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August 2019

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Welcome to the August edition of our UK Tax Round Up. As ever, August has been a reasonably quiet month but several noteworthy cases have been reported and two important sets of draft regulations have been published.

UK Case Law Developments

Valid notice crucial to tax indemnity claim

The Court of Appeal (CA) decision in *Stobart Group Ltd v Stobart and another* is a cautionary tale for any purchaser who, following the acquisition of a company, might be entitled to make a claim under a tax indemnity given by the seller of that company.

It is common for the seller of a target company to indemnify the purchaser in respect of any pre-completion tax arising that was not provided for in the transaction accounts. These tax indemnities are typically subject to various limitations and conditions, including time-based limitations under which the purchaser must notify the seller of any claim that it wishes to make within a certain period following completion (typically in the case of tax, between four and seven years).

Purchasers are also typically (as in *Stobart*) subject to a separate obligation to notify the seller of any enquiry or claim made by HMRC (or, potentially, other circumstances) from which it appears that the target company might be subject to tax for which the seller could **potentially** be liable under the tax indemnity in order to give the seller the opportunity to exercise its standard control rights in respect of that tax matter.

This dual notification requirement and the uncertainties arising from it was considered in *Stobart*, where the sellers contended that a letter the purchaser sent to them informing them that HMRC had made a claim for underpaid NICs against the target company did not constitute valid notice of a tax indemnity claim against the sellers. The letter made reference to the provision in the tax indemnity requiring the purchaser to notify the sellers of a claim or enquiry by HMRC but did not make reference to the provision requiring the purchaser to notify the sellers that it was making a claim under the tax indemnity. The time limit for making such a claim expired shortly after the letter was sent.

The CA (agreeing with the High Court) determined that the letter sent to the sellers did not constitute valid notice of the purchaser's tax claim for the purpose of complying with the obligation to notify the sellers of a claim being made under the tax indemnity.

The decision provides some helpful reminders as to what might constitute valid notice of a tax claim by a purchaser (as opposed to notification of an HMRC enquiry):

- notices should be read objectively (rather than by reference to the subjective understanding of the recipient) to determine what is being notified
- the notice should refer to a tax claim being made rather than the possibility of a claim
- care should be taken by a purchaser to distinguish SPA requirements to, on the one hand, notify the sellers of claims from which it appears the target company might be subject to tax in respect of which the sellers would be liable under the tax indemnity, and, on the other, notify the sellers of a tax claim actually being made against the sellers under the tax indemnity.

In order to avoid the difficulty of the interaction between the two types of notice that was evident in this case, purchasers might consider stating in transaction documents that notification of a claim or enquiry by HMRC also constitutes a notice of a tax claim being made by the purchaser under the tax indemnity.

Fee rebate loyalty bonus is an annual payment

In our March 2018 edition, we reported that the First-tier Tribunal (FTT) had, in *Hargreaves Lansdown v HMRC,* ruled in favour of Hargreaves Lansdown (HL) that "loyalty bonuses" paid by HL to investor clients which represented sums rebated by investment fund managers from their management fee were not "annual payments" and, therefore, not subject to withholding tax.

HMRC has now successfully appealed this decision at the Upper Tribunal (UT).

By way of background, HL received rebates (arising because HL was able to negotiate a reduction in management fees on behalf of its investor clients) from the investment fund managers in whose funds HL invested its clients' money. This reduction was paid by the funds to HL as a rebate. HL, in turn, paid it (or some of it) to its clients as a "loyalty payment". Before 2014, HL retained a portion of the rebate (instead of charging a fee to its investor clients for its services to them). After a change in law in 2014, HL could no longer retain any portion of the rebate and so passed on the whole amount (and separately charged its clients a fee for its services).

The basis of the FTT's decision had been that the loyalty bonus payments failed to meet one of the four requirements to be annual payments, as they did not represent pure income profit.

The UT disagreed with the FTT and held that the loyalty bonus payments were pure income profit (which then meant that the payments were "annual payments" and subject to withholding tax), noting particularly that:

- the key issue was whether investors received the loyalty bonus without having to do anything in return or incur further expense
- the investors' contractual arrangements to acquire units in the fund and the contractual arrangements agreed between HL and the fund manager for the payment of a rebate were independent of each other (and were therefore not a "composite arrangement")
- HL's decision to market the payment of the loyalty bonus as a reduction of its fee to its clients did not reflect the contractual reality.

The UT said that HL's clients should not be treated as bearing the costs of the fees paid by the funds to their investment managers and that HL's clients' only obligation was to retain its investment with HL.

The UT also confirmed the FTT's view that the loyalty bonus satisfied one of the other requirements for being an annual payment, being that the payment is recurrent (or capable of being recurrent). The fact that HL was not contractually bound to pay the loyalty bonus (before 2014) was not relevant because, as a commercial matter, it was likely to continue to do so, and this commercial background trumped a pure legal analysis.

This decision will be of interest in the private fund world to UK general partners or investment managers or advisers that pay management fee rebates to certain of their fund investors, although (i) the increasing trend of investor-by-investor waterfalls and management fee levels being baked into the fund terms may mean that this is a concern for fewer fund managers than might previously have been the case and (ii) depending on the facts, fund managers paying rebates may get comfortable that their rebate mechanisms are not "independent" from the original management fee payment obligation because of the difference in structure between a typical private fund and the *Hargreaves Lansdown* arrangements.

Transfer of assets abroad rules considered by FTT

In *Hoey v HMRC*, the FTT dismissed an appeal by Mr Hoey against a discovery assessment in respect of a tax avoidance scheme which aimed to reduce amounts paid to employees that were subject to UK employment tax by routing loan payments through an offshore trust.

Mr Hoey was an IT contractor who previously supplied services to end users through his own company but, having found this overly burdensome, he took advice and became an employee of a Guernsey trust company. He was paid a reduced salary by the Guernsey company which was subject to PAYE. In addition, the Guernsey company made contributions to a trust, of which Mr Hoey was a beneficiary. The trust provided interest-free loans to him. The loans were repayable on demand, but the commercial reality was that there was no expectation that the loans would ever be repaid. The loans were employment-related loans for UK tax purposes and the interest-free benefit was taxed accordingly. It was then decided that Mr Hoey should resign his Guernsey employment, in connection with which he would receive a tax-free termination "payment" which was offset against his prior loan receipts. The result of that was that Mr Hoey was (it was hoped) only taxed on the notional benefit of receiving the interest-free loan rather than on the benefit of receiving the full amount of money in a form taxable as income.

The FTT considered that HMRC had made a valid discovery and was entitled to recover under-deducted amounts of tax from Mr Hoey.

What makes this case noteworthy though is the detailed analysis included in the judgement of the application of UK transfer of asset abroad rules (the "TOAA rules") in relation to the sums received by Mr Hoey (although the FTT's decision did not depend on their analysis on this point).

The TOAA rules are broadly drafted anti-avoidance rules which seek to prevent UK residents avoiding UK income tax by transferring income-producing assets abroad.

The FTT found that the TOAA rules applied in principle on the basis that (a) the creation of the Guernsey employment constituted a "transfer" for TOAA purposes (given the broad definition of transfer) and (b) the "no tax avoidance purpose" exception to the TOAA rules did not apply (notwithstanding that Mr Hoey's intention in entering into the arrangement was to avoid the burden of running his own company and it was accepted that Mr Hoey had not considered the expected tax saving under the arrangement, since this test looks to the motive of any person who has designed, effected or advised in relation to the relevant transaction).

We think that it is significant that HMRC sought to use the TOAA rules in this case against the taxpayer. The TOAA rules are extremely broadly drafted and a potentially powerful weapon that, historically, HMRC has not used as readily as it might have done. It might be that, in the current tax climate, the TOAA rules are such that HMRC will seek to use more often.

That view appears to be supported by another case reported this month, *Rialas v HMRC,* in which HMRC also sought to use the TOAA legislation against a taxpayer.

Mr Rialas (R) was UK tax resident. He owned a UK fund management company (Argo) 50:50 with his business partner, Mr Cressman (C). R wanted to buy C's 50% stake in Argo (with a view to then selling 100% of Argo to a third party fund manager). A non-UK (Cypriot) trust, of which R and certain immediate family members were beneficiaries, was set up. The trust was the sole shareholder of Farkland Ventures Inc (Farkland), which entered into a loan agreement with a Greek company, Magnetic Corp, to finance the acquisition by Farkland of C's shares in Argo. Following the sale of C's shares in Argo to Farkland, dividends were paid to each R and Farkland. Subsequently, each of R and Farkland sold their 50% stake in Argo to the third party fund manager.

HMRC alleged that R had made a "transfer" for TOAA purposes in respect of the Farkland arrangements.

The FTT determined that the £10 that R used to set up Farkland should not be regarded as a "transfer" for TOAA purposes, on the basis that the TOAA rules were intended to deter UK residents from transferring income-producing assets already owned (and not income-producing assets being set up). This part of the judgement might, depending on the facts, provide some comfort to private fund managers establishing non-UK general partner, management or advisory structures using small amounts of set-up capital.

As a separate point, the FTT also noted that in "exceptional" cases there could in principle be a transfer for TOAA purposes where a UK resident "procures" a transfer (even if the individual is not itself making a transfer itself). HMRC's argument in this case was that R had procured the Farkland structure, having effectively negotiated the arrangements himself. Although this argument was rejected by the FTT in this case (on the basis that there were commercial reasons for using a non-UK acquisition company and it could not be said that R procured C's decision to sell his 50% stake in Argo to Farkland), this should act as a warning that the TOAA rules cannot, in principle, be circumnavigated by the use of intermediary structures.

Input VAT on pre-incorporation legal fees incurred by director recoverable by company

In *Koolmove Ltd v HMRC*, the FTT has confirmed that a company (K) was able to recover input VAT on pre-incorporation costs incurred by its director in connection with K's business subject to satisfying the criteria in the relevant VAT regulations.

The director was employed by an unconnected company (X) which issued copyright infringement and breach of contract proceedings against him in respect of software he developed whilst employed by X.

Prior to incorporating K, the director incurred legal costs in successfully defending the claim made by X. After incorporating K (through which he intended to run his software business) he attempted to recover the VAT incurred on those legal costs.

Although there is a specific VAT regulation that provides that HMRC "may" permit pre-incorporation VAT cost recovery, this case provides some assurance that if the conditions in that regulation are satisfied the VAT recovery should be permitted.

HMRC had argued that (i) there was no evidence that the software was owned by K rather than the individual and (ii) the legal services contract under which the costs were incurred was between the individual and the law firm and there was no reference to K (and therefore the legal services were for the benefit of the individual rather than K). K argued (and the court agreed) that there was no reason why the courts should not apply the relief provided by the relevant VAT regulation (notwithstanding it only stating that HMRC "may" allow relief in such a circumstance).

In broad terms, what is required to satisfy the terms of the VAT regulation is:

- the company is incorporated within 6 months of the supply and the individual becomes a shareholder, director or employee of the company – in this case it was noted that the short period of time between the conclusion of the legal proceedings and the incorporation of K was a helpful fact
- the individual is reimbursed by the company
- at the time of supply the individual is not registered for VAT
- the supplies are for the purpose of the business to be carried on by the company – in this case it was helpful that the director could evidence his intention to incorporate K and run his software business through K.

Other UK Developments

UK "DAC 6" consultation and draft regulations

Late last month HMRC published draft regulations and a consultation document relating to the UK implementation of EU Directive 2018/822/EU (amending Directive 2011/16/EU) relating to the mandatory automatic exchange of information in the field of taxation (commonly known as "DAC 6").

Under DAC 6, intermediaries and relevant taxpayers are required to file information on "reportable cross-border arrangements" the first step of which was implemented on or after 25 June 2018. A "cross-border arrangement" is, in broad terms, an arrangement which involves more than one jurisdiction including at least one EU member state. Such an arrangement is "reportable" if it satisfies one or more of certain applicable hallmarks (some, but not all, of which require there to be a main expected benefit of obtaining a tax advantage). This structure is similar to the UK's existing "Disclosure of Tax Avoidance Schemes" (DOTAS) legislation which was implemented in 2004.

Although the intention behind DAC 6 is specifically to encourage early disclosure of tax avoidance schemes, the current draft UK definition of reportable cross-border arrangement (which simply cross refers to the EU Directive definition) potentially necessitates disclosure of a wider range of arrangements and also extends beyond DOTAS.

The requirement is for affected intermediaries and taxpayers, in certain circumstances, to report relevant cross-border arrangements implemented between 25 June 2018 and 1 July 2020 by 31 August 2020. Following that reports will be required of subsequent arrangements as and when implemented.

Member States must implement domestic DAC 6 legislation by the end of 2019 and HMRC has invited comments on the draft regulations and related consultation to be received by 11 October.

In the context of private funds specifically, the introduction of DAC 6 represents another set of rules under which private fund managers may be required to disclose or allow their advisers to disclose information about their LPs. Private fund managers are also expected to be required by their LPs to provide reassurances as regards DAC 6 compliance. This is likely to involve establishing internal processes including procedures to determine that advisers or other intermediaries have made compliant disclosures within applicable time limits.

EU Developments

ATAD 2 regulations published in Luxembourg

Luxembourg published its draft regulations implementing the EU anti-tax avoidance directive (ATAD 2) on 9 August. The regulations include the Luxembourg implementation of anti-hybrid rules (which have already been implemented in the UK) and reverse hybrid rules.

The new rules could have a significant impact on private equity and other funds structured using tax transparent Luxembourg vehicles such as the Luxembourg limited partnership (SCSs) or special limited partnership (SCSps) depending on the tax characterisation of them by the fund's investors.

We and the Luxembourg advisers that we work with are continuing to analyse the impact of these rules and the scope of the exceptions that might apply to private equity funds.