The walls are crumbling

Large Corporate



01 June 2020

Edward Hellier considers the case of Union Castle, and its impact on transfer pricing and equity transactions

Key Points

What is the issue?

The traditional approach to transfer pricing has been that it does not apply to equity transactions. However, the recent decisions in *Union Castle* have challenged that conventional wisdom.

What does it mean for me?

The judgments provide a basis for revenue collection authorities to argue that transfer pricing rules apply to matters such as an issue of bonus shares or the payment of a dividend by a wholly owned subsidiary, and therefore merit careful consideration by advisers.

What can I take away?

Advisers must be conscious of the potential for transfer pricing rules to apply to equity transactions, and certainly for HMRC or other Revenue authorities to argue that they do.

The traditional approach to transfer pricing has been that it does not apply to equity transactions, such as the payment of a dividend or the issue of bonus shares. However, the recent decisions of the Upper Tribunal and Court of Appeal in the *Union Castle* case have challenged that conventional wisdom (see *Union Castle Mail Steamship Company v HMRC* [2018] UKUT 316 (TCC) ('*Union Castle UT*') and *Union Castle Mail Steamship Company Ltd and others v HMRC* [2020] EWCA Civ 547 ('*Union Castle CoA*')).

In the case of *Union Castle UT*, the Upper Tribunal found that the transfer pricing provisions, which at the time of the relevant transactions were contained in Income and Corporation Taxes Act (ICTA) 1988 Sch 28AA, applied to an issue of bonus shares by a fully owned subsidiary to its parent. (These provisions are now contained in the Taxation (International and Other Provisions) Act (TIOPA) 2010 Part 4.)

The Court of Appeal did not hear argument on the transfer pricing issue but, like the lower tribunals, reached its decision on other grounds. Although the provisions have moved, the issues discussed in this article remain relevant.

Whilst the Upper Tribunal's decision on transfer pricing was made in passing (and is thus not binding on other courts), it may provide a basis for revenue collection authorities to argue that transfer pricing rules apply to matters such as an issue of

bonus shares or the payment of a dividend by a wholly owned subsidiary.

The background to the decisions

The case of *Union Castle* concerned a disallowed deduction claimed in respect of the derecognition, in Union Castle's accounts, of cash flows from certain FTSE-based derivative contracts.

Union Castle was the wholly owned subsidiary of a publicly quoted investment trust, Caledonia Investments plc. In May 2007, the board of Caledonia was concerned about a possible fall in UK equity markets, and wanted to implement a hedging strategy by purchasing put options against a FTSE 100 index. However, the board was also concerned that purchasing such options might imperil Caledonia's investment trust status. It was therefore decided that Union Castle would purchase the options, which it did between 20 June and 31 December 2007.

In July 2008, accounting guidance for investment trusts clarified that Caledonia could invest in derivatives without losing its investment trust status, so it appeared that Caledonia could in fact hold the put options in its own name.

During the financial year ending 31 March 2009, some of the put options were exercised and further put options were purchased. By October 2008, Union Castle held three put options and three put spreads (the 'Contracts').

In November 2008, Caledonia considered novating the Contracts from Union Castle to Caledonia but realised that this would lead to a tax charge to Union Castle. Instead, it was decided that Union Castle would make a bonus issue of 'A Shares' to Caledonia, which carried a right to receive a dividend equal to 95% of the cash flows arising from the close-out of the Contracts. The A Shares were added to Caledonia's investment ledger as a new security with no cost attributed, but were ascribed at fair value, reflecting the pass-through right to 95% of the future cash flows from the derivatives. As a consequence of issuing the A Shares, Union Castle had to derecognise 95% of the value of the Contracts for accounting purposes.

Between January and August 2009, Union Castle closed out the Contracts and paid dividends equal to 95% of the proceeds to Caledonia. In relation to the derecognition of the Contracts, Union Castle sought to claim a deduction. HMRC denied this claim and Union Castle appealed.

The appeal covered a number of issues; the relevant one for these purposes was whether the bonus issue of shares amounted to a 'provision' for the purposes of Sch 28AA. If it was a 'provision', then the transfer pricing rules would apply. As discussed below, the case was not decided on the transfer pricing issue, although both the FTT and UT expressed their views on the point.

The arguments of the taxpayer

Among the taxpayer's arguments in support of the position that transfer pricing rules do not apply to equity transactions were that:

- the established global understanding and practice was that transfer pricing rules do not extend to shareholder transactions; and
- the OECD Guidelines draw a clear distinction between shareholder activity and other activity, without contemplation that transfer pricing rules would apply to the former.

Indeed, even if the share issue was subject to transfer pricing rules, it was unclear on what basis the arm's length calculation would be made, and if it would produce a different result.

The global consensus

The starting point of the taxpayer's arguments was the global understanding that transfer pricing does not apply to shareholder transactions. In short, transfer pricing rules are concerned with trading or other business relationships, being the provision of goods and services by one party to another related party in the course of their trade or business. In contrast, a bonus issue of shares does not bear the character of making or imposing conditions in 'commercial and financial relations', as required by OECD Model Tax Convention Article 9 and the accompanying OECD Transfer Pricing Guidelines. A company issues shares or pays dividends as part of its shareholder relations and not part of its trade or business that forms the context of its commercial or financial relations.

This consensus, the taxpayer argued, was clear from both domestic case law (*Ametalco UK v IRC* [1996] STC (SCD) 399) and foreign case law (*Vodafone Services Pvt Ltd v Union of India and others* (2014) 17 ITLR 209).

Ametalco is a decision of the Special Commissioners concerning the earlier transfer pricing provisions contained in ICTA 1988 s 770. The case proceeded on the basis, accepted by both parties, that the UK's transfer pricing rules did not cover a subscription for shares in an associated company.

Vodafone is a decision of the High Court of Judicature at Mumbai, in which an Indian subsidiary issued shares to its non-Indian parent for a subscription price that was said to have been below market value. The Indian Revenue had advanced a transfer pricing argument that was rejected by the court, which held that the regime could not operate in relation to the amounts received on the issue of share capital.

OECD Guidance

The OECD Guidelines and OECD Model Convention are relevant to interpreting the domestic legislation, as the UK legislation provides for it to be construed in accordance with OECD principles.

The taxpayer pointed to the OECD Guidelines, which it said drew a clear distinction between shareholder activity and other activity. The taxpayer argued that what is contemplated when applying the transfer pricing rules is the identification of the characteristics of the property concerned or the nature of the services themselves, in order to arrive at an arm's length price for such goods or services. The Guidelines do not contemplate such an analysis applying to shareholder activity.

In the context of the global understanding that transfer pricing does not apply to equity transactions â – bearing in mind that the preface to the OECD Guidelines emphasises the importance of an 'international consensus', and the distinction made between shareholder and non-shareholder activities â – it was necessary to construe the UK legislation to respect the distinction made in the OECD Guidelines and not apply the UK transfer pricing rules to the bonus issue.

The FTT decision

The FTT determined the appeal on a different basis from that of the transfer pricing issue; however, the taxpayers won in relation to that issue and the FTT held that the bonus issue was not a 'provision' for the purposes of Sch 28AA. In short, the FTT agreed that the distinction in the OECD Guidelines between shareholder and non-shareholder transactions had to be given life in the construction of the domestic

legislation, and saw nothing in the authorities cited to upset that conclusion.

The FTT accepted that were the transfer pricing rules to apply, it would be necessary to postulate a situation where Caledonia held shares in Union Castle but was not a controlling shareholder. In such circumstances, the FTT considered the issue of bonus shares to be an arm's length transaction.

The Upper Tribunal decision

The UT also determined the appeal on a different basis; however, it gave its conclusions on the transfer pricing issue. On that point, the UT overturned the decision of the FTT and held that the transfer pricing rules did apply to the bonus issue of shares. In particular, whilst the UT recognised that there is a distinction drawn by the OECD Guidelines between shareholder and non-shareholder activity, it held that the distinction does not operate as a blanket exclusion from the ambit of 'provision' in Sch 28AA of transactions concerning share capital between associated persons. The UT held that there was nothing in Sch 28AA itself that excludes from the ambit of transfer pricing an issue of shares such as the one in this case.

Although not wholeheartedly endorsing the decision of the FTT in *Abbey National Treasury Services plc v HMRC* [2015] UKFTT 341 (TC) (*ANTS*), which applied the transfer pricing rules to an issue of shares (a point which *Union Castle FTT* said was wrongly decided), the UT did specifically agree with the FTT's observations in *ANTS* that there was nothing in Sch 28AA or the OECD Model Convention or Guidance that took the issue of shares outside the transfer pricing rules, and neither the UK legislation nor the OECD Model Convention should be construed strictly so as to exclude such a transaction.

The UT drew no assistance from *Ametalco* or *Vodafone*. It stated that in *Ametalco,* the Crown had made a concession based on particular statutory language which HMRC had not made in this case; and held that the conclusion in *Vodafone* was not predicated on a principle that capital transactions such as the issue of shares must be outside the scope of transfer pricing, but on the basis that the relevant Indian statutory provision was confined to computations of income.

The UT did not determine what adjustment the application of the transfer pricing rules would have required.

The Court of Appeal

The Court of Appeal, having determined the appeal on a different basis, did not hear argument on the transfer pricing issue. The decision of the UT on this point was therefore undisturbed.

Practical implications

As a result of these decisions, the law is in a somewhat uncertain state when it comes to the question of whether, and how, transfer pricing rules apply to equity transactions. Against the backdrop of the orthodoxy that suggests that such transactions are outside the scope of the transfer pricing regime sits an obiter decision of the UT, undisturbed by the Court of Appeal, suggesting that orthodoxy is wrong. It is supported by an obiter observation of the FTT in *Abbey National* in a decision that was held to be wrongly decided in *Union Castle FTT* but endorsed by obiter statements in *Union Castle UT*.

The certainty for the adviser, however, is that HMRC, and other revenue authorities across the world, will see these decisions as supporting transfer pricing arguments in relation to shareholder transactions, and it will be necessary to meet those arguments. Indeed, certain foreign revenue authorities have already attempted to use *Union Castle UT* to argue that transfer pricing applies to shareholder transactions.

Conclusion

Until the transfer pricing issue has been decided in a way that is binding on other tribunals, there will not be legal certainty on the matter. However, the following points can be taken from the *Union Castle* litigation:

- Advisers must be conscious of the potential for transfer pricing rules to apply to equity transactions, and certainly for HMRC or other Revenue authorities to argue that they do.
- If transfer pricing rules do apply to an equity transaction, the basis for determining the correct arm's length price position, and so any adjustments that would be required, remains open for debate.
- Increasingly transfer pricing issues require an awareness, and analysis, of foreign case law.