Proskauer

UK Tax Round Up

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UK Case Law Developments

Contributions to remuneration trust scheme not tax deductible

In *Strategic Branding Ltd v HMRC*, the First-tier Tribunal (FTT) held that sums contributed by the taxpayer company to a remuneration trust scheme which were lent to the sole shareholder and director (the director) of a company (and of the taxpayer company) were not earnings from the director's employment but were disguised remuneration (and taxable as employment income) under Part 7A ITEPA 2003. The FTT also held that the taxpayer's contribution to the remuneration trust scheme was not tax deductible as the expense was not incurred wholly and exclusively for the purposes of the company's trade under section 54(1) CTA 2009.

The remuneration trust scheme involved the taxpayer contributing sums to a remuneration trust with the trust paying that sum to a company of which the director was the only shareholder and director. The company then made loans to the director. The loans were substantially the same amount as the relevant contribution by the taxpayer. The FTT found that the transactions were pre-ordained and that one of the advantages of the scheme included obtaining a tax deduction for making the contributions to the remuneration trust in circumstances where there would be no tax on any recipient. Regarding its conclusion that the payments to the director were disguised remuneration, the FTT held that the central and most important characteristic of the arrangement (whether looking at the contributions to the remuneration trust or the loans to the director) was a "means of providing loans in connection with [the director's employment]" with the taxpayer company. A number of "relevant steps" within the meaning of Part 7A were found to have taken place, including various payments and earmarking of sums.

The FTT acknowledged that the trust arrangements in the present case were almost identical to those considered in another FTT case, *Marlborough DP Ltd v HMRC* (as reported in our September 2021 Round Up). In *Marlborough*, the FTT had held that the relevant amounts were neither earnings from the director's employment nor disguised remuneration under ITEPA, instead being distributions to the owner as shareholder. It had noted that if it had determined that the contributions were earnings, then a tax deduction would have been allowed. In *Strategic Branding*, the FTT declined to follow the *Marlborough* reasoning because (1) it was obiter, (2) the distinction in the conclusions reached in the two cases as to the taxable nature of the receipts (and the purpose of the parties in each case) and (3) there was no required connection in the legislation between tax of the receipt and the deduction for the payment. The FTT accepted that there is often a correlation between taxation on the receipt and deduction for the payments. However, it held that the correct question is what is the taxpayer's purpose in making the payment. In *Strategic Branding*, the purpose was partly to benefit the director's family as well as for building relationships between the taxpayer and its suppliers. Therefore, the payments were not "wholly and exclusively" for the purposes of the taxpayer's trade.

Taxpayers should clearly and consistently document the purpose of payments to reduce the likelihood of, and defend their position in the event of, disputes or discussions with HMRC on the deductibility of expenses in these sort of situations.

Entrepreneurs' relief found to be available on lengthy disposal

In *Christopher Thomson v HMRC*, the FTT decided that the taxpayer's claim for entrepreneurs' relief (ER) (now business asset disposal relief or BADR) on his disposal of office premises should be allowed.

The facts of the case are rather unusual. The taxpayer had been a partner in an accountancy firm for many years. In planning for his retirement, it was agreed that his successors would pay him an annual sum in return for the firm's work in progress. The idea was that he would gradually transfer his clients and that his working hours and share of profits would, accordingly, be reduced. Due to various complications the total transfers took over twenty years to complete. The transfer of the firm's premises, of which the taxpayer owned 99.9%, was not dealt with under the (unwritten) agreement for the transfer of the work in progress. The premises were transferred to the taxpayer's pension scheme and then leased back to the accountancy firm.

The question for the FTT was whether ER applied to the transfer of the premises. In particular, was the transfer a disposal of business assets within section 169I(1) TCGA 1992. HMRC contended that, as the taxpayer had only transferred a single asset (i.e. the premises), the disposal was not a "disposal of business assets" as it was not a disposal "of the whole or part of a business" within the meaning of section 169I(2)(a) TCGA 1992. The FTT, however, decided that the disposal of the premises was "part and parcel of a wider disposal" of all of the taxpayer's share in the assets of the partnership which the taxpayer was still completing through the disposal of the premises.

This case is of interest because of the unusual facts and the taxpayer's clear demonstration that the disposal of the premises was part of the wider disposal of the business notwithstanding the time gap. However, the FTT acknowledged the "extreme" period of time over which the events took place and that the case was decided on its own "peculiar" facts.

Court of Appeal decides on the scope of sideways loss relief

In *Naghshineh v HMRC*, the Court of Appeal (CA) has upheld the Upper Tribunal's (UT's) decision to reject the taxpayer's claim for sideways loss relief.

As a reminder, sideways loss relief allows individuals to set off a trade loss against their general income for the year that the loss arises, the prior year or both. The relief is restricted so that, as set out in HMRC guidance, the relief "is only given for genuine commercial losses". Particular restrictions apply to relief in relation to farming or market gardening.

Section 67 ITA 2007 prevents sideways loss relief if a loss was made in the trade in each of the previous five tax years. This case concerned a taxpayer that had purchased a farm with no previous farming experience. The farm generated losses in each of the five previous tax years, partly due to the high cost base and partly to the unexpected outbreak of bird flu. Despite the restriction in section 67, relief is available if the "reasonable expectation of profits" test in section 68 ITA 2007 is satisfied. This requires that a competent person (i.e. a competent farmer) carrying on the activities in the current tax year would reasonably expect future profits (section 68(3)(a)) but a competent person carrying on the activities at the beginning of the prior period of loss (i.e. the five years before the current tax year) could not reasonably have expected the activities to become profitable until after the end of the current tax year (section 68(3)(b)).

In arriving at its decision, the CA examined the somewhat oblique drafting of section 68 by focusing on the meaning of "the activities at the beginning of the prior period of loss". The CA held that the meaning of "the activities" in this context was the farming activities (and market gardening activities, as applicable) that took place in the current tax year and that their nature and the way that they were carried on should be considered (i.e. the same meaning as for section 68(3)(a)). The taxpayer had argued that section 68(3)(b) should be construed as referring to the activities as carried on at the beginning of the prior period of loss as those activities might develop in the future. To accept the taxpayer's argument would have meant the relief would be potentially open-ended, and the CA said that such open-endedness would have undermined the statutory purpose of the provision. The CA held that, although section 68 was a relaxation to the five year rule in section 67, section 68(3)(b) was intended to be a time limit on the relaxation of the five year rule with it being a "long-stop" date beyond which sideways loss relief is not available. The CA upheld the UT's determination that section 68(3)(b) covered the reasonable expectation of the length of time for farming activities (as carried on in the year of loss) to become profitable, calculated from the beginning of the prior period of loss. Accordingly, the taxpayer's claims for sideways relief in each of the years of loss were rejected.

Other UK Tax Developments

HMRC launches consultation on the UK's implementation of the Pillar Two Model Rules

HMRC has launched a consultation on the domestic implementation of the Pillar Two model rules as part of the OECD's BEPS 2.0 project relating to the taxation of the digital economy. For further detail on the model rules themselves, please see our piece below in "Other EU Tax Developments".

The UK government aims to implement the rules domestically "as closely to the OECD Model Rules as possible". The consultation looks, in particular, at the UK's implementation of the income inclusion rule and the undertaxed profits rule. The income inclusion rule applies to multinational enterprises (MNEs) with consolidated annual revenues over €750 million that are headquartered in the UK. Under the rule, a top-up tax (detailed further below) would apply in jurisdictions where the MNE group has entities located in jurisdictions where the effective tax rate is below 15%. The undertaxed profits rule applies to MEN groups with revenue over €750 million, but is limited to UK entities of groups headquartered outside the UK and applies to the group's overseas profits that are not subject to a minimum level of tax.

Question asked of respondents include (but are not limited to) the following:

- Do you see any strong reason why UK legislation should not follow the OECD Model Rules as closely as possible to ensure consistency, bearing in mind the limited flexibility permitted by the common approach?
- Do respondents have any comments on the calculation of the €750m consolidated revenue threshold?
- Do respondents agree the income inclusion rule should only apply to groups that meet this threshold?
- Do respondents have any comments on how the income inclusion rule provisions should be reflected in the UK domestic legislation while respecting the agreed outcomes in the OECD Model Rules?
- Do respondents have comments on the practicalities of computing a constituent entity's accounting profit?
- Do respondents have views on the rules allocating profits between jurisdictions?
- Do respondents have views on the process for calculating top-up tax?
- Do respondents have views on how the undertaxed profits rule should be brought into charge in the UK?

The consultation closes on 4 April 2022 and the government expects to publish draft legislation this summer. Responses should be sent to: PillarTwoConsultation@hmtreasury.gov.uk.

EU Case Law Developments

ECJ decides that parking fee is consideration for supply for VAT purposes

In *Apcoa Parking Danmark A/S v Skatteministeriet*, the European Court of Justice (ECJ) decided that a parking fine for breaching the general terms and conditions of a private car park was consideration for the supply of services and, therefore, subject to VAT. The car park operator had contended that the fine was compensation so not subject to VAT.

The ECJ agreed with the Advocate General's opinion in holding that the fine was consideration for a parking service with a direct link between the fine and the parking service. The payment of the initial parking fee and then the subsequent penalty for parking in breach of the terms and conditions constituted consideration for the provision of a parking space. The initial parking fee and the fine were part of the terms and conditions under which the motorist actually benefited from a parking space, even if excessive use is made of it e.g. by exceeding the permitted parking time. The ECJ also found that the fine covered some of the costs incurred by the car park operator in supplying the service (i.e. it takes into account the higher cost of operating a car park which is caused by parking that does not satisfy the normal terms and conditions for use of the service offered) and the imposition of parking fees would not exist if the service of providing a parking space was not supplied in advance. Therefore, VAT was chargeable on the fine.

The ECJ distinguished between a previous ECJ judgment, *Société thermale d'Eugénie-les-Bains*, that established that certain payments under breached contracts were compensatory for VAT purposes and held that the earlier case had applied where no service had actually been supplied, whereas in the present case the parking service was supplied.

Although the UK is not bound by ECJ decisions since Brexit, UK courts can still have regard to such judgments. The result in *Apcoa* might, therefore, influence HMRC's future treatment of car parking fines for VAT purposes. In its *VAT Supply and Consideration Manual* at VATSC06140, HMRC draws a distinction between (1) a contract under which parking is supplied allows for the original terms to be extended and (2) where the terms and conditions of parking do not allow for extension and include punitive fines for breach. In the former scenario, the payment is further consideration for the supply of parking services whereas the latter is not further consideration, instead being a "true penalty" so outside the scope of VAT. The same distinction was not made by the ECJ in the present case with the penalty for breach of the terms and conditions being treated as consideration for VAT purposes.

Input tax not deductible as VAT not "due or paid"

In *Zipvit Ltd v HMRC*, the ECJ has held that a taxpayer (Zipvit) could not claim a deduction of input tax from HMRC as no VAT was "due or paid" in circumstances where the taxpayer and the supplier (Royal Mail) had mistakenly assumed, on the basis of an incorrect interpretation of EU law by the national authorities, that the supplies in question were exempt from VAT and so the invoices issued did not refer to it. The questions for the ECJ were referred by the UK's Supreme Court (as reported by us here).

By way of background, Royal Mail had originally treated its supplies of postal services to Zipvit as exempt. However, the services were actually (as determined in a later ECJ case) standard rated. Zipvit claimed that the consideration paid by it for the services should be treated as having included VAT and that it should be able to recover that input VAT. Although the CA said that it was unclear whether the payment by Zipvit should be treated as including VAT, it decided that Zipvit was not entitled to recover any input VAT cost because no VAT invoices were issued in respect of the supply.

The Advocate General (reported by us here) had suggested that holding a valid VAT invoice was a substantive requirement for the purposes of VAT recovery. The Advocate General also opined that VAT "due or paid" under the VAT Directive meant VAT due or paid by the supplier (Royal Mail) to the member state rather than VAT due or paid by the customer (Zipvit). This meant that any amount actually received included the VAT provided for by law. However, this was only relevant for Zipvit when it received a VAT invoice as the invoice demonstrated the passing on of the VAT to it and its right to recover it.

The ECJ decided that VAT was not "due or paid" under the VAT Directive and therefore was not deductible. Regarding the question of whether the VAT was "paid", the ECJ pointed out that as the contract between Zipvit and the Royal Mail expressly provided that the price was exclusive of VAT and that if VAT was due, Zipvit should bear the cost of it. Zipvit could not deduct VAT which it had not been charged. In reaching this conclusion, the ECJ distinguished this case from earlier ECJ decisions where the relevant contract was silent on VAT. Regarding whether the VAT was "due", the ECJ noted that for VAT to be "due" there needs to an enforceable tax claim which requires that the taxable person has an obligation to pay the amount of VAT which that person seeks to deduct as input VAT. This was not satisfied by Zipvit. Unlike the Advocate General, the ECJ did not base its conclusion on the requirement (or otherwise) for a VAT invoice.

This result provides welcome clarification because of its implications for a number of other cases between HMRC and taxpayers, with amounts of approximately £1 billion of VAT at issue. The case might also be of wider relevance in future circumstances where the VAT treatment of supplies is contested subsequent to an update to HMRC's guidance or practice on the matter.

Other EU Tax Developments

OECD publishes its Pillar Two Model Rules

Last month the OECD released its Pillar Two model rules for implementation of the minimum 15% tax rate for MNEs which forms part of its BEPS 2.0 initiative aimed at addressing taxation of the digital economy. For further background on the proposals, please see our Tax Blog on the OECD's October 2021 statement setting out the global agreement between 137 jurisdictions. In short, Pillar Two is aimed at establishing a minimum global effective tax rate of 15% with this rate applying to MNEs that exceed a consolidated annual revenue threshold of €750 million. In the OECD's own words, the Pillar Two model rules provide governments a precise template for taking forward the two pillar approach. Key points to note:

- Taxpayers with no foreign presence or less than €750 million in consolidated revenues are not in scope of the model rules.
- The rules do not apply to government entities, international organisations and non-profit organisations nor to entities that meet the definition of a pension, investment or real estate fund.
- Taxpayers within the ambit of the model rules are to calculate their effective tax rate for each jurisdiction where they operate and pay a top-up tax (known as the "Income Inclusion Rule") which reflects the difference between their effective tax rate per jurisdiction where they operate and the 15% rate. The top-up tax will usually be charged in the jurisdiction of the multinational enterprise's ultimate parent.
- There is a de minimis exclusion so that when revenues and profits in a jurisdiction fall below a certain threshold, no top-up tax will be charged on the profits of the group earned in that jurisdiction.
- The model rules allow for the possibility that jurisdictions can introduce their own domestic minimum top-up tax based on the global anti-base-erosion ("GLOBE") regime which is then fully creditable against any liability under GLOBE. This is to preserve a jurisdiction's primary right of taxation over its own income.
- One of the chapters in the model rules contains rules for an internationally co-ordinated approach to administering the rules, including a standardised information return and certain proposals for safe harbours. An Implementation Framework is to be released at a later date setting out further details of administration, co-ordination and any safe harbours.

The OECD expects to release its commentary on the model rules in early 2022 and to address the interaction between the model rules and the US's Global Intangible Low-Taxed Income (GILTI) rules.

Following the publication of the model rules, the European Commission's proposed Directive, which sets out how the Pillar Two minimum tax rate will be applied in practice within the EU, was published. The aim of the Directive is to ensure that the minimum rate is properly and consistently applied across the EU. Regarding differences between the Directive and the model rules, the Directive adjusts the scope of the model rules to also include purely domestic groups (with the scope of the Pillar Two model rules is limited to multinational enterprise groups and a parent entity subjects only its foreign subsidiaries to the income inclusion rule). This is to ensure that the Directive complies with the EU's freedom of establishment. For the Directive to progress, unanimity is needed from the EU member states in the European Council.

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