Proskauer

UK Tax Round Up

July 2023

Welcome to July's edition of our UK Tax Round Up. This month has seen a number of interesting tribunal decisions, including the denial of double tax relief and of employee expense deductions and the taxation on loans to a company director, as well as the publication of draft legislation for the Finance Bill 2024 and the ratification by Luxembourg of the new UK-Luxembourg double tax treaty.

UK Case Law Developments

UK resident partner in Delaware partnership granted double tax relief

In *GE Financial Investments v HMRC,* the Upper Tribunal (UT) has allowed GE Financial Investments' (GEFI's) appeal against the prior decision of the First-tier Tribunal (FTT) to deny it double tax relief. The UT ruled that GEFI was resident in the United States for the purposes of the UK/US double tax treaty (the Treaty) and could therefore claim relief against its UK tax for tax paid in the United States.

As previously reported in our June 2021 *UK Tax Round Up*, GEFI is a UK-resident taxpayer and the limited partner in a Delaware limited partnership (D LP) that was engaged in credit finance activities. GEFI's shares were stapled with the shares of D LP's US-based general partner (GEFI Inc). This meant that GEFI was subject to both UK and US tax on its profits from D LP. GEFI claimed UK double tax relief in respect of approximately £125m of US tax that it paid over a period of six tax years. HMRC rejected the claim.

GEFI's initial appeal against HMRC's denial was refused by the FTT, which held that GEFI was not entitled to double tax relief under (i) Article 24 of the Treaty because it was not US-resident for the purposes of the Treaty, as required under Article 4, and (ii) under Article 7 of the Treaty because it was not carrying on a business in the United States through a permanent establishment.

The UT disagreed with the FTT's findings on (i), ruling that the FTT was wrong to conclude that GEFI was not resident in the United States for the purposes of the Treaty. It referred to Article 4 of the Treaty, which defines a “resident of [the United States]” as “any person who, under the laws of [the United States], is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature”.

The UT held that the connection between the US residence criteria in the Treaty is that they are all “nothing more and nothing less” than commonly accepted ways in which “full taxation” is imposed. The effect is that residency is attributed wherever a territory has full taxing rights. Under US domestic law, a stapled foreign corporation is subject to full US taxation as if it were a US domestic corporation. The UT therefore found that, for the purposes of the Treaty, share stapling is an acceptable basis of US tax residency. It also found no basis for the FTT's additional requirement that the criterion should amount to a direct legal connection between a corporation and the United States and, so, concluded that GEFI was resident in the United States for the purposes of the Treaty**.**

That decision on its own was enough to allow GEFI's appeal. However, the UT also considered the point at (ii) above; the question of whether GEFI conducted a “business” in the US via its membership of D LP. In that capacity, GEFI had participated in five affiliate loans made by D LP over a six-year period. The FTT had ruled that this activity was too modest to qualify GEFI as a business. In view of the difficulty of finding a single statutory definition of business under UK tax law, the UT referred to a series of examples in case law. It found that the FTT had considered all the principles which these examples provided and agreed that GEFI's activity was not sufficient to constitute the carrying on of a business. It therefore did not interfere with the FTT's decision on (ii).

Although this case has a unique set of facts, this decision provides helpful authority on what amounts to a business, which is a relevant topic in many other areas of law, as well as a clear explanation of the type of tax nexus that could result in residency for tax treaty purposes.

Dentist fails in claim for deduction for rental expenses

In *HMRC v Jayanth Kunjur,* the UT has upheld HMRC's appeal and overturned the previous decision of the FTT which had allowed, in part, Mr Kunjur's claim for a deduction against his employment income for the cost of additional accommodation that he rented to be close to his workplace.

As previously reported in our October 2021 *UK Tax Round Up*, Mr Kunjur was a dentist who decided to retrain as a maxillofacial surgeon at St George's Hospital in London. His dental practice was in Southampton, where he and his family lived. Mr Kunjur initially commuted daily from Southampton which took three hours each way. He had to be on call two nights a week and one weekend in six and be able to be present at the hospital within 30 minutes of a call. He therefore decided to take accommodation closer to the hospital. He rented a flat where he would stay from Sunday night to Friday evening and when on call at the weekends. He claimed a deduction against his salary for the costs of the accommodation under section 336 Income Tax (Earnings and Pensions) Act 2003 (ITEPA), which HMRC denied. The FTT held that Mr Kunjur was entitled to a deduction for some of those costs in proportion to the amount of time he spent performing his duties of employment in his London flat.

1. Section 336 provides that for a successful claim for costs to be deducted against employment the employee is obliged to incur and pay the cost as holder of the employment; and
2. The cost must be incurred wholly, exclusively and necessarily in the performance of the duties of employment.

In deciding that part of Mr Kunjur's accommodation expenses were incurred necessarily and wholly and exclusively in the performance of his duties of employment it noted that Mr Kunjur was required by the General Medical Council to place the interests of his patients before his own and held that this requirement did necessitate that Mr Kunjur should have accommodation in London, therefore satisfying the "necessarily" part of the test. It also held that Mr Kunjur had met the "wholly and exclusively" part of the test, but only during the time in which he was on call.

HMRC argued that the FTT had erred in law in its approach to the issues of whether Mr Kunjur was obliged to incur these costs as part of his job, whether the costs were incurred wholly and exclusively in the performance of his duties of employment, and whether they were incurred in the performance of his duties of employment.

On the first point, the UT found that his decision to rent accommodation in London arose from his personal circumstances rather than necessarily from his employment. It noted that not all doctors employed in Mr Kunjur's position would incur the same costs. It therefore held that Mr Kunjur was not obliged to incur the costs because of his employment.

On the second point, the UT pointed out that the FTT had found that his accommodation in London served a “dual purpose” as he was living there as well as working. Following longstanding precedent, the UT determined that the FTT had erred in concluding that Mr Kunjur's expenditure could be apportioned between part that was incurred wholly and exclusively in the performance of his duties and part that was not. The “wholly and exclusively” test was a single test that needed to be applied to the totality of the costs in question.

On the third point, the UT found that Mr Kunjur's expenditure was ultimately incidental to his duties. While accepting that he used the accommodation as a base from which he performed his duties, it found nevertheless that his expenditure on it was not incurred in the performance of those duties.

The UT therefore remade the FTT's decision and dismissed Mr Kunjur's appeal and denied his claim for a deduction for the costs.

In our coverage of the FTT's original decision to grant Mr Kunjur a deduction, we noted that the case demonstrated how difficult it is for employees to satisfy the test on personally incurred expenditure. While the facts of Mr Kunjur's circumstances might be considered helpful to him, the UT's decision provides a reminder that the threshold for costs incurred wholly and exclusively and necessarily in the performance of employment duties is a high one.

Loan from EBT to director taxable as earnings

In *M R Currell Ltd v HMRC*, the FTT held that a payment from a company (MRCL) to an employee benefit trust (EBT), enabling the EBT to provide a loan to a director of MRCL (MC) was solely or substantially a reward to the director referable to his services as an employee/director of MRCL and was, therefore, taxable as earnings under section 62 ITEPA 2003. The fact that the loan was made on commercial terms with an obligation to repay, and such obligation might be enforced, did not prevent it from being a taxable reward or benefit.

MC established his business as a sole trader in the 1980s and incorporated the business as MRCL in 2002. In November 2010, MRCL established an EBT purportedly as a vehicle to facilitate rewarding employees and directors. MRCL contributed £800,000 to the EBT with the stated purpose of providing funds for future payment of bonuses to employees. Also in November 2010, MC signed an interest free loan agreement with the EBT in the amount of £800,000. The loan was repayable after five years. MC used the £800,000 to acquire shares in MRCL from his wife (KC). KC then lent the £800,000 back to MRCL. MC secured his £800,000 loan from the EBT against his shares in MRCL. At the time that the arrangements were put in place, MRCL was consistently paying bonuses to employees in the region of up to £8,000, dependent on salary. During the period 20 April 2009 to 30 April 2019, MC had taken a modest salary, together with similarly modest dividends, when payable. His remuneration during this period ranged from approximately £14,000 to £41,000 per annum.

HMRC did not allege that the loan or the use of the loan to purchase the shares was a sham. The loan was accepted as a real loan on commercial terms with a genuine obligation to repay. The question was whether the £800,000 loan made by the EBT to MC was a reward or benefit for his services as an employee or director and, therefore, taxable earnings under section 62 ITEPA. To be taxable under section 62, the payment to MC would, according to the FTT (and applying the words of Lord Hodge in the *Rangers* case), have to be a “reward or benefit” for MC’s services.

In considering what the overall purpose of the arrangements were, the FTT considered that the arrangement, in essence, allowed for the £800,000 paid by MRCL to the EBT to be returned to MRCL via MC and KC in a form that meant that the money was freely available to KC to withdraw as she pleased, ultimately benefitting MC as KC's spouse. Therefore, the purpose of the arrangement could not be said to be, as argued by MC, to create a pot of money in the EBT for future bonuses, or to ringfence an amount for such use and to protect it from future trading vagaries to benefit employees in future years. Viewed realistically, the substantial reason for the arrangement was to enable the EBT to make the loan with the intention of putting the money into the unfettered control of MC. There was no requirement to establish the EBT to pay bonuses, the figure of £800,000 was too large a figure to ringfence for bonuses given the level of bonuses previously paid by MRCL and the decision to set up the EBT had been taken before the figure of £800,000 had been determined.

Once the FTT was clear on the purpose of the arrangement viewed realistically, the question became what was the reason for the decision to allow MC such control over the money? Was it a reward or benefit provided to him because of his role as an employee and/or director or was it paid for some other reason?

In coming to its decision, the FTT considered whether the £800,000 ended up in MC's control by some other method of passing money to a director/shareholder, such as a payment of a dividend, an increase in the value of shares or a loan from a company to a director. The FTT concluded, on the balance of the facts, that it was inevitable that, at the time MRCL paid the £800,000 to the EBT, the money would be paid to MC by way of a loan. Without sufficient evidence to the contrary, the FTT felt compelled to take the position that it was far more likely than not that the loan was paid to MC as a reward for the services he provided to the company. The FTT specifically noted that the fact the loan was a genuine loan on commercial terms which was genuinely repayable did not prevent it from being a reward or benefit. The FTT also considered whether a loan on commercial terms (ignoring the interest-free element) could be a reward or benefit. It held that the concept of reward or benefit was wide ranging and any loan resulted in a benefit to the borrower by virtue of having money available that would not be available without the loan. Accordingly, and since the FTT decided that the £800,000 was paid by the company, via the EBT, to MC by reason of the services he supplied to the company, it followed that the payment fell within the meaning of earnings under section 62 ITEPA as a reward or benefit for the services and was taxable.

The FTT further considered whether the potential for double taxation (on the contribution to the EBT and loan to MC and then also if the loan was repaid and the money, or some of it, was paid out by the EBT as bonuses), was to be factored in when considering if the payment was taxable. The FTT decided that this was not a relevant consideration for the question of whether the payment to MC was taxable.

The FTT's position, in concluding that a genuinely repayable loan could be a reward or benefit, might be considered to contradict two previous FT decisions, *Strategic Branding Ltd v HMRC* and *CIA Insurance Services Ltd v HMRC*, both of which are under appeal. Given these appeals, it may be that we will soon have further clarity on the taxation of these types of arrangements, although the decision in this case shows that the courts are willing to take a broad approach to the sort of arrangement that can give rise to taxable earnings when employees or directors seek to extract money, or give themselves access to money, from the companies that they provide services to.

Transfer of a business between connected parties had £1 value and resulted in a distribution

In *HMRC v Conran*, the UT upheld the FTT's decision that assets transferred from a limited liability partnership (the LLP) controlled by the taxpayer (Conran) to a connected company (the company) had a proper market value of £1 rather than the £8.25 million claimed and that, therefore, the Company could not claim intangibles relief. The UT also determined that, while agreeing with the FTT that Conran did not realise a capital gain, the £8.25 million consideration paid by the Company, which was indirectly controlled by Conran, could be treated as a distribution to Conran and subject to tax as such.

Conran's business was designing, manufacturing, and marketing branded optical products. The business was operated as a limited liability partnership and Conran was the majority partner with a 99.9% share. Conran's transfer effectively incorporated the business. Conran was also the shareholder and sole director of the Company.

As consideration for the transfer of the business, excluding the grant of any licences to use or sub-licence any of Conran's trademarks, the Company paid £8.25 million to the LLP. The trademarks, or "intangible assets", were expressly excluded from the transfer of the business. Conran treated the £8.25 million received as a capital gain and paid the appropriate capital gains tax. The Company amortised the £8.25 million as an expense in its accounts and claimed relief under the intangible fixed assets regime. The business transfer agreement also included a "tax reducer clause" to the effect that if the Company was subject to a different tax treatment to the one expected, the consideration would be reduced to £1.

HMRC sought to deny the Company its deduction on the grounds that the £8.25 million did not represent the true value of the transferred business and that the real market value of the assets transferred from the LLP to the Company could only be £1. This valuation was based on the transfer not including any of Conran's trademarks. HMRC further argued that the £8.25 million received by Conran, through the LLP, was a distribution from the Company.

The FTT had held that, as a transfer between connected parties, the transfer of the LLP's assets to the Company was deemed to have been at market value, which was £1. The FTT noted that as Conran was a shareholder in, and sole director of, the Company, it followed that it was only right to assume that the Company had the right to use the trademarks as it would continue to conduct the business in the same was as had the LLP. If a third-party purchaser were to purchase the business without the assumed access to the trademarks that the Company had, the business would be inoperable and so the market value of the business would be no more than £1.

The FTT had, however, disagreed with HMRC's argument that the consideration was a distribution from the Company to Conran. The distribution legislation requires that a payment must be made "in respect of shares". The FTT held that Conran had received the payment of the £8.25 million as the majority partner in the LLP, the entity which had operated and sold the business, and not by reason of his indirect shareholding in the Company.

As stated, the UT upheld the FTT's decision on the valuation of the business, again citing the lack of trademarks as the reason for the low market and, in upholding this valuation, also upheld the FTT's decision that the Company could not claim intangible fixed assets relief on the £8.25 million consideration.

The UT also remade the FTT's decision that the payment of £8.25 million to the LLP did not constitute a distribution to Conran as its majority partner. Applying the *Ramsay* principle, the UT took a purposive approach to the term "in respect of shares" and, taking into account the tax reducer clause in the business transfer agreement mentioned above, the UT held that this showed a willingness from Conran to protect shareholder value in the Company at the expense of the LLP. This was an illustration of the control that Conran had over the overall transaction and was not consistent with a third-party arm's length transaction. The clause was, instead, more consistent with the £8.25 million being paid to Conran as a shareholder of the Company rather than as a partner in the LLP. HMRC's appeal was, therefore, allowed on that point.

The case provides another example of how the well-established approach to statutory construction and considering the purpose of legislation in the light of the facts of each individual transaction can and will be used by the courts to defeat structured transactions entered into on other than commercial, arm's length terms.

Other UK Tax Developments

Finance Bill 2024

HM Treasury published draft legislation for Finance Bill 2024 on 18 July. Here is a summary of some of the key proposals, most of which have been previously announced.

UK's continued implementation of the Pillar Two Model Rules

We previously reported on HMRC's consultation on the OECD's Pillar Two Model Rules and, specifically, on the introduction of a multinational top up tax (MTT), domestic top up tax (DTT) and undertaxed profits rule (UTPR), for which see our January 2022 *UK Tax Round Up*, we further discussed these in our November 2022 *UK Tax Round Up*. The OECD rules are contained in the global anti base erosion rules (GloBE Rules). The UK's primary charging mechanism of the GloBE Rules, the income inclusion rule (IIR), was implemented into UK law as the MTT in Part 3 and as the DTT in Part 4 of the Finance (No 2) Act 2023, both of which look to closely mirror the OECD Model Rules. The UK government has now published draft legislation designed to implement the undertaxed profits rule into UK law. The draft legislation is in line with the announcements made at the Autumn Statement 2022 and reflects the UK government's continued commitment to the implementation of the OECD's Pillar Two Model Rules.

At a high-level, the MTT requires 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 the DTT requires 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%.

The UTPR, effectively acts as a "sweep-up", applying where the other rules do not collect the total top up tax that a multinational group company should be paying. It allows countries in which group members are resident to, in effect, impose the tax a group company would have paid to its country of residence if that country adopted an IIR.

In addition to the implementation of the UTPR, the draft legislation seeks to amend Part 3 of the Finance (No 2) Act 2023 to keep the MTT consistent with the GloBE Rules and the administrative guidance on those rules. The purpose of the amendments are to ensure that the legislation "functions as intended and reflects the latest internationally agreed guidance".

The UK government’s decision not to simply enact the OECD Model Rules into domestic law and to move ahead with draft rules ahead of the OECD administrative guidance being completed is the reason for such immediate amendments and a reason that we may see further legislative amendments in the near future, arguably further complicating, rather than easing, the compliance burden for affected businesses.

R&D tax reliefs

The government has published draft legislation for the introduction of a single merged research and development (R&D) relief. The legislation is largely modelled on the existing R&D expenditure credit (RDEC) scheme and would allow all companies, regardless of size, to claim under a single scheme, merging and replacing the current RDEC scheme and SME R&D scheme.

Although the government has not yet decided whether or not the new regime will be introduced it is considered more likely than not to go ahead.

Stamp taxes, VAT on asset management services and corporate redomiciliation

No draft legislation was included on the three areas of modernising stamp taxes, VAT on asset management services or corporate redomiciliation, which have all been the subject of recent consultations, so we will have to wait to see if anything further comes of them or if draft legislation is proposed later in the year.

UK-Luxembourg Tax Treaty

On 19 July, Luxembourg ratified the new UK-Luxembourg double tax treaty which will replace the 1967 treaty with a new one and that was signed and ratified in the UK in 2022. The new treaty will become effective in Luxembourg and in respect of withholding tax on 1 January 2024 and in the UK in April 2024.

Some of the key changes in the treaty include the right for the UK to the sale of share sales by Luxembourg residents in companies that are “UK property rich”, a 0% withholding tax on almost all dividends (excluding certain real estate related dividends), the recognition of certain collective investment vehicles (CIVs) which are treated as being companies in Luxembourg and are owned by Luxembourg residents or persons with equivalent treaty benefits as being “resident” and beneficially owning their income and the replacement of the “place of effective management” residence tie breaker with a mutual agreement procedure.

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