Analysis

The tax and the City briefing for July

SPEED READ **The Court of Appeal finds that redemption proceeds can be characterised as interest if you draft the loan stock that way. HM Treasury does an about-turn on banding for the bank levy, and HMRC does the same on results dependent interest and statutory bail-in. Deductions for equity and the threatened closure of a quoted Eurobond tax 'loophole' are key features of a Labour Party policy review of business tax. The Upper Tribunal considers earn-out rights and beneficial ownership. FATCA withholding begins.**

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Redemption payments

The Court of Appeal (CA) has made short work of a case where loan stock was issued without interest but with a right to redemption proceeds of 7.25% per annum on the principal amount. The outcome is not surprising given the drafting that was used, with the CA judge wondering why he had agreed to hear the case in the first place.

The CA found that the authors of the conditions of the notes had done just about all they could to point to the redemption proceeds as interest. It was paid by reference to an underlying debt, at a stipulated rate, by reference to time elapsed and accrued daily. The loan stock was not therefore a relevant discounted security (under the rules now in ITTOIA 2005 Part 4) and no loss arose to the taxpayer on its transfer (see *Nicholas Pike v HMRC* [2014] EWCA Civ 824, reported in *Tax Journal*, 27 June 2014).

Guidance in the HMRC manuals suggests that a premium on redemption is not interest. Although this was noted by the lower courts, it was not enough to overcome the clear language used in this case which permitted the CA to characterise the payment as interest.

Bank levy

HM Treasury (HMT) has announced that a proposed banding approach for the bank levy will no longer go ahead (see written ministerial statement of 26 June 2014).

The proposal had been made in response to continuing criticism that the tax payable by the banks is too sensitive to economic and regulatory change, creating uncertainty and impacting on UK competitiveness, leading to risks of distortion and unintended changes in bank behaviour. While HMT was keen to point out that some of these failures might be imagined rather than actual, the proposal was made for a revenue neutral reform which would replace the headline rate with banding. Unfortunately, the banking community was singularly unimpressed, responding that banding would tackle none of the perceived drawbacks of the existing regime.

Although HMT won't be considering banding again, two wider proposals came out of the consultation. These would seek to address the inability to accrue the costs of the bank levy for quarterly reporting; and apply the levy to the opening rather than the closing balance sheet. HMT is not, however, committing to these changes as the case for making them is not yet clear.

'Bail-in' and the Banking Act 2009

The Banking Act 2009 includes a stabilisation or 'bail-in' option giving financial institutions and their investors a greater responsibility to absorb losses. Under the rules, the liability under a security can be written down or converted to equity. In CTA 2010 Part 23, payments under a security which are results dependent are treated as non-deductible distributions.

For additional tier 1 (AT1) or tier 2 (T2) instruments that are compliant with the Capital Requirements Regulation, any concerns relating to results dependent interest were dealt with through regulations which switched off these special securities rules (see the Taxation of Regulatory Capital Securities Regulations, SI 2013/3209).

However, for securities not within the scope of the regulations, previous guidance from HMRC (in June and September 2012) explained that, in its view, instruments subject to the statutory bail-in regime would be results dependent from the time the regime came into force.

In *Revenue & Customs Brief 24/14*, published on 19 June 2014, HMRC now accepts that for all securities (not just AT1 and T2) any possible change in terms triggered by the exercise of regulatory intervention powers is outside the scope of the rules for results dependent interest. This is regardless of whether or not the instrument specifically refers to the bail-in regime.

While banks might breathe a sigh of relief at this helpful and timely change of view, the new guidance only deals with the rules for distribution treatment. Other related provisions which can be impacted by results dependency (such as those dealing with entitlement to group relief and exemption from stamp duty for loan capital) are not dealt with specifically. The HMRC approach to instruments governed by non-UK bail-in provisions is also, as yet, not entirely clear.

Labour Party proposals

The Labour Party has issued a policy review document setting out its approach to business tax reform (see *Delivering long-term prosperity: reform of business taxation* via www.bit.ly/1jgNnNR).

The proposals include tackling the tax system's bias towards debt finance (which is seen as an instance of 'short-termism') by consulting on tax relief for a notional return on equity. This possibility has been mooted before (see, for

example, the 2011 Mirrlees review by the Institute for Fiscal Studies), and the Labour Party makes much of its approval by the IMF. However, the devil is, as usual, in the detail. The proposal does not explain, for example, how it can be revenue neutral without imposing further restrictions on the deductibility of interest.

More controversially, the Labour Party in government would also look to close what it calls the quoted Eurobond tax 'loophole'. Some might challenge this use of language – a loophole does not typically include an exemption specifically granted by Parliament for interest paid on a listed bond.

Nevertheless, the target of this proposed anti-avoidance is those companies which move profits to connected parties in tax havens. The review distinguishes between this behaviour and the legitimate use of the exemption to raise funds. The trick is to do this effectively in law, which is something the present government notably failed to do in its own consultation on limiting the quoted Eurobond exemption for intra-group financing in March 2012. If there is a new Labour government in May 2015, it is hoped that it will at least consult again on the detail of this proposal, which found little to recommend it last time around.

FATCA

1 July 2014 ushered in withholding for the first time under the US Foreign Account Tax Compliance Act (or FATCA) on payments of US source income that do not benefit from grandfathering. The withholding will principally apply where interest is paid to or for the benefit of non-compliant foreign financial institutions (FFIs). Thanks largely to the development of an ever increasing network of intergovernmental agreements (IGAs), including with the UK, there was no noticeable meltdown of the international financial system as some had predicted in the early days of FATCA. If anything, the lack of fanfare shows just how far and fast mindsets can be changed on the merits of international information exchange, at least when it is the US which initiates the debate.

Beneficial entitlement and group relief

In *Bupa Insurance Ltd v HMRC* [2014] UKUT 0262 (TCC) (reported in *Tax Journal*, 11 July 2014), the Upper Tribunal (UT) has held that contractual obligations under an earn-out right do not block entitlement to group relief. This is a well considered and helpful decision for those looking at the meaning of beneficial ownership or entitlement not only for group relief, but also in a number of other contexts.

In the case, Bupa Finance (BF) was the purchaser of 46.18% of the ordinary A shares in CX Re. Under an earn-out right agreed in the contract for sale, BF was required to pay the seller an amount equal to any distribution made by CX Re. No dividends were actually paid at any material time, since CX Re had no distributable profits. Indeed, CX Re had substantial trading losses, which CX Re sought to surrender to another member of the Bupa Group under the rules for consortium relief (now in CTA 2010 Part 5). Under these provisions, a limit is imposed on the amount that can be surrendered to a consortium member by reference to, amongst other things, *beneficial entitlement* to profits available for distribution to BF as shareholder.

As an initial point, the UT rejected an argument that if there had been tax avoidance the shares held by BF could be ignored completely (as they had commercial content, unlike the shares in *Arrowtown Assets Ltd* 6 ITLR 454). It is interesting to think why HMRC sought to play the tax avoidance card at all, given its lack of relevance to the rules in dispute. Of course, it introduced an element of indignation into the equation in what would otherwise have been just a case about group relief. It would also have limited the scope of the judgment if HMRC had been successful in the case. A decision which meant that a contractual obligation to deal with a payment resulted in a loss of beneficial ownership would have been very odd, with some far reaching implications.

However this was not to be the outcome in this case. Instead, the UT held that beneficial entitlement is the same as beneficial ownership for these purposes, and so the UT could look extensively to the two earlier leading cases as to the meaning of this (see *Sainsbury PLC v O'Connor* [1991] STC 318 and *Wood Preservation Ltd v Prior* (1968) 45 TC 112). The UT paid particular attention to BF's continued ability to assign the distribution, which it did not have to use to pay the earn-out. BF was also exposed to currency fluctuations on dividends paid in dollars, and could receive a return if the amount of the distribution was put on deposit. All of this amounted to far more than a 'mere legal shell', and so there were clear indicators of beneficial entitlement. It was a relief that the UT also agreed with both parties that the international fiscal meaning of beneficial ownership (in *Indofood International Finance Ltd v JP Morgan Chase Bank* [2006] EWCA Civ 158) had no relevance in this context.

It may well be that new tax avoidance rules (including those on transfer of deductions in CTA 2010 Part 14A) would make any tax planning which did take place in this case now much more difficult to achieve.

What to look out for

- Publication by HMRC of disclosure of tax avoidance schemes (or DOTAS) numbers for which accelerated payment notices will be issued (requiring tax to be paid upfront where it is in dispute).
- Royal assent to the Finance Bill 2014 is expected before 22 July (changes to loan relationships, follower notices, accelerated payments, high risk promoters and certain other changes come into force).

For related reading, visit www.taxjournal.com

Cases: *Nicholas Pike v HMRC* (25.6.14)

Quoted Eurobond 'loophole' shocker! (Helen Buchanan, 11.7.14)

Q&A: The US FATCA regulations have finally landed (Jayne Newton, 24.1.13)

Cases: *Bupa Insurance v HMRC* (9.7.14)