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Welcome to July's edition of our UK Tax Round Up. This month's edition discusses the multilateral progress made on the BEPS 2.0 proposals for international taxation and the publication of draft legislation proposed to be included in the Finance Act 2022 for enactment next year. There are also a number of interesting domestic and European case law developments, including the CJEU Advocate General's opinion in the long-running Zipvit case and the Supreme Court quashing a follower notice issued by HMRC.

UK Case Law Developments

Supreme Court quashes follower notice and accelerated payment notice

In *Haworth v HMRC* the Supreme Court (SC) upheld the Court of Appeal's (CA's) decision to quash a follower notice (FN) and accelerated payment notice (APN) issued to the taxpayer, Mr Haworth. An FN can be issued by HMRC where a tax avoidance scheme is being used that has the same or similar arrangements to one that HMRC has successfully challenged in court. An FN will ask the recipient to settle their tax affairs. The recipient can, however, continue to challenge HMRC's interpretation, but if it does so and loses, this may result in a penalty. An APN can follow an FN and requires payment of the disputed tax.

The case involved Mr Haworth's tax return for 2000-2001. He argued that the tax arrangements he had entered into legitimately allowed him to avoid tax on a capital gain on a share disposal by a trust of which he was a settlor, relying on the relevant provisions in the Taxation of Chargeable Gains Act 1992 (TCGA) and the UK/Mauritius double tax treaty (DTT). In particular, he asserted that the place of effective management of the trust was in Mauritius when the share disposal occurred thereby reserving taxing rights to Mauritius.

HMRC had issued an FN on the basis that an earlier CA decision (*Smallwood v HMRC*) involved arrangements that were the same in all material respects as Mr Haworth's and, in that case, the CA's interpretation of the DTT was that the provisions of the DTT did not relieve the taxpayer from the tax charge under the TCGA with HMRC concluding that, by applying *Smallwood*, the place of effective management of the trust was in the UK, rather than in Mauritius, at the time of share disposal.

The CA had allowed Mr Haworth's appeal from the High Court, holding that HMRC had not satisfied the conditions to issue an FN as set out in Finance Act 2014. In upholding the CA's decision, the main reason for the SC's decision was its conclusion that HMRC had not formed the opinion required by Finance Act 2014, being that the principles set out in the earlier case would, if applied to Mr Haworth's arrangements, deny the tax advantage.

The SC held that the word "would" should be interpreted restrictively because of the nature of the FN regime itself, with taxpayers having the option of challenging HMRC's interpretation of the relevant tax provision before a tribunal but potentially being reluctant to do so given the financial consequences if unsuccessful, thereby impacting on access to justice. The SC held that for HMRC to issue an FN, it should be of the opinion that there is "no scope for a reasonable person to disagree that the earlier ruling denies the taxpayer the advantage" and attached significance to the choice of "would" in the legislation instead of "might". An interpretation that it was "likely" (i.e. more than a 50% probability) that *Smallwood*, if applied on present facts, would have denied the tax advantage to Mr Haworth was insufficient.

Additionally, the SC held that HMRC had misdirected itself in its analysis of that earlier case and that this made a difference in issuing the FN to Haworth.

Taxpayers subject to FNs will welcome the confirmation that FNs should only be issued where the tax advantage "would" be denied based on the earlier case, rather than "might", or "is likely to", be denied. This case is also of interest because of the SC's acknowledgement that the FN regime and its impact on access to justice is potentially draconian.

Net not gross settlement sum held to be employment income

The Upper Tribunal (UT) in *Murphy v HMRC* has allowed the taxpayer's appeal against the First-tier Tribunal's (FTT's) decision reported in our November 2020 UK Tax Round Up.

By way of reminder, the taxpayer was a police officer who received sums under a settlement agreement with his employer, the Metropolitan Police Service (the Met), in connection with unpaid overtime and certain other allowances net of certain costs incurred in receiving the settlement sum. The amounts received under the settlement agreement for the unpaid overtime and allowances were taxable as employment income. The FTT had held that the costs of receiving those amounts (the police officer's solicitor's success fee and an insurance premium) were not relevant to Mr Murphy's employment tax liability, so that the gross receipt was taxed as his employment income.

The UT allowed the taxpayer's appeal. It looked at which amount under the settlement agreement was "profit" from the officer's employment within the meaning of section 62 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA). Interestingly, the FTT had focused on the meaning of the word "from", that is, whether the payment of the success fee and the insurance premium arose from the officer's employment or from something else. In deciding that such amounts arose from the employment, the FTT relied on what it considered to be the clear terms of the settlement agreement itself. The UT focused on what "profit" meant in this context and held that only the settlement amount actually received, that was the payments net of the success fee and insurance premium, was "profit" under ITEPA so only that amount was taxable as employment income.

The case is of interest for the extensive discussion of the meaning of "profit" in this context as the majority of previous cases when looking at the tax treatment of amounts received by employees was to look at whether such amounts were "from" the employment and the UT's approach could have significant effect in reducing the amount that is subject to tax under similar settlement agreements.

FTT applies valuation principles to shares gifted to charitable trust

Share valuation is an important topic that is familiar to anyone working on corporate transactions, albeit with the details left to the experts. The FTT in *McArthur v HMRC* applied well-established principles of valuation to attribute value to shares gifted to a charitable trust. As a reminder, gifts of shares to charity are relieved from capital gains tax as well as generating income tax relief for the donor on the market value of the shares.

The "open market" basis of asset valuation is set out in section 272 TCGA and is the price that the asset "might reasonably be expected to fetch on a sale in the open market". The FTT set out a number of principles on which a court or tribunal should approach the task of determining the market value of assets (including company shares) adopting this "open market" approach, including that there is a hypothetical sale between a willing seller and willing and prudent buyer and that the potential buyer has access to information reasonably available or accessible about the company. The market value is what the highest bidder would have offered for the asset in that hypothetical sale.

Applying these valuation principles to the facts, the FTT rejected the valuations of both experts. The valuation that the FTT reached was more favourable to HMRC but was between the experts' valuations. Of particular note is the extremes at which the respective expert witnesses valued the shares. On the first valuation date, one expert valued the shares at £1.08 per share and on the later valuation dates he attributed a lower value, whereas the other expert initially gave a value of £0.08 per share with the value higher on the later valuation dates. The difference in values was based largely on the different amounts of information that the experts assumed would be available to the hypothetical purchaser.

The shares were gifted to the charitable trust through a structure where a company acquired another company and floated on the CISX. HMRC contended that the flotation was a charity shell scheme. Broadly this is an arrangement structured to obtain the tax advantages of gift relief. Similar arrangements have been previously scrutinised by HMRC in connection with tax avoidance. The FTT decided that this was not relevant to the valuation itself holding that "whatever the tax background against which [the company] came to be floated on CISX, that background does not affect the market value of [the company's] shares at the various valuation dates".

The case provides a helpful look at how the tribunal decides on the value of shares and will be of interest to anyone working on matters involving the valuation of company shares. It is also interesting as a rare case in which the FTT (or higher court) questions the valuation given by independent valuers and replaces those values with its own, although the FTT might have been encouraged in that approach given the difference in the experts' values and the bases on which they came to them.

LLP liable to employer NICs on bonus payments to certain members

In *Charles Tyrwhitt LLP v HMRC*, the UT decided that an LLP was liable to employer NICs on bonuses paid to individuals after they had become members of the LLP since the individuals received the bonuses in their capacity as former employees of the LLP.

The question for the UT was whether the bonuses constituted employed or self-employed earnings. If the latter, the LLP would not be liable for employer NICs. The taxpayer LLP had created a LLP employees' bonus scheme for certain senior employees. Some of those employees became members of the LLP, rather than employees, before they had received any payments under the scheme and then received payments under it after they had ceased to be employees. Initially, the rights of the individuals to receive bonuses under the scheme was dependent on their continued employment and the amounts were calculated in relation to the LLP's performance during that employment, although the rules were changed when the individuals became members so that a payment could be received if an individual ceased employment but continued as a LLP member.

The UT agreed with the FTT, holding that the bonus payments constituted remuneration from the employment because they were paid in respect of the earlier periods when the members were employees and, therefore, derived from the employment. This was the case even though they had become members of the LLP before the conditions for the bonuses had been met. The UT held that whether an individual was an "employed earner" for the purpose of the relevant NICs legislation was determined based on the capacity in which the individual received the payment, and the individuals in the LLP received the payments from rights acquired when they were employees,

irrespective of the fact they were not employed when the actual payment was made. The UT held that the changes to the scheme rules were merely to ensure that the right to a bonus acquired when the individuals were employees was unaffected by the change of status to LLP member.

The case is of interest to anyone involved in employee incentive arrangements and to those considering the status of individuals as employees or members of LLPs. Careful thought is required when deciding the timing of bonus payments and in what capacity they are being received.

Other UK Tax Developments

GAAR panel opinion on employee remuneration arrangements

The GAAR Advisory Panel published its most recent decision of 11 May 2021. The panel concluded that entering into an employee remuneration arrangement put in place to avoid income tax was not a reasonable course of action in relation to the relevant tax provisions.

In summary, the decision involved a company (owned by its two directors) making contributions to an offshore trust with the trust then making loans to the directors. As a result of this arrangement, the company claimed a corporation tax deduction in respect of the contributions to the trust and the directors received funds that were not subject to PAYE income tax or NICs (as would have been the case if the amounts were paid to them as salaries).

The panel found that the arrangements as a whole were contrived and abnormal (features set out in the GAAR legislation as indicative of arrangements being abusive) and appeared to serve no purpose other than to avoid tax, flagging, in particular, that the company made substantial contributions to the trust without any clear link to benefits to its trade and certain features of the loan arrangements suggested that they were not independent investments of the trust.

The panel also concluded that much simpler means of extracting value could have been adopted (e.g. paying dividends) if the purpose had not been for the company to obtain a tax deduction without any tax on the funds in the hands of the recipients.

The decision is not surprising given the facts, and is a useful reminder that the GAAR panel is unlikely to be sympathetic to such “circular” arrangements involving owner managed companies. It is another example of a case where the GAAR panel appears to have had little difficulty in determining that a structured tax avoidance scheme was within the scope of the GAAR and might continue to encourage HMRC to broaden the sort of transaction that it refers to the panel for consideration.

Government publishes draft legislation for Finance Bill 2021-22

On 20 July 2021, HM Treasury published the draft legislation, and supporting documents, for inclusion in Finance Bill 2021-22 expected to be enacted next year. The key measures to note are set out below.

Taxation of asset holding companies in alternative fund structures

The draft legislation introduces an elective regime for the taxation of qualifying asset holding companies (QAHCs). To be eligible, a QAHC must (i) be at least 70% owned by what are described as Category A investors (including widely held funds that are managed by regulated managers or certain institutional or tax exempt investors) and (ii) exist to move capital, income and gains between investors and underlying investments with a view to spreading investment risk.

The published legislation is the first step in introducing this new QAHC regime with a view to improving the attractiveness of the UK as a jurisdiction for alternative investment funds and their

asset managers, and the policy notice published alongside the legislation makes it clear that there will be more law to come in this area.

The draft legislation for QAHCs covers:

- an exemption for gains accruing to a QAHC on a disposal of overseas land or relevant shares;
- payments made in respect of "special securities" (debt instruments where the consideration given by the company for the use of the principal secured depends to any extent on the results of the company's business) will not be treated as distributions;
- the late paid interest rules won't apply to "relevant debits" that arise on debtor relationships of the QAHC, so that interest payments made by the QAHC will be deductible on the accruals basis rather than the paid basis;
- the overseas property profits of a QAHC will be exempt from corporation tax to the extent that those profits are taxable in a foreign jurisdiction;
- an exemption from corporation tax in respect of the profits of a QAHC that arise from loan relationships and derivative contracts that a QAHC is party to for the purposes of the overseas property business of that QAHC (and this is regardless of whether or not those profits are taxable in a foreign jurisdiction); and
- the disapplication of the obligation to deduct withholding tax from interest payments where those payments are made to investors in the QAHC.

As the explanatory notes make clear, the aim of the legislation is to recognise circumstances where holding companies are used to facilitate the flow of capital, income and gains between investors and underling investments (but do not themselves carry on any substantial trading activity) and to tax investors as if they had invested in the underlying assets with the QAHC subject to tax only to the extent required to reflect its actual activities.

As the explanatory notes to the draft legislation make clear, the purpose of the legislation is to deliver an effective, proportionate and internationally competitive tax regime for QAHCs that will remove barriers to the establishment of these companies in the UK. The new regime aims to provide robust eligibility criteria to limit access to the intended users; tax rules to limit the QAHC's tax liability to an amount that is commensurate with its role; and rules for UK investors to ensure that they are taxed so far as possible as if they had invested in the underlying assets directly.

The initial draft legislation looks promising in providing a relatively simple and effective tax regime for QAHCs but, as stated, there is still considerable detail to come and the overall effectiveness of the proposals will have to be assessed once all of the draft legislation has been produced.

Large businesses: notification of uncertain tax treatment

Draft legislation has been published which will require large businesses to notify HMRC of uncertain tax treatments. This measure is intended to inform HMRC of differences in tax treatment and assist in closing the perceived "legal interpretation tax gap".

As a reminder, an uncertain tax treatment is one where the business believes that HMRC may not agree with its interpretation of the legislation, case law or published guidance. The reporting requirement measure to be introduced is intended to assist HMRC in identifying areas of law that are potentially unclear and so to help HMRC and the government in determining which areas to focus on and to bring increased clarity to the tax system.

Notification to HMRC is broadly required by companies and partnerships with group turnover of more than £200 million and balance sheet values of more than £2 billion if (i) the taxpayer adopts a tax treatment that differs from HMRC's known position; (ii) provision has been recognised in the

GAAP accounts of the taxpayer in respect of the uncertain tax outcome; or (iii) where there is a substantial possibility that a court or tribunal would disagree with the taxpayer's adopted position.

The threshold for notification has been increased from £1m to £5m and the requirement to notify will only apply to relevant companies, partnerships and LLPs that exceed the threshold for being large.

While the "large" business threshold might keep many companies and partnerships outside the rules, they will inevitably, where they apply, add an additional layer of compliance complexity to an already complex tax system. Unfortunately the draft legislation does not define "substantial possibility", which appears to introduce an entirely new legal concept for taxpayers to struggle with.

New proposals to clamp down on promoters of tax avoidance

The proposed measures include:

- a new power for HMRC to seek freezing orders that would prevent promoters from dissipating or hiding their assets before paying the penalties that are charged as a result of them breaching their obligations under the anti-avoidance regimes;
- new rules that would enable HMRC to make a UK entity, who facilitates the promotion of tax avoidance by offshore promoters, subject to a significant additional penalty;
- a new power to enable HMRC to present winding-up petitions to the court for companies operating against the public interest; and
- new legislation that would enable HMRC to name promoters, details of the way they promote tax avoidance, and the schemes they promote, at the earliest possible stage, to warn taxpayers of the risks and help those already involved to get out of avoidance.

Partnership basis period reform

Draft legislation has been published which will reform partnership basis periods so as to align the period over which partners in partnerships and members of limited liability partnerships are taxed with the tax year. Currently, partners and members are, in general terms, subject to tax for each tax year on the profits of the partnership's/LLP's profits for the accounting period ending in the tax year, with overlap profits arising in early years in some cases.

The proposal is to align each partner's/member's tax with profits arising in the relevant tax year. In order to achieve this, there will be a "transitional" year for the tax year 2022-2023 and partners/members will be subject to tax in that year on the profits of the accounting period ending in it plus the period from the end of the accounting period until 5 April 2023. In addition, any overlap relief available to the partner/member will be brought into account in the tax year 2022-2023.

This will in many cases lead to tax on profits of a period of more than 12 months in the tax year 2022-2023. In order to mitigate that effect, the draft legislation provides for an election to spread the additional tax over a five year period.

Where the partnership's/LLP's accounting period does not align with the tax year, the draft legislation requires the profits of the tax year to be determined on a day count basis unless a different method would be reasonable and is consistently applied. It remains to be seen, if the proposals are enacted, how straightforward it will be to align profits of the partnership's/LLP's accounting period with the tax year.

EU Case Law Developments

CJEU decides on the scope of the SIF management VAT exemption

The joint cases of *K and DBKAG v Finanzamt Österreich* considered whether particular services fell within the management limb of the VAT exemption for the management of special investment funds (SIFs). In the case of *K*, various management companies outsourced to K, a third party, certain services for the calculation of the taxable income of unitholders in the relevant funds. In the case of *DBKAG*, pursuant to a licence agreement, DBKAG (a manager of SIFs) was granted a right by a German company to use software which was essential to risk management and performance measurement for the funds.

The question for the Court of Justice of the EU (CJEU) was whether the exemption should be interpreted to mean that such services fell within the exemption. The CJEU held that services provided by a SIF manager must, broadly, "form a distinct whole fulfilling in effect the specific, essential functions of the management of SIFs". In respect of the specific services in question, it said that it, in principle, the services could fall within the exemption but that it is for the referring court to assess whether those services must be regarded as being specific to and essential for the activity of managing the relevant special investment funds, noting that where a service, such as the grant of a right to use software, is provided exclusively for the purposes of managing special investment funds, and not to other funds, it may be considered to be "specific" for that purpose.

The case is of relevance to any managers of SIFs within the EU or supplying services to fund managers inside the EU.

Advocate General gives opinion on the requirement for VAT invoice

The Advocate General (AG) of the CJEU has given its opinion in *Zipvit v HMRC*, suggesting that holding a valid VAT invoice is a substantive requirement for the purposes of VAT recovery.

The case centred on the VAT recovery position of Zipvit for postal services provided by Royal Mail which were originally VAT exempt but later determined to be standard rated (on the basis that the services were individually negotiated so the relevant exemption did not apply). As the services were originally treated as VAT exempt, no VAT invoice had been issued.

In the Court of Appeal (CA), Zipvit's claim for VAT recovery was based on an argument that the consideration it paid for the services should be treated as including VAT and that it should be able to recover that input VAT. In rejecting this argument, the CA said that it was not clear whether the consideration should be treated as including VAT and that Zipvit was not entitled to recover the VAT that it had suffered because no VAT invoices were issued in respect of the supply. Both EU and UK law generally require a taxpayer to hold a VAT invoice in order to make a claim for VAT recovery.

As reported in our April 2020 UK Tax Round Up, Zipvit appealed the CA's decision to the Supreme Court (SC). The SC concluded that a requirement for a VAT invoice and the meaning of "due or paid" (which entitles a person to recover VAT due or paid in respect of supplies to them) under the relevant VAT Directive was not sufficiently clear for it to decide. The SC referred a number of questions to the CJEU.

Regarding the importance of an invoice for the right of input VAT deduction, the AG said that VAT recovery would only be practically possible where Zipvit was in possession of a valid VAT invoice, suggesting that the possession of a VAT invoice is the decisive factor (and a substantive requirement) for the deduction of input VAT as the supply of the goods or services in itself does not contain any statement as to whether the customer sustains a charge to VAT. The AG noted, as a practical matter, that it is only the disclosure of how the VAT due is passed on to the recipient of

the supply by means of the price that ensures that the recipient of the supply knows (and the tax authorities can check) how much the supplier believes he or she should be charged in VAT; and that this is achieved through a VAT invoice.

Analysis of whether VAT was "due or paid" would only be required if the main court left open the question of the need to hold a VAT invoice. Despite this, the AG considered that "VAT due or paid" referred to VAT due or paid by the supplier (i.e. Royal Mail) to the relevant EU member state, rather than the VAT due or paid by the customer (i.e. Zipvit). Therefore, any amount actually received included the VAT provided for by law. However, this was only relevant for Zipvit when it received a VAT invoice, thereby demonstrating the passing on of the VAT to it and its right to recover it.

The opinion of the AG is not binding and the AG occupies only an advisory role. Therefore it remains to be seen what the final outcome of the referral will be. Having said this, the AG's opinion that a VAT invoice is a substantive requirement for VAT recovery is a significant conclusion with far reaching ramifications for those seeking VAT recovery, particularly for taxpayers in receipt of the same services from Royal Mail as Zipvit (or other services initially considered to be VAT exempt but turning out to be taxable).

Other Tax Developments

The OECD's framework for international tax reform

Significant progress has been made in the efforts of the OECD to reach international consensus on the BEPS 2.0 proposals. The 139 country OECD Inclusive Framework meeting concluded on 1 July 2021, with 130 countries and jurisdictions, representing in aggregate over 90% of global GDP, agreeing to the two pillar approach to international tax reform.

Among those to agree were the United Kingdom, the United States, the Cayman Islands, Jersey and Guernsey.

Please see our Tax Talks blog on this for further details.