Tax avoidance: leveraging tax reliefs

In The Vaccine Research Limited Partnership and others v HMRC [2014] UKUT 0839 (TC) (reported in Tax Journal, 12 September 2014), the Upper Tribunal (UT) has restricted entitlement to research and development (R&D) allowances where bank debt was used to leverage the expenditure for which the relief was claimed.

In the case, a partnership entered into a contract with an R&D contractor. The contractor then entered into a sub-contract with a biotech company, PepTcell, which carried out the research. A licence was granted by the partnership to the R&D contractor, in consideration for guaranteed, non-refundable licence payments, and a share of royalties. Of the capital invested by the individual partners, by far the largest part (of some £86m) came from bank borrowings. This was then paid under the R&D contract, and used by the R&D contractor to fund a deposit with a bank to secure its obligation to pay the licence fees (which matched the repayments due on the bank debt borrowed by the partners). £14m was paid by the R&D contractor to PepTcell. The rest was paid away in fees.

These facts follow a similar pattern to other recent cases (see, for example, Tower MCashback LLP [2011] UKSC 19 and Acornwood LLP [2014] UKFTT 416 (TC)). Individual partners leverage the extent of their investment (and resulting tax relief) with bank debt. Amounts are then paid away on the alleged trading activity, before making their way back to a bank as security for the borrowing.

The UT agreed with the First-tier Tribunal (FTT) that tax relief was not available on circular funding lent by one bank, and returned to another, as security for the debt.

The FTT had held that the expenditure qualifying for R&D allowances was limited to the £14m paid to PepTcell. This was because the £86m was a self-contained financing arrangement, separate from the genuine trading activity which required funding. Put simply, the act of purchasing an income stream to repay a loan is not ordinarily a trading activity.

Although HMRC was not successful in arguing that there was no trade in the partnership, the FTT and UT effectively separated out the trading (as to £14m) from the purchase of an income stream which was not part of the trade (as to £86m).

This is another novel approach to the question of trading. Some other cases, for example, Eclipse Film Partners (No.33) LLP [2013] UKUT 0639 (TCC) and Samarkand Film Partnership (No.3) [2011] UKFTT 610, have argued that leasing in a partnership is not a trade. Other cases have looked to defeat the tax planning instead, with a purposive approach to the question of whether expenditure has been incurred by treating the expenditure as capital; or by challenging the treatment of the arrangements in the accounts.

One might say that the variety of means used to defeat the taxpayer in these cases poses some danger to the general principles of tax law, particularly in relation to trading. To an extent there is some acknowledgement of this by the Supreme Court in Tower MCashback LLP; it was not too worried, however, if this caused upset to those involved in tax avoidance.

Although we are probably none the wiser now as to which route the courts will go down in any particular case, or how the judgments can be reconciled, what is certain is that HMRC will continue its campaign against abuses in this area. It would also seem that, one way or another, the courts will supportive of HMRC in this endeavour.

G20 finance ministers: BEPS deliverables

In their meeting in Cairns, the G20 finance ministers (excluding George Osborne, who we now know need not have stayed away) considered the first set of deliverables from the BEPS project published by the OECD on 16 September. The September release comprised three reports and four instruments covering seven different categories (including the digital economy, hybrid mismatches, treaty abuse, harmful tax practices and transfer pricing).

Although the OECD described the published measures as being ‘agreed’, it is clear from the detail that there is some way to go to achieve consensus on all of the deliverables. It is also interesting to note that, in the communiqué following their meeting, the G20 finance ministers welcomed the significant progress made towards completing BEPS, with a commitment to finalising all action items in 2015 (when the final set of deliverables is due to be published).

Perhaps ironically, BEPS itself now faces competition from other national and international measures. The EU, for example, has its own initiatives in areas such as hybrid mismatches, and is challenging harmful tax ruling regimes. Recent press reports would indicate that the EU is about to challenge favourable tax rulings given to taxpayers in Ireland, the Netherlands and Luxembourg, as comprising unlawful state aid.
The Conservative party at its conference last week announced its intention to introduce a tax aimed at companies which extract profits out of the UK and transfer them to lower tax jurisdictions (using structures such as the so-called ‘double Irish’). Exactly how this will work, and how it is supposed to tie in with BEPS, remains to be seen.

The G20 finance ministers did, however, agree to progress the OECD’s proposals on international tax information exchange between themselves, and with other countries, by 2017 or the end of 2018. These new rules will sit alongside the US Foreign Account Tax Compliance Act (FATCA), so that both regimes will apply to those financial institutions which are already the main target of FATCA.

Labour party conference targets ‘loopholes’
At its recent conference, the Labour party reiterated its intention, if it forms the next government in 2015, to limit the use of the quoted Eurobond exemption (in ITA 2007 s 874) for intra-group funding, described by Labour as a ‘loophole’.

A proposal was also outlined to target the use of tax loopholes by hedge funds. It was not immediately clear, however, which loophole (or existing exemption or relief) was being threatened with closure here. Some reports have speculated that this might be intermediary relief from stamp duty and stamp duty reserve tax (in FA 1986 ss 80A and 88A), where an intermediary is acting for a hedge fund client. There is no clarity, however, as to how any new restrictions on relief would be targeted at hedge funds in such a way that would it exclude other entities (such as pension funds, asset managers and insurers), which presumably it is not intended to catch.

As with the proposals on quoted Eurobonds, it is hoped that any resulting measures will be properly consulted on, so as to limit their scope for damaging liquidity in the London financial markets. A more careful use of language would also be helpful in the debate. A relief which prevents a double charge to tax where there is an intermediary, or which intentionally provides a relief from withholding regardless of who holds a bond, is hardly a tax loophole, whoever happens to benefit from it.

Issue of additional tier 1 capital (AT1) by non-UK banks
New guidance has been published by HMRC in its International Manual on the attribution of AT1 to the UK permanent establishment (PE) of a foreign bank (see INTM267776).

In this guidance, HMRC has confirmed that, even if the branch is not of a size to make an issue likely, an appropriate proportion of AT1 issued by a non-UK resident company can be attributed to the PE through the separate enterprise principle (in CTA 2009 s 21). For this treatment to apply, the PE must meet the regulatory requirements for an issue of AT1 if it was a separate enterprise. This means that the company must comply with the requirements of Basel III as to the holding of common equity tier 1 capital (CET1).

The guidance also deals with the position of where the home state of the company does not allow the issue of AT1 capital, but the UK PE, if it was a standalone company in the UK, would satisfy the regulatory requirements and be of sufficient size to issue AT1. In this case, HMRC will accept, in principle, that the UK PE may include an appropriate proportion of AT1 in its loan capital structure. However, this treatment is not likely to apply if an issue of AT1 is permitted, but there is no AT1 issued by the company.

The variety of means used to defeat the taxpayer in cases like these poses some danger to the general principles of tax law, particularly in relation to trading

When considering whether an issue qualifies to be treated as AT1, HMRC will have regard to how closely the terms and conditions of the instrument equate to those of a regulatory capital security meeting the EU’s capital requirements regulation (EU regulation No 575/2013).

HMRC then refers to certain provisions of The Taxation of Regulatory Capital Securities Regulations, SI 2013/3209, which it will apply where AT1 is attributed to a PE in this way. Applying these regulations, issues of AT1 attributed to the PE will be treated as loan relationships, so that the coupons are deductible. The regulations also provide that if there is any write down of the principal amount of the security, or conversion to CET1 (or any write up following a temporary write down), no credit or debit will be recognised.

HMRC says that this treatment will also apply in respect of AT1 attributed to a PE. The anti-avoidance rules in the regulations will also be applied, so that where there are arrangements with a main purpose of obtaining a tax advantage, loan relationship treatment will not apply.

Until now HMRC has not published guidance on the extent to which these regulations can be applied to non-EU issuers (it being generally understood that they can apply to an instrument by an EU issuer). However, while helpful, the new guidance is fairly limited in its scope. In particular, it only addresses AT1 capital but not tier 2 instruments.

What to look out for

- The 22 October closing date for comments on the HMRC consultation on implementing the OECD agreements on international information exchange (see www.bit.ly/1pHXts9).
- At the end of the month, the Supreme Court considers Anson v HMRC (on entitlement to double tax relief for profit shares in a Delaware LLC).

For related reading, visit www.taxjournal.com

Cases: The Vaccine Limited Partnership and Mr Vaughan v HMRC (9.9.14)

The OECD’s agreed recommendations on the 2014 BEPS deliverables (Richard Collier & Philip Greenfield, 25.9.14)