PM-Tax

News and Views from the Pinsent Masons Tax team

In this Issue

Our Comment
- Significant increase in EU tax cases by Andrew Scott
- Do we still need a GAAR? by Heather Self
- Changes to the tax treatment of termination payments by Chris Thomas

Recent Articles
- Greene King: loan relationships and accounting issues by Heather Self
- Our response to the latest consultation on interest deductibility by Penny Simmons
- Slicing the Apple Pie – Article for Accountancy Live by Heather Self

Our perspective on recent cases
- HMRC v Leekes Ltd [2016] UKUT 0320 (TCC)
- Chappell v HMRC [2016] EWCA Civ 809
- Praesto Consulting UK Ltd v HMRC [2016] UKFTT 0495 (TC)

Events

People
The average number of new tax cases sent to the Court of Justice of the European Union (CJEU) has risen by a fifth since the credit crunch, as more businesses and other taxpayers use the court to challenge the actions of national tax authorities.

According to figures obtained by Pinsent Masons, between 2005 and 2010, pre-credit crunch, there were 50 new tax cases per year on average brought to the CJEU. Between 2011 and 2015, this rose to 61 per year, an increase of 22%.

Since the credit crunch, national tax authorities across Europe have been under intense pressure to increase revenues, leading many to levy extra charges and ensure they maximise tax take wherever possible. Businesses and other taxpayers who believe they are being taxed unfairly in the process, contrary to principles of EU law, can bring a challenge to the CJEU.

The CJEU has ruled in favour of business claimants against national tax authorities in several high-profile cases, enabling millions in overpaid tax to be reclaimed.

In the EU referendum campaign, Vote Leave campaigners suggested that continued membership of the EU would mean that the UK would have to pay out up to £43 billion in tax refunds to multinational businesses. These figures were taken from HMRC’s annual report for 2014-15 but reflect the aggregate of both contingent liabilities – where the probability of a repayment is estimated at less than 50%, and provisions where a repayment is considered probable, relating to both domestic and EU litigation.

The most recent HMRC annual report shows a 37.9% increase in contingent liabilities to £49.1 billion in the year to March 2016. This includes 23 cases, each potentially involving many claimants, where the tax at stake is more than £100 million. However, HMRC’s provision for repayments fell £1.3 billion to £5.9 billion. Whilst not all of these contingent liabilities or provisions will relate to CJEU decisions, the figures involved in relation to CJEU decisions can be very large. For example in the Littlewoods case alone the compound interest amounts to £1.2 billion.

Although UK direct taxes, such as corporation tax are not EU taxes, whilst the UK is a member of the EU, UK taxes must comply with the ‘fundamental freedoms’ in EU law (freedom of movement of goods, free movement of services, freedom of establishment and the free movement of persons). These have been used to contest a range of provisions in UK direct tax law. For example the rules were used to challenge the foreign income dividend (FID) regime and the franked investment income (FII) regime.

The prospect of withdrawing from the EU, following the result of the EU referendum, means that more claimants may want to commence their proceedings while it is clear that EU law still applies in the UK.

Although it is business as usual at present, Brexit means that the power of the CJEU over UK law will end but at an unknown time in the future. UK claimants will therefore be considering whether to launch proceedings now so as to increase the likelihood that their claims are protected as and when the UK does leave the EU.

UK claimants might be concerned that, once it is out of the EU, the UK government will attempt without notice to remove the ability to bring a claim based on EU grounds even where EU law applied at the relevant time. The government tried to do this in 1996 by imposing a three year cap on VAT repayment claims with retrospective effect. However, the introduction of the cap without a transitional period was itself found to be contrary to EU law.

Many of the direct tax EU challenges have used the fact that the Limitation Act extends the limitation period for a mistake-based claim so that it runs from when the claimant discovers the mistake. With section 320 Finance Act 2004 and section 107 Finance Act 2007, the government tried retrospectively to cut the limitation period for a tax claim based on mistake of law to six years from the date on which the tax was paid. This was found to be contrary to EU law.
Significant increase in EU tax cases (continued)

Last year, the government tried a different strategy and introduced a 45% corporation tax charge on restitution interest paid in relation to mistake of law claims. This is being challenged by several companies in the Tax Tribunal and by judicial review.

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Last year, HMRC won 23 out of 26 avoidance cases in the courts. In the recent Court of Appeal decision in *Chappell*, Patten LJ summarised the history of the so-called Ramsay principle, including the recent Supreme Court decision in *UBS* and *Deutsche Bank*, and again found for HMRC. In the light of these recent case law developments, do we still need the general anti-abuse rule?

In his original [GAAR study report of 2011](#), Graham Aaronson QC said: ‘First and foremost, [the GAAR] would deter (and, where deterrence fails, counteract) contrived and artificial schemes which are widely regarded as an intolerable attack on the integrity of the UK’s tax regime.’

He went on to say: ‘Judges inevitably are faced with the temptation to stretch the interpretation, so far as possible, to achieve a sensible result; and this is widely regarded as producing considerable uncertainty in predicting the outcome of such disputes.’

The [current GAAR guidance](#) says, at para B6.1: ‘It is important to appreciate that the GAAR is designed to counteract the tax advantage which the abusive arrangements would otherwise (i.e. in the absence of the GAAR) achieve.’

In the light of recent court decisions in avoidance cases, do we still need a GAAR to achieve these objectives?

HMRC regularly claims to win over 80% of avoidance cases. In its [summary of avoidance cases for 2015/16](#), it lists 26 cases, of which it won 23, lost two and had a mixed result in one. The odds against the taxpayer have clearly lengthened in recent years, as noted in a number of articles I have written for Tax Journal over the last 12 months.

One of the most recent tax avoidance decisions by the Court of Appeal was *Chappell v HMRC* [2016] EWCA Civ 809, in which Mr Chappell claimed that a complex series of transactions, structured with the intention of falling within the manufactured overseas dividends (MODs) rules, should give rise to a tax deduction from his total income of some £300,000. The case is interesting for providing an updated analysis of the line of cases beginning with *Ramsay* [1981] STC 174, including in particular comments following the 2016 Supreme Court decisions in *UBS* and *Deutsche Bank* [2016] UKSC 13.

Patten LJ commends the ‘useful and extremely interesting description’ of the case law developments found in the judgment of Lord Millett NJP in *Arrowtown Assets* [2003] 6 ITLR 454. He also notes that the original approach in *Furniss v Dawson* [1984] STC 153 had given way to a broader, less formalistic approach by the time of *BMBF* [2005] STC 1, in which Lord Nicholls approved the statement of Ribeiro PJ in *Arrowtown* that: ‘The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.’

After summarising the judgment of Lord Reed in *UBS* and *Deutsche Bank*, Patten LJ considers the application of the Ramsay principle to the facts in *Chappell*. Counsel for the taxpayer, David Ewart QC, had argued that the decision in *MacNiven* [2001] STC 237 supported the taxpayer’s position; he also said that the legislation relating to MODs had provided a ‘complete code’. Patten LJ said that this was giving the relevant legislation an ‘essentially literal construction’, and distinguished *MacNiven* by noting that the tax losses suffered by Westmoreland in that case were ‘real liabilities arising from real commercial transactions’. He therefore found in favour of HMRC.

Ewart QC’s invoking of the phrase a ‘complete code’ appears to be an attempt to remind the court of a rare taxpayer victory in a pure avoidance case: the *Mayes* case [2011] STC 1269. In that case, the court found that the taxpayer had complied with the detailed requirements of a complex code, and that a purposive interpretation could not defeat the scheme. Indeed, this case is quoted as an example, showing the need for a GAAR, in the GAAR guidance (example D15).
Do we still need a GAAR? (continued)

It is debatable whether a case such as Mayes would succeed before today’s courts. At all levels, from the FTT to the Supreme Court, judges appear to be more and more confident in striking down schemes, particularly where the tax result does not appear to be in line with economic reality.

I therefore question whether the GAAR is really necessary, and indeed whether it will ever be relied on in a tax avoidance case. It is notable that the transactions in Chappell took place in 2005, just a few months after the judgment in BMBF was published. Indeed, many recent decisions have been given ten years or more after the transactions to which they relate: we may have to wait until the mid-2020s before the true impact of the GAAR can be measured. My view is that it will be less than many expected when it was introduced in 2013.

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See the case summary in this edition of PM-tax for more details of the Chappell case.
Changes to the tax treatment of termination payments

by Chris Thomas

Proposed changes to the tax treatment of payments on termination of employment are not as radical as originally feared, but will still be expensive for many employers.

From April 2018, the government proposes to remove the distinction for tax purposes between contractual and non-contractual payments in lieu of notice (PILONs) in order to “prevent manipulation” of the rules. The existing tax allowance on the first £30,000 of a termination payment will remain in place, although employer National Insurance contributions (NICs) will now be due on the amount above £30,000, as well as income tax.

The changes were announced as part of the 2016 Budget and HMRC is currently consulting on the draft legislation.

£30,000 exemption

The first £30,000 of a payment which is paid in connection with the termination of employment is tax free, as long as it is not otherwise taxable as earnings. Any excess over £30,000 is subject to income tax as normal, but is not currently subject to any NICs. This is due to change from April 2018, when employer, but not employee, NICs will also be payable on the amount over £30,000. Employer NICs are currently payable at 13.8%.

Although the change will represent a significant increase for employers in the cost of termination packages in excess of £30,000, the changes are not as onerous as they could have been.

The original proposal to replace the £30,000 exemption with a new exemption for redundancy payments only, which would increase proportionately with an employee’s number of years’ service, has thankfully been dropped. Some valuable reliefs have also been maintained, such as the exemption for payments on death, disability and for legal costs. However, the relief for payments made in respect of foreign service will be abolished, which could prove costly for employees who have had significant periods of service abroad.

Overall, therefore, this is probably about as good an outcome as could reasonably have been expected.

Although the £30,000 exemption survives, employers still need to take great care to ensure the correct tax treatment when making payments on termination of employment. The £30,000 exemption only applies to payments which are not otherwise taxable and specialist advice should be taken as there are many traps for the unwary. The proposed regime is not quite as ‘simplified’ as the consultation document may suggest!

PILONs

Employment contracts often provide that, instead of giving full notice of termination, an employer can terminate an employee’s employment immediately and make a payment in lieu of notice (PILON) instead of requiring the employee to work a notice period. If an employer makes a PILON in accordance with such a contract term, the payment will be fully taxable.

If a contract of employment contains no provisions relating to payment in lieu of notice, it is sometimes possible under the current rules to pay a compensation payment which takes into account any unworked notice period, if the employee is dismissed without proper notice and to argue that it is not taxable and falls within the £30,000 exemption.

The distinction in tax treatment between contractual and non-contractual PILONs has long been a bugbear for HMRC. It argues that PILONs made as an automatic response to the termination of employment can be regarded as coming from the employment itself and not the termination, making them fully taxable payments of earnings.

The government is concerned that the current rules are capable of manipulation by employers, who can reduce their tax exposure by “effectively turn[ing] a contractual payment into a non-contractual payment of damages”.

From April 2018, all PILONs, including those not provided for in the contract, would become subject to income tax and NICs, in the same way as any other payment which is provided for under the employment contract. It is not yet entirely clear how notice pay will be calculated for these purposes, but it appears likely to include anything which represents ‘earnings’ and has accrued during the notice period – this will need to be kept under review. The change is likely to substantially increase the tax bill on many smaller settlement packages in particular.
Changes to the tax treatment of termination payments (continued)

Although the change is not due to take effect until April 2018, HMRC’s stance on ‘auto-PILONs’ means that it cannot be assumed that before that time a non-contractual PILON will always be free of tax, so specialist advice should be sought before such a payment is made.

Salary sacrifice

In a separate consultation, HMRC has proposed removing the tax advantages of providing certain benefits-in-kind (BiKs) to employees through salary sacrifice arrangements in order to address the government’s concern about the rising costs of these schemes. However, the tax advantaged position of pension saving, cycle to work, childcare vouchers and other benefits that the government specifically wants to encourage employers to provide will not be affected.

Most BiKs are not subject to employee NICs, so it is the employer’s NIC bill that will rise as a result of the change, which will see employer’s NICs and income tax charged where a BiK is provided through salary sacrifice, even if it is normally exempt from tax and Class 1A NICs. It is proposed that the changes would take effect from 6 April 2017. There will be no change to the tax treatment of BiKs not provided by way of salary sacrifice and salary sacrifice for annual leave or flexible working will be unaffected.

Personal service companies

In the Budget the government announced that public sector bodies engaging workers through personal service companies (PSCs) would be responsible for paying the national insurance and income tax liabilities arising. In general where services are provided through a PSC the ‘IR35’ intermediaries legislation means that it is the PSC that is obliged to account for the tax, if the worker would have been an employee of the client if they had not been engaged through the PSC.

The government has now published a consultation document on the proposals. This was accompanied by a summary of the results of a survey commissioned by HMRC, which showed that employers were concerned about the impact a proposed change on who was liable for the tax would have on both employers and employees, particularly in relation to new administrative burdens and an anticipated loss in flexibility. Respondents were also cynical about the need to shift compliance burdens in the first place, and said that the current economic climate meant it was not a good time to introduce another burden.

Clearly the proposals could have major implications for many employers in terms of both financial exposure and compliance burdens. In addition, whilst HMRC promise a simple online tool which will provide an answer on worker status which HMRC is bound to accept, there will be concerns over how well this can deal with a matter as complex as employment status, and suspicions that it is likely to result in a greater number of individuals being brought within the employment income net.

Although the proposal at the moment would only apply to public sector engagers, there are concerns that the principal could be extended to the private sector in due course.

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TERMINATION OF EMPLOYMENT
Greene King: loan relationships and accounting issues

by Heather Self

This article appeared in Tax Journal on 5 August 2016

Heather Self considers the Court of Appeal decision in Greene King. This resulted in a partial victory for HMRC, but the double tax result implied by the Upper Tribunal decision has been overturned.

The Court of Appeal decision in Greene King PLC and Greene King Acquisitions Ltd v HMRC [2016] EWCA Civ 782 has now been released, a mere three weeks after the hearing at the beginning of July.

Although HMRC’s press release says that it has ‘defeated a tax avoidance scheme, protecting around £30m in tax’, the decision is significantly more favourable to the taxpayer than the earlier decision in the Upper Tribunal.

The facts

In 2000, Greene King PLC (PLC) lent £300m to a subsidiary, Greene King Brewing and Retailing Ltd (GKBR). This was a straightforward loan relationship, on which GKBR claimed deductions for interest costs. The tax position of GKBR was not in dispute.

In 2003, PLC implemented a scheme brought to it by Ernst & Young, which was also the company’s auditor. PLC assigned to another subsidiary, Greene King Acquisitions Ltd (GKA), the right to receive future interest receivable on the loan, in exchange for an issue of preference shares.

PLC claimed that it was entitled to continue to carry the loan principal at its original amount of £300m, and that it was not required to recognise a profit or loss on the transactions. Furthermore, as it was no longer entitled to receive the interest payments, it was not taxable on the interest paid by GKBR.

GKA, for its part, claimed to have acquired the corpus of an asset worth £20.5m (the net present value (NPV) of the future interest payments), in exchange for an issue of shares with nominal value of £1.5m and share premium of £19m. It received subsequent cash receipts of £21.3m and therefore recorded a profit of £800k, which it accepted was taxable.

Overall, this was therefore a scheme under which the intention was that GKBR should continue to claim deductions for interest costs, with neither PLC nor GKA being taxable on interest income. Not surprisingly, HMRC did not agree.

HMRC issued closure notices on both companies, asserting that PLC should have derecognised part of the loan receivable, so that its value would fall to £279.5m; and that PLC would then be taxable on the subsequent accretion to £300m. In the case of GKA, HMRC said that GKA did not have a loan relationship and was taxable on ‘general principles’ on the interest receipts of £21.3m.

Alternatively, it had a loan relationship, but was taxable on the amount of £19m, as this was an amount which was not ‘required’ to be transferred to its share premium account (FA 1996 s 84(2) (a)). Both companies appealed to the First-tier Tribunal (FTT).

The decisions of the tribunals

The judgment of the FTT, given in June 2012 ([2012] UKFTT 385 (TC)), was somewhat unclear. Judge Colin Bishopp held that PLC’s accounts were incorrect and that it should have derecogised part of the loan. He also agreed that PLC should then have brought into taxable profit the accretion of the loan back up to £300m, although very little reasoning was given for this conclusion. In the case of GKA, he declined to decide whether GKA had a loan relationship with GKBR, and instead found that the interest receipts related to the original loan between PLC and GKBR. He stated: “Thus even if there was a loan relationship between GKA and GKBR (and it is unnecessary for us to decide the point), the interest did not arise under it.”

Judge Bishopp did not go on to decide how the income of GKA should be taxed, but recognised that his judgment could lead to double taxation. He was, however, unsympathetic to this result: “The transactions were a device for ensuring that relief for payment was not matched by taxation of the receipt; and the appellants have no evident difficulty with that outcome. It does not seem to us that they can legitimately complain if the scheme fails in its purpose and instead results in their paying tax twice.”

The taxpayers appealed to the Upper Tribunal (UT), where the case was heard by Mr Justice Mann ([2014] UKUT 0178 (TCC)). Naturally, PLC argued strongly that its accounts were correct; and various other points were also advanced, focusing on the interaction of the accounting with the loan relationship rules.
Greene King: loan relationships and accounting issues (continued)

Mann J re-examined the accounting evidence in some detail, and concluded that the FTT was entitled to conclude that PLC should have derecognised the NPV of the interest. After further detailed consideration, he agreed with HMRC that PLC made a realised profit on the repayment of the loan, and that this amount was taxable.

Mann J’s decision in relation to GKA was more surprising. He held that: “The relationship between GKA and GKBR is one which involves a debt, but as a relationship it does not, in any meaningful sense, involve a transaction for the lending of money as between the two of them.”

So here we have a transaction where there is a debtor (GKBR) and a creditor (GKA) in respect of a money debt, which arose from the lending of money (by PLC to GKBR), and yet Mann J found that it was not a ‘meaningful’ relationship. As well as giving rise to potential double taxation, this decision appeared to undermine the loan relationships legislation, so again the taxpayers appealed.

The Court of Appeal’s judgment

The Court of Appeal came to a very clear decision that GKA had a loan relationship with GKBR. In the leading judgment, Etherton LJ said that: “Neither Mann J nor Mr Milne [counsel for HMRC] identified any legislative purpose or policy which would justify such a deviation from the literal meaning of s 81(1)(b).”

HMRC may still appeal the decision in GKA, but on reflection it may accept that the decision of Mann J would have caused considerable uncertainty, with both taxpayers and HMRC seeking to argue that the loan relationships code was not applicable in different circumstances. Those with long memories may recall that the 1996 changes were intended to provide a comprehensive framework, and it is helpful that the Court of Appeal has confirmed this.

Etherton LJ went on to consider the tax consequences for GKA. Counsel for the taxpayer argued that the initial capital contribution was not a ‘profit’ but was merely the acquisition of the corpus of an asset; only the sums subsequently earned (the £800k difference between the NPV of £20.5m and the cash receipts of £21.3m) should be taxed. HMRC argued that the £19m did not arise to GKA ‘from its loan relationships and related transactions’ and so GKA should be taxed on its gross receipts. This argument seems to ignore ‘from its loan relationships and related transactions’ and so GKA should be taxed on its gross receipts. This argument seems to ignore

VocalSpruce [2014] EWCA Civ 1302, but that it was excluded from taxation by FA 1996 s 84(2)(a) as it was a sum required to be transferred to its share premium account. At the UT, HMRC had agreed that, provided it was successful in its arguments about PLC’s accounting, the ‘minimum premium value’ under Companies Act 1985 s 132 would be £19m, and hence there was no dispute about the amount ‘required’ to be transferred to its share premium account.

One of the other judges, Sales LJ, also commented on this aspect of the appeal. He noted that GKA had ‘paid less than market value’ to acquire the income stream, and that the £19m therefore represented a profit to GKA. He did, however, agree that s 84(2)(a) took this sum out of tax.

It is not entirely clear that the reliance on VocalSpruce is fully justified. In that case, the nominal amount of the shares issued was equal to the NPV of the principal of the original loan notes; and the amounts transferred to its share premium represented profits arising on those loan notes. By contrast, GKA issued shares with a nominal value of £1.5m and a share premium of £19m in order to acquire the corpus of an asset (the NPV of the interest receivable).

Nevertheless, GKA succeeded in its appeal by virtue of FA 1996 s 84(2)(a) (a fact not mentioned by HMRC’s press release!) and the court went on to consider PLC.

It is clear from the judgment that the court was not minded to find in favour of the taxpayer in relation to both PLC and GKA. To do so would have been a rare example of a tax avoidance scheme succeeding completely, and HMRC would no doubt have appealed to the Supreme Court (and indeed, may still do so in relation to GKA).

PLC contended that the FTT’s conclusions on the accounting were inconsistent with the experts’ evidence, and that its reasoning was inadequate; and that the UT was wrong to conclude that the accretions were taxed as realised profit.

Etherton LJ reviewed the decisions of the FTT and UT and concluded that they were correct to conclude that PLC had made a realised profit of £20.5m. Pausing there, many accountants may consider that the judges were all wrong on this point. Looked at as a whole, PLC made a loan of £300m and received back £300m in cash at the end of the transaction, plus an investment in a subsidiary (GKA) with a value of £21.3m. However, this case illustrates, yet again, that once the FTT has made a finding of fact, it will be very difficult to overturn it in a higher court.

PLC tried to argue that the £20.5m did not ‘fairly represent’ a profit, but this was a hard argument to run in the context of an avoidance scheme and the court rejected it.
Greene King: loan relationships and accounting issues (continued)

PLC’s final argument was that the capital contribution to GKA was a ‘fixed capital asset’ within FA 1996 Sch 9 para 14, and therefore gave rise to a loss for loan relationship purposes. Etherton J disagreed, saying that he found the analysis in the FTT decision in Stagecoach [2016] UKFTT 120 to be ‘compelling’. He therefore held that the treatment of the assignment of the interest strip was not ‘in respect of’ the loan relationship between PLC and GKBR, and that the accounting treatment was required by virtue of FRS 5 and so was not ‘allowed’ by an authorised accounting method.

It is interesting that Sales LJ commented that GKA had acquired the asset at an undervalue, but that Etherton LJ held that there was no loss in PLC on the disposal. And yet the court was convinced that PLC made a realised profit on repayment of the loan, despite receiving total cash which was simply equal to the loan principal. It is hard to reconcile these conclusions, except in the light of a determination to defeat a tax avoidance scheme.

Final thoughts

The overall result is single tax for the Greene King group, with PLC being taxed on its ‘realised profit’ of £20.5m but no adjustments being required to GKA’s accounts. Whilst it is not surprising that HMRC’s press release refers to an avoidance scheme being defeated, it has not achieved double taxation and the taxpayers are likely to be relieved at the Court of Appeal’s decision.

HMRC will, however, be delighted to have defeated a ‘big four’ firm on an accounting issue – whether deservedly or not.

Heather Self is a Partner with almost 30 years of experience in tax. She has been Group Tax Director at Scottish Power, where she advised on numerous corporate transactions, including the $5 billion disposal of the regulated US energy business. She also worked at HMRC on complex disputes with FTSE 100 companies, and was a specialist adviser to the utilities sector, where she was involved in policy issues on energy generation and renewables.

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The public consultation period for responding to the Government’s consultation document on the detailed design and implementation of proposals to restrict the tax deductibility of corporate interest payments closed on 4 August 2016. In this article Penny Simmons discusses the main points we raised in our response to the consultation.

The publication of the consultation document followed the Government’s announcement at the 2016 Budget that from April 2017, it intended to introduce a limitation on corporate tax deductions for interest expenses operating by reference to a fixed ratio of 30% of a company’s earnings before interest, taxes, depreciation and amortisation (EBITDA).

This latest consultation document followed an initial consultation in October 2015 on how to implement the Organisation for Economic Cooperation and Development’s (OECD) best practice recommendations on designing a rule to prevent base erosion and profit shifting (BEPS) through the use of interest expense.

The BEPS project aims to combat the artificial shifting of profits of multinational groups to low tax jurisdictions and the exploitation of mismatches between different tax systems, so that little or no tax is paid. In October 2015, the OECD published a report recommending the introduction of a general interest limitation rule that restricts deductions for interest by reference to a fixed ratio of a company’s EBITDA.

A restriction on the future availability of tax relief on interest is a potentially explosive issue for UK corporates. Currently, UK corporates can obtain tax relief for interest payments. Generally, interest paid on debt financing is deductible from a company’s UK corporation tax profits and therefore a company’s liability to UK corporation tax is reduced. This form of tax relief is often invaluable to corporates operating in capital intensive industries, such as the energy, infrastructure and real estate sectors, where high gearing and the tax deductibility of expenses is crucial to the viability of projects and developments. This issue was something we highlighted extensively in our response to the initial consultation in October 2015 and on which we reported previously in PM Tax.

Pinsent Masons has continued to communicate our concerns about the impact of the proposed restrictions on interest deductibility. Full details of our latest response are available here.

The political and economic landscape has changed significantly since the initial proposals were published in October 2015, most notably as a result of the UK’s referendum vote to leave the European Union. Given the political and economic turmoil that has followed the referendum and the detrimental effect that the new interest deductibility restriction could have on UK businesses, we urged the Government to delay implementation until the nature of the UK’s exit from the European Union has been determined. We recommended that a delay would allow businesses adequate time to restructure and reorganise before the rule took effect.

We also voiced concern about the Government’s unchanged position regarding only introducing grandfathering rules in exceptional circumstances. We urged the Government to reconsider its approach and enable grandfathering for existing projects that are highly geared for genuine commercial reasons and whose viability is dependent on the tax deductibility of the project’s interest expenses. We explained that our disappointment was heightened by the fact that the OECD’s recommendations specifically enable countries to introduce grandfathering rules to ease the adverse effects on existing financing structures.

We welcomed the introduction of the proposed exemption for public benefit infrastructure projects (PBPE), whereby eligible tax-interest expenses of qualifying projects will not be subject to the interest deductibility restriction. However, we expressed concern that the exemption is too narrowly drawn and will not apply to many infrastructure projects, despite them providing a public benefit.

We also noted that it is particularly disappointing that the consultation envisages that the PBPE should only apply to exempt interest expenses on third party debt and will not extend to interest expenses on shareholder debt, since the use of shareholder debt to fund infrastructure projects is particularly prevalent in relation to PPP/PFI structures.
Our response to the latest consultation on interest deductibility (continued)

Broadly, we asked the Government to reconsider the scope of the PBPE to enable it to apply to shareholder debt in circumstances where the debt does not create a BEPS risk; rather, the high level of debt financing exists for genuine commercial purposes.

Additionally, we voiced concern that the applicability of the PBPE will be limited by future changes to the Government’s infrastructure policy. One of the stated conditions of the PBPE is that the project would have to “provide services which it is government policy to provide for the benefit of the public.” Following Brexit, a downturn in economic activity is anticipated, which may lead to a reduction in government funding available to finance infrastructure projects and therefore, the Government’s current infrastructure policy detailed in the National Infrastructure Plan may change. This in turn may lead to even fewer infrastructure projects satisfying the PBPE.

Our response also included comments on the proposed introduction of a group ratio rule (GRR) that will be based on the net interest to EBITDA ratio for the worldwide group. We welcomed the introduction of a rule of this nature, which in many cases will increase the tax deductibility of interest in groups with external gearing for genuine commercial purposes.

However, the current proposals envisage that all related party debt will be excluded when calculating qualifying group-interest expenses for the purpose of the GRR. We commented that the current definition of related parties is too wide and will limit the applicability of the GRR to joint venture structures. We noted our disappointment that the Government appears to be adopting a tougher stance than the OECD, which has recommended that countries should be allowed flexibility to adjust the total group interest expense for the purposes of the GRR to include interest expenses of joint venture enterprises.

On this basis, we asked the Government to review the definition of related parties for the GRR, to ensure that third party debt in joint venture companies is not categorized as related party debt for this purpose.

The significant concerns addressed in our response have been raised by many other industry experts who are keen for the Government to re-assess the timing and nature of how the restriction on interest deductibility will be implemented and particularly how the PBPE will be applied.

It is currently uncertain whether the Government will listen to industry concerns and revise its proposals. Clearly, the Government remains keen to demonstrate its leadership in implementing the OECD’s recommendations without unnecessary delay. However, it is hoped that the Government will address widespread concerns about the adverse consequences that the restriction is likely to have on business, particularly the infrastructure sector and at the very least provide some recognition that asset-backed financing structures do not represent a BEPS risk.

A further announcement about the proposed restriction on interest deductibility is expected in the Autumn Statement on 23 November, with draft legislation being published for inclusion in Finance Bill 2017 remaining a strong possibility.

Penny Simmons is a Senior Practice Development Lawyer in the tax team and provides technical assistance to clients and members of the team on all areas of corporate tax including corporate finance and M&A work, private equity, employment tax and property tax. Penny also has experience of advising high net worth individuals on various personal tax matters, particularly in relation to residence and domicile.

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Slicing the Apple Pie
by Heather Self

The EU Commission’s decision on Apple, announced on 30 August, caused a seismic shock in the business and tax worlds. From a business perspective, the sheer size of the proposed €13bn bill – the largest ever tax settlement, and more than twice Ireland’s annual corporation tax revenues – was the main issue. But for tax specialists, the deeper question is what is the EU trying to do?

It started with a press release from the EU Commission in June 2014, announcing investigations into transfer pricing arrangements of Apple, Starbucks and Fiat. Since then, McDonalds and Amazon have been drawn into the net, and the Commission has hinted that it is looking at many other potential cases – having requested copies of tax rulings from all EU Member States. The key question is whether the tax rulings could constitute State aid: the giving of a selective advantage to companies, in a way which could distort the functioning of the Single Market.

The Starbucks and Fiat decisions were announced in October 2015, although the detailed reasoning was not published for several months after. The amounts involved were relatively small – $20m to $30m – and the basis for the decisions was a highly technical analysis of the basis on which transfer prices had been set. It seemed that the EU Competition Directorate wanted to second-guess the detailed tax processes of Member States, and potentially apply a different test from the well-known OECD principles. This looked to be mainly a technical battle, with strong grounds for appeal by both Member States and Companies. The decisions caused concern about whether rulings could be relied on, and uncertainty about where there might be State aid risk, but did not appear to be of significant impact.

The Apple decision is in a different league. Fundamentally, the Commission considers that large amounts of profits have not been taxed anywhere, and that the allocation of profits to Ireland, accepted by the Irish Revenue, does not reflect economic reality. Apple, the Irish Government and the US Government have expressed outrage, but for different reasons – and that is where it gets interesting. It is clear that profits have not been taxed, but does that give the EU any power to intervene? And if someone should be able to tax the profits, is it Ireland (where the sales were booked), other EU countries (where the customers are) or the US (where the R&D was done)?

Now take another look at the preliminary decisions in McDonalds and Amazon. McDonalds has a company in Luxembourg, with a US branch which is not taxed in either country. Amazon pays royalties from a Luxembourg trading company to a Luxembourg partnership, which does not pay tax in either Luxembourg or the US. The similarities with Apple start to look striking.

A big part of the underlying problem is that the US tax system has not been reformed since 1986, and is increasingly out of step with the rest of the world. Theoretically, it is a global system, but in practice non-US profits are usually only subject to US tax once they are remitted back to the US – and hence many US companies have built up substantial cash piles outside the US (Apple has some $180bn). Various quirks of the US system, particularly their “check the box” rules which allow flexibility in choosing whether entities are taxed as companies or partnerships, and relatively weak anti-avoidance rules, mean that international tax planning by US multinationals has been prevalent for many years. Indeed, as far back as 1961, President Kennedy referred to US companies who use “artificial arrangements between parent and subsidiary...in order to reduce sharply or eliminate completely their tax liabilities”!

The EU appears to be using State aid as a lever to incentivise a real shift in behaviour: the key message to the US Government appears to be that if the US does not tax its multinationals, the EU will find a way to do so. Add that to the OECD BEPS project and the need by many countries to raise more tax revenues, and the climate begins to look fiercely hostile.

The answer, for those who have benefitted from low taxes as a result of sophisticated tax planning and past rulings, is to wake up and smell the coffee, as David Cameron once famously said. It’s time to recognise the risk of existing structures, and move towards something more robust – perhaps with a higher tax cost, but much less risk of challenge and uncertainty.

Heather Self is a Partner with almost 30 years of experience in tax. She has been Group Tax Director at Scottish Power, where she advised on numerous corporate transactions, including the $5 billion disposal of the regulated US energy business. She also worked at HMRC on complex disputes with FTSE 100 companies, and was a specialist adviser to the utilities sector, where she was involved in policy issues on energy generation and renewables.

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Leekes carried on a trade of running out of town department stores. In 2009 it purchased the share capital of Coles of Bilston Limited for £1. Coles’ trade at that date comprised three furniture stores plus warehousing facilities. In the eight months of trading prior to the sale Coles had a trading loss of £950,321. It had trading losses carried forward of £2,262,120.

The business of Coles was hived-up to Leekes and Coles became dormant. One of the Coles stores was renovated and re-opened selling Leekes’ products. All three Coles stores were re-branded as Leekes stores and continued to trade selling the same types of products. The three Coles stores sustained a trading loss for the accounting period ending 31 March 2010.

Leekes claimed relief for losses of £1,655,756 against its profits in its corporation tax return for the year ending 31 March 2010 as a result of its succession to the business of Coles. HMRC denied the claim.

HMRC accepted that Leekes had succeeded to the Coles trade but argued that the losses could only be used against profits of the Coles trade post succession. HMRC argued that s 343(3) on its face refers to a succession to “a trade” that trade being the trade of Coles and that therefore in determining what losses are available to be taken over by the successor company, only the losses which would have been available to Coles as a “relief” under s 393 in its trade had the succession not occurred are taken account of.

HMRC’s starting point was to look at s 393 as applied to Coles prior to the succession and ask what relief would have been available to Coles. Since Coles had no profits for the period, HMRC argued that no relief was available under s 393 and therefore there were no losses to which s 343(3) could apply. HMRC argued that in determining what losses were available to the successor company, it was necessary to treat the original company’s trade as a continuing separate trade after the succession and losses could only be claimed to the extent that that continuing trade gave rise to profits.

Leekes said there was no justification for restricting the losses available to it. It said that all of the losses stated in Coles’ accounts as at the date of succession could be used against the new combined trade of the two companies.

The FTT found for Leekes and said that the preferable interpretation of s 343, on the premise that a succession has occurred, is that all the losses of the predecessor’s trade which have been subsumed with the successor’s trade should be available for offset against the combined profits of the successor company.

HMRC appealed to the UT. The UT allowed the appeal. It said that the purpose of s 343 is not to put the successor in a better position than that in which the predecessor would have found itself had it carried on the trade, but to transfer the potential for relief, without change, to the successor. Roth J and Judge Colin Bishopp said that it was clear that ‘the trade’ to which s 343(3) refers is the same trade as that to which s 343(1) refers and there was indication that the draftsman intended to refer in s 343(1) to the predecessor’s trade but in s 343(3) was contemplating the enlarged trade of the successor.

They agreed with HMRC that the words of the statute could not be ignored because of a perception of practical difficulty in working out the profits of the original trade after the succession. They said: “the policy reasons behind the restriction of the successor to relief only in those circumstances in which relief would have been available to the predecessor are obvious: if it were otherwise there would be ample opportunity for abuse”.

Comment

This decision returns the position to HMRC’s understanding of the law as set out in the manuals.

Read the decision
Cases (continued)

Chappell v HMRC [2016] EWCA Civ 809

MODs tax scheme failed on Ramsay arguments.

Mr Chappell took part in a tax scheme which had the purpose of lowering his tax bill. First Mr Chappell entered into a stock lending agreement with an offshore company, Barsbury Limited, from which Mr Chappell then borrowed loan notes to the value of £6.3 million, on which interest was due. The loan notes had been issued by another company (SCL) which would be liable to pay interest to the bearer. Mr Chappell sold the notes to a third company. Mr Chappell claimed deductions for two payments he made to Barsbury on the basis that they were manufactured overseas dividends (MODs) and so were annual payments.

The payments he made to Barsbury were the same amounts as the interest paid to him from SCL. The scheme, when all the circular loans were paid back, left Mr Barsbury in exactly the same situation, but for having to pay fees to the scheme provider and claiming to have a tax deduction.

HMRC denied the deductions. The FTT found for HMRC by applying the Ramsay principle to deny the deductions. Mr Chappell appealed to the UT which upheld the FTT's decision. Mr Chappell appealed to the Court of Appeal.

Mr Chappell argued that the technical provisions dealing with MODs fell to be construed and treated like those in the MacNiven case so as to confer tax relief even though the transaction formed part of a scheme which was designed solely for the purpose of obtaining that relief and had no wider or other commercial justification. He argued that the MODs legislation provided a complete code which gave tax relief to the borrower or transferee of the overseas securities but also imposed a tax charge on the MODs in the hands of the payee.

Patten LJ said that MacNiven was not a case involving a tax scheme, the tax losses suffered by Westmoreland had been incurred as part of its ordinary business activities and were real liabilities arising from real commercial transactions. He distinguished MacNiven from UBS where he said the relief was claimed in reliance on transactions which had no commercial purpose and had only been entered into in order to obtain the relief.

Patten LJ disagreed with Mr Chappell’s arguments relying on the fact that the MODs legislation provided a complete code. He said that the significant aspect of the MODs regime was the relief given to the borrower in being able to avoid a tax charge on the dividends or interest from the securities. He said “this is clearly intended to benefit the parties to real-world, commercial transactions involving the lending of marketable securities and not to transactions which lack those characteristics and whose only purpose is to obtain tax relief”.

He said that the position was “exactly analogous to that in UBS” and so the appeal was dismissed.

Comment

The decision includes a useful summary of where we are now in relation to Ramsay, including comments post-UBS on how the law is to be applied. It illustrates the increasingly robust attitude of the higher courts to tax avoidance schemes. See also Heather Self’s comment piece in this edition of PM-Tax.

Read the decision
Praesto Consulting UK Ltd v HMRC [2016] UKFTT 495 (TC)

Legal fees paid by company for director had direct and immediate link to company’s taxable activities and so input VAT was recoverable.

Mr Ranson left his employment with CSP to set up Praesto, a competing business. CSP brought a claim against Mr Ranson, a director of Praesto, for breach of contract, fiduciary, and fidelity duties. Praesto was not a party to the legal proceedings but it paid the legal fees and reclaimed input VAT totalling about £80,000. Out of nine invoices, one was addressed to Praesto and eight to Mr Ranson. HMRC assessed Praesto for repayment of the reclaimed tax on the eight invoices, on the basis that those fees were not incurred for the purposes of its business. Praesto appealed to the FTT.

HMRC argued that input tax is only deductible where the supply is made to a taxable person for the purposes of their taxable activities. It argued the legal services were supplied to Mr Ranson, not Praesto, and no direct and immediate link existed between the services supplied and Praesto’s taxable activities.

Judge Cannan analysed domestic and CJEU decisions, including Becker and the Supreme Court’s recent decision in Airtours Holidays Transport Limited. He said that Becker was “not authority for the proposition that legal services supplied in connection with proceedings against individuals cannot have a direct and immediate link with the taxable activity of a taxable person” and said “it is a fact sensitive analysis.”

In reaching its decision, the FTT asked 1) Do the invoices relate to services supplied by the lawyers to Praesto? and (2) If so, did the services have a direct and immediate link to Praesto’s taxable activities?

Judge Cannan found as fact that the claim was being refuted by the lawyers on behalf of both Praesto and Mr Ranson, both of whom he was satisfied were clients of the lawyers in respect of the proceedings. He said that the legal services were supplied to Praesto just as much as if it had been a party to the litigation. The Judge said that it was Praesto that had made the profits from any breach of duty by Mr Ranson and it was Praesto’s profits that would have to be accounted for if CSP’s claim was successful. As such, Judge Cannan concluded that the invoices were for services supplied by the lawyers to Praesto.

Judge Cannan said the link between the legal supplies and Praesto’s taxable activities was sufficiently direct and immediate to entitle Praesto to the input tax credit. He said that Praesto had a direct interest in CSP’s claim being dismissed, otherwise there was a real risk that it would have to account for the profits it had made in competition with CSP. Objectively, the reason Praesto obtained the services was to limit any liability arising from its taxable activities. Judge Cannan therefore allowed the appeal.

Comment

This is a helpful decision and shows that, where the company could be liable for damages, VAT can be recoverable by a company in respect of legal fees to defend a director. It is still an issue however, that will depend very much upon the facts. It also shows the importance of getting VAT invoices addressed to the correct party, as HMRC allowed input tax recovery in respect of the one invoice that was addressed to Praesto, rather than Mr Ranson.

Read the decision
Diverted Profits Tax Roundtable event

The partners of the Pinsent Masons tax team invite you to a roundtable event to discuss how organisations are managing the risks associated with the diverted profits tax (DPT).

The roundtable discussion will be led by Andrew Scott, former Director of Business Tax at HMRC’s Solicitors Office, who joined Pinsent Masons earlier this year. During his time at HMRC, Andrew worked on the development and design of the diverted profits tax and was also a member of HMRC’s governance boards for the resolution of complex, high-profile disputes, including those involving diverted profits.

During the session, our panel of expert speakers will lead a discussion to provide you with:

- A high-level analysis of the DPT regime
- An analysis of what decisions must be taken before deciding whether to notify HMRC
- An understanding of how businesses should engage with HMRC in case of an enquiry into DPT risk
- A best-practice guide to preparing for an investigation by HMRC.

Our panel of expert speakers at the session will also include Head of Tax, Jason Collins and Heather Self, a Partner in our Tax team.

The roundtable will take place at our offices in the City and will be an opportunity for Tax and Finance Directors to have an open discussion on their approach to DPT risk.

Date: Monday 10 October 2016
Time: Registration 4:00pm; Seminar 4:30pm; Close by 6:00pm
Venue: Pinsent Masons LLP, 30 Crown Place, London EC2A 4ES
Tax transparency and the developing world

By Ewan Livingston (ActionAid UK), Dr Matti Kohonen (Christian Aid) and Radhika Sarin (Oxfam GB).

Over a number of years, ActionAid, Christian Aid and Oxfam have been campaigning for reform of the global corporate tax system. We do so because developing countries lose much-needed revenue that could be used to finance basic services including health and education, and contribute to meeting the ambitious new Sustainable Development Goals.

These losses are difficult to measure precisely but UNCTAD estimates that developing countries lose $100 billion annually from corporate tax avoidance, while an IMF study estimates the annual figure to be $200 billion. Furthermore since developing countries tend to rely on corporate income taxes for a much higher proportion of their tax revenues than higher income countries (16% and 8% respectively, according to the IMF), corporate tax avoidance is relatively of greater concern.

This reform needs to be government-led, and focused on regulatory and legislative rule change which business should support because a system of clear, consistent and transparent rules across all countries will help multinational companies. However since the OECD’s BEPS reforms do not alter the fundamentals of the global tax system, we believe that companies also have a role to play in terms of their own behaviour. So long as global tax rules allow for a degree of corporate choice (for example flexibilities inherent in transfer pricing rules), then corporate agency will have a bearing on tax outcomes for developing countries.

In light of this, ActionAid, Christian Aid and Oxfam recently published ‘Getting to Good: Towards Responsible Corporate Tax Behaviour’, a discussion paper intended to catalyse NGO-business dialogue on responsible tax. The paper sets out a number of propositions and example behaviours that highlight the sorts of actions that companies can take to demonstrate a responsible approach to tax. It also recognises that since no two companies’ tax affairs are the same, there can be no ‘one-size-fits-all’ solution. Instead, it encourages companies to embark on a journey towards more responsible behaviour, via a process of transparency; assessment; and progressive, measurable improvement over time.

The success of the ‘Getting to Good’ approach is contingent on a constructive dialogue between NGOs and businesses. Therefore via the UK Tax Dialogue platform, we are hosting a series of Chatham House roundtable discussions, each focusing on a different aspect of corporate tax behaviour. The inaugural event, which focused on the critical issue of tax transparency, took place in July 2016, kindly hosted by Pinsent Masons in London. Participants included a broad range of companies from sectors ranging from banking and finance to consumer goods and extractives, as well as business associations, legal experts and NGOs.

The session began with a recognition that most companies are motivated to act responsibly and ‘do the right thing’, including on tax, with the caveat that there are differing interpretations of what good practice might look like. It was also accepted that aside from corporate income tax, companies operating in the developing world can make positive contributions in a number of ways – both through the payment of other taxes, and through non-tax contributions such as investment and job creation. Tax impacts, therefore, are to be included amongst other sustainable development impacts of companies.

However it was also accepted that corporate income taxes specifically are an important part of the picture, and that corporate tax avoidance is a significant concern for developing country governments and citizens. Likewise, there was an acceptance that corporate income tax avoidance has attracted particular scrutiny in recent years, and as such has become a major corporate reputation concern. Public trust in business has eroded, and corporate tax avoidance is – according to surveys conducted for the Institute of Business Ethics – the issue of foremost concern to the British public about business behaviour. Multinationals (and others) have a job to do to rebuild this trust, and tax will be an important component in these efforts.

Against this backdrop, event participants considered what role transparency has to play.
Tax transparency and the developing world (continued)

Whilst there has been considerable focus on transparency from the civil society sector, it was agreed that in isolation, it will not be a panacea. It is a means to an end, rather than an end in itself. However it remains an important piece of the puzzle, since greater disclosure of data provides a valuable insight into a company’s tax affairs, and allows for comparisons between different companies. For example, corporate responsibility benchmarks and indices are further strengthened by including tax information that is publicly disclosed by companies. Furthermore, the provision of more comprehensive and reliable data will allow both tax campaigners and developing country revenue authorities to more readily identify cases of bad practice, and target their efforts accordingly. On this basis, many NGOs are challenging the question ‘why transparency?’ and instead asking ‘why not?’

From a corporate perspective, there was broad consensus around the principle of transparency. Many businesses in the room are very actively promoting the transparency agenda across various parts of their organisations, and there was agreement that openness is generally desirable and that feedback from stakeholders is welcome. On the issue of tax specifically, whilst the principle remained the same, there was concern about the practice of making corporate tax affairs more transparent.

Several practical considerations and challenges were discussed. These included concerns around the disclosure of commercially sensitive tax data; the potential for data to be misrepresented; the accessibility of (often complex) data to those who may not have a comprehensive technical understanding of tax; and the risk that, by disclosing more than their peers, companies could be more susceptible to unwarranted scrutiny and criticism.

In seeking to mitigate these concerns, there followed a rich and constructive discussion of how corporates and NGOs might work collaboratively to promote tax transparency in a mutually agreeable manner. From the corporate side, there was an acceptance that the presentation of data was paramount; that explanatory information and context needed to be provided alongside data; and that in order for data to be useful, it needed to be comparable across different companies. From the NGO side, there was a recognition that endorsement of good practice needed to happen alongside criticism of bad practice, and that this could be made possible through constructive engagement with business. Such efforts could shift the balance towards making voluntary disclosure of tax information more desirable for companies.

To advance some of these ideas, a number of proposals were put forward, including the establishment of bilateral dialogues; the formation of working groups to consider practical issues; and a greater role for business associations and professional bodies, both in coordinating transparency initiatives at a multilateral level, and in facilitating dialogue between all relevant stakeholders. The proposed continuation of Tax Dialogue roundtables was also welcomed.

Owing to its complexity, the issue of corporate tax will remain contentious. However if there was one key outcome that participants would have taken from this successful roundtable event, it is that whilst there remains disagreement on some of the practicalities of tax transparency, there is likewise a good degree of consensus when it comes to the principles. It is on the back of that consensus that we are seeking to move from dialogue towards tangible action on tax transparency, and to tackle the types of aggressive tax avoidance that is so harmful to the developing world.

ActionAid, Christian Aid and Oxfam would like to thank Pinsent Masons for kindly hosting the July 2016 Tax Dialogue roundtable.