Proskauer

UK Tax Round Up

November 2022

Welcome to the November edition of the UK Tax Round Up. This month has seen the new Chancellor deliver his Autumn Statement following from the previous Chancellor's so-called mini budget in October and the Court of Appeal's decision denying deductions for certain expenses incurred in respect of the sale of part of the Centrica group's business, among other developments.

UK Autumn Statement Tax Announcements

On 17 November, the Chancellor presented his Autumn Statement to Parliament. Some of the key tax announcements are highlighted below.

Income tax

In an unexpected move, from 6 April 2023 the threshold for the income tax additional rate will be lowered from £150,000 to £125,140. Other income tax, national insurance and inheritance tax thresholds will be maintained at their current levels until April 2028 (two years longer than previously proposed).

Dividend allowance and capital gains tax annual exempt amount

The annual exempt dividend allowance will be reduced from £2,000 to £1,000 from April 2023, and to £500 from April 2024. The government will also reduce the capital gains tax annual exempt amount from £12,300 to £6,000 from April 2023, and to £3,000 from April 2024.

National insurance contributions - secondary threshold

The government will fix the level at which employers start to pay Class 1 secondary (employer) NICs in respect of their employees at £9,100 from April 2023 until April 2028.

Bank corporation tax surcharge

From April 2023, banks will be charged an additional 3% corporation tax rate on their profits above £100 million.

Increasing the rate of diverted profits tax

From April 2023, the rate of diverted profits tax will increase from 25% to 31% in order to retain the 6 percentage point differential above the main rate of corporation tax that currently exists when the main corporation tax rate is increased to 25%.

VAT registration and deregistration

The VAT registration and deregistration thresholds will remain at £85,000 for a further period of two years from 1 April 2024.

OECD Pillar 2

The government will legislate to implement the globally agreed G20-OECD Inclusive Pillar 2 Framework in the UK. For accounting periods beginning on or after 31 December 2023, the government will:

- introduce an income inclusion rule (IIR) which will require large UK headquartered multinational groups to pay a top-up tax where their foreign operations have an effective tax rate of less than 15%; and
- introduce a supplementary qualified domestic minimum top-up tax (QDMTT) rule which will require large groups, including those operating exclusively in the UK, to pay a top-up tax where their UK operations have an effective tax rate of less than 15%.

Both the IIR and QDMTT will incorporate the substance based income exclusion that formed part of the G20-OECD agreement.

Transfer pricing documentation

From April 2023, large multinational businesses operating in the UK will be required to keep and retain transfer pricing documentation in a prescribed and standardised format, set out in the OECD’s Transfer Pricing Guidelines (Master File and Local File). This will give businesses certainty on the appropriate documentation they need to keep and enable HMRC to identify risks and conduct transfer pricing investigations more efficiently.

Capital Gains Tax anti-avoidance

The government will include legislation in the Spring Finance Bill 2023 to provide that shares and securities in a non-UK company (which would be close if a UK company) which are received in exchange for shares or securities in a UK close company will be deemed to be located in the UK for the purposes of Capital Gains Tax. Individuals will pay tax on gains, dividends and distribution income received in respect of those securities deemed to be located in the UK in the same way as they would if the securities were in a UK company so that non-domiciled, but UK tax resident, individuals will not be able to apply the remittance basis of tax to those gains and income.

This measure will only apply where the UK company is a close company and non-UK company would be a close company if it were a UK company.

This measure will have effect where the share-for-share exchange is carried out on or after 17 November 2022.

Online sales tax

The government has confirmed that it will not be introducing this tax.

Reforms to research and development (R&D) tax reliefs

For expenditure on or after 1 April 2023, the research and development expenditure credit rate will increase from 13% to 20%, the small and medium-sized enterprises (SME) additional deduction will decrease from 130% to 86% and the SME credit rate will decrease from 14.5% to 10%.

UK Case Law Developments

Deduction disallowed for expenditure on services relating to the proposed sale of a subsidiary

In *HMRC v Centrica Overseas Holdings Ltd*, the Court of Appeal (CA) has held in favour of HMRC, overturning the previous decision of the Upper Tribunal (UT), that expenses incurred by Centrica Overseas Holdings Ltd (COHL) in respect of the sale of a subsidiary (or the assets of some of its subsidiaries) were not deductible for corporation tax purposes as expenses of management.

The relevant facts of the case were that the Centrica group made the decision to sell a Dutch subsidiary called Oxxio in 2009. The transaction was actually completed as a sale by Oxxio in 2011 of certain assets of its four Dutch subsidiaries. Between 2009 and 2011, COHL, an intermediate holding company in the group, incurred expenses for services related to these transactions and claimed a deduction for the expenses under section 1219 CTA 2009 as expenses of management of its investment business. HMRC determined that the taxpayer was not entitled to relief because either the expenses were not expenses of management or they were capital in nature.

Previously, the First-tier Tribunal (FTT) had found against COHL on the basis that COHL had not made the decisions relating to the sale so the expenses were not expenses of management (although they were expenses of management as a general matter). The UT had found in favour of COHL that the expenses incurred up to the identification of a specific purchaser for the relevant assets in 2011 were deductible.

The two issues considered by the CA in the appeal were, firstly, whether the disputed expenses were expenses of management and, second, if they were, whether the expenses were expenses of a revenue or capital nature. In order for expenditure to be deductible, it must be both an expense of management and not capital in nature under different limbs of section 1219. Prior to this decision, and as determined by the FTT and the UT, it has been generally considered that expenses would be deductible up to the point of identification of a specific purchaser and negotiation of a specific sale transaction.

On the first point, the CA confirmed the FTT’s and UT’s analysis on what are and are not expenses of management, stating that “there is a distinction between expenses incurred in deciding whether to acquire or dispose of an asset [which are expenses of management] and expenses incurred on the ‘mechanics of implementation’ once that decision has been taken [which are not]”. It is the nature of the expenses, rather than when they are incurred, which is relevant to the determination.

Having determined that expenses incurred up to the identification of a purchaser in 2011, or not incurred as part of the “mechanics of implementation”, were, in principle, expenses of management, the CA went on to consider whether they were of a capital nature. Having discussed this, the CA said that the FTT and UT had erred in law in assuming that the revenue/capital question was informed by the question of whether the expenses were expenses of management of the investments or incurred as part of the mechanics of implementation. It considered that the question was a separate one to be considered on its own merits in respect of which it is the nature of the expenditure that is important rather than when it was occurred.

Without giving any detailed consideration to the details of the expenses in question, the CA then concluded that all expenditure incurred from Centrica’s decision to sell the Oxxio business in 2009 was capital in nature and, therefore, none of it was deductible. So, while not expressly stated in the decision, it appears that the cut-off point for expenditure to be capital in nature is when a business has decided in principle to sell (or acquire) an asset rather than when a particular purchaser has been identified or specific negotiations have been commenced. In taking this position, the CA appears to have limited the importance of when an expense has ceased to be an expense of management and is incurred as part of the “mechanics of implementation” of a transaction by treating expenses as being of a capital nature so early in the acquisition or disposal process.

The decision is both surprising and significant because it is a question that both buyers and sellers face in M&A transactions and, while not helpful for taxpayers, it sets a clear line for when expenses relating to sales are likely to be treated as capital in nature, subject to any appeal succeeding to reset this timeline.

Payments received under a settlement agreement taxed as employment income

In *Mrs A v HMRC*, the FTT has rejected Mrs A’s request for a tax repayment and agreed with HMRC that the full amount received by Mrs A under a settlement agreement with her employer was *subject* to tax as employment tax under section 225 ITEPA or, otherwise, section 401 ITEPA.

The claim related to an amount of £1,055,000 received by Mrs A under a settlement agreement that related to Mrs A agreeing not to pursue a claim that she has lodged with the Employment Tribunal (ET) relating to, among other things, sexual harassment by the owner of her employer and to keep confidential and not speak about information around the ET claim. The sum was described in the settlement agreement as the Compensation Sum and was paid to Mrs A alongside what was described as a Tribunal Claim Compensation Sum of £45,000 and a Monthly Compensation Sum of £14,083 for a number of months.

Section 401 ITEPA applies to any amount received by an employee directly or indirectly in consideration or in consequence of, or otherwise in connection with, the termination of their employment. Section 225 ITEPA applies to payments which are received in respect of a “restrictive undertaking” given by an employee in connection with their employment.

Mrs A contended that the Compensation Sum had no connection with the termination of her employment but was paid wholly in consideration for her agreeing to desist with her ET claim and enter into the confidentiality and non-disclosure obligations. This was notwithstanding that the settlement agreement stated in its preamble that it set out arrangements relating to, among other things, the termination of Mrs A’s employment and that the Compensation Sum was “compensation for the termination of [Mrs A’s] employment and any and all claims [she had] or may have against [her employer]”. The £45,000 Tribunal Claim Compensation Sum was described as “compensation for injury to feelings and aggravated damages in full and final settlement of [Mrs A’s ET claim]”. The settlement agreement also stated that the amount of the Compensation Sum in excess of £30,000 was taxable as a termination award.

HMRC claimed that the Compensation Sum was a payment received by Mrs A “otherwise in connection with” the termination of her employment under section 401 ITEPA or, in the alternative, if it was consideration for Mrs A entering into the confidentiality and non-disclosure obligations in the settlement agreement then it amounted to a payment for a “restrictive undertaking” in connection with her current, future or past employment and was taxable as employment income under section 225 ITEPA. A “restrictive undertaking” is “an undertaking which restricts the individual's conduct or activities”.

Mrs A accepted that the confidentiality and non-disclosure obligations were “an undertaking which restricted her conduct or activities”. She argued, however, that the definition of restrictive undertaking should be qualified by adding the words “in connection with her current, future or past employment” so that not only must the restrictive undertaking be given in connection with her employment but it must also restrict her conduct or activities in relation to employment and not generally. If read in that way, Mrs A argued, the confidentiality and non-disclosure obligations did not fall within section 225.

The questions for the FTT to consider were whether the Compensation Sum was (i) received directly or indirectly in consideration or in consequence of, or otherwise in connection with, the termination of Mrs A’s employment or for something else and/or (ii) consideration for Mrs A entering into the confidentiality and non-disclosure obligations, being a payment for a restrictive undertaking in connection with Mrs A’s current, future or past employment. Although HMRC had put forward tax under section 401 as its primary argument and tax under section 225 in the alternative, the FTT considered section 225 first since it takes priority and section 401 only applies to amounts which are “not otherwise subject to income tax”.

The FTT agreed with the interpretation of section 225 ITEPA put forward by HMRC and stated that it did not consider that a restrictive undertaking must relate to the individual’s conduct or activities in the course of their employment in order for it to fall within section 225. Any undertaking which restricts the individual’s conduct or activities and is given in connection with their employment is within the scope of this section. They also agreed that Mrs A had given restrictive undertakings in connection with her employment in the settlement agreement. Therefore, the Compensation Sum was chargeable to tax as earnings from employment under section 225. As a matter of interest, but not material to the FTT’s decision, the FTT referred to HMRC Statement of Practice SP 3/96, which states that “undertakings in termination agreements to discontinue legal proceedings relating to the employment or reaffirming undertakings given as part of the original terms of the employment” are not considered to have chargeable value for the purpose of section 225. The FTT stated simply that Statements of Practice do not have the force of law and that it would ignore SP 3/96 in its deliberations.

On the section 401 question, the FTT accepted that payment of the Compensation Sum was in part consideration for Mrs A entering into the confidentiality and non-disclosure clauses and might not have been paid had she not agreed to withdraw her ET claim and enter into the confidentiality arrangements, but said that (i) the "otherwise in connection with" the termination of Mrs A's employment terms were extremely wide in scope, (ii) it didn't matter if the payment was only in part in connection with that termination and (iii) in this case, as evidenced, at least in part, by the terms of the settlement agreement, there was a connection between the payment of the Compensation Sum and the termination of Mrs A's employment. Therefore, the payment was within the scope of section 401 ITEPA.

The case raises two key points. First, depending on the facts, it might be difficult to ensure that payments under a settlement agreement incorporating restrictions on an employee's future behaviour do not fall within one of section 225 or 401 ITEPA. Second, while it is not clear that Mrs A could have avoided employment tax on the Compensation Sum had her settlement been drafted in different terms, care should be taken when drafting such an agreement to try to ensure that any relevant payment is stated to be made purely as damages relating to employer behaviour or similar since that is the only category of payment that is likely to (or might) avoid employment tax.

Denial of tax loss arising under gilt strips scheme

In Timothy Watts v HMRC, the FTT decided in favour of HMRC, denying the taxpayer a substantial income tax loss which he claimed arose in connection with a disposal of gilt strips under a tax avoidance scheme.

The relevant facts of the case were:

- the taxpayer acquired gilt strips with a value of £1.5 million using borrowed funds;
- the taxpayer granted an option to buy the gilt strips to an interest in possession (IIP) trust of which the taxpayer was the settlor and life tenant for a premium of £1.3 million with an exercise price of £150,000;
- the IIP trust assigned the option in respect of the gilt strips to a bank (Investec) for a payment to the IIP trust of £1.3 million; and
- Investec exercised the option and paid the exercise price of £150,000 to the taxpayer.

As a result of the exercise of the option, the taxpayer claimed an income tax loss of £1.35 million which he considered allowable under paragraph 14A Schedule 13 Finance Act 1996 (as was then in force), with the amount of the loss being calculated as the difference between the amount that the taxpayer paid to acquire the gilt strips (£1.5 million) and the exercise price of the option paid to the taxpayer by Investec, but excluding the premium paid by Investec to the IIP trust for the purchase of the option.

Under paragraph 14A Schedule 13 FA 1996, the taxpayer suffered a "loss" in respect of a gilt strip if he or she transferred the strip or became entitled to a payment on its redemption and the amount paid for the strip exceeded the amount payable on the transfer or redemption. The judgement focuses on how the so-called *Ramsay* approach to applying tax legislation to particular transactions (taking a purposive approach to the legislation in question and determining whether, or how, the relevant provision applies to the transaction based on a realistic view of the facts) should be applied to this definition of loss and whether it required a "legal" or "commercial" approach to what the amount of the "loss" was. Relevant to this question have been a number of previous tax avoidance cases looking at other provisions in Schedule 13 FA 1996 where the method of what the relevant "loss" was is set out in relatively detailed arithmetic terms and in which the courts have decided in favour of the taxpayer because there was no scope to deviate from the mechanistic method in the rules. The taxpayer in this case sought to apply a "legal" approach to the definition of loss in paragraph 14A and argued that only the £150,000 should be treated as "payable on the transfer" of the gilt strips because it was only the exercise price for the option that was a payment for the transfer and not the premium paid by Investec to acquire the option.

Notwithstanding these previous cases looking at different provisions in Schedule 13, the FTT came to the conclusion that the question of what the "transfer" of the option covered was a "commercial" rather than a "legal" one. In this case therefore, giving the term "transfer" a wide practical meaning, the transfer of the gilt strips from Mr Watts to Investec involved both the acquisition by Investec of the option and its exercise so that the "amount payable on the transfer" (considering this from the perspective of Investec which was the party by which the amount was payable) was £1.5 million and not £150,000. This reduced Mr Watts' loss to a negligible amount.

As a general point, the FTT also noted that it was not the case that all statutory provisions should be divided into those with a “legal” meaning and those with a “commercial” meaning. Rather, the job of the courts (and the taxpayers and their advisers) is to apply a purposive construction to the legislation and determine how the legislation, so construed, applied to the facts of the case viewed realistically. Depending on the terms of the legislation, such a purposive approach might lead to slavishly following the words of the legislation or might lead to a broader interpretation of particular terms (such as “payment on transfer”).

Other UK Tax Developments

The Taxation (International and Other Provisions) Act 2010 Transfer Pricing Guidelines Designation Order

The government has updated the UK’s transfer pricing legislation to add a reference to the latest OECD Transfer Pricing Guidelines. The Taxation (International and Other Provisions) Act 2010 Transfer Pricing Guidelines Designation Order, SI 2022/1147, will update the definition of transfer pricing guidelines in section 164 TIOPA 2010 to refer to the 2022 OECD's transfer pricing guidelines.

This ensures domestic legislation aligns with the international consensus on the interpretation of the arm’s length principle: both to comply with its bilateral tax treaties, and to provide clarity for individual businesses.

This Order comes into force on 1 January 2023.

Closure of the Office of Tax Simplification after final report on hybrid and distance working

As announced in the government’s Growth Plan 2022 on 23 September 2022, the Office of Tax Simplification (OTS) will be closed when the Spring Finance Bill 2023 receives Royal Assent. The OTS is the independent adviser to the government on simplifying the UK tax system which has operated for a number of years undertaking formal reviews commissioned by the Chancellor and reviews on its own initiative covering many of the issues facing the UK tax system.

In August 2022, the OTS announced a review looking at the tax and social security implications of both domestic and international hybrid and remote working arrangements, and will provide its findings and recommendations to the government by the end of this year. The OTS will cease to operate following its publication of this report.

UK government publishes consultation response on replacement for DAC6

Following Brexit, the UK authorities had announced in early 2021 that it planned to implement the OECD's mandatory disclosure rules (MDR) under which intermediaries will have to report arrangements that may otherwise avoid international exchange of information under the OECD's Common Reporting Standard (CRS) and other arrangements entered into that hide the identity of beneficial owners in place of the European Union's reporting system put in place by EU Directive 2018/822 (DAC6). Please refer to our UK Tax Round Ups from June 2020 and January 2021 for background. On 24 November, the UK government published a response consultation on how to implement these new rules.

The key decisions to be made related to the "look-back" period for reporting of pre-existing arrangements and the availability of an online manual reporting system.

HMRC initially suggested a look-back period that extends back to 29 October 2014 but it has now agreed that reporting pre-existing arrangements should be required to look only up to 25 June 2018, on the grounds that the burden placed on business had to be balanced with the likely compliance benefits and that this is the date already required under the UK's initial and revised implementation of DAC6.

On the second point, HMRC has decided that it is not able to provide a manual system for reporting and has confirmed that reporting will have to be done online using an Extensible Markup Language (XML) file format, which is the commonly agreed method for international automatic exchanges of information, including the CRS, to facilitate effective exchange of information with other tax authorities.

The consultation response now states that the new MDR regulations will be tabled and take effect in the first half of 2023.

UK signs new agreements on exchange of information

The UK has signed up to two new OECD multilateral agreements which will facilitate the exchange of information from digital platforms and on Common Reporting Standard avoidance arrangements.

The first agreement is the multilateral competent authority agreement (MCAA) for the automatic exchange of information under the OECD Model Rules for Reporting by Digital Platforms. This agreement will allow jurisdictions to automatically exchange information collected by operators of digital platforms with respect to transactions and income realised by platform sellers in the sharing economy and from the sale of goods through such platforms. The annual exchange of this information will assist tax administrations and taxpayers to ensure efficient taxation.

The second agreement is a separate MCAA supporting the Model Mandatory Disclosure Rules on Common Reporting Standard Avoidance Arrangements and Opaque Offshore Structures (CRS Mandatory Disclosure Rules). This agreement will enable the annual automatic exchange of information collected from intermediaries that have identified arrangements to circumvent CRS and structures that hide the beneficial owners of assets held offshore with the jurisdiction of tax residence of the taxpayers. This will allow tax authorities to ensure compliance of both the taxpayers and the intermediaries involved in such arrangements.

European Case Law Developments

Transfer pricing and State aid

In *Fiat Chrysler Finance Europe and Ireland v Commission*, the European Court of Justice (ECJ) has set aside the decision of the General Court of the European Union (GCEU) and the EU Commission's decision that had assessed Fiat under State aid rules in relation to a transfer pricing tax ruling given by the Luxembourg tax authority (LTA) on the basis that the Commission had been wrong to extend the question of what was an appropriate arm's length comparator beyond the relevant terms of generally applicable Luxembourg law.

The broad facts of the case were that Fiat Finance and Trade Ltd (FFT), a Luxembourg resident company, provided treasury services and financing to the Fiat/Chrysler group companies established in Europe and requested a tax ruling from the LTA to agree a transfer pricing agreement. The LTA confirmed that FFT's proposed transfer pricing method was acceptable and that its ruling was binding for five years. The LTA's ruling was based on it applying the general Luxembourg principles for determining the appropriate taxable profit for members of an integrated group.

The Commission considered that the transfer pricing methodology used by FFT and approved by the LTA was not in accordance with an appropriate "arm's length principle" and resulted in lowering FFT's tax liability as compared to the amount which would have been payable by a standalone company and determined that the LTA's tax ruling amounted to unlawful State aid. The GCEU agreed with the Commission.

The ECJ has held that the Commission and GCEU were wrong to replace the generally applied Luxembourg law method for determining FFT's profit with a more general EU-determined arm's length principle and that, because tax remains the responsibility of individual Member States, the unlawful State aid criteria should have been tested against the valid Luxembourg law domestic approach to determining FFT's appropriate profit. This failure by the Commission infringed Luxembourg's autonomy in the field of direct taxation since, without harmonisation of tax at the EU level, any selection of methods and criteria for determining an "arm's length" outcome falls within the discretion of the Member States.

While not necessarily of interest in the UK following Brexit, the decision provides useful clarity on how the Commission should approach State aid cases relating to tax while it remains within the au

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