Analysis

Covid-19: the tax fallout

Speed read

Tax implications for businesses and individuals will arise from the coronavirus outbreak. The enforced travel restrictions could impact non-UK resident corporates which are centrally managed and controlled in the UK and create permanent establishment risks for non-resident employers. Foreign citizens and British expatriates who are stuck in the UK for longer than they intend may also risk becoming UK tax resident under the statutory residence test, although HMRC's recent guidance should prove helpful. Employers may be able to reimburse homeworking expenses of their employees, although more guidance from HMRC would be helpful.

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A matter of months ago we had not even heard of coronavirus (Covid-19), yet now we find ourselves in the 'worst public health crisis for a generation'. In addition to the alarming social impact the spread of the virus is having, the economic fall-out is already apparent. Unsurprisingly, at the Budget on 11 March, the government announced tax support measures for businesses (and self-employed individuals) in financial distress due to the current crisis, through bespoke time to pay arrangements and the waiving of late payment penalties and interest. Some further measures enabling businesses to defer the next quarter of VAT payments and self-employed individuals to defer self-assessment payments were announced on 20 March.

Whilst the tax implications of the current crisis are unlikely to be at the forefront of people's minds, there are some longer-term tax implications which arise because of widespread travel restrictions, such as the tax residency of non-UK incorporated companies and non-UK resident individuals. Businesses and individuals affected should consider these issues now to avoid unintended tax consequences in the future. There are also other more immediate tax implications for employers dealing with large scale homeworking of their employees.

Corporate tax residency

There are many reasons why a company would want to be tax resident in the UK, including a relatively low level of 19% corporation tax, an exemption from chargeable gains on the disposal of substantial shareholdings and an exemption on dividends received from overseas subsidiaries, as well as the ability to rely on the UK's extensive double tax treaty network.

A company will generally be treated as UK tax resident if it is incorporated in the UK (CTA 2009 s 14), subject in certain cases to being treated as resident in another jurisdiction pursuant to a tie-breaker clause in an applicable double tax treaty. Conversely, a non-UK incorporated company will be treated as UK tax resident if it is 'centrally managed and controlled' in the UK (the CMC test).

The CMC test is not a statutory test but is rather based on case law. The seminal test of company residence is as stated by Lord Loreburn in *De Beers Consolidated Mines v Howe* (1903-1911) 5 TC 198): 'a company resides, for the purposes of Income Tax, where its real business is carried on… I regard that as the true rule; and the real business is carried on where the central management and control actually abides.' This CMC test was endorsed by a series of other subsequent decisions; in particular, the case of *Bullock v Unit Construction Company* (1959) 38 TC 712, in which Lord Radcliffe confirmed (at page 738): 'To me … it seems impossible to read Lord Loreburn's words without seeing that he regarded the formula he was propounding as constituting the test of residence.'

HMRC has confirmed the following points in its guidance on tax residency (Statement of Practice 1/90):

- In broad terms, the case law concept of CMC is directed at the highest level of control of the business of a company and it is to be distinguished from the place where the main operations of a business are to be found (though those two places may often coincide).
- The place of CMC is wholly a question of fact, but case law has attached importance to where the board of directors physically meet (provided that this is where the directors in fact carry out the control of the company).

Consequently, it would generally be expected that if a non-UK incorporated company regularly holds its board meetings in the UK and those meetings constitute the medium through which CMC is exercised, then it should be treated as UK tax resident.

The outbreak of Covid-19 may cause problems for a non-UK incorporated company which is treated as UK tax resident due to the CMC test if the directors are not resident in the UK and cannot physically get to the UK to hold the board meetings. This could ultimately lead to a loss of UK tax residency and give rise to adverse tax implications for the company, such as corporation tax exit charges. This tax issue could be compounded if it unintentionally becomes tax resident in another jurisdiction; for example, where a majority of non-UK directors are resident in a third country, potentially giving rise to local country corporate income taxes.

As the spread of Covid-19 leads to widespread inability for travel, then precautionary measures are considered advisable. Non-UK incorporated companies which are treated as UK tax resident under the CMC test and which are faced with a possible loss of UK tax residency should consider whether the powers of the board could be delegated to other individuals who are UK resident for the duration of the outbreak to help ensure that CMC is still being exercised in the UK.

Permanent establishments

The increase in employees working from home could cause local tax authorities to question whether a non-resident employer has established a permanent establishment (PE) in their local jurisdiction. This could be a particular concern where the employee has a senior role and/or enters into profit making contracts on behalf of the non-resident employer.

The OECD Model Tax Convention ('the Model Treaty') defines PE as 'a fixed place of business through which the business of an enterprise is wholly or partly carried on'. Where the employer company is resident in a jurisdiction which has a tax treaty with the local country, provided the local country has a definition of a PE which is consistent with article 5 of the Model Treaty (such as the UK), there are a number of arguments which the employer company could raise to counter such a challenge, particularly if the employee has a junior role in the organisation.

First, based on the commentary to article 5 of the Model Treaty, if the individual is working from home it could be argued that the individual's home is not 'at the disposal' of the employer company and therefore cannot be a 'place of business through which the business of an enterprise is wholly or partly carried on' as required by article 5(1). Alternatively, if such a place of business is held to exist, it could be argued that it is by definition temporary, existing purely for reasons of necessity, during the Covid-19 crisis.

The situation would be different, however, if the employee is a senior employee, such as a director, who regularly enters into contracts on behalf of the employer entity. In such circumstances, the individual may be treated as creating a PE for the employing company under article 5(5), which treats a person who 'habitually concludes contracts' on behalf of a company as a PE. Companies in such circumstances may wish to consider adopting new protocols to allow for individuals who are resident in the same country as the employer to authorise and sign contracts during the crisis. Such procedures should reduce, but may not entirely eliminate, the risk.

In the UK, if a non-resident company is being treated as trading in the UK through a PE, this would result in the income, profits and gains attributable to that PE being brought within the charge to UK corporation tax (CTA 2009 ss 5(3) and 19). Pursuant to CTA 2010 s 969, the UK resident individual would be treated as the UK representative of the non-resident company and the corporation tax liabilities of the non-resident company could be recovered from the UK resident individual (CTA 2010 s 970).

Tax residency issues for individuals

On 20 March 2020, the foreign secretary announced his estimate that between 300,000 and 1m Britons remained overseas, struggling to return as a result of travel restrictions and flight cancellations. Currently, most airlines have grounded their fleets. A similar number of foreign citizens and British expatriates are likely to be stuck in the UK for longer than they intended from a combination of travel difficulties, self-isolation, illness or caring for others.

For some, this could lead to them risking UK residence under the statutory residence test (FA 2003 Sch 45). The statutory residence test first considers whether an individual has met one of five automatic overseas tests for the year (rendering them non-UK resident) and, if not, whether they meet one of four automatic UK tests (rendering them UK resident). The fallback position is the 'sufficient ties' test, which allocates a day count threshold depending on the number of ties they have to the country – be it available accommodation, resident family members, time spent working here, UK days in the preceding year (the '90-day tie') or the country in which they spent the most time.

Day counts feature in virtually all the tests. Any person in the UK for fewer than 16 days will be non-resident. At the opposite end of the scale, any person who spends 183 days in the country will be resident for the year. For those falling outside of all of the automatic tests, the sufficient ties thresholds fall at 45, 90 and 120 days (FA 2003 Sch 45 paras 18–19).

Fortunately for visitors caught in the UK by the Covid-19 pandemic, the test does make some allowances for those unable to leave. FA 2003 Sch 45 para 22 allows a maximum of 60 days to be ignored in any day count where the visitor (P) 'would not be present in the UK at the end of that day but for exceptional circumstances beyond P's control that prevent P from leaving the UK' and 'P intends to leave the UK as soon as those circumstances permit'.

Two main hurdles stand in the way of the innocent visitor. First, HMRC has always taken a very strict interpretation of the term 'exceptional circumstances'. Second, to get any deduction, they must always intend, and use their best efforts, to leave the UK as soon as possible. This partly stems from the legislation itself, which does not define exceptional circumstances. Instead, Sch 45 para 22(5) includes two sets of statutory examples, which are 'national or local emergencies such as war, civil unrest or natural disasters' and 'a sudden or life-threatening illness or injury'. HMRC's guidance follows in the same rigid vein. Its additional examples (set out in HMRC's *Residence, Domicile and Remittance Basis Manual* at RDRM13240) involve a litany of serious injuries, including poor Anna who is both unconscious and badly burnt, Henrik whose child may have major neck injuries and Claude who suffers multiple injuries in a car crash. An emergency landing in the UK is exceptional, provided the passenger takes the next available flight out of the country. HMRC generally expects the individual to make arrangements to leave as soon as possible, including medical transfer where feasible.

To its credit, HMRC has been quick to clear up much of the uncertainty. On 19 March 2020, HMRC provided specific guidance on Covid-19, included as an update to its manual at RDRM11005. This confirms that the circumstances are considered exceptional if a person:

- is quarantined or advised by a health professional or public health guidance to self-isolate in the UK as a result of the virus;
- is advised by official government advice not to travel from the UK as a result of the virus;
- is unable to leave the UK as a result of the closure of international borders; or
- is asked by their employer to return to the UK temporarily as a result of the virus.

This definitely covers self-isolating families where a member meets the criteria and should include those whose immediate family members are hospitalised. It should also cover all British nationals given the current FCO advice as at 20 March, which reads '*the FCO advises British nationals against all but essential international travel*' (emphasis in original). Areas in which advisers (and the well advised) should be cautious, given HMRC's ongoing strict interpretations, include individuals who:

- are holding out for a reasonable mode of travel (for example, are unwilling or unable to commit to long waits at the airport seeking a flight or are holding out for flights where a long train journey might be theoretically possible);
- stay to support elderly, but otherwise healthy, parents in the UK; or
- are not British but understandably delay their return while their home country or region is suffering from a worse phase of the pandemic.

It is to be hoped that HMRC will take a lenient view on some of these in times of national emergency; however, it should be remembered that, even where caught by exceptional circumstances, the relief only applies for a maximum of 60 days. HMRC has not indicated any willingness to provide relief beyond this limit. In addition, while it applies to most day counts in the legislation (and there are many), these are limited to those measuring time spent in the UK. Every day spent in the UK will still count for numerous other tests, such as:

- the second automatic UK test when calculating the time spent in a UK home;
- the third automatic UK test when calculating days worked in the UK;
- the family tie (a child at school here will trigger the family tie for their parent if the parent spends more than 60 days with the child in the UK);
- the work tie (days spent working in the UK); and
- the country tie (days spent in the UK versus other countries).

Employee homeworking

On 16 March 2020, the government called for everyone to work from home where possible. With the expected surge in employees working from home and incurring expenses they may not otherwise have suffered, they may look to employers for a reimbursement of homeworking expenses.

Exempt homeworking payments

In general, the reimbursement by an employer of employee expenses is treated for tax purposes as earnings from the employment for the tax year in which they are paid (ITEPA 2003 ss 70 and 72) and will be taxed in the normal way. There is, however, an exemption for 'homeworking arrangements' which covers payments made by an employer to an employee in respect of reasonable additional household expenses incurred in carrying out duties of their employment at home (ITEPA s 316A). This is currently up to £4 a week (or £18 a month) but, as announced in the Budget, will be increased to £6 a week from 6 April 2020. An exempt homeworking payment under s 316A can be made to employees who work at home under a voluntary homeworking scheme (which is a crucial difference to other expenses claimed by employees outside of these arrangements).

A 'homeworking arrangement' is an arrangement between an employee and the employer under which the employee regularly performs some or all of the employment duties at home. HMRC's *Employment Income Manual* (at EIM01472) provides that whilst the arrangement need not be in writing, it usually will be and it is sufficient for an employee to work at home frequently or for the days spent working at home to follow a pattern. It is not clear that homeworking arrangements instituted as a result of the Covid-19 crisis would fall within the definition of 'homeworking arrangements', as it is arguable that the arrangement is not 'regularly' performed and may not follow any particular pattern. It would be helpful if HMRC published guidance on this point (particularly if the homeworking measures are widespread and long lasting). In the meantime, however, it would be good practice for employers to formalise the arrangements to help ensure that they would fall within the statutory exemption should employers be considering making a homeworking payment.

Costs that may be covered by such homeworking payments include additional costs of heating and lighting the work area or the metered cost of increased water use, provided that the additional household costs are reasonable and incurred in carrying out the employee's duties. There might also be increased charges for internet access, home contents insurance, business telephone calls or the additional cost incurred as a result of business rates liability (EIM01474). Broadband costs will only be tax exempt if the employee is not already paying for a broadband connection (EIM01475). Payments for costs that would be incurred whether or not the employee worked at home – for example, mortgage interest, rent, council tax or water rates – will not be tax exempt.

Deduction for employee's homeworking expenses

A tax deduction from earnings for expenses which fall outside the exemption for homeworking payments will only be permissible if the household expense has been incurred wholly, exclusively and necessarily in the performance of the duties of their employment (ITEPA 2003 s 336). This is a stringent test to satisfy.

HMRC guidance at EIM32760 (and the examples at EIM32790) suggests that to pass the wholly, exclusively and necessarily test, the employee is not able to choose between working at the employer's premises or elsewhere. This means that homeworking expenses (which fall outside the exemption for homeworking payments) incurred as part of a voluntary working from home arrangement with the employer would not qualify. In the current Covid-19 crisis, employers may have recommended their employees work from home (or the employees may have voluntarily chosen to work from home) but for those employees not under an obligation to do so, it is unlikely that a tax deduction would be available for household expenses falling outside the exemption for homeworking payments.

Final thoughts

Everyone hopes that the Covid-19 crisis will not last long, but sadly it is looking increasingly likely that this may not be the case. Businesses should prepare for long term disruption and displacement of employees which may give rise to unintended tax consequences. Most individuals who genuinely find themselves caught in the UK by family illness, self-isolation, travel chaos or closed borders should be able to disregard up to 60 days towards their residence analysis but advisers should consider whether their stay could trigger other aspects of the statutory residence test and, if a longer stay looks likely, should prepare their clients for the possibility of UK tax residence. ■