THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

December 2022

MODULE 2.09 – UNITED KINGDOM OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

To: Board of Directors, Cumulus Ltd
From: Tax Advice LLP
Date: December 2022
Subject: Stratus Inc – UK Tax Implications

You recently raised certain questions with respect to the UK controlled foreign companies (CFC) and permanent establishment (PE) considerations for Stratus Inc, and how the tax residence of Stratus Inc could be migrated to the UK. This memo sets out our advice in relation to each of these topics.

Part 1

A CFC is defined in s.371AA TIOPA 2010 as a company which is not resident in the UK and which is controlled by a UK resident person or persons. Stratus Inc is tax resident in Utopia and is now 100% owned by Cumulus Ltd, so meets both of these conditions and is therefore a CFC of Cumulus Ltd.

As a CFC, Stratus Inc's profits will be apportioned to Cumulus Ltd and subject to tax in the UK if they pass through one of several "gateways", each of which relates to a different type of profit. However, there are five statutory exemptions which may apply and, if applicable, all of Stratus Inc's profits will be exempt from apportionment under the UK CFC rules.

The first exemption to consider is the excluded territories exemption. This exemption will be met if Stratus Inc is resident in a country which is on the UK's list of excluded territories and meets certain income-related conditions. However, as Utopia is not on the list of excluded territories, this exemption will not apply.

The second exemption is the low profits exemption. This will be met if Stratus Inc has accounting profits or taxable total profits of no more than £50,000, or has accounting profits or total taxable profits of no more than £500,000 of which no more than £50,000 relates to non-trading income. As Stratus Inc has profits of £10 million, this de minimis will not be met.

The third exemption is the low profit margin exemption. This applies if the CFC has accounting profits of no more than 10% of its relevant operating expenditure. Stratus Inc's accounting profits of £10 million exceed 10% of its £5 million operating expenditure, so this exemption will not apply.

The fourth exemption is the tax exemption. This will apply if the local tax paid by Stratus Inc in Utopia is at least 75% of the corresponding UK tax, calculated as if the company were UK tax resident and applying all the relevant claims and deductions that would be available. More information will be required to determine the exact corresponding UK tax, but based on the accounting profit of £10 million we can assume a corresponding UK tax of £1.9 million (£10 million x 19%). The local tax paid in Utopia of £1 million is 52.6% of the assumed corresponding UK tax, which is less than the threshold of 75% so this exemption is unlikely to apply.

The final exemption to consider is the exempt period exemption. This is intended to provide CFCs coming under UK control with a 12-month "grace" period, within which they can reorganise their activities so that a UK CFC charge does not arise going forward. Stratus Inc will be able to benefit from this exemption for the period in which it is acquired by Cumulus Ltd, but importantly will need to meet the "subsequent period condition": there must be an accounting period after the exempt period in which the CFC rules apply and there is no CFC charge. This may be because one of the other exemptions applies, or because no profits pass through any of the gateways.

Like the exemptions, the gateways must be considered in turn. However, given the nature of Stratus Inc's heating business, the gateways relating to captive insurance businesses and solo consolidation need not be considered.

The first gateway to consider relates to profits attributable to UK activities. This seeks to identify profits arising from arrangements where the CFC is reliant on UK-based staff or activities in taking on and managing its risks. However, the gateway does not apply if one of several safe harbours apply. In Stratus Inc's case, a number of the safe harbours can be relied upon: Stratus Inc does not appear to hold assets or bear risks under an arrangement to reduce a UK tax liability; it does not have any UK managed assets or risks; and it has the capability to ensure its business is commercially effective without reliance on the UK. As such, no profits pass through this gateway.

The second and third gateways apply to non-trading finance profits and trading finance profits, respectively. As all of Stratus Inc's profits are generated from its sales of heating units, neither of these gateways will apply.

As a result, none of Stratus Inc's profits will pass through any of the gateways and no apportionment in Cumulus Ltd will be required, even if Stratus does not benefit from the exempt period entity-level exemption.

Part 2

Under UK domestic law, a non-UK tax resident company will have a taxable presence in the UK if its activities in the UK give rise to a PE. Under s.1141 CTA 2010, Stratus Inc will have a UK PE if:

- It has a fixed place of business in the UK through which Stratus Inc's business is wholly or partly carried on; or

- An agent acting on behalf of Stratus Inc has and habitually exercises authority to do business on behalf of Stratus Inc in the UK (a "dependent agent PE").

The legislation specifically refers to an office as constituting a fixed place of business, so the representative office of Stratus Inc in the UK will constitute a fixed place of business.

However, s.1143 CTA 2010 states that a company will not be regarded as having a PE if the activities carried on at a fixed place of business are of a preparatory or auxiliary character. The legislation goes on to list certain specific activities which are considered to be preparatory or auxiliary, including "collecting information" for the company.

The staff sent to the UK representative office will be carrying out market research and assessing whether demand for heating units exists in the UK. It is likely that such activities will constitute "collecting information", and will therefore be considered to have a preparatory or auxiliary character. As a result, the representative office will not constitute a PE for Stratus Inc.

It is important to note that the "preparatory or auxiliary" exclusion will not apply where the activities are deemed to be part of a fragmented business operation. This is the case where the activities are carried out by the company (or a related company, such as Cumulus Ltd) and constitute complementary functions that are part of a cohesive business operation, such that the overall activity goes beyond preparatory or auxiliary. In light of the separate businesses operated by Cumulus Ltd and Stratus Inc, it is unlikely that a fragmented business operation will be deemed to exist in Stratus Inc's case, but the Board of Directors should monitor this risk. If demand is proven, Stratus Inc will engage professional salespeople to negotiate and sign contracts on its behalf in the UK. This is likely to create a dependent agent PE, as the salespeople will be habitually exercising authority to do business on Stratus Inc's behalf.

However, s.1142 CTA 2010 contains an exception for "agents of independent status" acting in the ordinary course of their business. Whether an agent – in this case, the professional salesperson – meets this definition is a question of fact, and certain factors will be relevant.

These include the number of unrelated principals that the agent acts for, the extent of the obligations which the agent has towards the company, whether the agent is subject to detailed instructions with respect to their work, whether they bear the entrepreneurial risk, and whether approval from the company is required.

In Stratus Inc's case, the salespeople will not be employees and will have authority to sign contracts, both of which point to independent status. They will also work for "several" other companies, although one of these is Cumulus Ltd which, as the parent of Stratus Inc, is a related company. If a salesperson is reliant on Cumulus Ltd and Stratus Inc for the bulk of their work, they are less likely to be seen as independent.

Assuming the work carried out for Stratus Inc and Cumulus Ltd is only a small proportion of the salespeople's portfolio, it is likely that the agent of independent status exemption will be met and Stratus Inc will not have a UK PE.

If, however, the salespeople are deemed to be dependent agents of Stratus Inc, they will constitute a PE of the company in the UK and Stratus Inc will be subject to UK corporation tax on the profit attributable to them.

Part 3

A company is deemed to be tax resident in the UK if it is incorporated in the UK or if it is centrally managed and controlled in the UK. As Stratus Inc was not incorporated in the UK, it will need to move its central management and control (CMC) to the UK in order to become UK tax resident.

The CMC test is not enshrined in statute but has instead been developed over a series of common law precedents. In particular, De Beers Consolidated Mines Ltd v Howe largely established CMC as the test for residence. CMC broadly refers to the highest level of strategic control over the company, as opposed to the place where the main operations take place, albeit in many cases these may be the same.

Establishing where this CMC, or strategic control, takes place has itself been the subject of a number of cases. The De Beers case is equally notable for establishing that where directors convene for board meetings will be a key factor in determining where CMC takes place.

However, HMRC made clear in a Statement of Practice, SP 1/90, that the location of board meetings is not necessarily conclusive, and the place of CMC is a question of fact; it may be that the directors themselves do not exercise CMC, or do not do so at the board meetings, as evidenced in the more recent case of Laerstate BV v Revenue and Customs Commissioners.

So, in order for Stratus Inc to be centrally managed and controlled, and therefore tax resident, in the UK, it should ensure not only that the board meetings take place in the UK, but also that it is through these board meetings that the strategic decision-making takes place.

If Stratus Inc is deemed resident in both the UK and Utopia under local domestic law, it will be dual resident unless a tie breaker clause exists in an applicable tax treaty between the two countries. A tie breaker clause may provide for residence to be determined through the mutual agreement procedure between the authorities of each country.

If Stratus Inc migrates its tax residence to the UK, it will no longer be a CFC of Cumulus Ltd. Instead, it will need to register for UK corporation tax and will be subject to tax on its worldwide income.

Question 2

Part 1

Domicile is a common law concept which can impact the basis on which an individual is subject to UK income tax, capital gains tax, and inheritance tax. 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 Emily was born in Sweden to Swedish parents, we can safely assume that she has a domicile of origin in Sweden. The question is therefore whether Emily has acquired a domicile of origin in the UK by living and working in the UK for the past 15 years. Despite the fact that Emily has been living in the UK for a long time and has acquired strong links to the UK, she has retained links to Sweden including a Swedish property where she spends a quarter of her time. Furthermore, she intends to return to Sweden within the next few years and therefore she does not have an intention to resident indefinitely in the UK. As such, Emily should be considered as Swedish domiciled.

From 6 April 2017, HMRC introduced 'deemed domicile' rules. These rules classed individuals as domiciled in the UK irrespective of the above if they have been resident in the UK for 15 of the 20 years immediately before the tax year in question. The 2021/22 UK tax year will be Emily's 15th consecutive year of UK tax residence and therefore for the 2022/23 UK tax year, she will be deemed domiciled in the UK.

Part 2

As Emily is domiciled outside of the UK, she is eligible to elect, on her UK tax return, to be taxed on the remittance basis. Under the remittance basis, Emily will be subject to UK tax on her UK sourced income and gains. She will only be subject to UK tax on her non-UK income and gains if she remits the funds to the UK. She will lose the benefit of the personal allowance (already lost due to her level of taxable income) and the annual exemption for capital gains tax purposes. The remittance basis applies automatically, and an individual's personal allowance/annual exemption is retained if their unremitted foreign income and gains for the tax year do not exceed £2,000 which will not be the case here.

Emily will be subject to the remittance basis charge of £60,000 as she has been UK tax resident for 12 of the prior 14 UK tax years.

Although some of her employment income relates to duties performed outside of the UK, Emily is no longer eligible for Overseas Workday Relief as this is only available for the first three years of UK tax residence. Therefore 100% of her employment income is taxable in the UK under the remittance basis as follows:

£37,700 @ 20% = £7,540
£112,300 @ 40% = £44,920
£150,000 @ 45% = £67,500
Total = £119,960

Emily will still be entitled to the dividend allowance of £2,000 and would be entitled to the personal savings allowance were she not an additional rate taxpayer. The tax due on her UK dividend is therefore:

£2,000 @ 0% = £0
£13,000 @ 38.1% = £4,953

Under the remittance basis, the remittance of her French dividend income is not taxed as a dividend but instead as a 'remittance' and is therefore not eligible for the dividend allowance. It is also taxed at the rates of tax applied to savings income rather than dividend rates.

£50,000 @ 45% = £22,500

The gain on her UK shares is UK sourced and taxed at the CGT rates without the annual exemption as follows:

£20,000 @ 20% = £4,000

The life insurance policy gain is not taxed under the remittance basis and is therefore UK taxable income despite it being a Swedish scheme and the proceeds haven't been remitted.

£25,000 @ 45% = £11,250

The gain on her Swedish share disposal and her Swedish dividends are exempt from UK tax as they are non-UK sourced and have not been remitted to the UK. No FTC relief is available. Her total liability under the remittance basis is therefore:

(£60,000 + £119,960 + £4,953 + £22,500 + £4,000 + £11,250) = £222,663

Alternatively, if beneficial, Emily may elect to be taxed on the arising basis. Under the arising basis, Emily will be subject to tax on her worldwide income and gains. Income types will retain their nature for the purpose of the dividend allowance etc, and she will receive the annual exemption. She will also not be subject to the remittance basis charge.

100% of her employment income will be taxable in the UK as follows:

£37,700 @ 20% = £7,540
£112,300 @ 40% = £44,920
£150,000 @ 45% = £67,500
Total = £119,960

Emily will be entitled to the dividend allowance of £2,000 and all her dividend income is taxable in the UK at dividend rates. A foreign tax credit is available in full on her Swedish dividend income as the Swedish tax due is lower than the UK tax.

£15,000 @ 38.1% = £5,715
£50,000 @ 38.1% = £19,050
£30,000 @ 38.1% = £11,430
Less FTC: £30,000 @ 15% = (£4,500)

All her capital gains are taxable in the UK although the annual exemption is available:

£200,000 - £12,300 = £187,700
£187,700 @ 20% = £37,540

The life insurance policy gain is taxable as income.

£25,000 @ 45% = £11,250

Her total tax liability under the arising basis is therefore:

(£119,960 + £5,715 + £19,050 + £37,540 + £11,430 - £4,500 + £11,250) = £200,445.

The arising basis is therefore more beneficial.

PART B

Question 3

Part 1

Craggy BV

For UK tax purposes, the source of a dividend is determined by reference to where the paying company is tax resident. In the case of Craggy BV, the dividend will have a UK source as a result of the company migrating its tax residence to the UK. This is the case notwithstanding the fact that it is incorporated and registered in Montania.

Part 2

Blanc SAS

Blanc SAS carries out sales and marketing activities outside the UK, so prima facie its trading activities do not have a UK source. With respect to the purchasing of products in the UK, HMRC consider that the purchase of goods or services in the UK to be used in an overseas business is trading "with" the UK, and does not constitute trading "in" the UK, as established in the cases of Sulley v Attorney General and Grainger v Gough. Equally, it was shown in Smidth & Co v Greenwood that a representative office will not amount to trading in the UK if it is not where the operations giving rise to profits take place. Accordingly, the activities of Blanc SAS will not constitute trading in the UK.

Elbrus Pty Ltd

HMRC will consider a range of factors in determining whether a company is trading in the UK. One of the key factors is where the company's contracts for sale are made, as established in Erichsen v Last and supported by the Champagne Cases. In Elbrus Pty Ltd's case, the contracts are negotiated and executed in Snowtopia, which provides strong support for the position that the company is not trading in the UK.

However, in line with comments made in Smidth, together with the judgment in Firestone Tyre & Rubber Co Ltd which held that "the place of sale will not be the determining factor if there are circumstances present that outweigh its importance", the general test is to establish where the operations take place from which the profits in substance arise. As such, consideration must also be given to the manufacturing activities in the UK, and it is likely that these activities contribute significantly to the making of profits. HMRC make clear that if a company has activities other than the making of sales contracts, a trade could be carried on from more than one country, so it is likely that at least part of Elbrus Pty Ltd's operations will constitute trading in the UK irrespective of the contracts being made elsewhere. With respect to the provision of camper van repair and maintenance services, HMRC make clear that the provision of services in the UK will constitute trading in the UK no matter where the contracts are concluded.

Note: marks will be awarded for appropriate reference to case law, but the extensive reference in the suggested answer is beyond that which would be expected of candidates.

Part 3

HMRC's approach to determining the source of interest is grounded in case law, consolidated in the so-called "Greek case", and HMRC will consider a range of sources in their determination.

An early case concerning the source of interest is IRC v Broome's Executors, in which a debt secured in both the UK and Kenya gave rise to interest which was payable in Kenya to a Kenya resident. Following the death of the debtor, the executors paid the interest in the UK out of UK assets. It was held that if interest is paid by a UK resident out of UK assets, the source of that interest is the UK.

This was developed further by the Greek case, National Bank of Greece v Westminster Bank Executor and Trustee Co (Channel Islands) Ltd, which involved a Greek bank which had issued bonds, guaranteed by a separate Greek bank, and the funds used to pay the interest had to originate from Greece. A nuance of the local Greek legislation, however, meant that the debt could only be enforced in London (from the guarantor's London branch). It was held that ostensibly replacing the guarantor with a UK guarantor was not sufficient to migrate the source of the interest to the UK.

The judgment in the Greek case made clear that where the interest is enforceable is not determinative of source, but it also made clear that neither is the residence of the debtor; otherwise, the case could have been decided on the basis that the debtor was resident in Greece. Likewise, the location and governing law of the debt itself was not deemed to be relevant in the Greek case.

A subsequent case, Hafton Properties Ltd v McHugh, gave some weight to the location of the funds used to pay the interest and the place where payment is made. In this case, interest on a mortgage over a US property was paid using the rental income, and was held not to have a UK source, while interest paid on a Swiss loan from the UK was held to have a UK source.

More recently, in Ardmore Construction Ltd v HMRC, the Court of Appeal made clear that a multi-factorial approach must be taken, and that this will be very dependent on the facts of the case. This is reflected in the HMRC Manuals, which refer to "exactly how the transactions are carried out".

Building beyond the Greek case, HMRC consider the most important factors to be:

- The location of the debtor and their assets, as this will help determine where the creditor would seek to enforce any judgment in the case of default;

- The place and method of payment under the contract, which considers the substantive origin of the funds from which the interest is paid;

- The competent jurisdiction for legal action and contract law; and

- The residence of the guarantor and location of the security.

For companies, certain additional factors must also be considered. In part, this is because a company's residence may be more complicated than that of an individual, with incorporation, registration and management and control all potentially being in different locations. Where this is the case, the detail in the loan agreement regarding where the interest and loan are payable will help determine whether the interest has a UK source.

Companies may also have overseas branches, in which case the source of the interest will be overseas if all of the following factors apply: the overseas branch has entered into a loan agreement overseas; the loan is for the business of the branch; the branch pays the interest from its own income; and the loan is enforceable in the branch's jurisdiction.

Overall, it is clear that the simplistic tests of the early case law established a framework for determining the source of interest, and these were supplemented and built upon as more complex issues arose. Ultimately, these have been codified in HMRC's Manuals, which employ a multifactorial approach with weight given to a number of key factors depending on the facts of the case.

Note: marks will be awarded for appropriate reference to case law, but the extensive reference in the suggested answer is beyond that which would be expected of candidates.

Question 4

Part 1

Gary's residence position shall be determined by the Statutory Residence Test. This is a series of tests which must be applied in a specific order to determine his residence position. The tests are different depending on whether the individual is an 'arriver' or a 'leaver'. As Gary has been resident in the UK for at least one of the three tax years prior to his departure, he shall be a leaver.

The 1st test to apply is the 1st automatic non-residence test. Gary would be UK tax non-resident if he spent fewer than 16 days in the UK during the tax year. Clearly, this is not the case and so he does not meet this test.

The next test to consider is whether Gary is in Full Time Work Abroad (FTWA).

For this test to be met, Gary would need to meet all of the following conditions:

- Fewer than 91 days in the UK in the tax year;
- Fewer than 31 workdays in the UK in the tax year;
- Work 'sufficient hours' overseas during the tax year; and
- Not have a significant break from overseas work during the tax year.

A significant break is defined as a 31 day consecutive period where the individual does not perform an overseas workday unless the individual is on sick leave, annual leave, or parenting leave and would have otherwise performed an overseas workday.

As such, the period prior to his departure (6 April 2022 – 31 May 2022) and after his return (1 March 2024 – 5 April 2024) are each periods of more than 30 days where Gary does not perform an overseas workday. Therefore he will have a significant break from overseas work in each tax year.

He is also likely to have more than 91 days of UK presence and more than 31 UK workdays in 2022/23. As such, he will not be considered to be in FTWA in either the 22/23 or 23/24 tax years.

The next set of tests are the automatic residence tests.

The 1st is whether Gary spends more than 182 days in the UK which is not the case in either tax year.

The 2nd is the home test which states that a taxpayer will be UK resident for the tax year if they have, or have had, a home in the UK for all or part of the year and the following conditions all apply:

- there is at least one period of 91 consecutive days when they had a home in the UK;
- at least 30 of these 91 days fall in the tax year when they have a home in the UK and are present in that home for at least 30 days at any time during the year; and
- at that time either, the taxpayer had no overseas home, or if they had an overseas home, they were present in it for fewer than 30 days in the tax year.

This is met in both the 22/23 and 23/24 tax years as the periods before and after his assignment we can find such a period.

As such, Gary will be considered as UK tax resident throughout his assignment.

Gary will therefore remain subject to UK tax on his employment income. As Gary is also considered as tax resident in Germany, we should consult the UK/Germany DTA to determine which country has taxing rights over his income.

Firstly, we determine whether the individual has a home in one country and not in the other. In this scenario, the individual retains his home in the UK and also acquires a German home.

As such, we need to determine which country the individual's Centre of Vital Interests lies. As Gary's family remain in the UK, he returns to the UK during his free time and is only in Germany for work purposes of a fixed duration, his CVI is most likely in the UK.

As such, he should be considered as UK tax resident and treaty resident.

His income will be subject to UK tax and a foreign tax credit available in the UK to the extent that his income is also taxed in Germany (i.e. income relating to German workdays). Foreign tax credit relief is available up to the lower of the UK tax due on his income or the German tax. The income relating to his UK workdays will remain taxable in the UK and foreign tax credit relief is not available on this income as this should not be taxed in Germany.

Part 2

If the assignment was extended to 31 March 2024, Gary would no longer have a significant break in 23/24 and would meet the FTWA conditions. As such, he would be considered as UK tax non-resident for that year.

He would still have a significant break in 22/23 and so be resident however we can now consider split year treatment as he will be NR in 23/24. Split year treatment for individuals leaving the UK can only be considered where they were UK tax resident in the previous tax year, and UK tax non-resident in the following tax year. Under Case 1, the individual must also meet the FTWA conditions for the whole of the following tax year.

To split the 22/23 tax year under Case 1 starting FTWA, the 91 days of presence test and 31 workday test are pro-rated down based on the date of the individual's departure. i.e. Gary would be permitted 25 UK Workdays and 75 days of presence from his departure in June to the end of the 22/23 tax year. As these thresholds are met, he could be considered as UK tax non-resident from his first overseas workday (1 June 2022.)

He could apply for an NT tax code via Form P85 to suspend actual PAYE withholding and mitigate cash flow difficulties.

PART C

Question 5

Part 1

Diverted Profits Tax (DPT) operates independently of corporation tax and seeks to capture the artificial diversion of profits out of the UK.

Under s.80 Finance Act 2015, DPT will apply if a UK resident company enters into a transaction with another person which has insufficient economic substance and which results in an effective tax mismatch outcome, and neither party to the transaction is a small or medium-sized entity. For DPT to apply, one company must participate in the management, control or capital of the other, or a third company must participate, directly or indirectly, in the management, control or capital of both of them.

In this case, Duff Ltd is UK resident and we can assume that both it and Slash Inc are large companies. Both companies are 100% subsidiaries of Rose Ltd, so these conditions are met. Duff Ltd has entered into a transaction – the operating lease – with Slash Inc. It therefore needs to be assessed whether this transaction has insufficient economic substance and results in an effective tax mismatch outcome.

A tax mismatch outcome is defined in s.107 Finance Act 2015 and arises where: the transaction results in deductible expenses and/or a reduction in income for the UK resident company; the resulting reduction in taxes payable by the UK resident exceeds the resulting increase in the taxes payable by the other party; the reduction or increase does not arise solely by reason of contributions paid under a registered pension scheme or a payment to charity; and the resulting increase in the taxes payable by the other party to the transaction is less than 80% of the resulting reduction. It does not matter how the effective tax mismatch outcome arises (e.g. through different tax rates, application of reliefs, or income exclusions); only that one exists.

In Duff Ltd's case, the operating lease payments are deductible and therefore the tax payable by Duff Ltd is reduced by £9.5 million per year (£50 million x 19%). Based on Rodinia's 8% tax rate, it can be assumed that Slash Inc's tax payable will increase by £4 million per year (£50 million x 8%. Clearly, the reduction in Duff Ltd's tax payable is not a result of a contribution to a pension fund or charity. The £4 million increase in Slash Inc's tax is less than £7.6 million (being 80% of the £9.5 million reduction in Duff Ltd's tax). As a result, there is an effective tax mismatch outcome.

To establish whether there is the transaction has insufficient economic substance, one or both of the tests in s.110 Finance Act 2015 must be met. Broadly, these test the commerciality of a transaction.

The first test is whether it is reasonable to assume that the transaction itself was designed to secure the tax reduction. If, at the time the transaction is entered into, it is concluded that the non-tax benefits would exceed the financial benefit of the tax reduction, based on a comparison of such benefits referable to the transaction, then the transaction will not be regarded as lacking economic substance.

The second test is whether it is reasonable to assume that the involvement of, in this case, Duff Ltd or Slash Inc in the transaction was designed to secure the tax reduction. However, the transaction will not be regarded as lacking economic substance if either: at the time the transaction is entered into, it is reasonable to assume that, for the two companies taken together, the non-tax financial benefit of the contribution to the transaction by the activities of the person's staff would exceed the financial benefit of the tax reduction; or the income

attributable to the ongoing activities of the person's staff exceeds the income derived from the transaction.

The first test appears to be met, because securing the £9.5 million annual tax reduction in Duff Ltd seems to be what the transaction was designed to achieve (and Mr Leffen said as much to the Board). Any non-tax benefits of the lease do not appear to exceed this benefit.

The second test also appears to be met, because the £9.5 million annual tax reduction is almost certainly more than the contribution of Slash Inc's two part-time administrative employees to the value of the transaction; and Slash Inc's income from the operating lease clearly exceeds the income attributable to the part-time administrative staff.

As all the conditions are met, it is likely that this transaction will be caught by the UK's DPT rules, and DPT will be payable at 25% on the amount of the taxable diverted profit, plus any true up interest. The taxable diverted profit will be ascertained by recharacterising the transaction to determine the transaction a company might reasonably have entered if tax had not been a relevant consideration. In Duff Ltd's case, this may be an arrangement whereby Duff Ltd purchases the audio equipment itself, without engaging in an operating lease arrangement with Slash Inc at all.

Part 2

Unlike the self-assessment rules for corporation tax, companies are required to notify HMRC if they are potentially in scope of DPT. Notification must be made in writing within three months of the end of the relevant accounting period.

Determining whether there is a duty to notify is not simply a case of working through the DPT conditions. Instead, for a company with a UK presence (as in the case of Duff Ltd), the insufficient economic substance test is replaced with a test of whether the financial benefit of the tax reduction is significant relative to the non-tax benefits of the arrangement.

However, no requirement to notify arises if, under s.92(7) Finance Act 2015, it is reasonable to conclude that no DPT charge will arise, or HMRC have confirmed that the company is not required to notify, or the company has provided sufficient information to HMRC to inform their decision as to whether to issue a preliminary notice, or the company has already notified HMRC (or was not required to notify) for the preceding accounting period and there have been not material changes to the circumstances.

As none of these exceptions are likely to apply to Duff Ltd, the company must notify HMRC or risk a tax-geared penalty being issued.

Question 6

The preamble to the 2017 OECD Model Convention, upon which many UK tax treaties are based, includes a reference to the prevention of tax evasion and avoidance, and certain Articles specifically seek to achieve this goal. It is therefore true that this is one of the goals of the treaties, together with the elimination of double taxation. The UK's domestic legislation also includes a number of anti-avoidance measures. However, the extent to which their existence makes the provisions in the treaties superfluous is debatable, as tax abuse takes many forms.

The UK's domestic anti-avoidance is wide-ranging. It includes a number of provisions relating to transfer pricing, which seek to ensure that transactions taking place between related parties are carried out on arm's length terms to ensure that profits are not artificially "shifted" to low tax jurisdictions through increased UK deductions. Similarly, thin capitalisation rules provide for a disallowance of interest in companies if their debt:equity ratio is too high, to prevent them from loading up with debt beyond that which would be commercially available and benefiting from increased interest deductions.

A number of measures were introduced or bolstered by the UK in response to, or in anticipation of, the OECD's Base Erosion and Profit Shifting (BEPS) project. One of these is the Corporate Interest Restriction, which broadly restricts the availability of interest deductions to 30% of a company's EBITDA, in similar fashion to the thin capitalisation rules. Others are more international-facing, though: the UK's Controlled Foreign Company rules target UK companies shifting profits to subsidiaries overseas, and seek to apportion some or all of this income to the UK company to be subject to tax in the UK. Equally, the UK's anti-hybrids legislation targets companies which take advantage of the different treatment of entities and financial instruments across different jurisdictions to achieve double deductions, or deductions in one country without corresponding taxation in the other.

Despite many of these anti-avoidance measures, including the transfer pricing rules, being primarily concerned with international structuring by multinationals, they target situations which are not equivalently addressed by the tax treaties. In particular, they target scenarios which, if otherwise unmitigated, would be to the detriment of the UK's tax base.

Conversely, the anti-avoidance provisions of the treaties tend to target situations which could impact either of the Contracting States depending on the facts and circumstances. Another of the BEPS Actions focused on prevention of tax treaty abuse: in particular, this considered the practice of "treaty-shopping", which can take many forms, but which may involve a multinational group setting up companies overseas with little substance in order to take advantage of treaty benefits in those countries, for instance through routing dividend flows through countries whose tax treaty networks provide for 0% withholding tax.

The OECD Model Convention, and therefore many of the UK's tax treaties, counter this through the use of beneficial ownership requirements (e.g. in Articles 10, 11 and 12 of the OECD Model). This requirement ensures that the benefits of the dividend, interest and royalties articles are only available to the beneficial owners of the income. Beneficial ownership was considered in the Indofood and Prevost cases, which ultimately determined the beneficial owner to be the party which received the dividend for their own use and enjoyment, and which assumed the risk and control of the dividend. In this respect, the beneficial ownership requirement seeks to exclude so-called conduit companies through which a dividend or other income would pass. Without such a clause, there is little in domestic UK legislation to prevent the use of such arrangements.

Treaty abuse is also tackled, in some cases, through the use of a Limitation on Benefits (LoB) Article, such as in the UK-US treaty. A LoB Article will deny treaty benefits unless the person is a "qualifying resident", although exceptions exist for companies which, for example, have been determined not to have been set up with a view to obtaining treaty benefits, or which are engaged in an active trade or business in connection with the relevant income. There is little domestic equivalent, because a LoB Article acknowledges that one of the purposes of a tax treaty is to prevent double taxation, so simply denying such benefits outright is an effective means of preventing abuse.

One of the most wide-reaching UK anti-avoidance measures is the General Anti-Abuse Rule, or GAAR, which allows HMRC to make a just and reasonable adjustment to counteract an abusive tax advantage, where it is reasonable to conclude that obtaining the tax advantage was the main purpose or one of the main purposes of the arrangement. HMRC guidance makes clear that arrangements which benefit from tax treaties will not be subject to the GAAR, except where there are abusive arrangements which try to exploit the provisions of the treaties. Arguably, then, the GAAR affords the UK a degree of protection from treaty abuse.

However, following adoption of the Multilateral Instrument (MLI), the UK has opted to apply a Principal Purpose Test (PPT) in its treaties, which denies the treaty benefits in much the same way as the UK GAAR: broadly, if it is reasonable to conclude that obtaining the benefit was one of the principal purposes of entering into the arrangement. From a UK-specific perspective, it may be argued that the GAAR itself provides sufficient protection, but the PPT undeniably extends that protection to other contracting states which otherwise may not have a domestic remedy.

One element of the MLI which the UK did not opt for is the enhanced Permanent Establishment (PE) rules seeking to counter "Commissionaire" arrangements, where a PE is artificially avoided through having an agent of the company negotiate the terms of a contract overseas but pass it back to head office for signing. Some commentators suggest that the UK decided not to implement the revised PE standards in the MLI because the UK's Diverted Profits Tax (DPT) already goes a long way to addressing the same artificially avoided PE concerns. DPT does, however, involve a motive test, which is not present in the revised PE standards.

Perhaps, then, DPT is an example of the UK considering its domestic legislation to be sufficiently robust, as the statement suggests.

However, on the whole, the UK's domestic anti-avoidance measures are geared towards protecting the UK's tax base, and are supplemented by the provisions of the tax treaties. Without the treaty protections, the UK would be exposed to many of the arrangements that BEPS sought to counter, and, as an influential global player on the international tax scene, the UK has a responsibility to ensure its treaty partners are duly protected where possible.

<u>Question 7</u>

To: Bruno
From: Tax Advice LLP
Date: December 2022
Subject: Your French Assignment – UK Tax Implications

Dear Bruno,

Please see our comments below regarding your tax equalisation policy, treaty residence position under the terms of the UK/France Double Taxation Agreement, and your social security position.

<u>Tax Equalisation</u>

The overarching principle of tax equalisation is that you will be no better and no worse off from a tax perspective because of your assignment.

As you remain UK tax resident, you will continue to be subject to UK tax via the UK payroll. Any net allowances such as your cost-of-living allowance (COLA) will be 'grossed up' prior to being paid to you. This process involves calculating the gross amount to be processed via the UK payroll to ensure that you receive the promised net amount and that your employer funds the tax and social security cost arising.

Your personal position will then be reconciled at the end of the UK tax year via a Tax Equalisation Calculation. This calculates the UK tax due on your 'stay at home' income that you would have received had you not gone on assignment (salary etc and not including assignment allowances or assignment related benefits such as accommodation) and compares this to the tax withheld from you during the year. Any over/under payments showing on this calculation are settled between you and your employer.

The French taxes arising on your employment income will be paid by your employer and any payments/refunds arising on your UK and French tax returns will be paid by/to your employer.

<u>Treaty Position</u>

Where an individual is resident in two countries under their domestic legislation, we determine which country has primary taxing rights over that individual's income with reference to the Double Taxation Agreement (DTA). Article 4 of the UK/France DTA covers treaty residence and includes the following tests.

First, we must consider where an individual has permanent homes. An individual will be considered as treaty resident in the country they have a permanent home if they do not have a permanent home in the other country.

A permanent home is defined by OECD guidance as one that the individual must have arranged and retained for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration. Typically, this is for at least six months. This can be any form of 'home' including a house, apartment occupied through ownership or rental agreement.

Under these definitions, your UK home will clearly be seen as a permanent home under the terms of the treaty.

While staying in French hotel accommodation, you will not be seen to have a French permanent home. This is because the short-term nature of the hotel accommodation does not meet the

permanence condition of this test. Therefore, for the first six months of your assignment, you will be considered as UK treaty resident by virtue of your only home being in the UK.

Once you have access to the French apartment, you will have a French permanent home and therefore a permanent home in both locations. As mentioned above, the French apartment will be seen as a permanent home even if you do not legally own it due to its continuous period of availability.

As such, your treaty residence position for the latter period of your assignment cannot be determined by the availability of permanent homes. Instead, where an individual has a permanent home in both locations, we must consider the individual's Centre of Vital Interests. This is a consideration of the individual's personal, social and economic ties to determine to which country this is more closely held.

OECD commentary states 'If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in the first State'

As your family remain in the UK and you retain your other connection factors to the UK including spending the majority of your free time here, we reasonably expect that your Centre of Vital Interests will remain in the UK throughout the duration of your assignment.

You should therefore be considered as UK treaty resident throughout your assignment and the impact of this is that the UK retains primary taxing rights of your employment income. You will be subject to UK tax on your worldwide income and France should limit their taxation to the income relating to your French workdays. You should be able to claim a foreign tax credit in the UK to the extent that your income is also subject to tax in France. This relief is given at the lower of the UK tax due on your doubly taxed income and the French tax due on the same income.

Social Security

Under UK domestic legislation, you are employed by a UK company on a UK employment contract and will therefore be subject to UK National Insurance. However, as you will be spending most of your working time physically in France, we should also consider your French social security position. As you are being seconded to an EU country, your social security position is dictated by the UK's agreement with the EU. Post-Brexit this is called the Trade and Co-operation Agreement.

As you are spending more than 5% of your working time in two or more EU countries (including the UK), you are deemed to be a 'multistate worker'.

Your will therefore pay social security in the country of your 'habitual residence' if you spend more than 25% of your working time there. Your country of habitual residence is defined as the country to which your personal ties are stronger and should therefore be the UK however as you only work in the UK for one day per week, you will not spend 25% of your working time here.

As such, you will pay social security in the country that your employment contract is held. Despite your French assignment, your underlying employment is held in the UK meaning that you will remain subject to UK NIC which will continue to be withheld from you via the UK payroll. Your employer should apply for an A1 Certificate certifying that you remain subject to UK NIC and are not subject to French SS. Under multistate rules, this can be obtained for a period of

up to two years however your employer can apply for an extension to cover the remaining year of your assignment.

No apportionment is required in respect of your employment income for NIC purposes and there will be a UK NIC liability on your worldwide employment income. For your cash earnings this will be a Class 1 Primary and Secondary NIC liability, and for your benefits in kind (employer provided accommodation) this will be an employer only Class 1A NIC liability. Foreign taxes paid by your employer on your behalf constitute additional taxable and Class 1 NICable income however this should be covered by your equalisation policy. The foreign taxes should be reported via the UK payroll for Class 1 NIC purposes and reported on your UK tax return with FTC relief becoming available.

I trust this provides adequate support in relation to your assignment however please let me know if you have any further queries.

Question 8

To: Tamara
From: Tax Advice LLP
Date: December 2022
Subject: Capital Disposals – UK Tax Implications

Tax Position on 6 October 2022

UK tax non-residents are not subject to capital gains tax however on 6 April 2015 HMRC introduced non-resident capital gains tax payable by non-residents in respect of UK residential property only. You will still be eligible for the annual exemption whilst non-resident.

Therefore, your disposals of UK shares are not subject to capital gains tax at the point of disposal.

Whilst this logic would also apply to your Rolex watch, this is in fact an example of a wasting chattel as it is considered as 'machinery' and has a useful life of less than 50 years. Wasting chattels are exempt from capital gains tax and therefore the disposal of the watch is not subject to capital gains tax irrespective of your residence status.

As mentioned above, the disposal of your UK residential property is subject to non-residents capital gains tax. This is calculated using one of three methods and you can choose the most beneficial.

The gain/loss is calculated in the usual way i.e. proceeds less base cost. The enhancement costs can be included as we are calculating the gain over the entire period.

£450,000 - £5,000 - £300,000 - £25,000 = £120,000

The gain/loss is calculated using a base cost equal to the market value of the property on 6 April 2015. The enhancement costs cannot be included as they were incurred prior to 6 April 2015.

£450,000 - £5,000 - £350,000 = £95,000

The gain/loss is calculated using the proceeds and base cost, and then apportioned based on the period that the property has been owned since 6 April 2015 over the total period of ownership.

£450,000 - £5,000 - £300,000 - £25,000 = £120,000
£120,000 x 7.5 / 12.5 = £72,000

As the property was owned and occupied as your sole residence, you should also be entitled to Private Residence Relief (PRR). This is available on a time apportioned basis relating to the period that the property was your main residence. You are also eligible for PRR relief for the final 9 months of ownership. For the period you are non-resident, you would need to either occupy the property for 90 days per tax year to be eligible for PRR or meet the conditions for 'deemed occupation'. The 'deemed occupation' conditions require you to reoccupy the property following a period of absence which is not the case here and therefore you will not be eligible for PRR whilst non-resident other than the final 9 months of ownership.

Method A above results in PRR entitlement of 10 years and 9 months out of the total ownership period of 12.5 years.

PRR can only be assessed from 6 April 2015 onwards for methods B and C resulting in a PRR entitlement of 5 years and 9 months out of a total period of 7.5 years.

The final gains are therefore:

£120,000 x 21 months / 150 months = £16,800
£95,000 x 21 months / 90 months = £22,167
£72,000 x 21 months / 90 months = £16,800

Methods A and C result in the same capital gain. This gain less than Annual Exemption of £12,300 is subject to NRCGT at 18% on the assumption that you don't have any other sources of UK taxable income or gains.

Total NRCGT due is therefore £810.

You will be required to file a NRCGT return within 60 days of disposing of the property even if no gain is made or no tax is payable. Penalties will apply to late returns following the penalty regime of self-assessment tax returns.

Tax Position on 6 April 2024

Following your return to the UK, you will be subject to temporary non-resident rules. This is because you:

- were resident in the UK for 4 of the 7 years prior to your departure; and
- are non-resident for less than 5 years; and
- dispose of an asset held when UK tax resident whilst non-resident.

The impact of this is that any gains made whilst you were non-resident in relation to assets held prior to your departure will become taxable in the UK in the year of your return.

As you acquired some shares whilst non-resident, these will not be caught by the temporary non-resident rules as they were not held prior to your departure and therefore no capital gains tax is payable in relation to this disposal upon your return.

The shares acquired prior to your departure will become fully taxable on your return to the UK. Your property disposal will also become taxable in the UK on your return to the UK however the gain subjected to NRCGT can be deducted from the gain calculated on return to prevent double taxation. This should not result in any additional taxable gain as the full gain (subject to PRR) was taxed on disposal.

Question 9

Tax Advisor
Tax Advice LLP
Susie
Susie's address

December 2022

Dear Susie,

General Anti-Abuse Rule (GAAR)

Individuals may sometimes look to bend the existing tax legislation to avoid payment of tax. Whilst this 'tax avoidance' is technically legal, HMRC will look to disallow advantages obtained through abusive arrangements which involve pro-active action by the taxpayer and often elaborate schemes designed to reduce a tax burden.

The General Anti-Abuse Rules (GAAR) were introduced to deter taxpayers from adopting abusive arrangements and to deter promoters from promoting such arrangements.

S207 of FA2013 defines an arrangement as 'abusive' where the steps taken as part of the arrangement cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions, and where a tax advantage can be reasonably considered to be the main reason for the arrangement.

There are safeguards built into the GAAR which HMRC must meet to ensure that their judgement is reasonable.

If HMRC find that the GAAR applies, any tax advantages obtained are counteracted by making just and reasonable adjustments.

When submitting your tax return, you have a duty to submit a tax return that you believe is complete and correct, and you should therefore take the GAAR into consideration when doing so. Failure to do so could result in penalties for failing to take reasonable care in completing your tax return.

Furthermore, a penalty of 60% of the counteracted tax may be charged if you are subject to a counteraction adjustment under the GAAR.

Transfer of Assets Abroad (TOAA)

In addition to the GAAR, there are pieces of anti-avoidance legislation that apply to specific types of anti-avoidance schemes. One of these is the Transfer of Assets Abroad (TOCA) legislation.

Under this legislation, an 'Income Charge' applies where an individual transfers assets abroad and the following conditions are met:

- There must be a transfer of assets by an individual;

- As a result of the transfer (alone or in conjunction with associated operations), income becomes payable to a person/entity abroad;

- The individual has power to enjoy that income in some way as a result of a transfer of assets or receive/be entitled to receive a capital sum in any way connected with any relevant transactions; and

- The individual must be ordinarily resident in the UK in the year of liability.

Where these conditions are met, the income that becomes payable to the overseas person/entity is treated as arising to the individual who transferred the assets.

Applying this to your circumstances, you are ordinarily resident in the UK and would be making a transfer of assets resulting in income becoming payable to the overseas company. You would also have the power to enjoy that income by virtue of being a shareholder of the newly formed company.

As such, the TOAA legislation would apply effectively nullifying the potential benefits of the proposed scheme. You are able to make the transfer however you should still report the income as taxable on your UK tax return and penalties would apply if your tax return is completed incorrectly as a result which higher penalties applicable for deliberate and/or concealed errors. The sources of income would retain their nature i.e. the UK rental properties would be considered UK sourced and the overseas properties would be considered as overseas sourced however, due to your UK tax residence status, all of this income would remain taxable in the UK.

Going forward, we recommend that you exercise care and caution when considering schemes that promise tax benefits however should you wish to discuss this or any other topic in more detail then please let me know.

Yours sincerely,
Tax Advisor