign subsidiary to a group company where the shares are non-redeemable and issued for market value cash consideration.

The reporting requirement falls on the “UK Corporate Parent” (a UK resident company controlling one or more non-UK resident companies that is not itself controlled by a UK company).

The report must include a full description of the steps taken in the course of a transaction including in particular the date, the names of the parties, the reasons for it, and an estimate of its effect on liability to United Kingdom tax.

Failure to comply with the IMOC reporting requirements will result in a penalty chargeable under S98 TMA 1970.

Review of transactions

Issue of share capital by Alpha Inc – not reportable as Alpha Inc. isn’t a foreign subsidiary.

Issue of debentures by Delta Ltd – not reportable as Delta Ltd isn’t a foreign subsidiary.

Issue of debentures by Epsilon GmbH - not reportable as value does not exceed £100m

Issue of share capital by Epsilon GmbH – reportable. Epsilon is a foreign subsidiary of a UK corporate parent and the transaction (issue of shares) is over £100m. There is an exclusion for market value shares issued by a foreign subsidiary to another company in the same group as the reporting body in exchange for cash. However, the exclusion only applies if the shares are non-redeemable. As these shares are redeemable, the exclusion doesn’t apply and the transaction is reportable.

Gamma Ltd is the reporting body as the UK corporate parent and will be required to submit the IMOC report to HMRC by 1 February 2025.

The fact that none of the transactions were intended to create a UK Corporation Tax advantage is immaterial.

Question 8

Part 1

As Luke is domestically tax resident in the UK and Triton, we refer to Article 4 of the UK/ Triton DTA to determine his treaty residence position.

Article 4 (2a) states that he will be treaty resident in the country that he has a permanent home or, if he has a permanent home in both countries, he will be treaty resident in the country that his 'centre of vital interests' lies in. Luke has permanent homes in both the UK and Triton as he has maintained homes in both countries for the past 25 years and they have sufficient degree of permanence to be classed as permanent homes under the definition of the DTA.

We must then assess Luke's centre of vital interests which is defined as his family and social relations, occupations, political, cultural or other activities, his place of business, the place from which he administers his property. Luke has maintained his home in Triton and returns there frequently however he has lived and worked in the UK for 20 years and continued to maintain his UK home following his retirement. He has social and property ties in both locations, and splits his time equally between the two countries and therefore there is an argument that his centre of vital interests does not lie in one country alone.

The OECD model commentary states the following which does not appear to be the case for Luke's centre of vital interests:

> *As far as possible, the preference criterion must be of such a nature that there can be no question but that the person concerned will satisfy it in one State only, and at the same time it must reflect such an attachment that it is felt to be natural that the right to tax devolves upon that particular State.*

If Luke's centre of vital interests cannot be determined, we must consider in which country his 'habitual abode' lies. This is defined as whether he lived habitually, in the sense of being customarily or usually present, in one of the two States but not in the other during a given period. This notion refers to the frequency, duration and regularity of stays that are part of the settled routine of an individual's life and are therefore more than transient.

As Luke has split his time between both countries for the past 25 years, we cannot conclude that his habitual abode is in one country and not the other as he has not established a settled mode of life in one country but not in the other. As we cannot establish Luke's habitual abode, he will be treaty resident in the country of which he is a national which we are told is Triton.

Part 2

Pension income is assessed under Article 18 of the DTA. This states that pensions and other similar remuneration paid to a resident of Triton in consideration of past employment is taxable only in Triton. Therefore Luke's pension income is not taxable in the UK.

The French rental income is income from immovable property however, as the income is sourced to France, it is not covered by Article 6 of the UK/Triton DTA and instead falls under Article 21 'Other Income'. Under this article, the income is not taxable in the UK as Luke is treaty non-resident in the UK.

The UK dividend income is UK taxable under domestic provisions and may be taxed in the UK under Article 10 of the DTA however the tax due on this income cannot exceed 15% of the gross amount of the dividend (i.e. £3,000).

The UK bank interest is UK taxable under domestic provisions and may be taxed in the UK under Article 11 of the DTA however the tax due on this income cannot exceed 10% of the gross amount of the dividend (i.e. £1,000).

Question 9

To: Rose Trust
From: Tax Adviser
Date: December 2024

Capital Gains Tax

Since 6 April 2015, UK non-resident trusts are subject to UK capital gains tax on UK residential property disposals. The Rose Trust is a non-resident trust as both of its trustees are non-resident. As non-residents were not subject to CGT prior to this, they can elect the most beneficial basis of calculating their gain from the following three methods:

- Full gain method – calculate the gain/loss in the 'normal' way using proceeds less acquisition cost and other allowable costs.

- Straight line method – apportion the full gain/loss on a straight line basis and subject the portion relating to the period after 6 April 2015 to CGT.

- Rebasing (default) method – calculate the gain/loss using the market value of the property at 6 April 2015 as the base cost.

We will apply the above three methods to the disposal of 10 Green Street as follows:

Full gain

Proceeds	£500,000
Less: Legal fees at sale	(£2,000)
Net proceeds	£498,000
Less: Purchase price	(£200,000)
Less: Legal fees at purchase	(£3,000)
Less: Enhancement expenditure	(£40,000)
Chargeable Gain	£255,000

The costs for replacing the damaged roof are not deductible under s.38 as they are not "reflected in the state or nature of the asset at the time of disposal".

Straight line method

Taking the above gain of £255,000, we apportion on a straight line basis to calculate the portion relating to the period from 6 April 2015 to disposal over the total period of ownership.

The property was purchased on 6 April 2010 and sold on 6 September 2024 which is a total period of 173 months. The period from 6 April 2015 – 6 September 2024 is 113 months.

The chargeable gain under this method is therefore £255,000 x 113 months / 173 months = £166,561.

Rebasing method

Proceeds	£500,000
Less: Legal fees at sale	(£2,000)
Net proceeds	£498,000
Less: Market value at 6 April 2015	(£350,000)
Chargeable Gain	£148,000

The enhancement expenditure is not deductible in this method as it was incurred prior to 6 April 2015 and is therefore reflected in the market value at 6 April 2015.

It is therefore beneficial for the gain to be calculated on the default rebasing method.

CGT is calculated as follows:

Gain	£148,000
Less: Trust Allowance	(£1,500)
Chargeable Gain	£146,500
£146,500 @ 28%	£41,020
Total CGT	£41,020

The gain must be reported to HMRC on a Non-Resident Capital Gains Tax Return within 60 days of sale. The tax is also payable within 60 days of sale by the trustees.

Yours sincerely
Tax Adviser