Proskauer

UK Tax Round Up

February 2023

Welcome to February's edition of our UK Tax Round Up. The month has seen interesting cases on the "entitlement" to income and the single and multiple supply tests for VAT as well as announcement of the publication date for the next Finance Bill and HMRC guidance on the imminent changes to the CSOP regime.

Finance Bill Publication

The government has announced that the Finance (No 2) Bill 2023 will be published on 23 March following the Chancellor's Spring Budget statement on 15 March. We will report on any interesting aspects of the Budget and Finance Bill in next month's UK Tax Round Up.

UK Case Law Developments

Person taxable on income they had assigned to lender as security

In *Thomas Good v HMRC*, the Court of Appeal (CA) has agreed with the previous decisions of the First-tier Tribunal (FTT) and the Upper Tribunal (UT) that an individual who had entered into a film financing scheme under which he had assigned his right to receive certain income to the lender that provided him with financing for the scheme was subject to tax on the income on the basis that he was "entitled" to it notwithstanding that he didn't actually receive it.

The broad terms of the arrangement involved Mr Good, as an investor, acquiring certain rights to exploit the distribution of films. Mr Good financed his purchase of the rights partially from his own resources and predominantly from a loan made to him by the group that set up and managed the scheme. Mr Good was entitled to receive certain payments from the exploitation of the films including what was described as a "minimum annual payment" (MAP) sufficient to cover the interest payable on the loan. The loan was limited recourse as to capital repayment and full recourse against Mr Good's assets as to interest payments. Mr Good assigned by way of security his right to the MAPs to the lender in order to satisfy his interest payment obligations and so that the MAPs were paid directly to the lender to satisfy those obligations.

The question considered by the CA (and the FTT and UT before) was whether Mr Good was subject to tax on the minimum annual payments under section 611 ITTOIA 2005 which states that the person liable to tax on income from a business exploiting film rights is the person “receiving or entitled to” the income. In addition to this question, the FTT and UT had previously decided that the arrangement did not amount to a trade for Mr Good so that he was not entitled to a deduction for his interest expense or other losses associated with the scheme. That point wasn’t further considered by the CA.

The question of “entitlement” to income has recently been considered by the CA in the unfortunate *Bostan Khan v HMRC* case which decided that the taxpayer was entitled to a distribution from a company on repurchase of its shares notwithstanding that he used the distribution to repay a loan that he had been given to acquire the shares from their previous owners just before the share repurchase.

As in that case, Mr Good sought to argue that he was not subject to tax on the MAPs because either he didn’t receive them or obtain any benefit from them or because, applying a purposive approach to the arrangement as a whole, it should be considered that he was not entitled to them as they would always be paid directly to the lender.

The CA agreed with the UT that the reference to “receiving or entitled to” in section 611 could apply to more than one person so that tax could be charged on either the person receiving the income, or the person entitled to it if they were different. The CA also considered that, looking at the documents used to give effect to the scheme as a whole, Mr Good did benefit from the MAPs because they discharged his real obligation under the loan to pay interest. If the MAPs had not been made, Mr Good would have retained a personal obligation to pay the interest.

In considering how the *Ramsay* basis of purposive construction should be applied to the transaction, the CA rejected the taxpayer's assertion that his "entitlement" should simply take into account the expected end result of the structured and preordained sequence of transactions. Rather, the CA said that the purposive approach should be applied to the particular piece of legislation in question taking a realistic view of the particular elements of the transaction in the context of its whole. In this case that was whether Mr Good was "entitled" to the MAPs taking into account the loan and the security assignment. The CA decided that Mr Good's obligations under the loan and the use of the MAPs to satisfy those obligations were real and that Mr Good was "entitled" to the MAPs notwithstanding the security assignment to the lender and the use of the MAPs to discharge the interest payment obligations.

The case provides another useful discussion on the question of who might be "receiving or entitled to" income, a phrase which is used in a number of income tax provisions. It also provides another useful discussion on the approach to be taken to the purposive construction of legislation (particularly anti-avoidance legislation) in the context of highly structured arrangements and a cautionary reminder of just how wrong such arrangements can go for the taxpayer.

Matchmaking services are not "consultancy" services for VAT purposes

In *Gray & Farrar International LLP v HMRC*, the CA has considered whether the services supplied by a matchmaking provider amounted to "consultancy" services for VAT purposes. This was relevant to determining whether the services in question supplied to individuals (non-business customers) were supplied in the UK (and so subject to VAT) or supplied outside the UK (and so not), since supplies of certain "consultancy" services to non-business customers are treated as supplied where the customer belongs and not where the supplier belongs. If the service supplied did not amount to "consultancy" services, then they would be treated as supplied in the UK and subject to VAT.

Gray & Farrar (G&F) provided high end matchmaking services to its customers and argued that the supply was of consultancy services since the supply depended on the expertise of the business's founder.

The CA has overturned the previous decision of the UT and agreed with HMRC and the FTT (although on a slightly different basis to the FTT) that the matchmaking services did not amount to consultancy services of the sort referred to in Article 59(c) of the EU Council Directive 2006/112/EC (being “consultancy services … or similar services … and the provision of information”).

It was accepted by all parties that the matchmaking services constituted a single, composite (or complex) supply of services for VAT purposes. That is, there was a single, rather than a multiple, service supply which involved a number of elements. The CA confirmed that, in such cases, the primary method for characterising the service was to determine its “predominant element”, as referred to in the ECJ’s Mesto case, and that, if it wasn’t possible to determine the nature of the supply on that basis, then other, similar tests could be applied. The CA also noted that the question of predominant element should be considered from the perspective of the typical consumer of the services having regard to the objective characteristics of the supply.

The UT had decided that the services did amount to consultancy services on the basis that customers were using the particular expertise of the founder of the business to identify suitable potential matches for them and that, from the customer’s perspective, the supply was of advice and of information about the matched person. The CA considered that this was not the correct test and found that the predominant element of the services viewed from the perspective of the customer was the introductory service itself, rather than the expertise of the business founder and the provision of information, and that the introductory service was not the sort of service habitually provided by consultants and was not data processing or the supply of information, meaning that G&F should have charged VAT to their non-EU customers.

Although it may seem like this is a decision on a relatively specific set of facts, it provides a useful explanation of how to assess the character of a single composite service for VAT purposes, that the scope of consultancy services is not as wide as one might think and that the important thing to think about is how the typical customer would characterise the supply applying a realistic approach to exactly what is being purchased.

Supply of operating theatre services single or multiple supply for VAT purposes?

In *R (on the application of Gloucestershire Hospitals NHS Foundation Trust) v HMRC*, the UT considered a judicial review application by Gloucestershire NHS trust (the trust) on whether a supply of services relating to the management of operating theatres provided to the trust by a third party amounted to a single supply of managed theatre services with ancillary supplies of certain goods or to a multiple supply of managed theatre services and the associated consumables.

The question arose because NHS trusts are generally entitled to claim recovery of input VAT on supplies relating to the operation of "managed healthcare facilities" but are not entitled to claim refunds of VAT on supplies of certain goods, such as bandages, gauze, sutures or protheses. The rules in question are specific, UK rules introduced to encourage the outsourcing of services by NHS trusts and sit outside the general UK and EU VAT rules. The UT decided, however, that the question of whether the service as a whole constituted a single supply of managed theatre services or a supply of managed theatre services and a separate supply of consumables should be considered applying EU VAT principles. This required an assessment of whether the service that was provided, viewed objectively, comprised a single supply with closely associated ancillary elements or comprised multiple supplies.

The UT accepted the trust's explanation that, in entering into the outsourcing contract, its intention was to allow its staff to walk into a fully functional operating theatre and that this would include the provision of everything required including the consumables used in the operations. Accordingly, the UT agreed with the trust that it could recover all of its input VAT incurred under the contract.

The case provides a useful reminder of the need to understand whether a putative supply is a single supply (and, if so, what that supply is for VAT purposes) or multiple supplies since the VAT consequences can be very different in each case and that in making this determination it is necessary to apply an objective and realistic assessment of exactly what it is that the relevant contract is seeking to achieve.

Other UK Tax Developments

HMRC raises late payment interest rate

Following the increase in the Bank of England base rate, HMRC has raised its interest rate for late payment of tax to 6.5% pa from 21 February 2023. Please see here for further details.

HMRC raises the official rate on beneficial loans

In addition to the above, HMRC has announced that the “official rate” of interest will increase from 2% pa to 2.25% pa from 6 April 2023.

This is the interest rate that is used to determine whether an employee receives a taxable benefit in kind (reportable in a P11D) when the employee receives a loan from their employer (or other relevant entity). Under the relevant beneficial loan rules in ITEPA 2003, an employee is treated (subject to various exemptions) as receiving earnings for a tax year when the employee is advanced a loan and does not pay interest in respect of the loan for the tax year in question equal to at least the official rate.

HMRC guidance on changes to the CSOP regime

HMRC has published guidance on the changes to be made from 6 April to the company share option plan (CSOP) regime that are intended to make the regime more attractive to a wider range of businesses.

Under the CSOP regime in Schedule 4 ITEPA 2003, companies can grant share options to employees on tax advantaged terms which, when they apply, can mean that the employees can acquire shares on exercise of the options with no employment income tax liability even when the shares are acquired for less than their market value at the time of exercise.

Along with the enterprise management incentive (EMI) regime, the CSOP regime has provided a tax-advantaged method of incentivising employees using share options.

The regime has, however, suffered from a restriction on the type of share that can be the subject of the options, so that CSOP options could only be granted over either the single class of share issued by the relevant company or over shares of a class which either resulted in control of the company by its employees or were held in the majority by investors who were not employees. These restrictions have mitigated against the use of CSOP options by early-stage companies which often have a bespoke share capital comprising different classes of share for different stakeholders.

There are two significant changes that are going to be made to the CSOP rules for options granted on or after 6 April 2023. These are:

1. removing the restriction on the type of share that can be acquired under a CSOP option; and
2. increasing the maximum market value at the time of grant of the shares that each employee can have under unexercised CSOP options from £30,000 to £60,000.

While EMI schemes have been more popular in early-stage companies than CSOP schemes to date, EMI options cannot be granted by companies that carry on "excluded activities" which include "banking, insurance, money-lending, debt-factoring, hire purchase financing or other financial activities". This restriction does not apply to CSOP schemes.

Accordingly, once the changes are implemented, CSOP schemes might become more attractive to groups carrying on EMI "excluded activities", particularly given the new flexibility in the type of share that can be the subject of the options meaning that options can be granted over shares like growth shares or hurdle shares that might have a low value at the time that the options are granted.

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