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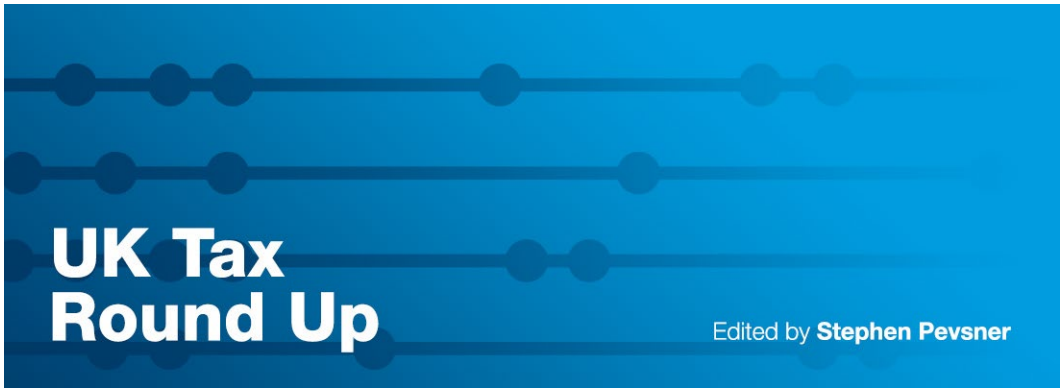

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Welcome to the June edition of our UK Tax Round Up, which discusses HMRC's response to its consultation on the new UK carried interest regime to be introduced next year and interesting cases on the main purpose test in the transactions in securities rules, the "connection" with employment required in the disguised remuneration rules and the valuation of goodwill when acquiring properties used for a trade.

HMRC Carried Interest Tax Changes

HMRC has published its response to the consultation on the proposed changes to the taxation of carried interest which were announced in last year's Autumn Budget. In summary, the new regime involves:

- increasing the general rate of tax on carried interest from 28% to 32% from 6 April 2025; and
- introducing a new set of rules from 6 April 2026, which will tax all carried interest as self-employed trading income with a multiplier of 72.5% applying to "qualifying" carried interest, meaning an effective rate of 34.1% (based on current additional rate tax of 45% income tax plus 2% self-employed national insurance contributions).

We summarise HMRC's response in our *Tax Talks:* UK Government Carried Interest Tax Reforms Consultation Process: No New Conditions, Territorial Limits Clarified | Tax Talks.

The highlights of the response are that:

- the basic proposal to tax carried interest as trading income subject to the 72.5% multiplier for "qualifying" carried interest will be retained;
- the only requirement for carried interest to be "qualifying" is that is it not "income-based carried interest";
- the suggestion that additional conditions for carried interest to be "qualifying" might be included, requiring that the relevant carried interest recipient had held their carried interest for a minimum period and/or that there was a minimum co-investment made alongside the carried interest, have been dropped;

- following considerable concern about the extra territoriality of the new regime and that it will bring non-UK residents who perform work in the UK that is associated with their carried interest into the scope of UK tax on their carried interest (which is not the case under the current rules), HMRC have added some "statutory limitation", principally stating that non-UK residents who carry out work in the UK on fewer than 60 work days in a tax year will not be treated as having carried out any work in the UK in that tax year.

These changes and clarifications are welcome but the draft legislation (expected to be published before the end of July) will require careful scrutiny to ensure that the new regime does not contain undue burdens, particularly for non-UK residents carrying out some of their work in the UK.

UK Case Law Developments

Ensuring relief from CGT not an income tax advantage

In *Hugh Osmond v HMRC*, the Upper Tribunal (UT) overturned the previous decision of the First-tier Tribunal (FTT) and allowed Mr Osmond's appeal that he did not have a main purpose of obtaining an "income tax advantage" when he sold shares in order to ensure that he could claim exemption from capital gains tax (CGT) under the employment incentive scheme (EIS) rules.

The case involved the application of the transactions in securities anti-avoidance rules in Chapter 1 Part 13 ITA 2007. Under those rules, HMRC can assess a taxpayer to income tax to the extent that they receive "relevant consideration" from a transaction(s) in securities under which the taxpayer has a main purpose of obtaining an income tax advantage (section 684(1)(c) ITA). Section 687 ITA states that a person obtains an income tax advantage if the amount of income tax payable that would be payable in respect of the relevant consideration (here, the amount that Mr Osmond received for selling his shares) if it were paid as a distribution exceeds the amount of capital gains tax payable in respect of it, limited to the amount that could have been paid as a distribution at the time that the relevant transaction in securities occurs.

Mr Osmond was an entrepreneur who had made investments in various companies over a long period of time with a view to generating capital gains on the investments. As one of those investments he held shares in Xercise Ltd, which he had acquired under the EIS scheme. Over a number of years, the investors in Xercise Ltd had changed, and only Mr Osmond and one other shareholder could still qualify for EIS relief from CGT if they were to dispose of their shares. In 2015, Mr Osmond and his fellow shareholder became concerned that the EIS regime might be amended or repealed so that they would not be able to benefit from CGT relief if they were to dispose of their shares. In order to trigger the EIS relief, the company agreed to buy back Mr Osmond's shares, and the shares were bought back for £11 million (and his fellow shareholder's shares were bought back for £9 million). Those amounts reflected the capital in the shares as a result of numerous prior corporate reorganisations so that none of the amount was treated as a distribution for income tax purposes. At the time of the buyback, the company had a credit on its profit and loss account of more than £36 million. It was accepted by Mr Osmond that he disposed of his shares in order to trigger the CGT exemption under the EIS regime, but he also stated that he would never have accepted the payment of a dividend from the company. If that were the alternative, he would have just retained his shares and disposed of them at a later date.

HMRC argued that Mr Osmond had a main purpose of securing an income tax advantage by definition because his purpose of obtaining relief against CGT when there was no income tax charge meant that his main purpose of paying no CGT on the transaction was a main purpose

of paying less CGT than the income tax that he would have had to pay were the share buyback consideration received as a distribution.

The FTT agreed and stated that, although the general approach to determining whether a taxpayer has a main purpose of obtaining a tax advantage has been to identify an alternative transaction what would have triggered a different (and greater) liability to tax, that alternative transaction was built into the definition of income tax advantage for the purposes of section 684 ITA as being the receipt of a distribution whether or not, on the facts, Mr Osmond would have deliberately entered into a transaction involving the payment to him of a distribution. Even though the FTT stated that its conclusion depended on Mr Osmond's stated purpose of obtaining EIS relief, this was still a surprising conclusion.

The UT has overturned this decision and allowed Mr Osmond's appeal. The UT approached the question of what the relevant purpose was and that the purpose of entering into a transaction was not necessarily the same as the inevitable effect of the transaction. So, while the inevitable effect of the share buyback was that Mr Osmond paid less CGT than he would have paid income tax had he received a distribution, that did not mean that his purpose was to pay less CGT than he would have paid income tax. It was accepted that he would not have entered into a transaction that triggered a liability to income tax and that his purpose was to pay no CGT, by applying CGT relief, instead of possibly paying some CGT in the future if EIS relief were removed.

It was also noted that the definition of income tax advantage had been introduced by changes to the transactions in securities rules by FA 2010 and that HMRC would not have been able to argue that the share buyback transaction was subject to counteraction under the rules in existence before 2010. Further, the UT did not think that the changes made in 2010 had the intention (or the effect) of changing the fundamentals of the "main purpose" requirement under the rules.

Given Mr Osmond's stated intention of ensuring that he could benefit from EIS relief and that he would not have wanted to receive a dividend, which was accepted by the FTT, the UT's decision is useful in restating that there is a difference between a taxpayer's subjective purpose in entering into a transaction and its effect and that the simple fact that a taxpayer enters into a transaction with a stated purpose of exploiting a CGT relief (or even maybe triggering CGT before a possible rate increase) does not, by definition, mean that they have a purpose of obtaining an income tax advantage.

Remuneration trust arrangement for director subject to disguised remuneration rules

In *Marlborough DP Ltd v HMRC*, the Court of Appeal (CA) has upheld the previous decision of the UT (which overturned the FTT's decision) that a loan to the director of Marlborough DP Ltd (MDPL) made to him through a remuneration trust arrangement did fall within the terms of the disguised remuneration rules in Part 7A ITEPA 2003 because the loan was made "in connection with" the director's employment (which includes directorships).

MDPL operated a dental practice and was owned 100% by its sole director, Dr Thomas. In 2008, MDPL set up a remuneration trust and contributed its profits for the year (and repeated this for a number of years afterwards). The trust then lent the money to Dr Thomas. MDPL claimed a corporation tax deduction for the contribution to the trust and Dr Thomas did not declare an income tax liability.

Prior to the remuneration trust and loan arrangement being put in place, Dr Thomas had received a low level of salary from MDPL with the rest of the money received by him each year paid as a dividend.

HMRC had sought to assess Dr Thomas to income tax on two bases. Firstly, that the loans from the trust were simple taxable earnings for him. Secondly, that they were subject to tax as earnings under the disguised remuneration rules.

The FTT held that the loans were not taxable as general earnings because MDPL had no contractual obligation to pay amounts equivalent to the loans to Dr Thomas, they reflected the overall profit of the business attributable to the work of other staff as well as Dr Thomas and if the payments hadn't been made as loans they would have been paid as dividends. HMRC did not pursue that basis of claim.

The FTT had also determined that the loans were not treated as earnings under Part 7A ITEPA, and were not paid to him "in connection with" his employment (or status as a director), concluding that in order to be "in connection" with his employment "the employment must be part of the reason for the loans" and so the analysis in respect of the disguised remuneration rules required essentially the same analysis as for the question of whether the loans were earnings.

The UT held that the FTT had erred in law in concluding that the "in connection with" test required that the employment was part of the reason for the loan being made and that the test applied by the rules was one of connection rather than of causation, although there did have to be a strong or direct connection between the loan and the employment (or directorship). The UT then held that there was a sufficiently strong connection between the loan being made to Dr Thomas and his directorship of MDPL because he, acting as director of MDPL, was the guiding mind behind setting up the remuneration trust, resolving to make the contribution to the trust and suggesting to the trust that it might make the loan to him.

The appeal to the CA suggested that the UT had erred in a number of ways, but they all really boiled down to the proposition that the disguised remuneration rules in Part 7A should be read as an alternative way of taxing what were general earnings and so required that the employment (or directorship) was the reason for the relevant payment and as applying to a particular tax avoidance scheme prevalent when the rules were introduced which sought to avoid an earnings charge by interposing a third party to make the payment. The CA rejected this basic proposition and concluded that the words of the statute must be considered and that if the legislature had intended to apply a "but for" test it could (or would) have adopted appropriate wording. It had, though, chosen to adopt an "in connection with" test.

On that basis, the CA upheld the UT's decision and agreed that there was sufficient "connection" between Mr Thomas's role as a director of MDPL and the loans being made to him. While unsurprising, this provides useful clarity to the requirement to assess the words in the statute in their context and that, in this case, that means that the connection required under the disguised remuneration rules is not the same as, and might be looser than, the link required for a payment to be general earnings from employment (or a directorship).

The other point considered was whether the contributions made to the trust by MDPL were deductible. The FTT had held that if the loans were subject to tax as earnings or under Part 7A ITEPA then the contributions would be deductible. The UT had disagreed and held that the contributions were not made by MDPL solely and exclusively for the purpose of its trade because there was another purpose of making them in a form which would generate a corporation tax deduction with no income tax liability for Dr Thomas. The CA agreed that the tax structuring purpose was a relevant purpose of the overall arrangement and the contributions to the trust so that the payments were not deductible. On this point, MDPL argued that the UT had not been entitled to overrule the FTT's decision because the question of MDPL's purpose was one of fact. The CA stated that, if it were simply a question of fact, the UT had concluded that the FTT's finding that, if the loans to Dr Thomas were taxed as earnings, then MDPL's purpose in paying those earnings was wholly and exclusively for the

purpose of its trade was “impossible” and “simply unrealistic”. So, even if the UT could only overrule the FTT if the FTT’s conclusion had been wholly unreasonable, the UT had expressed its decision in those terms and the CA agreed with it.

Company providing boat mooring facilities not trading

In *Moffat v HMRC*, the FTT has held that a company owned by Andrew and Charlotte Moffat (the Moffats) that owned rights to provide mooring and other related facilities at Cheyne Pier in Chelsea was not the holding company of a trading group for the purposes of entrepreneurs’ relief (ER) (not business asset disposal relief or BADR) because its activities (or those of its subsidiaries) comprised substantially non trading activities.

The Moffats established two holding companies, Chelsea Marine Ltd (CML) and Chelsea Marine (Jersey) Ltd (CMJL), which they used to acquire Chelsea Boat and Yacht Club Ltd (CBYC) for £4.3 million in February 2016. CBYC provided mooring as well as boat maintenance and related services and boat repair and renovation. The Moffats were directors of another company, Thames River Moorings Ltd (TRML). In July 2016, CML was valued by TRML at £17.8 million on the basis that CBYC had been undervalued when acquired by CMJL. TRML acquired CML from the Moffats in September 2016, who claimed ER in respect of their capital gain. In order to be able to claim ER, CML had to be the holding company of a trading group.

In order to be the holding company of a trading group, the activities of CML and its subsidiaries had to be trading activities and not to include non trading activities to “a substantial extent”. HMRC’s longstanding guidance on “substantial” has been that it means more than 20% by reference to relevant indicators of the company’s/group’s activities, but, as referred to by the FTT, the UT has rejected this quantitative assessment in the *Allam* case and stated that substantial means “of material or real importance in the context of the activities of the company as a whole”.

The case revolved around the question of whether the CML group’s activities did comprise non trading activities to a substantial extent. The Moffats argued that the part of the group’s (or, CBYC’s) activity that constituted non trading activity was just the fees received for the licensing of the moorings and that all of the other services supplied to the boatowners were trading and that, as well as the split of fee income, the vast majority of the work done was in relation to the provision of those services, and so comprising trading activity. The FTT disagreed and held that the majority of the income and the work done was for services that were closely linked to the provision of moorings and receipt of rent for them and not separable so as to create a separate trading activity.

The services that were supplied by CBYC comprised, broadly, granting licences for the moorings and providing services such as maintenance of the premises, provision of utilities and certain other services. The fee income received by CBYC in the year ended 31 March 2017 was recorded as about 49% from mooring fees and licences, 19% from maintenance charges, 26% from boat fittings and repairs, 5% from lighting and heating and 0.25% sundries. The Moffats argued that the only amount that was not from a separate trading activity was that element of the mooring fees and licences that equated to what would have been charged for a “trot” site licence (that is mooring at a buoy with no other services). They argued that case law supports the position that when a landowner remains in occupation and derives income from allowing others to use part of the that property, together with the provisions of additional services, this is a trading activity and not a property business applied to CBYC’s occupation of the Cheyne Pier and the provision of services to the boatowners. The UT disagreed and applied the longstanding analysis that it was a “cardinal principle” that income derived from the exercise of property rights by the owner of land is not income derived

from the carrying on of a trade, except to the extend that the facts support the landowner operating a separate trade. Such a separation would, however, require a clear distinction between the provision of the rights over the land and ancillary services closely related to it and the separate trading activity. The FTT held in this case that a diversion from the cardinal principle was not warranted and that the nature of the services supplied by CBYC and their close link to the provision of mooring access meant that the fees described above as mooring fees and licences, at least, were not derived from a trading activity. Accordingly, the group's activities did include non trading activities to a substantial extent.

The case is interesting in its discussion of the factual matrix that needs to be taken into account in determining the extent to which a group's activities might be trading and non trading as well as emphasising the starting assumption that fees derived from exploiting an interest in land are likely to be non trading unless clearly separable from the provision of rights to use the land.

Value of goodwill associated with trading properties

In *Nellsar Ltd v HMRC*, the UT has considered how much of the consideration paid for a number of operating care homes could be attributable to goodwill rather than to the inherent value of the properties. The case was brought because Nellsar was seeking to claim amortisation of the element of the price paid by it for a number of care homes under the fixed intangible regime in Part 8 CTA 2009, and HMRC argued that the amount claimed was not paid for goodwill, but was simply the value of the properties. In order for Nellsar to be able to claim under Part 8 CTA 2009, the amount attributed to goodwill had to be what would have been attributed had Nellsar prepared its accounts in accordance with GAAP (paragraph 5 Schedule 29 CTA 2009).

Nellsar had acquired five operational care homes and had attributed significant amounts of the purpose price for each to goodwill (between about 15% and a bit over 50% of the price depending on the home). HMRC rejected those numbers and said that the goodwill element should be only between about 25% and 8% of what was claimed, again depending on the home in question.

The basic difference in approach was how to determine the "fair value" of each home under GAAP, which should be based on "market value, if assets similar in type and condition are bought and sold on an open market". Where no open market comparator could be identified it should be based on "depreciated replacement cost, reflecting the acquired business's normal buying process and the sources of supply and prices available to it".

Nellsar argued that the freehold value should be assessed on the basis that there was no business being carried on and that there was no open market comparator for care homes not being operated as such. Accordingly, under GAAP, the fair value of each care home should be its depreciated replacement cost and the rest of the purchase price for each home should be allocated to goodwill.

HMRC argued that where a freehold care home is valued for these purposes, the combined effect of the accounting rules and RICS valuation standards is that its value should be determined having regard to the inherent trading potential of the property and taking into account the business which is actually being operated from it and that the effect of doing so is to characterise much or all of what might otherwise be considered as goodwill as simply part of the fair value of the property.

The UT preferred HMRC's argument and agreed with the FTT that the goodwill claimed by Nellsar was too high because it was not appropriate to calculate fair value on the basis of depreciated replacement cost and that, accordingly, Nellsar's accounts hadn't been prepared in accordance with GAAP. The UT instead held that the fair values should, in accordance with

GAAP, be determined taking into account the potential income generating power of the home as an operating business by applying the "profits method of valuation" set out in RICS Guidance Note GN2. That method took into account the profit generating potential of the property run as a going concern by a reasonably competent operator, but did not necessarily apply the actual profit generation of the home in question or the nature of the goodwill actually attached to the home.

Nellsar also argued that, if it was wrong that the lack of comparable sales of care homes that were not operational meant that paragraph 105 Schedule 29 CTA 2009 should be applied, then paragraph 105(3)(b) stated that a "just and reasonable apportionment" should be applied and that should include an apportionment using the depreciated replacement cost value because that was permitted under GAAP. Paragraph 105 states that where assets are acquired together, any values allocated to an asset in accordance with GAAP shall be accepted, and if the accounts are not prepared in accordance with GAAP a "just and reasonable apportionment" shall be applied. The UT agreed with the FTT that paragraph 105(3)(b) was only in point if GAAP compliant accounts were prepared and those accounts did not allocate values across the different assets. In this case, because Nellsar's accounts were not GAAP compliant, paragraph 5 Schedule 29 required the value of the homes and the value of the goodwill to be calculated applying GAAP compliant principles and those would, in the context of the fair value of an operational care home, apply the profit method of valuation.

The other issue that was discussed was the stamp duty land tax (SDLT) value for the homes. The SDLT was calculated based on a just and reasonable apportionment between the properties and the other assets in accordance with paragraph 4 Schedule 4 FA 2003. The FTT had determined that this also required a "profit method" valuation of the property but separated that valuation from the actual goodwill associated with the home. Consequently, the inherent profit making ability of a care home operated by a reasonably competent operator, but in the actual location of the home in question, should be used to determine the SDLT due on its transfer.

The case reiterates the position taken by HMRC that the inherent profit generating potential of a property sold as a business as a going concern is part of the value of the property itself and the goodwill associated with business is simply the difference between that value and what a purchaser is willing to pay based on the specific characteristics of the business being acquired.