Proskauer

UK Tax Round Up

November 2020

UK COVID-19 Developments

Extension of support for employed and self-employed workers

On 5 November, the UK Chancellor announced the extension of the Coronavirus Job Retention Scheme (or furlough scheme) to the end of March 2021 (with a review in January 2021). He also announced that the Self-Employment Income Support Scheme (SEISS) grant for the self-employed will be 80% of average trading profits for November to January 2021 (up to £7,500). More details of this and other COVID-19 developments can be found on our Tax Talks Blog.

Deferral of uncertain tax treatment notification

On 12 November, the Financial Secretary to the Treasury announced that the implementation of the new requirement for large businesses to notify HMRC of uncertain tax treatments will be delayed until April 2022. This delay is to allow for further engagement with stakeholders and to give affected businesses more time to prepare for the change.

As a reminder, an uncertain tax treatment is one where the business believes that HMRC may not agree with its interpretation of the legislation, case law or published guidance. The reporting requirement measure to be introduced is intended to assist HMRC in identifying areas of law that are potentially unclear and so to help HMRC and the government in determining which areas to focus on and to bring increased clarity to the tax system.

Large businesses will be relieved at the reprieve for 2021.

It is hoped that in the intervening period further clarity will be found on the meaning of "uncertain" for the purposes of the notification to HMRC and, for private investment funds, that they will not be required to aggregate their individual investments when assessing whether any particular business is large.

Other UK Tax Developments

OTS report recommends changes to UK's capital gains tax regime

On 11 November, the Office of Tax Simplification (OTS) published its initial report following its review of parts of the UK's capital gains tax regime.

This review was requested by the Chancellor in July of this year, ostensibly as part of the government's long running process of reviewing and seeking to simplify the UK's tax system, but with the specific purpose of "identify[ing] opportunities relating to administrative and technical issues as well as areas where the present rules can distort behaviour or do not meet their policy intent".

The OTS report sets out a number of alternative recommendations, including:

- aligning the capital gains tax and income tax rates more closely, with the OTS considering that the current disparity can lead to distorted decision making and create an incentive for taxpayers to arrange their affairs in order to try to recharacterise income receipts as capital;
- alternatively, if the capital gains tax and income tax rates are not more closely aligned:
  - attempting to reduce the number of "boundary issues" between capital and income, with the report placing a particular focus on the question of whether more employee share-based rewards should be taxed at income tax rates; and
  - considering reducing the number of capital gains tax rates from its current four;
- reducing the annual exempt amount (an individual's capital gains tax-free allowance) to ensure that it operates effectively as an "administrative de minimis" rather than as a form of relief;
- removing the capital gains uplift on death and instead providing that the recipient is treated as acquiring the relevant assets at the historic base cost of the deceased. This recommendation relates to the interaction between capital gains tax and inheritance tax; and
- considering how effective certain reliefs are, including business asset disposal relief (previously called entrepreneurs' relief) and investors' relief and whether such reliefs should be amended and/or abolished.

More details on the report and the potential for change are set out in our Tax Talks Blog.

HMRC publishes proposed amendments to the UK's anti-hybrid rules

As we reported in March's UK Tax Round Up HMRC has been consulting on the UK's anti-hybrid and other mismatches regime. The consultation closed on 28 August 2020. On 12 November, HMRC published a summary of stakeholder responses and the government's response to them, including draft legislation making certain amendments to the existing rules. The consultation on the draft legislation will close on 7 January 2021.

The anti-hybrid rules are detailed and complex and have thrown up a number of anomalous results since their introduction in January 2017. The changes that have been advanced follow a lengthy process of stakeholder representations on certain aspects of the rules and will be of particular interest to the private investment fund industry. The changes include amending the definition of dual inclusion which can be used to avoid deduction disallowance in certain circumstances and of the acting together concept which is key to determining whether or not certain arrangements are subject to the rules at all. Those changes are retrospective and will be effective from 1 January 2017. Other changes will have effect from Royal Assent for the Finance Bill 2021.

Dual inclusion income

Deductions can be disallowed under the rules where there is a so-called deduction/non-inclusion or double deduction. The deductions remains deductible under these rules if deducted from "dual inclusion income". The narrow definition of dual inclusion income has to date raised particular problems for US/UK groups where a UK company is owned by a US parent and the UK company has elected to be treated as tax transparent for US tax purposes. The draft legislation broadens the circumstances in which dual inclusion income is treated as arising and will be welcomed by groups previously suffering from the narrow scope of the dual inclusion income concept.

"Acting together" definition

The concept of “acting together” is fundamental in determining whether the participants in an arrangement are sufficiently connected for the rules to apply. HMRC has acknowledged that the existing definition of acting together cast its net too widely and the proposed amendments to the rules will disapply the existing acting together rules in cases where the otherwise unconnected party holds no more than a 5% equity interest in a member of the group seeking the relevant deduction. This change will apply from 1 January 2017. This amendment is aimed, in particular, at removing the risk that UK companies borrowing from third party lenders with no significant equity interest in the relevant borrower group might suffer an anti-hybrid disallowance on their interest expense.

In addition, changes are to be made to the rules where partnerships are involved, so that an investor in a collective investment scheme will not be treated as acting together with the other partners unless its partnership interest is 10%.

These changes should significantly reduce the circumstances in which the rules might apply to portfolio companies owned by widely-held partnership collective investment schemes.

Exempt investors in hybrid entities

The existing rules deem, in certain circumstances, the tax-free nature of an exempt entity’s receipt to be derived from hybridity (and so susceptible to disallowance) even where that receipt would not have been subject to tax without the hybridity.

HMRC has acknowledged that the existing rules are disproportionate in their application to exempt entities. Although draft legislation in this area is yet to be published, the existing rules will be amended so that where the recipient of a particular payment under the rules is a tax exempt investor the payment that this investor receives will not be subject to disallowance for the payer applying similar rules to those applicable to qualifying institutional investors under the UK’s substantial shareholding exemption.

Part of the government’s intention with the changes is to improve the practical workability and proportionality of the rules.

These changes will be of particular interest to private investment funds where the application of the rules to their portfolio companies should be significantly simplified.

UK Case Law Developments

Transfer of assets abroad rules applied to tax avoidance schemes

In *Lancashire and others v HMRC*¸ the First-tier Tribunal (FTT) held that profits arising to offshore partnerships as part of a marketed tax avoidance scheme fell within the transfer of assets abroad (TOAA) rules with the result that the UK resident taxpayers (the appellants) were taxable on those profits.

Under the schemes, the appellants established Isle of Man trusts (with themselves as the life tenants) with the trustee setting up Isle of Man partnerships (with the appellants entitled to the partnership profits). The appellants also entered into employment and consultancy agreements with the Isle of Man partnerships under which they would provide services to clients resident in the UK. The partnership received a fee from the end client and the partnership paid part of the fee to the appellant as well as allocating a proportion of the profits of the partnership to the trustee as a partner in the partnership with the appellants entitled to their profit share as the life tenants of the trusts. The appellants paid UK income tax and national insurance contributions on the fee that they received but not on their profit shares. They claimed that the profit shares were exempt from UK tax by virtue of the terms of the Isle of Man-UK double taxation agreement.

The appellants accepted HMRC's argument that the fee and profit share were earnings from employment (based on a previous FTT decision on the same tax avoidance scheme). However, they also claimed an entitlement to a PAYE credit for amounts of tax which should have been deducted. The FTT decided that, irrespective of any PAYE credit, the TOAA rules applied to the profit share, meaning that the appellants' profit share receipts were taxable as ordinary income.

The TOAA rules are aimed at preventing UK resident individuals from avoiding liability to income tax by transferring assets (including the creation of rights) abroad so that income derived from the assets arises to a person resident outside the UK, but where the UK resident individual still has power to enjoy the income. The FTT concluded that the creation of rights under the agreements between the appellants and the partnerships constituted a transfer of assets abroad by the appellants. The FTT further held that the TOAA rules had priority over the charge to tax on employment income so that the profits arising to the partnership (and so the appellants) should be treated as the trading income of the appellants rather than as employment income.

This is an interesting case showing the interaction between the TOAA rules and other taxing provisions. It also highlights that, where there is an arrangement structured to benefit from a tax exemption under, for example, a double taxation agreement, the taxpayer should keep in mind that there is a swathe of rules targeting tax avoidance available to HMRC. It is also the latest in a number of recent cases where HMRC has successfully applied the TOAA rules, highlighting that this is an important tool for HMRC and should be considered carefully by taxpayers when setting up arrangements to which the rules might apply.

The Court of Appeal considers "just and reasonable" apportionment

In *Total E&P North Sea UK Ltd v HMRC*, the Court of Appeal (CA) considered the correct approach to the apportionment of company profits during a transitional period in which the supplementary tax charge on ring fence oil and gas profits increased from 20% to 32%. The relevant legislation provided for time-based apportionment of profits during this, but allowed companies, where such basis of apportionment produced an unreasonable result, to apportion their profits on a "just and reasonable" basis.

The FTT had allowed the taxpayer's use of a just and reasonable apportionment basis in the original case. In particular, the tribunal said that the taxpayers only had to show that their approach was a just and reasonable approach, not that it was the most just and reasonable approach.

The Upper Tribunal (UT) reversed the FTT's decision, finding that the FTT had erred in law and that it should have considered whether the result went beyond what was necessary to compensate for factors which made time-based apportionment unjust or unreasonable.

The CA has allowed the taxpayer's appeal and held that the "just and reasonable" basis of apportionment was not just catering for exceptional circumstances.

As stated above, the relevant provision says that if the time-based apportionment would work unjustly or unreasonably in the company's case, the company can elect to apportion on another basis that is just and reasonable.

In rejecting the UT’s approach that this only caters to the exceptional, the CA held that the use of “in the company’s case” was not limited to circumstances specific to a particular company alone and that if Parliament had intended the legislation to operate with such a limitation it could be expected to have spelled that out. The CA also held that although time apportionment is the default position, this does not assist in the determination of “unjust or unreasonably” and concluded that any company which earned profits at a significantly faster rate in one period of apportionment than the other (and could, therefore, be materially prejudiced by time apportionment) can elect for an alternative basis of apportionment, regardless of “whether the differential profitability arose from the exceptional or the routine”.

This case is of interest in shedding some light on when a just and reasonable override can be used and limits HMRC’s ability to reject a taxpayer’s approach to its method of apportionment to cases of exceptional circumstances.

The FTT examines the tax treatment of intragroup loan notes in a corporate acquisition

In *BlackRock Holdco 5 LLC v HMRC*, the FTT considered the tax treatment of some intragroup loan notes issued in relation to a corporate acquisition. The key issues that it decided on related to transfer pricing and whether there was an unallowable purpose for the loan.

The case centred on loan notes issued by BlackRock Holdco 5 LLC (LLC5) to its parent company. HMRC contended that the deduction by LLC5 for interest on the loan notes should be disallowed. The FTT rejected that claim and found in favour of LLC5.

Loan relationship debits (e.g. interest deductions on the loan notes) can be disallowed on a just and reasonable basis under the unallowable purpose anti-avoidance rules if a main purpose of the debtor being party to a loan relationship is to secure a tax advantage. The FTT had to decide whether LLC5 did have such a main purpose in being party to the loan notes and, if so, what amount of the interest deduction was attributable (on a just and reasonable apportionment) to that main purpose.

LLC5 argued that its only purpose in entering into the loan notes was to facilitate the acquisition and so was commercial. The FTT held that LLC5 had both a commercial purpose and a tax advantage purpose but that the debits should be apportioned on a just and reasonable basis solely to the commercial purpose because it was accepted that LLC5 would have entered into the loan notes even if there hadn't been a tax advantage and so the tax advantage purpose had not increased the debits. Accordingly, LLC5's loan relationship debits were allowed.

In making this apportionment, the FTT adopted the approach taken in the earlier *Oxford Instruments* case that "as long as the company can show that it had one or more commercial main purposes unrelated to any tax advantage in entering into, and remaining party to, the loan relationship, and that the relevant debits would have been incurred in any event, even in the absence of the company's tax advantage main purpose, then none of the relevant debits should be apportioned to the tax advantage main purpose". In *BlackRock,* the tax advantage did not change the loan relationship debits incurred.

Regarding transfer pricing, the question for the FTT was whether the parties would have entered into the loans on the same terms and in the same amounts if they had been independent enterprises. The FTT held that the actual provision ($4 million loan) by the parent to LLC5 would have been provided by an independent lender to LLC5 subject to it being able to obtain particular covenants, with the FTT deciding that such covenants would have been forthcoming. Accordingly, the FTT rejected HMRC's claim that some of the interest deductions should be disallowed under the transfer pricing rules.

The case is interesting in how the courts might approach wider questions of apportionment between commercial and tax advantage main purposes and that commercial purposes can override tax advantage purposes when the taxpayer would have entered into the relevant arrangements absent the tax advantage.

The FTT considers double tax treaty relief and domestic time limits

The appellant in *Uddin v HMRC*, a Bangladeshi national, lived, studied and worked in the UK for five years. He had income tax deducted from his earnings. Under the UK-Bangladesh double tax agreement (DTA) he was entitled, as a student, to an exemption from UK tax. HMRC made a repayment for the four years prior to his claim, but not for the fifth because it was outside the time limit for making claims under the UK's domestic legislation.

The FTT considered the questions of whether HMRC was correct to refuse the repayment of the deduction for the period beyond the four years (i.e. 2012-13) and whether it was entitled to deduct the amount of additional tax due for that year from the taxpayer's claims for repayments in the subsequent year. It concurred with HMRC's request to strike out of the appellant's appeal to the extent it related to the year 2012-13 but refused to strike out the appeal against HMRC's reduction of the amount repaid for 2013-14 and 2014-15 by making the offset relating to 2012-13.

The relevant article in the DTA which the appellant relied on for the tax reclaim could only be relied on by an individual for five years (under the article itself). The FTT confirmed that the statutory time limit for claims in domestic law was not overridden by any provision in the DTA and stated that the relevant article in the DTA said nothing about claims in respect of tax but instead deals only with liability to tax. Accordingly, the FTT allowed the strike out of the appeal regarding the repayment of tax paid during 2012-13.

Regarding HMRC's reduction of the amount repaid for particular periods by the offset for underpayments in 2012-13, the FTT refused to strike out the appellant's appeal as "it is far from clear" that HMRC has the right to make such offset "and it is certainly arguable that they do not" and so the question should be considered by the FTT as a substantive matter.

It will be interesting to see how this matter progresses and it is a helpful reminder of the three stages in the imposition of a tax and the distinction between a tax liability and its assessment as well as the limits that might be placed on HMRC to set off tax owed to it against tax repayments that it owes.

The line between evasion and avoidance

As part of HMRC's ongoing criminal investigation into the activities of the claimants in this case, HMRC had previously obtained search warrants. In the claimants' application for judicial review before the Crown Court in *Ashbolt and another v HMRC* they argued that the warrants could only have been issued if the judge that granted the warrants was satisfied that there were reasonable grounds for believing that an indictable offence had been committed. The claimants submitted that the evidence available to the judge that had approved the warrants showed only that the claimants had engaged in lawful tax avoidance and not in unlawful tax evasion, and so there were no reasonable grounds for believing they had acted dishonestly.

The claimants had used loan agreements to reduce their liability to tax. Those arrangements were made subject to tax under the disguised remuneration loan charge that was introduced in 2016. In response to the introduction of that tax charge, the claimants had sought to characterise the arrangements as fiduciary receipts agreements so that they fell outside the loan charge.

The Crown Court held that there was sufficient evidence for HMRC to have considered that the claimants acted dishonestly and the claimants' application for judicial review was dismissed.

The court touched upon the line between avoidance and evasion, stating that tax avoidance will move "from lawful conduct to criminal conduct when it involves the deliberate and dishonest submission of false documents to HMRC with the intent of gain by the taxpayer". Significantly, in recharacterising the arrangements the claimants had stated that under the loan arrangements the users had been fiduciaries from the outset. The court said that this was inaccurate.

The Crown Court decided that the warrants were granted lawfully since, although the original disguised remuneration tax avoidance scheme was not necessarily illegal, the claimants' conduct was potentially criminal when they later submitted a document in which they made false representations and there were reasonable grounds to believe that the claimants knew that the claim that they were fiduciaries was false.

Success fee and insurance premium under a settlement agreement taxable as employment income

In *Murphy v HMRC*, the appellant taxpayer was a police officer who, alongside others, had brought a group litigation claim against the Metropolitan Police Service (the MET) for unpaid overtime and other allowances. The action was settled and under the settlement agreement certain costs (the police officer's solicitor's success fee and an insurance premium) were deducted from the overall settlement amount and paid directly to the solicitors and insurance company, respectively. The appellant appealed against HMRC's contention that those amounts constituted employment income for tax purposes. The FTT rejected his appeal, holding that the success fee and insurance premium were taxable as employment income.

As a reminder, income tax is payable on an employee's general earnings with the meaning of earnings set out in case law and in the Income Tax (Earnings and Pensions) Act 2003. The question for the FTT was whether the payment of the success fee and the insurance premium arose from the appellant's employment or from something else. In deciding that such amounts arose from the employment, the FTT relied on what it considered to be the clear terms of the settlement agreement itself. The agreement was clear that the claim was in respect of unpaid allowances and overtime and that if such amounts had been paid by the MET in the first place they would have constituted taxable earnings. The agreement stated that the parties would bear their own costs other than the agreed costs (which included legal costs), with the FTT concluding that the settlement amount paid by the MET included the success fee and was, therefore, earnings. The fact that the insurance premium did not fall within agreed costs did not, in the FTT's opinion, alter the underlying character of the amounts paid under the settlement agreement being to or for the account of the claimants (including the appellant).

As acknowledged by the FTT in this case, there are few areas of tax law which have provoked more judicial comment and discussion than the question of whether a payment made to an employee constitutes employment income.

It should be noted that this case was decided on the clear terms of the settlement agreement, so that the extent to which its conclusion would apply more broadly, to similar arrangements on different terms, remains to be seen. However, the conclusion will be of interest in M&A transactions where the seller, purchaser or target company pays its management team's legal fees in circumstances when, for example, management is separately advised on warranties and equity they will acquire in the new structure. If nothing else, it shows the importance of the terms of any arrangement under which the management team's costs are to be paid by another person.

EU Case Law Developments

Actual use rather than intended use of services determinative for input VAT deductibility

The European Court of Justice (ECJ) in *Sonaecom SGPS SA v Autoridade Tributária e Aduaneira* has agreed with the Advocate General's (AG's) opinion in deciding that the actual use of services will determine the deductibility of input VAT irrespective of a previous different intended use.

The case concerned the recoverability of VAT incurred by a company on an aborted transaction. The input VAT on consultancy services was recoverable, and the input VAT on services relating to the raising of capital in a bond issue was not. The capital raised was intended to fund the share purchase (which was eventually aborted). The capital was instead used by the company to make a loan to its parent.

The ECJ held that the input VAT was not recoverable as the eventual supply (the loan) was exempt for VAT purposes. The actual supply therefore was determinative for the VAT recoverability when the intended supply had been replaced by the actual supply. The input VAT on the consultancy services was recoverable because of the intention of the company to provide management services (a taxable supply for VAT purposes) to the company that it intended to acquire shares in. This intention remained despite the transaction and taxable supply did not occur since the intended supply had not been replaced by an actual supply.

For more detail on this case, please see our May UK Tax Round Up, where we reported on the AG's opinion.

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