Proskauer

UK Tax Round Up

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Welcome to February's edition of our UK Tax Round Up. This month's edition includes updated guidance on the VAT treatment of contractual termination payments, updated HMRC guidance on the assessment of "substantial" activities for business asset disposal relief, the latest in the recent line of IR35 cases and the publication of the responses to the government's consultation on the UK's funds regime.

UK Case Law Developments

Growth securities ownership plan arrangements resulted in earnings receipt

In *Jones Bros Ruthin (Civil Engineering) Co Ltd and another v HMRC*, the First-tier Tribunal (FTT) heard two cases together which raised similar questions of fact and law in relation to certain so-called "growth securities ownership plans" (GSOPs). The particular focus was whether sums received by the appellants from the GSOPs should be taxed as "earnings" (that is, like ordinary salary) or taxed as receipts from securities under the employment-related securities (ERS) tax rules in Part 7 ITEPA 2003 (in which case any gain arising from the GSOP would be subject to capital gains tax rather than employment tax).

GSOP arrangements were implemented by Jones Bros (JB) and Britannia Hotels (BH). In each case, the appellants had entered into contracts with employees which the appellants argued were (or were similar to) contracts for differences (CFDs). The CFD terms required each participating employee to make an up-front payment, along with an additional payment if the profits of the company fell below a specified threshold. In return, the employee would receive a payment if certain future conditions were met, including the relevant company's profits exceeding a specified amount and the employee remaining in employment. JB and BH considered that those payments should be subject to capital gains tax on the basis that the payments were from rights under a CFD and the CFD was an ERS.

HMRC issued tax and national insurance determinations against JB and BH on the basis that the arrangements should be taxed as earnings. JB and BH appealed.

In dismissing the appeal, the FTT found that the predominant purpose of the GSOP arrangements was to pay amounts which would otherwise have been paid as cash bonuses and that the amounts should, therefore, be properly categorised as earnings. Accordingly, the amounts received were subject to employment tax rather than capital gains tax.

The FTT commented that, while the contracts were designed to have similar characteristics to CFDs, they did not contain the required element of speculation and that the purpose of the arrangement was not to secure a profit by reference to fluctuations in the value of property. In particular, the FTT considered that there was no commercial objective to the arrangement because the CFD terms were such that the hurdle triggering the payment to the participating employee would almost certainly be met. The FTT also noted that the fact that employees were required to make an upfront payment to participate in the GSOP did not mean that the receipts from the GSOP could not be within the scope of earnings for employment tax purposes.

The findings of this case are unsurprising but highlight the importance of structuring arrangements with a real commercial purpose and that remuneration schemes which may have been accepted previously may not survive scrutiny by HMRC in the current tax environment.

IR35 victory for Adrian Chiles

In *Basic Broadcasting Ltd v HMRC*, the FTT has found in favour of Adrian Chiles and his media-based company, Basic Broadcasting Ltd (BBL), in relation to the provision of his services to the BBC and ITV between 2012 and 2017 in the most recent IR35 case involving television and radio presenters. HMRC claimed that Mr Chiles' arrangements with the broadcasters were contracts of service (that is, of employment) rather than contracts for services (that is, of self-employment) and had sought payment of income tax and national insurance contributions totalling £1.7 million from him pursuant to the so-called IR35 rules.

In broad terms, the IR35 rules treat an individual who provides his or her services through a personal service company (PSC) as an employee where, based on the "hypothetical contract" between the individual and end client, the individual would have been an employee rather than a self-employed contractor had he or she contracted with the end client directly.

As has been discussed in recent IR35 cases, in order for that hypothetical relationship to be one of employment there has to be sufficient mutuality of obligation and control by the end client and no other factors in the relationship that point to the individual operating on a self-employed basis.

In Mr Chiles' case, the FTT found that the contracts contained sufficient mutuality of obligation. In addition, the contracts gave the BBC and ITV sufficient control over how Mr Chiles performed his services to indicate that a contract for services could exists. In particular, both the BBC and ITV had final editorial control over programmes and over ensuring that Mr Chiles complied with Ofcom rules.

Notwithstanding this, the FTT found that the extent of the broadcasters' control was not the overriding factor. Critically, the FTT determined that no employment relationship existed under the hypothetical contract because Mr Chiles demonstrated, for the purpose of the third limb of the employment/self-employment test referred to above, that he was in business on his own account. Relevant evidence provided to substantiate this claim included that Mr Chiles engaged an agent to promote and manage his career in return for a commission, that he employed a personal assistant and that he provided services to other clients during his periods of engagement with the BBC and ITV.

In this wider context, the FTT held that the hypothetical contracts with the BBC and ITV should be viewed as one part of Mr Chiles' business and, therefore, were contracts for services and not contracts of employment. Accordingly, IR35 did not apply.

The FTT decision makes clear that the existence of both mutuality of obligation and a certain level of control is not conclusive evidence that an employment relationship exists. As previous case law has determined, it is possible for the emphasis on these two tests to be negated with evidence that an individual is engaged in business on his own account, and that should be sufficient to find that the arrangement falls within a contract for services. It remains to be seen whether or not HMRC will appeal this decision.

Other UK Tax Developments

Finance Bill 2022 receives Royal Assent

The Finance Bill 2022 received Royal Assent on 24 February and became the Finance Act 2022.

Update to HMRC guidance on meaning of "substantial" for BADR

Business asset disposal relief (BADR) (previously known as entrepreneurs' relief) is a capital gains tax relief available to individuals on the disposal of shares in certain qualifying "personal" companies and reduces the applicable capital gains tax (CGT) rate on certain capital gains to 10%. To qualify for the relief, the shares being disposed of must be shares in either a trading company or the holding company of a trading group. A trading company is defined as a company that is "carrying on trading activities whose activities do not include, to a substantial extent, activities other than trading activities".

Previously HMRC's guidance outlined that when analysing whether or not a company's activities amounted to "substantial" non-trading activities, an assessment of whether more than 20% of the company's turnover, asset base, management time and expenditure related to non-trading (or investment) activity.

Following the decision of the Upper Tribunal (UT) in *Assem Allam* (reported on in our December 2021 UK Tax Round Up), HMRC has updated its guidance to include a less quantitative view of the "substantial" test. In *Assem Allam*, the UT outlined that, when considering whether or not the non-trading activities were "substantial", the nature of the activities had to be analysed in the context of the company's activities as a whole and that, rather than applying a numerical test, the real question was whether the activities were substantial in the round.

Although the updated guidance still refers to the non-trading 20% element, it does so in less definitive terms than before, and includes additional language with a view to providing flexibility regarding the interpretation of the trading company status condition reflecting *Assem Allam*. The guidance states that "for practical purposes it is likely that from accounts submitted some consideration can be given to the level of non-trading income and the asset base of the company. Where neither of these suggest the non-trading element exceeds 20% the case is unlikely to warrant any more detailed review".

This emphasises that an overall view of the company's activities is required to be taken into account when determining whether or not non-trading activities should be considered to be substantial and that there is no simple formula which can be applied in all cases, particularly as some indicators may point in one direction and others in another.

HMRC updates guidance on VAT treatment early termination and compensation payments

On 7 February 2022, HMRC published HMRC Brief 2/2022 which sets out updated guidance on the VAT treatment of early termination and compensation payments. This replaces HMRC Brief 12/2020 (discussed in a previous Tax Blog).

The VAT treatment of early termination and compensation payments has long been uncertain in the UK. In summary:

- Prior to HMRC Brief 12/2020, the general approach adopted by HMRC was that early termination and other payments described as "compensation" were outside the scope of VAT. However, this position was frequently called into question as it appeared contrary to the position taken in various ECJ decisions and differentiating between a consideration payment and a compensation payment was often not straightforward.

- Following the *Vodafone Portugal* case (on which, see our June 2020 UK Tax Round Up), in which the ECJ found that contractual termination fees payable by customers to Vodafone were subject to VAT on the basis that they formed part of the contractual remuneration for the services (even in circumstances where the amounts paid did not reflect the outstanding amounts due under the contract), HMRC issued Brief 12/2020.
- HMRC Brief 12/2020 broadly suggested that all contractual early termination payments or payments for liquidated damages would be subject to VAT (regardless of the VAT treatment of the underlying supply).
- HMRC Brief 12/2020 was widely criticised for being insufficiently nuanced and was considered to be inconsistent with the relevant ECJ decisions. In January 2021, the guidance was suspended.
- In February 2022, HMRC replaced Brief 12/2020 with Brief 2/2022.

The new Brief 2/2022 and updated guidance reiterates the change of approach taken by HMRC in 2020 position, but now does so in a more nuanced way.

Firstly, the guidance clarifies that early termination or liquidated damages payments will, in most cases, be treated as additional consideration payments for the underlying supply. Therefore, such payments will potentially be subject to VAT, depending on the VAT treatment of the underlying supply.

In addition, the new guidance acknowledges that there may be circumstances where such payments fall outside of the scope of VAT. This will be the case where there is not a "necessary direct link" between the payment and the supply. For example, where punitive fees are charged as a deterrent to breach contract terms (such as parking fines) this direct link between the payment and supply may be broken. On the other hand, there is likely to be such a link where fees charged to effectively compensate a supplier for loss of earnings or covering a supplier's costs. Outside these simple examples, such as in a circumstance where the amount of a liquidated damages payment takes into account a wide range of factors only some of which may be sufficiently linked to the underlying supply to be potentially within the scope of VAT, taxpayers may be subject to a complex and uncertain analysis.

The guidance remains limited to contractual compensation, including where the original contract provides for the payment and where a separate contractual agreement is subsequently reached. The guidance does not address the VAT treatment of damages payments in other circumstance.

The new Brief and guidance overrides any prior VAT rulings provided by HMRC, so all businesses will be required to comply with the new position from 1 April 2022. The challenge facing businesses now will be in determining whether there is a sufficient link between additional fees charged and the underlying supply.

HM Treasury publishes summary of responses to its review of the UK funds regime

As mentioned in our January 2021 UK Tax Round Up, HM Treasury launched a consultation in January 2021 into possible regulatory and tax reforms of the UK private funds regime with a view to increasing the attractiveness of the UK as a location for investment funds and preventing (or slowing down) the movement of such funds to jurisdictions such as Luxembourg and the Channel Islands. This is part of a wider review and reform of the UK funds environment, including the new qualifying asset holding company (QAHC) regime which will come into force from 1 April.

On 10 February 2022, HM Treasury published its summary of responses and next steps to the consultation. The document is extremely wide ranging. In relation to private investment funds, some of the key tax points arising from the consultation include:

- A consultation will be launched regarding VAT aspects of fund arrangements, including the VAT treatment of fund management fees and, in particular, whether such fees should become zero rated.
- An indication that the government will look to further simplify the process by which partners in a UK limited partnership may avail themselves of an exemption from the requirement to obtain a UK taxpayer number (a UTR).
- A suggestion that, notwithstanding the complexity of the direct taxation of UK private fund limited partnerships and the potential application of stamp duty and other UK transfer taxes to them, the government generally considers the current UK tax regime to be fit for purpose.

Developments on the VAT treatment of investment management and advisory fees will be of particular interest in this area.