Proskauer

UK Tax Round Up

December 2021

Welcome to December's edition of the UK Tax Round Up. This month saw some significant and interesting case law developments, including a decision by the Upper Tribunal on the extent of the employment related securities charging regime. The European Commission's proposed new rules aimed at preventing the misuse of shell companies is also important and may have material repercussions for some fund houses' holding company structures.

UK Case Law Developments

Taxpayer treated as receiving distribution in tax avoidance case

We reported on First-tier Tribunal's (FTT's) decision in *Dunsby v Revenue & Customs* in our June 2020 UK Tax Round Up. By way of reminder, the case involved a marketed tax avoidance scheme under which a company, Majordegree Ltd, controlled by Mr Dunsby through his holding of ordinary shares, issued a newly created Class "S" share to an unconnected, non-UK resident individual, Mrs Gower, for £100. Mrs Gower then contributed the S share to an offshore trust of which Mr Dunsby was a beneficiary. A dividend of £200,000 was then paid on the S share and Mr Dunsby received £195,400. The rest was used to pay the costs of the scheme and a fee to the promoter.

Mr Dunsby argued that he was not subject to tax on his receipt because the settlements rules applied to Mrs Gower's contribution of the S share to the trust as settled property and stated that she and only she was subject to income tax on the income arising from the settled property.

The FTT had decided that:

- the payment received by Mr Dunsby was not a dividend or distribution on the ordinary shares;
- Mr Dunsby was a "settlor" of a "settlement" and accordingly the whole of the £200,000 income arising under the "settlement" (being the dividend income on the S share) should be treated as income of Mr Dunsby; and
- if (2) were wrong, Mr Dunsby was taxable under the transfer of assets abroad rules so that the income of the trust (being the dividend income on the S share) should

be treated as arising to Mr Dunsby.

Mr. Dunsby appealed to the Upper Tribunal (UT) against the decisions at (2) and (3). HMRC challenged the FTT's finding (1).

The UT, hearing the case on appeal, overturned the FTT finding under (1) above (although the result was still that Mr. Dunsby remained liable to tax, just on an alternative basis). Specifically, it held that the dividend/distribution charging provisions in sections 383 to 385 of ITTOIA 2005, applying a purposive construction, did not require the taxable person to be the holder of the shares on which the distribution is made. What is required is that they are the person to whom the distribution is made or treated as made or the person receiving or entitled to the distribution. The overarching purpose is to ensure that a person who either does receive, or is entitled to receive, a distribution from a UK resident company is subject to income tax on that distribution. The UT decided that Mr Dunsby was entitled to receive the dividend (or £195,400 of it) through his status as beneficiary of the trust.

This ruling highlights the fact that the dividend and distribution provisions in the UK tax code can be construed widely, particularly in tax avoidance cases, and the immediate legal recipient of a dividend might not be the taxable person in all circumstances.

Decision on “substantial” non-trading activities

Another case to have been heard on appeal recently was *Assem Allam v HMRC*. We reported on the FTT decision in our February 2020 UK Tax Round Up. This case covered three different tax issues: the availability of entrepreneurs' relief (ER) (now known as business asset disposal relief (BADR)), the transactions in securities rules and the availability of business investment relief. The judgement related to a disposal of shares by Dr Allam in Allam Developments Limited (ADL) to Allam Marine Limited (AML). AML was a wholly-owned subsidiary of Allamhouse. Allamhouse was a holding company owned by Dr Allam and his wife. ADL, AML and Allamhouse were close companies owned by either Dr Allam or Dr Allam and his wife. HMRC rejected Dr Allam's claim for ER and issued a counteraction notice under the transactions in securities rules seeking to treat the disposal proceeds as a taxable distribution.

The UT has upheld the FTT decision on all three points.

The most interesting question was whether ADL's activities consisted "substantially" of non-trading activities such that Dr Allam was not entitled to ER on his disposal of the shares. The UT reviewed at length how to apply the tests in looking at the activities of a company for this purpose and confirmed that the question of what the company actually does must be looked at in commercial terms. On the key question of whether the company had carried on non-trading activities "to a substantial extent", the UT held that "substantial" should be taken to mean of material or real importance in the context of the activities of the company as a whole and confirmed that it is not appropriate to apply any sort of numerical threshold, as suggested by HMRC's guidance on the topic. The test is not confined to physical human activity, but requires an overall consideration of what it is that the relevant company does. On the facts, the UT decided that ADL did carry on non-trading activities to a substantial extent.

This is an important case, as it confirms that the test for what counts as non-trading activities being substantial needs to be looked at holistically in the context of all the facts. Sticking too rigidly to the rule of thumb in HMRC guidance, that 20% or lower would not generally be viewed as substantial (or, rather, that more than 20% of a key activity would be) is not recommended.

When was a share option acquired?

In *Charman v Revenue and Customs Commissioners*, the UT overturned the previous decision of the FTT on the question of when Mr Charman acquired a securities option that was subject to a continued employment vesting condition.

Mr Charman was granted some share options when he was UK resident. The options vested (i.e. became capable of exercise unconditionally) in three tranches. By the time the third tranche vested Mr Charman had ceased to be UK tax resident. Under the relevant employment related securities rules in force at the time, there was an exclusion for tax on exercise of a share option if the individual was non-UK tax resident and not UK tax ordinarily resident at the time that the option was acquired. That law has since changed such that a proportion of the gain arsing on exercise of the option could now be taxable depending on the fact pattern.

The case turned on the time at which the share option was treated as acquired by Mr Charman. The legislation applies to the acquisition of a “securities option”, which is defined as “a right to acquire securities”. The FTT had ruled that this meant that Mr Charman acquired his securities options when they vested. In Mr. Charman’s case this meant that the third tranche of share options fell outside the scope of UK tax as he was non-UK resident by the time they vested. The decision was made on the basis that the options were conditional on Mr Charman remaining in employment with the group until the relevant vesting date and, until that point, he only had a hope, not a right, that they would be exercisable. In other words, no “right to acquire securities” arose until the options vested.

The UT disagreed with this. In its view, applying the normal rules of statutory construction and taking into account the applicable case law, the contractual right created by the share option documents on grant amounted to the creation of a “right to acquire securities” and, therefore, a securities option at the time the options were granted. The UT noted that, if the FTT’s view had been correct, among other things the charging provisions of the UK tax code that apply to securities options would not be applied to any chargeable event occurring between the date of grant and the date of vesting (such as the disposal of the options by the holder for value).

Mr Charman also appealed against the FTT’s conclusion that some restricted shares that he held in Axis Capital were acquired “as a director or employee”, arguing that he acquired his shares in his capacity as a shareholder. This was because he acquired those shares as part of a share for share exchange. However, the original shares (in Axis Specialty) that he exchanged for the Axis Capital shares had been acquired by him as an employee. After an extensive review of the case law in the area, the UT upheld the FTT’s conclusion that, on the facts, the “source” of the Axis Capital shares was Mr Charman's employment and so those shares were also related to his employment.

This is not a surprising result, given the purpose of the securities options rules and the breadth of the legislation and case law that attributes awards of securities and options to employment relationships.

Input VAT recovery and fundraising activities

In *Hotel La Tour v HMRC*, the FTT was asked to decide on whether input VAT incurred on fees for professional services relating to the sale of shares by Hotel La Tour Ltd (HLT) in HLT's subsidiary, Hotel La Tour Birmingham Ltd (HLTB), was recoverable. HLTB owned and operated a luxury hotel in Birmingham under the name "Hotel La Tour". HLT provided HLTB with management services for consideration. These management services included the provision of key personnel such as the general manager of the hotel. HLT and HLTB were in a VAT group.

HLT intended to use the sale proceeds to construct a new hotel in Milton Keynes, which it intended to operate as a VATable business. HMRC had issued an assessment blocking the recovery of the input VAT incurred on the fees on the basis that it was incurred in connection with an exempt sale of shares. HLT appealed on three grounds. First, that the relevant services were directly and immediately linked to HLT's intended taxable activities. Second, that the effect of HLT and HLTB being in a VAT group is that the supply of the HLTB shares is to be treated as outside the scope of VAT. Third, that the sale of the shares in HLTB should be treated as a sale of a going concern (TOGC) and the fees as general overheads.

HLT argued that the VAT on the professional fees was incurred as part of the sale process which was undertaken with the intention of raising funds to construct and run the Milton Keynes hotel, that the sale represented a sale of the totality of HLT's assets and that the money raised would be invested back into the business to further its taxable supplies. HLT also argued that the management services constituted an economic activity and that, if there had not been a supply of management services, the transaction would have been a transaction outside the scope of VAT in order to raise funds for its taxable business and, therefore, the costs would have been a general overhead of the business.

Interestingly, the FTT held in favour of HLT, concluding that there was a direct and immediate link between the professional services and HLT's taxable economic activities (including the future operation of its new hotel) and that the chain was not broken by the share sale. This relied on the Supreme Court decision in *Frank A Smart* and a line of European Court of Justice case law (particularly *SKF*). In other words, a direct and immediate link to a share sale that is exempt or outside the scope of VAT does not break the chain and the use of a supply for an initial fundraising transaction does not prevent input VAT recovery if the purpose of the fundraising transaction was to raise funds for actual or potential taxable activities (the planned new Milton Keynes hotel development). The taxpayer lost on the other two grounds of appeal.

While of interest, this case is unlikely to help taxpayers recover input VAT costs incurred in relation to share sales when the sale proceeds are not used in funding VATable supplies but, rather, are simply returned to investors.

Legal expenses were incurred wholly and exclusively for purpose of a trade

In *Rogers v HMRC*, the FTT has agreed with two members of the Rogers family that legal expenses in excess of £500,000 incurred to defend their criminal prosecution were incurred wholly and exclusively for the purpose of their scrap metal trade and so were deductible in determining the business's profits.

The case related to criminal proceedings that were brought against two of the partners in the business for buying from the police what the police had implied was stolen property, Mr T Roger was found not guilty. Mr S Rogers was found guilty at his first trial but was acquitted by the Court of Appeal. Following their arrest and criminal charges, a number of important trading stakeholders were making it clear to the partnership that the matter was being taken extremely seriously and that conviction would lead to the withdrawal of the partnership's lease, insurance, banking services and various licences to carry on the scrap metal business, not to speak of customers and suppliers no longer dealing with them.

HMRC had denied the deduction on the basis that the fees were incurred for the dual purpose of avoiding jail and protecting their personal reputations, It was, however, accepted, as a matter of fact, that there was no real prospect of imprisonment and that the appellants were not concerned about it and that the appellants' personal reputations had already been damaged by the press coverage at the time of their arrest. Taking this into consideration, the FTT decided that avoiding jail and the defence of personal reputation were not considerations when the partnership incurred the fees, although the consequence of the Court of Appeal's judgement was that the personal reputation of Mr. S Rogers may have improved slightly.

On this basis, the FTT agreed that the fees had been incurred wholly and exclusively for the purpose of saving the scrap metal business and not with any dual purpose related to the personal circumstances of the Rogers.

This is an interesting decision given the difficulty that taxpayers often face in separating business and non-business purposes where expenditure might be taken to serve more than the purpose of a business and shows that, given the right facts, individuals' legal (or other) expenses might be deductible for the business that they work for. The fact that the business would, effectively, have had to cease to trade if the convictions had been upheld was the pivotal point here.

Other UK Tax Developments

Tax Administration and Maintenance Day

On 30 November, the Government published a package of updates and new proposals. None of this material will form part of the Finance Bill published last month but contains additional items for change and consultation. The most noteworthy of the items published were:

- New draft regulations to introduce the OECD mandatory disclosure rules (MDR) into UK law in place of the European Union's so-called DAC6 rules. This follows the Government's announcement in Spring 2021 that it intended to do this. The MDR require advisers (and sometimes taxpayers) to report information to their tax authorities on certain prescribed arrangements and structures, specifically those that could circumvent existing tax transparency reporting rules known as the Common Reporting Standard or where opaque offshore structures are employed to hide beneficial ownership. The reported information will be exchanged with

relevant tax authorities to help deter non-compliance, assist in identifying and challenging evasion and support the development of tax policy.

- Details of the proposed reform to research and development (R&D) reliefs. The proposed reforms are intended to support modern research methods by expanding qualifying expenditure to include data and cloud costs, to capture more effectively the benefits of R&D funded by the reliefs through refocusing support towards innovation in the UK and to target abuse and improve compliance.

International Tax Developments

European Commission proposed Directive to prevent the misuse of shell entities

On 22 December, the European Commission published the text of a proposed Directive intended to prevent so-called “shell entities” based in EU member states being entitled to certain tax benefits granted by other EU Directive and member states’ double tax treaties. If adopted (and all 27 EU member states will need to approve it), the Directive will come into effect on 1 January 2024. The initiative is known as “Unshell”.

The proposed new measures will establish transparency standards around the use of shell entities, so that their abuse can more easily be detected by tax authorities. Using a number of objective indicators related to income, staff and premises, the proposal will help national tax authorities detect entities that exist with insufficient commercial substance to merit access to tax benefits.

The draft Directive sets out three “gateways”:

- The first gateway looks at the activities of the entity based on the income it receives. The gateway is met if more than 75% of an entity's overall revenue in the previous two tax years is passive income (for example, interest, dividends, real estate rental income or royalties, which is defined as “relevant income” in the Directive) or if more than 75% of the book value of its assets are real estate or other private property of particularly high value
- The second gateway requires a cross-border element. If at least 60% of the undertaking’s relevant income is earned or paid out via cross-border transactions the entity passes through this gateway. This will also be the case if more than 60% of the book value of its assets are real estate or other high value private property
- The third gateway focuses on whether corporate management and administration services are performed in-house or are outsourced. The entity passes through the

gateway if the services are outsourced

If an entity passes through all three gateways, then it will be required to report information in its tax return related, among other things, to the premises of the company, its bank accounts and the tax residency of its directors and employees. These are known as “substance indicators”. All declarations need to be accompanied by supporting evidence. If an entity fails at least one of the substance indicators, it will be presumed to be a “shell”. This will result in the entity not being able to access certain tax reliefs or the benefits of the tax treaty network of its member state and/or to qualify for the treatment under the relevant EU Directives. The member state of residence of the company will either deny the shell company a tax residence certificate or the certificate will specify that the company has been determined to be a shell.

Of these the most significant of the tests (referred to as the employee test below) is that the company much be able to show that either:

a) it has at least one director resident in its member state, the director is not provided by a service provider and that the director is qualified and authorised to take decisions about the business of the company and actively and independently uses that authorisation; or

b) the majority of its full time employees are resident in the member state or live close to it and are qualified to carry out the undertaking’s relevant income generating activities.

An undertaking presumed to be a shell through not satisfying the substance indicators can still prove that it does have sufficient substance or is not misused for tax purposes. To do this, it will have to present additional evidence, such as detailed information about the commercial, non-tax reason for its establishment, the profiles of the employees and demonstrate the fact that decision-making takes place in the member state of its tax residence.

There are exceptions from these rules for certain classes of entity. The exemptions are:

a) companies which have listed securities;

b) regulated financial undertakings;

c) undertakings that have the main activity of holding shares in operational businesses in the same member state while their beneficial owners are also resident for tax purposes in the same member state;

d) undertakings with holding activities that are resident for tax purposes in the same member state as the undertaking's shareholder(s) or the ultimate parent entity; and

e) undertakings with at least five own full-time equivalent employees or members of staff exclusively carrying out the activities generating the relevant income.

Companies based in EU member states will need to check whether they may be affected by these new rules well in advance of January 2024 and to take steps to amend their structures and/or operations if necessary to avoid losing valuable tax benefits. Companies which function as holding or investment vehicles may well need to look closely at the rules and their fact patterns.

It is likely that the ease or difficulty for relevant companies to avoid being designated shell entities will depend on how stringently the employee test is applied and just how much of the substantive decision taking and operation of the undertaking will have to be taken in the relevant member state without effective control from a different jurisdiction.

Depending on how stringently the test is applied, it might be that these new rules will help the UK's drive, (reflected in the new UK qualifying asset holding company regime) to attract more fund-related holding companies into the UK on the basis that the UK will be the natural jurisdiction from which to control the companies.

Related Professionals

- **Catherine Sear**
  Partner
- **Richard Miller**
  Partner