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LOCKDOWN THOUGHTS

By David Goldberg QC

Most people will have asked questions of themselves in lockdown, not questions of the "Who invented liquid soap and why?" kind, but deeper, self searching questions like "Is my life worth living?" That is certainly not a question I intend to answer here, but I might attempt an answer to a slightly shallower question: "What am I doing?".

Well, what I am doing during lockdown is to carry on working, only mainly from home rather than from Chambers, and I have covered a largeish area of work in the roughly three quarters of a year or so that has passed since the pandemic more or less closed our offices. There have been issues about the difference between income and capital, mainly from non-UK jurisdictions; there have been questions from both home and abroad about the deductibility of certain payments; there has been a domicile question with a story so fascinating it would be hard to believe if written in a book, but which is, nonetheless, true; there have been questions about intangible property and there have been more usual questions about loan relationships, about unallowable purpose and about hybrids. There has been a surprising amount of work involving the transfer of assets abroad legislation; there has been a case about whether damages for discrimination are taxable as employment income. (Who, apart from employment lawyers, knew how much employment law there is!) And there have been several cases about how to manage enquiries being made by HMRC.

Does anything in particular stand out from this *pot pourri*?

Well, two cases do. In one, HMRC made a contract promising not to impose certain possible charges to tax on the taxpayer: it falls within certain express powers of HMRC, it is terms are clear and it is not a future agreement. HMRC have threatened to breach it – are, perhaps, breaching it already: they seem content to dishonour their promises and, by doing that, themselves. In the other, HMRC have expressed disagreement with the taxpayer's self-assessment (which, by the way, is certainly right) and have immediately started talking about penalties. The day before I wrote this passage, there was a headline in the newspaper which read "Tax enforcers threaten families left penniless by the pandemic" and, on the day I write it, the headlines say "HMRC debt collectors linked to tax haven and payday loan lenders" and "I got the letter, went upstairs and cried". This is happening when, more or less everyday, I receive an email from HMRC which is headed "HMRC help and support to you", which reminds me of what President Reagan said: "The eight most frightening words in the English language are, "I am from the government, I am here to help".

When the publisher, Hamish Hamilton asked Lord Radcliffe if he would allow the publication of a book of his essays, he is supposed to have attempted to persuade him to say yes by adding "it will help to show the flow of your thought". Whatever the reason, the book was published: it is called "Not in Feather Beds" which is part of a quotation, "We may not look to go at our pleasure to heaven in feather beds. It is not the way". I am doing this from memory, so I may not have the quotation exactly right, but it is near enough so, and I hope I am also right in remembering that, in the preface to the book, Lord Radcliffe said that he was surprised to learn from Hamish Hamilton that there was a flow to his thought.

Lord Radcliffe is, of course, remembered by history as the man who decided where the boundary between India and Pakistan was to be, and is well known to tax lawyers because, as "our Right Honourable Trusty and Well-Beloved Cyril Radcliffe", he was Chairman of the Royal Commission on the

Taxation of Profits and Income, whose reports, published in the 1950s, remain influential today.

For some reason I have always had a great affection for Not in Feather Beds and the idea of the flow of thought: perhaps, in the tangle of my mind, it links to the concept of the river of time and the idea that we draw the means of survival from the wellspring of suffering itself – a thought which is, perhaps, apt in a time of pandemic. No matter whether that is why I like Not in Feather Beds or not, I have always hoped that I would have a flow of thought, if not in relation to brain surgery or quantum mechanics at least in relation to my work as a tax barrister. I have been doing that job for some time now, time enough to develop a flow, but, if I look back for a moment – I generally spend my time looking forward – I find that, in relation to a central feature of our tax system, my thoughts have stayed the same.

Quite early in my career it became apparent that HMRC or their predecessors had too much power; that they did not always use their power wisely and well; that, in part, the power came from a lack of clarity in the tax system; and that the concatenation of complexity and power made the tax system burdensome for those subject to it, or, at least, for those who are not taxed by PAYE. A fair society is not created by providing for the poor or relatively poor while over-burdening the rich: it is created by balancing rights and obligations, by ensuring that those made subject to State power have remedies if those powers are over-used. It is important to recognise that when the State gives, it is performing an entirely different function from that it performs when it takes, and that, while the giving must not be grudging, equally the taking must not feel like extortion. Because that is so, it can often be necessary to limit, or to attempt the limit, the use of power; and experience taught me that, with sufficient energy, with sufficient will and with sufficient imagination, it is often possible to control the

Revenue's excess. Those, then, were the views which I formed some years ago.

What has happened since then? The tax system has become more and more complicated: the legislation governing it has grown from under 500 pages in 1952 to tens of thousands of pages today. HMRC have been given more and more powers – so many powers that the thought of enumerating them makes me weary – and the width of the powers, both in relation to substantive law and in relation to administration, makes it harder (though not impossible) to control what is done with them. It is claimed that many of these new powers have been introduced in accordance with thinking derived from the relatively new discipline of behavioural economics. If that is right, it involves a considerable misunderstanding and misapplication of the thinking.

The central idea of behavioural economics is that people respond more willingly to nudges than to threats, and that is why so many new penalties have been introduced into our tax code: they are supposed to nudge taxpayers into paying more tax. But a threat remains a threat even if called a nudge and these new penalties threaten and are intended to threaten. It is, no doubt, possible to give these threats fancy names, to call them nudges, but it does not change what they really are, nor does it change their character which is unpleasant and nasty. At the same time, the general political climate is unfavourable to many taxpayers and the inclement weather is often reflected in the judicial approach to these matters.

Now, of course, HMRC need powers. I was recently told by a reliable source that there were still something like 3000 organisations selling arrangements which involved EBTs and loans, on the hopeless basis that the purchasers of these schemes would lawfully save tax. It is because of that scale of thing that we had the miserable suicide-inducing experience of the loan charge largely corrected by the loan charge review.

The continued and continuing sale – or, more accurately, misselling – of bad tax schemes brought forth a mix, embedded within our tax law, of administrative and substantive legislation, when the problem should have been addressed by the criminal law. Indeed, the misselling of bad tax schemes is trebly criminal: it is criminal in the act; it is criminal in the effect it has on the innocent purchaser and it is criminal because of the affect it has had on all of those subject to the tax system.

What has wholly disappeared from our tax system is any sense of balance: legislators endow administrators with huge powers, no doubt in the deeply held view that, here in the United Kingdom, they will be used reasonably; but administrators, who have been given these powers, then use them to the full; Courts which were once willing to control administrative excesses too often feel compelled to hold that it has been sanctioned by Parliament.

The tax system should leave us (to borrow from Kipling) with

"Ancient right unnoticed as the breath we draw – Leave
to live by no man's leave underneath the law"

Instead, we live in a culture in which

"He shall mark our goings, question whence we came
Set his guards about us as in Freedom's name.
He shall take a tribute toll of all our ware;
He shall change our gold for arms – arms we may not bear"

So here I am, stuck with exactly the same thoughts I developed several decades ago: taxpayers are facing substantially the same problems as they faced all those decades ago, but now HMRC has even greater power to enforce their will.

What am I doing?

The answer seems to be "Not enough".

But, by the living God, tomorrow we shall try the game again.

OFFSHORE LONDON

By Milton Grundy and Sam Brodsky

Those who live in the United Kingdom do not think of their capital city as an offshore centre. Quite the contrary. But those who do not live in the United Kingdom have found ways of doing business with a British face but without a British tax liability. This may facilitate doing business with customers whose local law prevents them from making payments to jurisdictions regarded as tax havens, or refuses to allow such payments to be deducted in computing their profits for tax purposes. And the image of the United Kingdom is undoubtedly that of a high-tax country: a tax inspector outside the United Kingdom, coming across a UK vehicle in a taxpayer's file, is not thereby stimulated to look for some tax avoidance scheme. On the other hand, the investment and professional services provided by the City make such an important contribution to the GDP, and one cannot avoid the impression that the tax system has been to some degree shaped so as to encourage foreigners to make use of those services without thereby exposing themselves to tax.

Let us take for our first example the UK partnership of which all the members are non-resident. The United Kingdom does not tax partnerships as such. The partners are taxed on their share of the partnership income. It follows that if the partner is non-resident and the source of the partnership income is outside the United Kingdom, he has no liability to UK tax. Let us call this the "Tax-favoured Partnership". Picture, then, a Tax-favoured Partnership carrying on a business of buying refrigerators in Nigeria and selling them in Greenland. If all its sales contracts are made outside the United Kingdom, the source of the profit will be outside the country and be outside the tax charge. The best way of ensuring that the business is carried on abroad is by having an office abroad which makes the sales contracts, but it is sufficient if all offers for sale are – and can be shown to be – accepted abroad. It makes no difference if the partnership has a UK office or holds partners' meetings in the UK. No tax consequence flows from the Partnership having a non-interest-bearing UK bank account. These rules apply, whether the partnership is a simple (or "open") partnership, a limited partnership or a limited liability partnership. Partners in an open partnership are fully liable for partnership debts, and the partnership interests are UK assets for inheritance purposes. One solution to these problems is for the partners not to be individuals but offshore companies owned by individuals. This is a popular structure: it is easy for the client to understand, it is not prone to UK Inheritance tax and it of course frees the individuals from liability for partnership debts. There are two kinds of limited partnerships. There is the old kind, formed under the 1907 Act, and the newer kind – called a "limited liability partnership" – formed under an Act passed in 2000. The essential difference is that under the earlier Act a partner cannot have limited liability if he participates in the management of the firm, but under the later Act he can. Like the "open" partnerships already discussed, they give rise to tax liability only on income with a UK source, but they have the great advantage of having a registered number, which makes it easier for the partnership to open a bank account and do business in civil law countries.

Our second "British Face" is the UK-resident trust company which is trustee of a settlement made by a non-resident and non-domiciled settlor and has a non-resident co-trustee. The trust is treated as non-resident for income tax and capital gains tax purposes. Let us call this a "Tax-favoured Trust". Picture, in this case, a UK-resident and – taxpaying company. It is called Brodsky & Grundy Refrigerators Ltd. It carries on abroad the business of selling refrigerators, as before. It does so as trustee of a Tax-favoured Trust, but customers, or other outsiders, do not necessarily know that. This is not an unintended loophole but the opposite: Parliament has expressly provided a tax-free regime for the Tax-favoured Trust. The upshot is that the UK-resident trustee is fully taxable on profits and gains it makes for itself, but the trust is treated as a separate, and non-resident, person. As a result, capital gains and foreign income can accrue to the trust, without attracting any UK tax. Again, we have to remember that the United Kingdom has a far-reaching Inheritance Tax and partnership assets and bank deposits should be kept abroad. Can a Tax-favoured Trust get the benefit of tax treaties to which the United Kingdom is party? It seems, in a way, anomalous that it should, and the question in each case will be for the non-UK jurisdiction to decide. But our experience is that trustees generally get treaty relief without argument, whether the trust is Tax-favoured or not.

Older readers will remember the days when the zero-tax non-resident English company was a popular offshore vehicle. It was based upon the rule that a company is resident where its business is managed and controlled. It made no difference where it was incorporated, so it could still be tax-free even if it was incorporated in England & Wales – or, for that matter, in Scotland or Northern Ireland. These days came to an end on the 15th March 1988, since when a company incorporated in any part of the United Kingdom is resident there for tax purposes. But the old non-resident company was re-invented in 1994, in consequence – and it was probably an unintended consequence – of s.249 of that year's Finance Act, by which a company incorporated in the United Kingdom, but qualifying as a resident of some other country for treaty purposes, is to be treated for domestic purposes as not resident in the United Kingdom. Section 249 is now gone but similar provision has been made in section 18 of the 2009 Corporation Tax Act.

Let us call a company which benefits from section 18 the "Tax-favoured Company". At first blush, it does not look like a very interesting provision. Who would want to avoid tax in the United Kingdom in order to have the pleasure of paying tax in some other country? But that line of thought does not take into account the fact that some countries do not tax – or do not fully tax – all the income of all their residents, and the United Kingdom has treaties with several of them. Take Barbados, for example. A company resident there but incorporated elsewhere has a local tax regime which echoes the UK provisions applicable to individuals who are resident but not domiciled there. Accordingly, a company incorporated in the United Kingdom but resident in Barbados will pay local tax on its foreign income only to the extent – if at all – that such income is remitted to Barbados. The United Kingdom has many treaties with countries which tax on a territorial basis, and each of these may be considered for the residence of our third "British Face", the Tax-favoured Company.

A website might also be a British face and the Revenue do not consider that a website alone amounts to a permanent establishment. Accordingly, the ability to run a business from abroad but with a UK face remains and, with all the changes that have come in the remarkable year of 2020, it is now much more than a theoretical possibility. It does not make sense to pay London rents (or rates) when business is conducted over video calls and the UK must consider its tax strategy carefully in the coming years now that a villa in the sun can exist with a British face. But for those who wish to "try" working abroad before returning in a few years, be careful: there are tax traps which tax those who dare to leave may encounter in their year of return.

A person may strive for a British face without a correlative tax liability. Rather less often does a person strive for a British tax liability without a British face. It may not surprise the reader however than such occasions do now arise more frequently and indeed more dangerously. The clearest example of this phenomenon is the taxation of UK property. It used to be thought that we wanted foreign investment in our property market because more property was good and brought prices down. Now it is bad (or at least, less good) because the wealthy buy property and keep it empty and so we should tax foreign owners of UK property.

On 1 April 2013 capital gains tax became payable on gains made on the disposals of dwellings subject to the annual tax on enveloped dwellings, irrespective of the residence status of the person making the gain. In 2015 certain non-residents were brought within the charge to capital gains tax when disposing of UK residential property. In 2016 non-resident persons carrying on a trade of dealing in or developing UK land became subject to income tax or corporation tax. And now non-residents are liable on the disposal of interests in UK land whether residential or not. There are similar provisions in other parts of the tax code and those with offshore structures with links to UK property should consider the implications carefully.

This is not so much a slippery slope as a cliff jump and not so much a tax creep as a sprint. The sprint will pick up speed if the Government begins to tax capital gains at the same rate as income. Have these changes increased the tax take? The amount of tax revenue actually raised is beside the point when it is a vote winner, and raising tax from those who do not vote often seems like a very good idea to those who do.

SOME PITFALLS IN THE TAX TREATMENT OF COMPENSATION PAYMENTS

By Laura K. Inglis

Introduction

It is a common misconception that, as a result of the House of Lords' decision in *British Transport Commission v* Gourley [1956] A.C. 185, UK compensation payments are not subject to income tax. Nothing could be further from the truth.

Whilst it is the case that some compensation payments are not subject to income tax because they are capital in nature (or because they benefit from a specific exemption), there have been cases in recent years where HMRC have successfully sought to treat compensation receipts calculated by reference to lost earnings or incurred expenses as employment or trading income (and therefore subject to income tax). These cases appear to suggest an increasingly aggressive predilection on HMRC's part to characterise such compensation receipts as income, with the result that the risk of challenge in this area cannot be discounted.

Moreover, even where the capital nature of a payment is clear, the £500,000 cap on the concessionary treatment offered under ESC D33, together with the lack of judicial authority on the scope of the CGT exemption in s.52 TCGA 1992, mean that it is always wise to seek clearance from HMRC, particularly in regard to large compensation receipts.

The *Gourley* principle

In *British Transport Commission v Gourley*, the claimant, who had suffered serious personal injuries in a railway accident, was awarded damages of £37,720 in respect of actual and prospective loss of earnings. It was agreed between the parties that this award itself was not taxable, presumably because the receipt was recognized to be capital in nature. Capital gains tax had not yet been introduced.) However, it was also recognized that, if the claimant had earned the sum in question through his professional activities, he would have had to pay income tax (and surtax, as it then was) on the amount.

[1] Paying the full amount of damages over to the claimant would thus place him in a better position than he would have been in apart from the accident, so the House of Lords held that the award should be adjusted downwards to take account of the tax he would have suffered on the earnings, leading to an alternative award of £6,695. This adjustment of a non-taxable damages award in light of tax that would have been suffered in the absence of the wrong has become known as the *Gourley* principle.

However, with the passage of time, the fact that the damages award in *Gourley* was recognized as non-taxable *before* the House of Lords reached its decision has become somewhat obscured. It is now not unusual for the *Gourley* principle to be described as somehow *rendering* compensation awards exempt from income tax, as though the principle itself binds HMRC.[2] However, this is to put the cart before the horse. The *Gourley* principle does not *make* compensation awards exempt from income tax, but rather provides for such an award to be adjusted in circumstances where the award itself is *already* exempt under the applicable tax legislation. *Gourley* is thus not a tax case at all, but merely an outworking of the general legal principle of *retitutio in integrum* – namely, that a compensation award ought to be assessed by reference to what the injured part has really lost, and ought not to make him better off than he would have been had he not suffered the wrong in question.[3]

Most importantly, though, the *Gourley* principle does not bind HMRC. HMRC are required to collect whatever tax may be due on a compensation award or settlement under the relevant tax legislation, regardless of whether or not an adjustment has been made under *Gourley*.[4] It is thus entirely possible that a damages award or settlement could be adjusted downwards under *Gourley*, and that HMRC could subsequently seek to tax the adjusted award in the hands of the successful claimant. The danger of mis-applying the *Gourley* principle is that claimants may end up under-compensated by having their awards not only adjusted on account of tax but then actually taxed as well.

This is why, in *Stoke-on-Trent City Council v Wood Mitchell & Co Ltd* [1980] 1 W.L.R. 254, the Court of Appeal recommended that the *Gourley* principle not be applied in circumstances where the tax treatment of a compensation award is uncertain. In that case, which concerned a compensation settlement for business disruption on the compulsory acquisition of land, Roskill LJ stated at 259:

> *Since the purpose of decisions such as those in British Transport Commission v. Gourley [1956] A.C. 185 and West Suffolk County Council v. W. Rought Ltd. [1957] A.C. 403 was to secure that a successful plaintiff or claimant did not get more by way of damages or compensation than would have been received by him in the absence of his injuries or of the compulsory acquisition in question, as the case might be, it seems somewhat strange that the principle underlying those decisions should be able to be invoked by the acquiring authority [the defendant] in order to produce the result that the claimants, in the absence of any assurance from the Inland Revenue that no attempt would be made to levy tax upon this sum, stood in peril of receiving considerably less than that which they would have received had their capacity to earn continued unaffected by compulsory acquisition. In such circumstances the more natural course, which would avoid any risk of injustice, would be for the*

> *claimants to receive the full sum, leaving the question of liability to tax, if any, to be adjusted thereafter between the claimants and the Inland Revenue.*
>
> *We take the view that the principles laid down in West Suffolk County Council v. W. Rought Ltd. can only be applied if after examination of the relevant statutory provisions it is clear beyond peradventure that the sum in question would not be taxable in the hands of the claimants. If that is clear, then it would be wrong to require the acquiring authority to compensate the claimants beyond the amount of the loss which the claimants would in truth suffer. But if it is not, then it seems to us unjust that in a doubtful situation the acquiring authority can get the benefit of a reduced payment while leaving the claimants exposed to the risks we have mentioned. Considerations of abstract justice might be thought to suggest that the claimants should receive the full sum and then in due course account to the Inland Revenue for any tax properly chargeable upon that amount.*

It is therefore necessary to establish the treatment of a compensation payment under the relevant tax legislation before considering any adjustment under *Gourley*.

HMRC's efforts to characterise compensation payments as income

There is a general principle (see *London and Thames Haven Oil v Attwooll* [1967] Ch. 772) that compensation payments are to be treated for income tax purposes in the same way as that which they are compensation for. The *Attwooll* case itself concerned a receipt which was found to be taxable as trading profits, but the principle set out therein by the Court of Appeal is not limited to trading profits.[5] Diplock LJ stated at 815:

> *Where, pursuant to a legal right, a trader receives from another person compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits (if any) arising in any year from the trade carried on by him at the time when the compensation is so*

> *received, the compensation is to be treated for income tax purposes in the same way as that sum of money would have been treated if it had been received instead of the compensation. The rule is applicable whatever the source of the legal right of the trader to recover the compensation. It may arise from a primary obligation under a contract, such as a contract of insurance, from a secondary obligation arising out of non-performance of a contract, such as a right to damages, either liquidated, as under the demurrage clause in a charter-party, or unliquidated, from an obligation to pay damages for tort, as in the present case, from a statutory obligation, or in any other way in which legal obligations arise.*

This principle was echoed by Lord Woolf in *Mairs v Haughey* [1994] 1 A.C. 303 at 319:

> *It is inevitable that if a payment is made in substitution for a payment, which might, subject to a contingency, have been payable, that the nature of the payment which is made in lieu will be affected by the nature of the payment which might otherwise have been made. There will usually be no legitimate reason for treating the two payments in a different way.*

Attwooll and *Mairs* both involved compensation for failure to receive a sum of money, but the same principle applies equally to compensation for an incurred expense: the nature of a compensation payment, for tax purposes, mirrors that of the payment it replaces.[6] However, in *Attwooll* itself at 816, Diplock LJ cautioned against confusing the nature of a compensation payment with its mode of assessment:

> *The method by which compensation has been assessed in the particular case does not identify what it was paid for; it is no more than a factor which may assist in the solution of the problem of identification.*

In practice, distinguishing the nature of a compensation award from its method of assessment is not always a straightforward exercise, as the following cases from recent years reveal.

In *A v HMRC* [2015] UKFTT 189 (TC), an employee brought a race discrimination claim against his employer. HMRC argued that the settlement payment received represented arrears of wages that should have been paid and therefore was taxable as employment income. The Tribunal rejected this argument, finding instead that the payment was compensation for the statutory tort of discrimination, and therefore was not subject to income tax. Judge Raghaven stated at [81]:

> *If an Employment Tribunal were to award damages for discrimination (whether calculated by reference to earnings or whether they included injury to feelings) these are recompense for the right not to be discriminated against under statute. They are paid because the employer has breached a statutory obligation not to treat the employee in a detrimental way due to his race. They are treated in like manner to a tort claim. It could be said that where the complaint is of underpayment of remuneration that the damages would not have arisen if were not for the fact the claimant was an employee but it is clear that it is not enough. That sort of wide test of causation (a "but for" test) is insufficient (see Hochstrasse [sic] v Mayes). When we pose the question: "Why did the employee receive the payment?" the answer is not that it was in return for the employee's services but because it has been determined that the employer has acted unlawfully by discriminating against the employee. Where damages are calculated by reference to under-paid earnings, while the discrimination may have manifested itself through the way in which the employee was remunerated, the damages arise not because the employee was under remunerated but because the under payment was discriminatory. An award in these circumstances cannot in our view be described as a reward for services. The award is paid for some reason other than the employment and is not earnings.*

However, in *Pettigrew v HMRC* [2018] UKFTT 240 (TC), HMRC successfully argued that a compensation payment received by a part-time employment tribunal judge in settlement of a discrimination claim against the Ministry of Justice was taxable as employment income. The taxpayer argued that the compensation payment was damages for the statutory tort of breach of the Part Time Workers (Prevention of Less Favourable Treatment) Regulations 2000. However, HMRC maintained that, notwithstanding the discrimination claim, the employment was a sufficiently substantial reason for the settlement payment, such that it qualified as an emolument of the judge's employment under s.62 ITEPA 2003 and should be taxed as earnings. The Tribunal accepted this view, with Judge Kempster stating at [99] (emphasis added):

> *[E]ven though the prompt for MoJ to make the Payment was the settlement of claims stood behind the Miller litigation, the methodology and quantification of the Payment was to remedy the underpayments in the period April 2010 to December 2013 under the contract of employment; there was a simple calculation of differences between what Mr Pettigrew was actually paid at the time and what a salaried judge comparator would have earned for the same duties performed. I agree with Mr Stone's comment that Mr Pettigrew had concentrated on the mechanism for the Payment rather than the reason for it being paid. <u>Even if the Miller litigation was one reason for the Payment, that does not displace the employment relationship also being another reason; one would then apply the test in Kuehne + Nagel: was the employment a sufficiently substantial reason for the payment? For the reasons set out at [70-71] above, I am sure that the employment was a sufficiently substantial reason for the Payment</u>.*

As decisions of the First-Tier Tribunal, both *A v HMRC* and *Pettigrew* carry only persuasive authority in future cases, but in January 2020 HMRC updated their Employment Income Manual to reflect the decision in *Pettigrew*. EIM12965 now reads:

> *Section 62 [ITEPA 2003] may also apply to any payments in respect of amounts which the employee would have been entitled to but for discrimination. In Pettigrew v HMRC (2018 TC*

06473) a part-time judge received compensation for unequal pay because he had been underpaid compared to full-time colleagues. Applying Mairs v Haughey (1993 BTC 339), the First-Tier Tribunal found that the compensation should derive its character from the nature of the payment it replaces (which would have been an emolument from the employment) and was therefore earnings. The same treatment would apply to other types of discrimination.

The former version of this guidance (which stated that compensation payments for discrimination are only taxable under s.401 ITEPA 2003, and then only when connected with termination of the employment) still appears at EIM12966, but carries the following health warning:

The guidance at EIM12965 has now been updated to clarify that compensation payments may be taxable under provisions other than s401 ITEPA 2003 in certain circumstances.

The wording of the previous guidance (copied below for reference) does not accurately reflect HMRC's view of the legislation in that it states that compensation payments for discrimination can only be taxable under s401 ITEPA 2003. It should not be relied upon for payments made after 5 April 2021.

These statements together evidence HMRC's future intention to characterise compensation payments for lost earnings due to workplace discrimination as employment income.

Another example of HMRC's appetite for taxing certain compensation awards as income is seen in the case of *Ghadhavi v HMRC* [2018] UKFTT 600. Here seven brothers received compensation from a bank that that had mis-sold them certain interest rate hedging products which had resulted in the failure of their property letting business. The taxpayers argued that the payment was compensation *for* the mis-selling which had occurred, that the method of calculating the payment (by reference to revenue expenses incurred) does not determine its nature, and that the redress received should be regarded as a capital receipt and therefore exempt from tax (see [37]-[39]). Although the Tribunal acknowledged that the compensation could in a sense be said to be "for" the mis-selling, it accepted HMRC's view that the compensation was actually for various revenue expenses incurred by the taxpayers as a result of the mis-selling, such that the compensation should be characterised as a post-cessation revenue receipt of the business under the *Attwooll* principle (see [63]-[65]).

Continued uncertainty regarding capital compensation receipts

Nor is the uncertainty regarding the tax treatment of compensation payments limited to settlements or awards that may be characterised as income. Even if a receipt is plainly capital in nature, the tax treatment can be far from clear. Although it has long been recognised that a right of action is an "asset" for capital gains tax purposes, with the result that sums derived therefrom are subject to tax under s.22 TCGA 1992[7], HMRC's extra-statutory concession D33 long meant that sums derived from rights of action not connected with property escaped taxation all together. However, since 2014, HMRC have imposed a limit of £500,000 on the concession, requiring specific clearance to be sought in respect of greater amounts.

It is also possible that many compensation payments that are capital in nature may be exempt from CGT by statute. Section 51(2) TCGA 1992 reads as follows:

> *It is hereby declared that sums obtained by way of compensation or damages for any wrong or injury suffered by an individual in his person or in his profession or vocation are not chargeable gains.*

Whilst this exemption is unlimited as to amount and plainly is only applicable to wrongs suffered by individuals, its scope remains highly uncertain. HMRC's interpretation of this provision is set out in paragraph 12 of ESC D33:

> *The words 'in his person' are to be read in distinction to 'in his finances' but they embrace more than physical injury so that*

> *distress, embarrassment loss of reputation or dignity may all be suffered 'in the person'. Compensation or damages for unfair or unlawful discrimination suffered 'in the person' and for libel or slander (in Scotland defamation) would thus be included. Similarly the words 'in his profession or vocation' refer to compensation or damages suffered by an individual in his professional capacity such as unfair discrimination, libel or slander (in Scotland, defamation) as distinct from 'in his finances'...*
>
> *The exemption is extended by concession to such compensation received by an individual in his trade or employment.*[8]

In practice, it can at times be difficult to distinguish wrongs suffered by individual "in his person" or "his profession" from wrongs suffered "in his finances". Furthermore, the validity of this distinction remains questionable at best. There are very few judgments touching on the meaning and scope of s.52(2) TCGA 1992, and apparently none more from sources more authoritative than the First-Tier Tribunal. The provision was considered (obiter) in *Ghadavi*, where Judge McKeever stated at [71]:

> *The Appellant submitted that the payments fell within Section 51(2) of the TCGA which provides 'It is hereby declared that sums obtained by way of compensation or damages for any wrong or injury suffered by an individual in his person or in his profession or vocation are not chargeable gains.'. <u>This provision applies to damages for personal injury or defamation</u>. It has no application in the present case* (emphasis added).

It was considered again in *Robinson v HMRC* [2019] UKFTT 483 (TC), where Judge Bedenham stated at [56]:

> *<u>I agree with the observations made in Gadhavi v HMRC [2018] UKFTT 600 at [71] that s 51(2) TCGA 1992 applies to damages for personal injury and defamation (although there may also be other causes of action that can be said to arise from 'wrong[s] or injury suffered by an individual in his person or vocation</u>').*

> *In my view, a payment made for settlement of a claim that was brought under a provision relating solely to fair value for shares cannot be said to be damages/compensation for "any wrong or injury suffered by an individual in his person or in his profession or vocation" such as to bring the payment within the exemption provided for in s 51(2) TCGA 1992. This is so regardless of the motives behind the commencement of the claim and/or the motives behind settling the claim* (emphasis added).

In addition to carrying only persuasive authority, neither of these judgments goes further by way of analysis or explanation than to repeat HMRC's view on the scope of s.51(2) as set out in paragraph 12 of ESC D33.

Where does this leave us?

The possibility of the *Attwooll* principle being used to characterise compensation payments as income receipts, together with the uncertainty surrounding the treatment of payments that are clearly capital in nature, have rendered HMRC clearances in respect of such payments arguably more necessary than ever before. The recent consequentials hearing in *Rihan v Ernst and Young Global Ltd* accentuates the difficulties now facing many successful claimants.

The main proceedings in *Rihan* ([2020] EWHC 901 (QB)) involved a negligence claim brought by a former audit partner in an accountancy firm against the parent firms of his former employer. The claimant alleged that his former employer had colluded with an overseas regulator and a client who were pressuring him to conduct an audit unethically. He argued that the employer had breached a duty to take reasonable steps to prevent him suffering financial loss by reason of their failure to conduct the audit ethically and without professional misconduct. The court acknowledged an incremental extension of the employer's duty of care (see [600]-[635]), found that the duty had been breached (see [673]-[760]), and awarded the claimant damages for loss of earnings in excess of USD 10 million (see [778], [888]).

The tax treatment of this damages award came to the fore at the subsequent consequentials hearing ([2020] EWHC 1380 (QB)). The claimant argued that the loss of earnings award could be subject to income tax or to CGT, and if the latter, that HMRC could not be relied upon to accept that s.51(2) TCGA 1992 applied (see [11]-[12]). He therefore argued that the award should be grossed up (by reference to his worst-case tax position) in order to protect him from the risk of under-compensation, should the award prove to be taxable. The defendants, on the other hand, argued that the damages award was plainly capital in nature and exempt from tax under s.51(2) TCGA 1992. Moreover, as the lost earnings would have been subject to tax had the claimant received them, the defendants argued that the award should be reduced under the *Gourley* principle (see [17]-[19]).

Kerr J accepted that the tax treatment of the damages award was unclear. He stated at [22]-[24]:

> *Subject to two qualifications, I prefer the claimant's submissions on this issue for the following reasons. First, the tax position is uncertain…*
>
> *Discussion about the nature of the injury done to the claimant could occupy many pages of skeleton arguments in contested tax proceedings. No clear authority (the claimant's two tax cases are not on all fours) elucidates "any wrong or injury suffered by an individual in his person or in his profession or vocation" in the TCGA section 51(2). It is not clear whether HMRC is right to differentiate damages "suffered … in a professional capacity such as unfair discrimination, libel or slander …" from damages suffered "'in his finances'".*
>
> *There was a further debate between the parties about whether HMRC might grant relief from CGT. It is common ground that the first £500,000 of damages is exempt from CGT but there is*

> *a difference over whether amounts above that sum may be granted relief. For the avoidance of doubt, I regard that issue too as unpredictable, except in relation to the first £500,000.*

In light of the uncertain tax position and the Court of Appeal's approach in *Stoke on Trent City Council*, Kerr J declined to apply the *Gourley* principle to reduce the damages award. He stated:

> *"The interest of the successful receiving party in avoiding under-compensation prevails over that of the unsuccessful paying party in avoiding over-compensation, provided suitable undertakings are given to prevent any over-compensation once the tax position is known."*

He then ordered the claimant to seek a ruling from HMRC concerning the tax treatment of the award, and the defendant to pay the grossed-up sum sought, with the tax element to remain in court until the tax position was clarified.

Kerr J's approach had the advantage of ensuring that the successful claimant could move on with his life without concern for the tax position as ultimately determined by HMRC and without the additional burden of having to seek further sums from the defendant should the award turn out to be taxable. An alternative approach, of course (and perhaps one better suited to a settlement scenario), would be to seek a ruling from HMRC and to require the defendant to gross up the claimant in respect of any tax ultimately found to be payable on the compensation sum.

The most significant result of the *Rihan* litigation from a tax perspective, however, is the High Court's affirmation (i) that the tax treatment of such a compensation award is uncertain; (ii) that the scope of s.51(2) TCGA 1992 is unclear, with the correctness of HMRC's interpretation (as set out in CG13030 and in paragraph 12 of ESC D33) remaining untested; and (iii) that the concessionary treatment of capital compensation in excess of £500,000 is unpredictable. This ruling accentuates the importance of seeking clearance from

HMRC as to the proper tax treatment of compensation payments, and also of taking steps to protect the claimant's interests in the meantime.

A recognition of the limitations of the *Gourley* principle, together with an awareness of HMRC's increasing appetite for characterising certain compensation payments as income and of their published views on the limited scope of the exemption in s.51(2) TCGA 1992, should help practitioners to take appropriate steps to protect clients against the risk of unpleasant tax surprises in the aftermath of receiving a compensation sum.

Endnotes

1. See *British Transport Commission v Gourley* [1955] A.C. 185 at 197 per Earl Jowett:

   The trial judge awarded the respondent the sum of £37,720 in respect of loss of earnings actual and prospective, and in arriving at this sum paid no regard to the fact that had the respondent been able by his activities in his profession as a civil engineer to achieve the earnings represented by the sum of £37,729 he would have had to pay a large amount in respect of income tax and surtax on the amount of such earnings. The trial judge, at the request of the appellants, made an alternative assessment of £6,695, which represented the sum he would have awarded if he ought to have taken into account in assessing damages the tax which the respondence would have had to pay if he had in fact earned by his professional activities the sums lost. It was agreed by counsel on both side – and I think rightly agreed – that the respondent would incur no tax liability in respect of the award of £37,720, or alternatively of £6,695.

2. See, for example, FT Adviser (10 January 2018): https://www.ftadviser.com/your-industry/2018/01/10/q-a-when-does-tax-apply-to-compensation/

   "*It is generally accepted practice that compensation for loss of earnings should be claimed in respect of the net loss after tax. The employee should be put back into the same financial position that they would have been in, had they worked – that* *is, the loss of net pay. The compensation payment will then be treated by HM Revenue & Customs as exempt in the hands of the recipient. This is known as the Gourley principle…*"

3. See Gourley at 203 per Earl Jowett:

"*I see no reason why in this case we should depart from the dominant rule or why the respondent should not have his damages assessed upon the basis of what he has really lost, and I consider that in determining what he has really lost the judge ought to have considered the tax liability of the respondent.*"

(See also 207 per Lord Goddard on the injustice of over-compensation by *not* taking tax into account when assessing damages).

4. See HMRC's Employment Income Manual at EIM13070, which considers the example of a damages award against an employer who failed to give proper notice of termination to an employee. It is calculated that the employee would have received gross pay of £2000 during the notice period had proper notice been given, but it is recognized that a damages award of £2000 would place the employee in a better position than if the contract had been performed. The damages award is therefore adjusted down to £1500 under the Gourley Principle. EIM13070 then states:

"*It is important to recognise that the £500 adjustment to the sum of damages is not a deduction of tax and must not be dealt with as such. The actual payment made to the employee (£1,500 above) must be considered under the normal taxation rules for that termination payment… What is actually paid is taxed, under the appropriate tax law. If the parties make mistakes in this process that leave a party out of pocket, that is a matter for the parties to remedy between themselves*" (emphasis added).

See also EIM13995, which states:

"*The Gourley principle is to do with the calculation of damages under non-tax law and is not a matter than HMRC can become involved with.*"

See also *MacGregor on Damages* (20th edition) at 18-010:

"*The bare proposition, sometimes stated, that damages are not subject to tax on income is entirely false… Whether damages are taxable turns upon the nature of the loss for which they are awarded and upon the complexities of the Income Tax Acts, the annual Finance Acts, and any other relevant taxing legislation.*"

5. As was recognised by Judge Kemptser in *Pettigrew v HMRC* [2018] UKFTT

240 (TC) at [78]: *"[T]he principle expressed by the Court of Appeal [in Attwooll] is not limited to taxation of trading profits.*"

6. See *Donald Fisher (Ealing) Ltd. v. Spencer* [1989] S.T.C. 256 (CA); see also *Deeny v Gooda Walker* [1996] 1 W.L.R. 426 (HL) at 436 per Lord Hoffmann.
7. See *Zim Properties Ltd v Proctor* [1985] STC 90 (Ch).
8. See also HMRC's Capital Gains Manual at CG13030, which sets out the same position.

REDOMICILIATION AND THE SEMIFREDDO RABBIT

By Nikhil V. Mehta

Introduction

When I was a junior tax solicitor in my first year of practice many years ago, I made the mistake of walking into a tax partner's room. Well, the real mistake was walking into an empty room and fielding the ringing phone. At the other end of the line was a very senior finance partner from one of the firm's overseas offices. When I told him his intended call recipient was absent, I thought he would just ask me to leave a message for a return call. But instead, I heard the following words:

"Can a dual resident company do a bond issue?"

The rabbit in me froze in the aural headlights (thank goodness there was no Zoom in those days). I really did not know the answer. But rather than try and bluster my way around the question, I put up my hands and pleaded ignorance. When I got round to reporting the question to the tax partner, he simply shrugged as if the answer was a piece of cake and we called the finance partner together. Well, I listened to the answer and learnt. I now know that the literal answer to the question is "Yes, if it really wants to". But the tax literate answer (at least then) was: "Yes, but whether it gets a double dip of tax deductions in both its jurisdictions of residence for the financing costs of the bond issue requires careful investigation". This was in the days before anti-arbitrage rules and so forth. Indeed, it was in the days before the UK had a statutory test of corporate residence in the form of incorporation. The answer is a lot simpler today, if not exactly taxpayer-friendly.

Many years on, in 2020, I have had a touch of the returning rabbit when I was asked, on more than one occasion in the year:

" Can a company redomicile from one country to another?" Implicit in the question, but somewhat hidden, is the follow-on question of what are the tax implications, if any, of redomiciliation. Well, by now the rabbit was not so much like a frozen ice cream as a semifreddo dessert with years of practising tax law and lore behind him. But the question startled him and continues to startle for this simple reason: redomiciliation comes in different shapes and sizes and it all depends on what you mean by the word. The "It all depends" sounds like a cop-out to give my rabbit time to cross the road. It could be, but actually it isn't.

The question also appears to have taken on greater significance with BREXIT and the implications for UK groups with interests in different EU markets. But it is also of interest outside those parameters. For example, companies incorporated in low tax jurisdictions have to think about external pressures like OECD-driven rules requiring companies in such jurisdictions to have economic substance: if a company is in the "wrong" jurisdiction, then redomiciliation to a better jurisdiction makes good fiscal and commercial sense.

In this article, I discuss the ways in which an English company can redomicile, as well as some of the issues arising when a company in a low tax jurisdiction moves to another.

Can an English Company Redomicile by Changing its Citizenship?

The most recent variant of the question posed above came to me from a tax lawyer practising in an EU jurisdiction, let us say Eutopia. He started talking about how it was possible for a company to change its passport and he naturally assumed there was nothing objectionable about our mutual client, an English holding company of an international group, switching its corporate citizenship to Eutopia. The proposal is not BREXIT driven as such, but the coincidence of the finality of BREXIT gives it added purpose and flavour. But we are not into fancy measures like setting up a Societas Europaea: this is a young and highly successful privately-owned international financial services group looking simply to relocate its holding company away from the UK and to remain private: the ultimate shareholders are from Eutopia and most of the active businesses are carried on in different countries outside the UK.

So, what my Eutopian tax colleague meant by redomicilation is a company being able to change its country of incorporation and to remain in existence as the same legal entity. It is almost like an individual changing from a domicile of origin to a domicile of choice. But there is more to it than that: it involves changing the domicile of origin itself, which of course an individual cannot do. If one equates incorporation with origin for an individual, the change of corporate citizenship involves the outgoing country agreeing that a company ceases to be incorporated there from a particular date and the incoming country agreeing that the company is treated as incorporated there from that date onwards. I look at this route in a little more detail towards the end of this article, when I look at redomiciliations between low tax jurisdictions. Let's call this redomicilation route the "change of corporate passport" or "CoCP" route.

The key to the CoCP route is that the legal personality of the company is recognised by both outgoing and incoming countries as remaining intact i.e. it is the same company before and after the change.

This route is possible in a number of jurisdictions, not just low-tax jurisdictions. But it is not possible under English company law, both in terms of outward movement from, and inward movement to, the UK. Once a company is incorporated, it stays incorporated in the same place until it is liquidated.

It cannot change its place of incorporation. My Eutopian tax colleague was incredulous when I gave him this news, as it is apparently quite straightforward for a company to get a new passport in Eutopia. In fact, he double-checked my response with an English company law solicitor also working on the transaction, who endorsed my advice. I did not take this second opinion exercise too personally-after all, it was not a tax issue as such, and what does a tax lawyer know about company law? I might have been more concerned if he had double-checked with the corporate lawyer our corporate tax residence rules after asking me first.

So, one thing is clear: an English incorporated company cannot redomicile by changing its corporate passport. So how can it redomicile, if at all?

Redomiciliation by Corporate Inversion

Towards the end of the noughties, a number of public corporate movements occurred involving companies supposedly leaving the UK. Some were quite high profile, and were influenced to a large part by tax considerations where a group had built up substantial overseas operations. The trend involved relocations to countries like Ireland, Switzerland or Bermuda with a view to simplification of tax compliance matters as well as substantive reductions in tax on non-UK profits. Some of the thinking had to do with the then Labour Government's aggressive approach to taxation of offshore royalties, and more generally, the regime, as it was then, for controlled foreign companies.

So, what did this form of redomiciliation involve? The first company to "go", in 2008, was Shire plc, which was the UK holding company of an international biopharmaceutical group. Over the years, the business of the group had shifted from UK-centric activities to offshore operations to such a degree that the vast majority of profits were generated overseas. In its press release on the move, the company said that its business and shareholders "would be better served by having an international holding company with a group structure that is designed to protect the group's taxation position, and better facilitate the group's financial management."

To achieve the objective of an international (in tax language, non-resident!) holding company, the group set up a new company which was incorporated in Jersey but tax resident in Ireland. The corporate mechanics involved an English statutory scheme of arrangement. Under the scheme, the shares in the existing English holding company (OldCo) were cancelled, and the cancellation reserve applied in issuing new ordinary shares to the new offshore holding company, NewCo. NewCo in turn issued its ordinary shares to the former shareholders of OldCo. Putting a new holding company on top of another is known as a corporate inversion.

The next stage involves a reorganisation of group subsidiaries held by OldCo so as to put offshore controlled foreign companies directly under NewCo's ownership. Provided NewCo is run as a true non-resident company, this eliminates the application of the CFC rules to the group so as to maximise post-tax foreign profits. While CFC exposure is less of an issue since the revamp of the CFC legislation in 2012, there are still good tax reasons, including the increasing burden of tax compliance for multi-national groups, to reorganise group structures where the top company redomiciles as above. Of course, any reorganisation itself should be done in a tax-efficient manner. The substantial shareholdings exemption is a valuable tool to facilitate this.

The main tax reason for a Jersey incorporated company is to mitigate stamp duty, which would otherwise apply on shares in an Irish company. Of course, it needs to be non-UK incorporated anyway to avoid being UK resident under the place of incorporation test of residence.

Ireland was chosen as a place for non-residence partly because of its physical proximity to the UK so as to facilitate the running of the company as a non-UK resident (and Irish resident) even if some UK resident individuals remained as directors. Also, its attractive tax regime for holding companies was a big factor in selection. Other groups which relocated to Ireland included WPP (advertising), United Business Media (media) and Henderson (asset management). Famously, once the UK had introduced a more liberal CFC regime, WPP returned to the UK after a 4-year Irish sojourn. Chancellor George Osborne had publicly suggested that they should come back, and they responded positively. The mode of return, incidentally, involved another corporate inversion where a UK resident holding company was put on top of the group.

So, this form of redomiciliation involves swapping one top holding company for another. There is no question of the same legal entity continuing as the head of the group. It may continue to exist, but only as a subsidiary of the new offshore holding company, and holding only UK resident subsidiaries. An important point about this route is that it is tax neutral. No UK tax charges arise in relation to the scheme of arrangement itself, either for the holding companies or for the shareholders: UK resident shareholders will get rollover relief for giving up shares in OldCo and getting shares in NewCo under Section 136 of the Taxation of Chargeable Gains Act 1992. No stamp duty or stamp duty reserve tax charges arise on the cancellation scheme as no transfers are involved.

One might ask why a straightforward cross-border takeover of one group by another does not amount to a redomiciliation. If one takes the example of a bidder group in Country X acquiring shares in the target group's holding company in Country Y for cash and/or shares, what is the difference between that and the holding company swap discussed above? Well, there is a fundamental difference: the holding company swap is an internal transaction to a single group and its shareholders:

all the shareholders in the first holding company will become the only shareholders in the new holding company. In the takeover context, the shareholders may not even get shares in the bidder, for example, in a cash bid. And if shares are issued as consideration, the shareholders would join the existing shareholders in the bidder group i.e. there would not be parity of identity of shareholders before and after the takeover.

On the other hand, in the privately held context, a corporate inversion could be achieved without a scheme of arrangement: there would simply be a share-for-share exchange whereby the new company acquired shares in the existing company in exchange for issuing its own shares to the shareholder(s). In transactions involving public companies, the scheme route is preferred to get 100% shareholder approval.

The corporate inversion route was, however, of not much use to the privately held group which my Eutopian tax colleague and I were advising. Our clients still wanted the holding company to continue as the same legal entity for their own commercial reasons. So, is anything left in the UK which could get us there? The answer is found in our tax code, and involves a tax migration.

Redomiciliation by Tax Migration

It is possible for a UK resident company to cease being resident here and to take up residence elsewhere. But this is not without tax consequences. If a company ceases to be UK tax resident, various tax charges can arise by way of "exit" charges. For a UK incorporated company, it is quite difficult to cease to be tax resident because, as I said earlier, it will always be incorporated in the UK. That makes it tax resident under our domestic test of incorporation. If its central management and control moves abroad, it would technically become dual resident (my rabbit remembers dual residence well!)

But in our set of facts, if the holding company moves its management and control to Eutopia, I understand that it will be tax resident there under the local tax law. Eutopia has a double tax treaty with the UK. The fact of dual residence triggers the residence "tiebreaker" test under the treaty. The relevant tiebreaker test involves finding the place of effective management. This test of effective management will lead to Eutopia and not the UK, as essentially, there will be no management in the UK, let alone effective management. Section 18 of the Corporation Tax Act 2009 then comes into play. That imports the treaty tiebreaker into our domestic law so that, for all corporation tax purposes, the company will be regarded as resident outside the UK and non-UK resident. That in turn means it has ceased to be UK tax resident, so the exit charges become relevant.

For the purposes of the exit charges, the company is treated as disposing of specified assets and reacquiring them at market value. Any profit or gain arising on the deemed disposal is taxable. The most relevant assets for a holding company are capital assets, loan relationships, derivative contracts, and intangibles.

So, unlike the corporate inversion route, there could be a significant tax cost of migration. However, this can be significantly reduced in relation to a holding company's principal assets, which are usually the shares in its subsidiaries. The deemed disposal of these shares on exit may qualify for the "substantial shareholdings exemption" and if it does, then no tax would be payable in relation to gains arising on these assets. Where the SSE is relevant, it is critical to carry out a detailed study of the group to ensure it applies.

Apart from tax in relation to exit charges, the company also has to settle any "normal" tax liabilities like income tax (PAYE) as part of the migration arrangements with HMRC.

But because of the SSE, it is quite feasible for a holding company to redomicile by migration without incurring substantial exit charges.

If exit tax charges are payable, then the tax administration allows for arrangements to be entered into for settlement including an instalment plan, if required. This has been amended to deal with BREXIT and companies migrating to somewhere in the EU.

So, corporate tax migration is the only form of redomiciliation available to an English company if the idea is for it to remain in existence after the redomiciliation. Company lawyers may not recognise this as a true redomiciliation, particularly as the company will continue to have obligations under the Companies Acts by virtue of remaining incorporated here.

Redomiciliation by CoCP

Having established that the CoCP route is not available to an English company, I would like to look at some of the issues that arise where offshore companies use this route. For this route to get off the ground, both the outgoing and the incoming countries must recognise its validity. A number of Caribbean countries permit this route. These include common law countries where the company law is to a large extent based on English law. But where redomiciliation is concerned, the laws diverge. The British Virgin Islands, Bermuda and the Cayman Islands permit both inward and outward redomiciliation with countries where there is reciprocity.

Once there is reciprocity between two countries the procedure is pretty straightforward. Typically, in the outgoing country, the following steps would be required:

- The passing of appropriate board resolutions approving the redomiciliation proposal;
- Compliance with the redomiciliation process under local law and satisfying the requirements as to good standing;
- External counsel's legal opinion;
- The making of the required filings resulting in

certificates of continuance as a legal entity and discontinuance as to place of incorporation.

In the incoming country, the steps would include:

- Approval of the beneficial owners of the company;
- Evidence that all required authorisations and approvals have been obtained in the outgoing jurisdiction (this may require an external counsel's opinion);
- Filings with the relevant authority including as to continuance as a company in the new country;
- Evidence of solvency (usually in the form of financial statements);
- Adoption of local bye-laws.

Depending on the countries involved, I understand the process can be carried out within two to three months.

The effect of redomiciliation is that both countries treat the company as no longer incorporated in the outgoing country, and newly incorporated in the incoming country. All the assets and liabilities remain intact and continue to belong to the same entity. But unlike tax migration, the company will no longer have to comply with the company law of the outgoing country. It is interesting to note that if both countries used the test of incorporation as a test of tax residence, this type of redomiciliation would result in a change of tax residence by virtue of the change in incorporation, which seems somewhat remarkable to a UK tax lawyer. If the company has an ultimate UK resident parent company, that provides some interesting results under our controlled foreign companies legislation, particularly if the change means the company undergoing a difference in CFC status from one country to another. Even without incorporation being an actual test of tax residence e.g. because a relevant country is a nil-tax jurisdiction, the rules for determining residence of CFCs in Part 9A Chapter 20 TIOPA 2010 could still have the effect of importing or exporting a company into or out of CFC status; the place of incorporation is part of the tiebreaker rules in Section 371TA for determining residence.

The fact that both countries recognise the new status of the company, does not bind a third country. The important question is whether the change results in a disposal of any assets by the company, coupled with a reacquisition, like our corporate tax migration rules. Where there are UK resident shareholders and the company is a close company, that would require consideration of the attribution rules in Section 3 of the Taxation of Chargeable Gains Act 1992. Similarly, the question arises whether a UK resident shareholder makes a disposal of shares in the company and acquires new shares of the company now incorporated in a different country.

The key to the answers to these questions is that nothing has affected the legal status of the company. Its continued existence means that nobody disposes of anything. The offshore treatment should be respected for UK tax purposes. Of course, the documentation needs careful inspection to ensure the tax neutrality of the redomiciliation, and a local legal opinion as to the effect of redomiciliation in both countries is essential. Things might be very different if, for example, the outgoing and incoming countries had non-tax laws which deemed the company to dispose of its assets at market value and reacquire them in the new country also at market value. But I do not know of any jurisdictions which do this and, frankly, it is hard to think why they should, particularly if there are no local taxes.

An interesting issue arises in relation to India, with perhaps even more far-reaching consequences. The Indian tax charge on capital gains extends to transfers of shares in foreign companies where a substantial part of the foreign company's assets consists of shares with an Indian *situs*. Offshore structures for foreign investors investing into India frequently involve the use of sub-holding companies in zero tax jurisdictions, which hold the Indian investments. If such a company were to redomicile, the question arises whether that involves a "transfer" of shares in that company for Indian CGT, or even whether the company itself is treated as disposing of Indian assets. A "transfer" is the Indian equivalent of "disposal" but has a statutory definition.

The definition includes the following:

(i) the sale, exchange or relinquishment of the asset ; or

(ii) the extinguishment of any rights therein.

Again, it is difficult to see how the redomiciliation process falls within any of these on the basis that the shareholder continues to have the same shares in the same company, and the company itself continues to own the same assets. There are other technical reasons in the Indian tax code why the charge may not apply anyway, but the starting point is to identify whether there is a transfer in the first place, and the answer is no.

But the Indian situation is a good example of how redomiciliation can have wider third country implications where the company concerned is part of an international group.

Concluding Remarks

Change of tax residence is an important factor in both inversions and tax migrations: in the former, the new holding company needs to be resident in the right jurisdiction, and in the latter, the existing company needs to shift its residence successfully without becoming dual resident. It could be equally important in a redomiciliation by CoCP between countries which have corporate taxes as opposed to those which have none. It is easier to start off as a new company with residence in a particular place than for a company with an established status of residence in one jurisdiction to change to another. The issues involved in changing tax residence should not be underestimated, and a clear timetable should be drawn up to achieve the change of non-residence. Where the test is effective management under a treaty, in many cases that will equate with central management and control through the board of directors. The composition of the board will need to change in order to ensure decisions are taken in the new jurisdiction. But it would be quite normal for some directors to be resident in the outgoing country if they are already serving as directors and the intention is that they should continue to do so. Clearly, they should be in a minority and not have any dominant influence over new offshore directors. It would also be sensible for management and control to be located in a single location, so as to make the new place of residence clearly identifiable.

The reasons for redomiciliation continue to evolve, and are not simply tax driven, although tax can play a significant part. Even in cases where tax is not a main motivation, it is clearly important to ensure that the structuring is tax efficient. Equally importantly, the new structure should operate sensibly from the tax viewpoint; not only should there be good practice regarding governance at the outset, but it should be followed consistently on an ongoing basis.

So, my rabbit has now moved from a semifreddo temperature to something resembling a warm apple crumble, when it comes to redomiciliation questions. But please do not encourage his American cousin, Harvey, to ask him how the UK views forward and reverse triangular mergers and the magic of the disappearing company in those transactions. Thereby hangs another tail…

A FEW POINTS OF INTEREST

By Laurent Sykes QC

Zero rate preference shares

The Upper Tribunal case of *Revenue and Customs Commissioners v McQuillan* [2017] UKUT 344 (TCC) establishes that shares carrying no rights to profits are ordinary shares for the purposes of s1119 CTA 2010 / s989 ITA 2007 – as opposed to capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the company's profits. Mr and Mrs McQuillan's appeal succeeded before the First-tier Tribunal but the decision was reversed by the Upper Tribunal which held that no rights to dividends is not equivalent to the right to a dividend at a fixed rate of 0%. The shares in question were the Upper Tribunal considered therefore "ordinary shares" within s989 Income Tax Act 2007.

Mr and Mrs McQuillan were not represented by counsel before the Upper Tribunal, and consequently, the Upper Tribunal did not have the benefit of full legal submissions. The issue in the case was whether shares for UK company law purposes which do not carry any right to profits (whether capital or income) but simply to repayment of the amount subscribed are "ordinary share capital" within the definition which provides that:

> " 'ordinary share capital', in relation to a company, means all the company's issued share capital (however described), other than capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the company's profits".

The author considers the Upper Tribunal decision to be unsatisfactory and one which is liable to be challenged in future cases. It is perfectly plausible to argue that such shares are not “issued share capital” within the intendment of the legislation *even if* the Upper Tribunal was right that no right to a dividend is not equivalent to the right to a dividend at a fixed rate of 0%.

In *South Shore Mutual Insurance Co Ltd v Blair* [1999] STC (SCD) 296, a case not cited to the Upper Tribunal, the Special Commissioner (Dr Nuala Brice) stated (with regards to defining the concept of a share for the purposes of the predecessor to s989):

> “56. In the light of these authorities it appears that the phrase ‘issued share capital’, while perhaps not a term of art in English law, does embody an idea which Parliament has used in other statute law where the phrase is used to mean that part of a company’s authorised share capital as has been issued. Thus, following the principle in *R v Barnet London BC, ex p Shah* [1983] 2 AC 309, that meaning should be adopted unless it can be shown that the statutory framework, or the legal context in which the words are used, require a different meaning.”

The statutory framework was taken into account by the Privy Council in *Collector of Stamp Assets v Arrowtown Assets Limited* 6 ITLR 454, where Lord Millett NPJ held the following:

> “[157] Section 45 is not an end in itself. The words ‘issued share capital’ in the section, properly construed, mean share capital issued for a commercial purpose and not merely to enable the taxpayer to claim that the requirements of the section have been complied with. It follows that the ‘B’ non-voting shares issued to Shiu Wing are not ‘share capital’ within the meaning of the section, and should be disregarded when calculating the proportions of the nominal share capital owned by Shiu Wing and Calm Seas respectively.”

Statutory context is relevant when in considering whether an instrument is a share for the purposes of the relevant legislation, still more so given the law in question can apply to a number of different entities formed under the legal systems of a number of different jurisdictions. The words “however described” in the definition cited above indicate that a more searching enquiry is needed than merely considering the legal form.

Construing “issued share capital” as requiring that the instruments in question have a right to profit, is suggested by the wording of the s1119/s989 definition as read in the statutory context. As can be seen from the definition, the carve out “other than capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the company’s profits” implies one of two things: either that shares which constitute “issued share capital” must carry a right to profit of some description so that the carve out in s989 (beginning “other than”) does not need to apply to shares which carry no rights to profits, or that shares which have no rights to profit are “ordinary share capital” and the carve out is specifically aimed (for an uncertain legislative purpose) at shares which carry a right to dividends at a fixed rate (but not to shares which carry no rights to profits). In deciding which of these constructions is correct, regard must be had to the purpose of the legislation.

The definitional term “ordinary share capital” denotes a right to participate in profit. Although the term is a defined term, that sheds light on the meaning of the words which it defines (see *Dextra v McDonald (Inspector of Taxes) v Dextra Accessories Ltd* [2005] UKHL 47 per Lord Hoffmann at [18]). A share which carries no rights to profits is as far from being an ordinary share as it is possible to get and the stark contrast between the defined term and the definition itself, on one of the two possible constructions, is relevant in construing the definition.

The Special Commissioner’s decision in *South Shore Mutual* supports this construction. She said:

> "[59.] With those principles in mind it is now possible to return to the words 'issued share capital (by whatever name called)' which appear in s 832(1). The phrase is open to two possible interpretations. The first, and narrower, interpretation is that the phrase means such authorised share capital of a company as has been issued, whether or not it is called ordinary share capital, so long as it gives a right to a share in the profits. This interpretation follows from giving the 'normal' meaning to 'issued share capital' but ensuring that it is not limited to issued share capital with any particular name. So, for example, it could include issued preference share capital. The second, and wider, interpretation, is that for which Mr Peacock argues and is that the phrase includes anything that can be identified as being 'issued' and 'share' and 'capital'. This interpretation follows from allowing the phrase 'by whatever name called' to govern the meaning of 'issued share capital'." (underlining added)

Having regard to the wider statutory context, it appears fairly clear that the purpose of s989 is to exclude, from the definition of ordinary share capital, shares which have no right to a share in profits other than a right to dividends at a fixed rate, rather than to include within the definition all shares (even those with no right to a share in profits) but then to exclude shares which have a right to dividends at a fixed rate. Shares with no rights to profits are more akin to shares with only a right to a dividend at a fixed rate. The definition of ordinary share capital is used to delineate owners of the equity of a company for the purposes of a number of different rules (including entrepreneur's relief, group relief, capital gains grouping etc). All of these are concerned with economic ownership. That purpose would be manifestly flouted if one could increase a right to ordinary share capital by subscribing for shares with no right to profits at all. It is no answer to this to say that there are, in some of these provisions, other requirements which must be satisfied (a point relied on in *McQuillan*). The issue is this specific requirement and why Parliament could have intended it to be met by rights such as the ones discussed.

It can be argued that shares with no rights to profit are not "issued share capital" for these purposes. Alternatively the words "other than capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the company's profits" in context should be construed as meaning "other than capital the holders of which have no right to share in the company's profits beyond a right to a dividend at a fixed rate". In other words, shares which do not carry a right to profits are within the carve out even if they do constitute "issued share capital". Support for this is to be found in the *South Shore Mutual* case and it fits the statutory context for the reasons set out above. If those two interpretations are wrong, then it is considered that the analysis adopted by the First-tier Tribunal in *McQuillan* with respect to the shares carrying a right to dividends at a fixed rate of zero is correct.

The Upper Tribunal considered that there was no ambiguity in s989 ITA 2007. However, the question of ambiguity is not a matter which is settled by looking at the words of legislation in isolation. Ambiguity can arise where the clear meaning of words enters into conflict with their surrounding context (see for instance *Bryan Francis O'Rourke (H.M. Inspector of Taxes) v Edward Binks* [1992] STC 703 at 707-708). The view of that Upper Tribunal at [35] that "there is in our view no possible recourse in this case to the spirit of the legislation" puts the position too strongly, and it is a shame that the position was not tested more fully.

Attributing loss to a failure to notify

Unless a notice is received under s8 TMA 1970, every taxpayer is under an obligation to notify HMRC within 6 months of the end of the tax year if they are chargeable to income or capital gains tax (s7 TMA). The same is true of companies (para 46(2A)(b) Schedule 18 FA 1998). HMRC's power to raise an assessment where a loss of tax is "attributable" to a failure to notify is wide. Such an assessment can be raised up to 20 years from the end of the tax year to which the assessment relates[1].

Suppose that the taxpayer did not take advice on a particular matter arising in year X and has no defence to an assessment under s36 (or, in the case of companies, para 46) as a result of the taxpayer's failure to notify but that, on another matter arising in the same tax year, the taxpayer did take and relied upon advice to the effect that no liability arose with respect to that other matter. Can HMRC assess the tax in respect of this other beyond the usual four – year time limit in the way they can assess tax arising from the first-mentioned matter? The better answer is that it cannot be said that the tax arising in relation to the second matter is attributable to the failure to notify.

As a matter of ordinary language, a loss will only be so attributable if it has been *caused* by the failure to notify (see *James Fuller v HMRC* [2020] UKFTT 189 (TC), in particular, at [50]; see also *Glasgow Coal Co v Sneddon* (1905) 7 F 485 per Lord McLaren at 487 for a similar interpretation of the word 'attributable' in a different context). As a matter of general law, the question of causation requires the positing of a hypothetical scenario. In these circumstances, the scenario is one in which the taxpayer *has* notified HMRC of their chargeability. Working through that scenario, the next question is what the hypothetical taxpayer would have reported in their tax return. The hypothetical taxpayer must be deemed to be reasonable (see, for example, *McWilliams v Sir William Arrol* [1962] 1 WLR 295 per Lord Reid and 306) but not omniscient in tax matters. It is very likely that they would have relied on professional advice received (see *Fuller* for confirmation of the relevance of 'likelihoods'). Indeed, there is a presumption that such advice will be causative (*Levicom International Holdings BV v Linklaters* [2010] EWCA Civ 494 per Jacob LJ at [284]).

It may on the facts be that the loss of tax would have arisen whether or not there had been a failure to notify. In other words, the loss of tax is not "attributable" to the failure to notify. The presence of a loss of tax and a failure to notify are not, *per se,* sufficient. Where the relevant conditions are satisfied so as to permit the assessment of tax in relation to one matter, that does not mean all matters are open to extended time limits.

Document retention obligations

The case of *McMillan v HMRC* [2020] UKFTT 82 (TC) is a useful reminder of the primary burden of proof that rests on HMRC. A discovery assessment, as the words suggest, requires HMRC to have "discovered" a loss of tax (s29 TMA 1970; for companies para 41 Schedule 18 FA 1998). It is not sufficient that the taxpayer's evidence as to the source of funds is doubted; the obligation is on HMRC to show that there is a loss of tax. Inherent within that is an obligation to show that the taxpayer has derived funds from a taxable source on which tax should have been paid.

In *McMillan*, the taxpayer had been a very successful gambler between 1998 and 2010. To avoid attention, for reasons unconnected to tax, the money had been paid in cash into a number of bank accounts over several years in small amounts. HMRC were suspicious and raised assessments.

Records of the gambling had not been kept beyond the period required by s12B TMA (until the first anniversary of 31 January following the year of assessment). That document retention obligation is recorded in HMRC's Self-Assessment Guidance (at CH14550). HMRC's reliance on *Brimelow v Price*

(1965) 49 TC 1, to rely on the absence of records as meaningful was accordingly rejected. The burden required of HMRC was not discharged and the absence of records was of no automatic assistance to them. HMRC could not point to an alternative to the taxpayer's explanation as regards the source of the funds, which was accepted.

The case is also interesting in that the review officer's conclusions (that the assessments should be vacated) had been changed following the intervention of the inspector. This was discovered because the wrong review letter was included by HMRC in their list of documents. This casts doubt on the independence of the review process.

The availability of Treaty benefits for remittance basis users

The Italian Supreme Court has recently concluded (in the case of *Tiziano Ferro* (judgment No. 21696 of 8 October 2020)) that a remittance basis user was not UK Treaty resident. The decision in that case was strictly not decisive as the court had already concluded that the change in residence from Italy to the UK was purely fictitious. However, the comments are concerning for those claiming the remittance basis in the UK and claiming treaty benefits in the state of source.

Most fundamentally, the Italian Supreme Court appears to have confused being "liable to tax" and being "subject to tax". In the domestic context, the distinction is reflected in *Weiser* [2012] UKFTT 501 (TC), in line with case law of other jurisdictions. The Supreme Court's reliance on the fact that no UK tax was ultimately paid on foreign source income as the income had not been remitted was misplaced.

A remittance basis user who *does*, in contrast to the taxpayer in *Tiziano Ferro*, remit funds would be "liable for tax" following the logic of the Italian Supreme Court. Funds, once remitted, do not automatically develop a UK source. So, a remittance basis user who remits, say, £100 to the UK would be a "resident" of the UK for treaty purposes. However there is no such concept as partial residence. It would be bizarre if a remittance so small could have such a significant effect. The correct position is that a remittance basis user is liable for tax on foreign source income even if no tax is paid.

Whilst treaties need to be interpreted in light of their purpose (the elimination of double taxation and abusive double non-taxation), there is nothing abusive in opting to be taxed under a beneficial tax regime; particularly where that regime existed and was known about prior to the treaty being signed (see, for example, *MIL (Investments) SA v Canada* 9 ITLR 25 at [73]). Further, there is a real risk of double taxation on the approach adopted by the Italian Supreme Court as the UK will only give a credit for foreign tax paid in accordance with the Treaty.

The relevant part of the decision in *Tiziano Ferro* is short but concerning. It is hoped that the error can be corrected in due course. It is of note that the Italian authorities believe that an Italian resident paying the Italian flat tax for non-Italian income would be a resident of Italy for treaty purposes. There appears to be an inconsistency of approach.

Endnotes

1. Subject to the application of s118 TMA 1970.

DOMICILE AND TAX: A POCKET REMINDER

By Harry Winter

Introduction

This article aims to provide a brief crib to domicile, deemed domicile, and domicile under inheritance tax ("IHT") double tax treaties.

Common Law Domicile

There are three types of Common Law Domicile: a domicile of origin, a domicile of choice, and a domicile of dependency. An individual may only have one at a time. The place of domicile is a legal jurisdiction not a country; hence, in a federal state, one has a jurisdiction in New Jersey rather than the USA (*Re Fuld's Estate* (No 3) [1968] P 675). Companies are domiciled where they are registered and no more is said here about companies (*Gasque v IRC* (1940) 23 TC 210).

A domicile of origin is the default domicile: if domicile of choice or dependency cease, domicile of origin reasserts itself (*Henwood v Barlow Clowes International Ltd* [2008] EWCA Civ 577). A legitimate child born during his father's life has his domicile of origin where his father was domiciled at the date of that child's birth; If illegitimate, the same applies but using the mother (*Udny v Udny* (1869) L.R. 1 Sc. & Div. 441). A foundling has his domicile of origin where he is found (*Re McKenzie* (1951) 51 S.R.N.S.W. 293). Tom Jones can relax!

Domicile of choice is acquired by both residence and intention. Residence here means physical presence as an inhabitant, i.e. more than being a mere traveller (*IRC v Duchess of Portland* [1982] Ch 314). Illegality of physical presence is no bar (*Mark v Mark* [2005] UKHL 42). Intention here means the intention to reside permanently or for an unlimited time (*Udny v Udny*);

residence without any intention of leaving it, i.e. indefinite residence, is enough (*Bell v Bell* [1922] 2 I.R. 152). If the intention is to leave should a contingency occur, the more likely the contingency the less likely there is to be the required intention (Dicey 6-040).

Domicile of choice is lost when both the residence and intention required for its acquisition are abandoned (*Udny v Udny*). When this occurs, either another domicile of choice is acquired, or the domicile of origin revives.

Domicile of dependency is generally the same as, and changes with, the domicile of person on whom the dependency falls. Since the Domicile and Matrimonial Proceedings Act 1973, dependent persons are unmarried children under sixteen and those with mental disorders. Unmarried children are generally dependent on their father, except (broadly) where the child is illegitimate or the child lives with his mother and not his father: see section 4 of the aforementioned Act. Prior to that Act, married women were viewed as dependent on their husbands.

Deemed Domicile

There are different deemed domicile regimes for IHT on the one hand and Income Tax ("IT")/Capital Gains Tax ("CGT") on the other. These override the Common Law position.

For IT and CGT, deemed domicile is governed by s.835BA ITA 2007. An individual is deemed domiciled in the UK in two sets of circumstances. First, he was born in the UK with a domicile of origin in the UK, and is UK tax-resident for the relevant tax year. Second, he has been UK tax-resident for at least 15 of the last 20 tax years. There is a carve-out from this latter scenario where he is not tax-resident for the relevant tax year and he has not been UK-resident in any tax year after 2016-17.

For IHT, there are four circumstances in which an individual be deemed domiciled in the UK. Three are governed by s.267(1) IHTA 1984. First, he has been domiciled in the UK within the last three years. These are calendar years (HMRC Manual IHTM13024). Second, he was born in the UK with a domicile of origin in the UK, is UK tax-resident in the relevant tax year, and was tax-resident in the UK for at least one of the two tax years immediately proceeding the relevant tax year. Third, he was tax-resident in the UK for at least fifteen of the twenty tax years immediately preceding the relevant tax year and for at least one of the four tax years ending with the relevant tax year. Note that these rules were slightly changed with effect from 2017-18. The fourth circumstance is governed by s.267ZA IHTA 1984. This is an election to be deemed domiciled, which may be made in two cases. First, where at any time on or after 6 April 2013 and during the period of 7 years ending with the date on which the election is made, the individual had a spouse or civil partner who was domiciled in the UK. Second (broadly), where an individual's spouse or civil partner has died and at any time on or after 6 April 2013 and during the period of 7 years ending with the date of death that spouse or civil partner was UK domiciled.

Domicile under IHT Double Tax Treaties

The rules around domicile in the various IHT double tax treaties ("DTT") of the UK are too various to go into in detail. Suffice to say that they must always be considered when looking at IHT: they can override not merely Common Law domicile but also deemed domicile. The override of deemed domicile is particularly important because where deemed domicile is relevant an individual will have a domicile elsewhere. In short: always check when the client may be domiciled in any of the ten countries where there is a IHT DTT. Those with France, India, Italy, and Pakistan only apply to IHT charges on death, but those with Ireland, the Netherlands, South Africa, Sweden, Switzerland, and the USA can apply to lifetime transfers too.