

# UK Tax Round Up

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Welcome to May's edition of the UK Tax Round Up. This month has seen a number of interesting court decisions, an important opinion of the European Commission's Advocate General and the commencement of a Treasury consultation on potential reform of the capital allowance rules.

## UK Case Law Developments

### Remuneration trust scheme failed

In *CIA Insurance Services v HMRC*, the First-tier Tribunal (FTT) has ruled that a scheme involving the funding of a remuneration trust which made loans to certain employees gave rise to taxable employment income for the employees under the disguised remuneration rules in Part 7A ITEPA 2003 and did not result in an immediate tax deduction for the company employer funding the remuneration trust.

Under the scheme, CIA was a subsidiary of another company which was wholly owned by three individuals, each of whom was an employee, and two of whom were directors, of CIA. The company made contributions to a trust and the contributions were used to make loans to the individuals. Each loan was made for a period of 10 years and one day. The FTT was asked to consider two issues:

- a. whether the company was entitled to a tax deduction for the contributions that it made to the trust. This relied on whether the contribution had been made "wholly and exclusively" for the purposes of the company's trade; and
- b. whether the loans made to the individuals by the trust were taxable as earnings (or otherwise) of the individuals.

In respect of the corporation tax deduction, the company made submissions to the FTT that the contributions were made to provide a "fighting fund" to protect CIA's businesses, that the company had lost confidence in the security of banks and that the purpose was to provide discretionary benefits to providers of services, products, custom or finance. The FTT rejected these as reasons for the contributions and determined that obtaining a corporation tax deduction was the only remaining reason, since the money could have been paid to the individuals by way of dividends. Accordingly, the FTT denied the corporation tax deduction on the basis that the contributions to the trust had not been made "wholly and exclusively" for the purposes of CIA's business but, rather, to obtain the tax deduction.

On the second point, HMRC argued that the loans made by the remuneration trust to the individuals constituted "earnings" or "redirected earnings" of the individuals. The FTT rejected this

proposition on the basis that the money had been made available to the individuals under loan agreements the terms of which included an obligation for repayment.

The FTT went on to consider whether the loans should be treated as taxable earnings of the individuals under the disguised remuneration rules in Part 7A ITEPA on the basis that they were sums paid to the individuals by a third party in connection with the individuals' employment or with a purpose of rewarding the individuals in connection with their employment.

The whole arrangement had been put in place under a marketed scheme involving a number of preordained steps and, as part of the overall arrangement, the individuals had taken significant salary reductions. The FTT determined that there was no reason for the reduction in salary other than that the equivalent payments were intended to be made to the individuals by the trust.

On that basis, the FTT decided that the loans were connected with the individuals' employment and, consequently, that the disguised remuneration rules applied so that the amount of the loans were treated as earnings of the individuals when received by the individuals.

The case highlights, once again, the dangers of entering into highly structured arrangements that are linked to individuals' employment and that HMRC has a wide range of recharacterisation and anti-avoidance tools available to it under which it and the courts are quite likely to find a basis on which to tax amounts purportedly outside the scope of employment income tax as if they were earnings.

### **Tax clearance ignored for lack of disclosure**

In *Wroe v HMRC*, the FTT has upheld HMRC's application of the transactions in securities rules in sections 682 to 713 ITA 2007 notwithstanding that the taxpayers had obtained a statutory clearance that those rules would not apply to the proposed transaction. This decision was reached on the basis that the taxpayers had not provided full disclosure of the total scheme that they were entering into when they had applied for their clearance so that it could not be relied on.

The case involved three individuals who each owned 30% of a company alongside a fourth individual who owned 10%. As part of succession planning, the three major shareholders intended to retire from the business over a number of years and wanted to increase the fourth shareholder's interest from 10% to 25% alongside compensating themselves for the reductions in their shareholdings.

In order to effect the change in ownership in a way that was intended not to result in an income tax charge on the consideration received by the three major shareholders, a new company was inserted above the existing company and the new company issued shares to the four individuals so that they each owned 25% of the ordinary share capital. In addition, the three major shareholders received preference shares treated as fully paid up with a principal amount of £600,000 each. The £1.8m of preference share capital reflected what was taken to be the value attributable to the 5% reduction in ordinary shareholding of the three major shareholders that was "transferred" to the fourth individual.

The preference shares were then repurchased by the new holding company over a number of years using money received by the new holding company by way of dividend from its now subsidiary.

The individuals had received advice from their tax advisors that, had they simply sold their existing holdings for consideration, HMRC might have sought to apply the transactions in securities rules to that transaction on the basis that they could have paid themselves dividends to receive the money.

At the time of the reorganisation and insertion of the new holding company, the taxpayers had applied for clearance in respect of the transactions in securities rules. The clearance letter had set

out the commercial drivers behind the reorganisation, being the succession planning and the ability to reflect the value of the reduced ordinary shareholdings in the principal amount of the preference shares. The preference shares had, however, been described as "not redeemable" in the clearance application and no reference was made to any intention for the preference shares to be repurchased by the new holding company.

The preference shares were repurchased for their total amounts of £1.8m over the subsequent years and HMRC sought to apply the transactions in securities rules to the amount received in order to tax it as dividends rather than as capital gains.

The FTT upheld HMRC's assessment and application of the transactions in securities rules, applying the principle in the *MFK Undertaking* case that, in order to rely on a clearance granted by HMRC, the taxpayer must "put all cards face upwards on the table". The FTT decided that the taxpayers had not fully described the intended overall transaction in respect of the reorganisation of the company, the issue of the preference shares and their subsequent repurchase by the new holding company.

The case is a cautionary reminder that when seeking clearance from HMRC in respect of what might be considered to be a tax advantaged transaction, taxpayers would be advised to make full disclosure of the facts in order to be certain that any clearance confirmation received from HMRC can actually be relied on.

### **Court of Appeal upholds transfer of assets abroad ruling and HMRC's PAYE discretion**

In *Hoey v HMRC*, the Court of Appeal (CA) has upheld the decisions of the FTT and Upper Tribunal (UT) that, while a transaction entered into by Mr Hoey did fall within the scope of the transfer of assets abroad (ToAA) rules, no "income" had arisen to the offshore company that was part of the overall arrangement that could be attributed to him. Accordingly, no income tax liability arose to him applying the ToAA rules. This was in contrast to HMRC's argument that the gross receipt of the offshore company in question should be attributed to Mr Hoey rather than the net trading profit that the offshore company properly reflected in its accounts. It should be noted that the offshore company in question had made a payment to Mr Hoey that was itself subject to UK income tax as Mr Hoey's earnings and which was a payment that reduced its gross income in its accounts and that HMRC was, effectively, seeking to tax that amount twice; both as earnings and applying the ToAA rules.

In addition, the CA agreed with the FTT and UT that HMRC had the discretion under section 684(7A)(b) ITEPA 2003 to assess the individual to income tax rather than seek that payment through PAYE from the individual's employer and that the FTT had no standing to question HMRC's use of that wide discretion.

The case related to an offshore employer company scheme that Mr Hoey entered into. In simple terms, the scheme involved Mr Hoey entering into an employment engagement with an offshore employment company which contributed money that it received as a fee relating to providing Mr Hoey's services into an employee benefit trust which then lent the money to Mr Hoey.

The contribution by the offshore employment company was deducted from its income receipt so as to reduce its trading profits reflected in its accounts. HMRC argued that the amount contributed to the trust was not deductible because it was not incurred wholly and exclusively for the purposes of the company's trade.

Mr Hoey had already agreed (contrary to the expectation when the arrangement was put in place) that the loan amount should be taxed as his earnings and the case related solely to whether Mr

Hoey could also be subject to tax under the ToAA rules in respect of the fee income received by the offshore trust. This would have resulted in effective double taxation for Mr Hoey.

The CA agreed with the FTT and the UT that the "income" of the offshore employer that could, in principle, be attributed to Mr Hoey under the ToAA rules should be only the trading profit reflected in the offshore employer's accounts applying generally accepted accounting principles. That was nil because the offshore employer had properly claimed a tax deduction for the contribution that it made to the offshore trust.

By way of comment only, the CA also indicated that it thought that HMRC should only use the ToAA rules as an additional tool to subject people to UK income tax in the absence of any other simpler and more natural basis of taxation. In this case, Mr Hoey had already accepted that he was subject to tax on the loan made to him by the offshore trust which was, effectively, the same money as the gross income receipt of the offshore employer that HMRC was also seeking to assess him on under the ToAA rules.

The case provides some welcome comfort on the limited extent to which the ToAA rules should be applied in relevant circumstances. It also provides confirmation that HMRC has wide discretion in seeking to assess earnings related income tax from the individual employee rather than seek to recover it through PAYE from the individual's employer.

### **Unallowable purpose for acquisition finance**

In *JTI Acquisitions Company (2011) Limited v HMRC*, the FTT has held that a loan advanced to JTI (a UK resident company) by its US parent in order to fund the acquisition by JTI of a US target was entered into with an "unallowable purpose" for the purposes of the loan relationship rules, such that none of the interest paid by JTI on the loan was allowable as a tax deduction.

Some surprise has been expressed at the decision because of HMRC's longstanding guidance that, in general terms, the unallowable purpose test will not be applied to debt that is used in bona fide commercial acquisitions on the basis that, even if there is an element of seeking to obtain a tax advantage from the loan, the commercial elements of the acquisition are likely to mean that any tax advantage is not a "main purpose" of entering into the loan.

Having said that, the facts of this particular case were quite extreme and that is probably what led the FTT to come to the decision that it came to.

JTI was a newly formed subsidiary of a US parent (Joy Inc). Prior to the establishment of JTI, Joy Inc intended to acquire a US target and to raise \$500,000,000 of external bank debt to assist in that acquisition. Before the transaction was completed, Deloitte proposed a nine stage "global tax planning idea" to Joy Inc that they said would allow the Joy group to generate "substantial prospective tax savings" in the UK. In broad terms, the plan involved establishing JTI as a new UK subsidiary of the group, electing for JTI to be treated as if it were a tax transparent entity for US tax purposes, Joy Inc lending \$500,000,000 to JTI at a commercial rate of interest (as well as lending an amount of debt on interest free terms and injecting some equity) and JTI using the money provided to it to acquire the US target. JTI agreed to an advanced thin capitalisation agreement (ATCA) with HMRC confirming that the interest payable on the \$500,000,000 of interest-bearing debt was, for transfer pricing purposes, deductible in its entirety. JTI completed the acquisition of the US target.

The loan relationship unallowable purpose test applies where:

- a. a tax avoidance purposes (that is, a purpose of securing a UK tax advantage for any person) is one of the purposes for which a company is party to a loan relationship; and

- b. it cannot be shown by the company that the tax avoidance purpose is not the main purpose or one of the main purposes for which it is party to the loan relationship.

The FTT recited past case law on how to determine what the purpose of a company was, stating that it was the subjective purpose of the company that was in question, which should be taken to be the purpose of the "directing minds" of the company and which could include the minds of people other than the directors of the company in question where they were, as a matter of fact, taken to be those directing minds.

The evidence in this case was clearly that the decision to enter into the plan proposed by Deloitte had been considered by the directors of Joy Inc and that they were the people that had taken the decision and had directed JTI and the relevant people in the group who were based in the UK that the transaction should go ahead as planned.

In addition to the simple advance of the loan from Joy Inc to JTI, the group set up a new Cayman Islands incorporated and tax resident company to which Joy Inc assigned its loan receivable from JTI in order to avoid the application of the UK's then anti-arbitrage rules that would have otherwise operated to deny the deduction for interest paid on the loan by JTI. JTI itself had no taxable profits and the intention was that it would surrender its interest deductions to other UK members of the Joy group as group relief. The overall arrangements, and electing that JTI would be treated as a tax transparent entity for US tax purposes, meant that Joy Inc did not bring the interest paid to it by JTI into account for US tax purposes, so that there was an effective "double dip" of the interest paid by Joy Inc to its external lender in the US and of the interest paid by JTI to Joy Inc.

The FTT had no difficulty in determining that JTI had a purpose (being the purpose of the directors of Joy Inc) of securing a UK tax advantage in entering into the loan with Joy Inc through the group relief surrender of the interest expense on the loan. It also held that there was no overriding commercial reason for JTI to be included in the transaction and acquire the US target, that the commercial drivers behind effecting the acquisition through a new UK company proposed by the Joy group witnesses that were heard were wholly unconvincing and that the obtaining of the UK tax advantage was, therefore, a main purpose of JTI being party to the loan.

This is a timely reminder that it is dangerous to place too much weight on HMRC guidance and public statements that may be made in general terms, but are clearly applicable to commercially driven transactions, and to seek to rely on elements of those statements when entering into the sort of tax-motivated transaction that was considered in this case.

## EU Case Law Developments

### Payment under a loan sub-participation arrangement subject to VAT

The Supreme Administrative Court of Poland has referred a question to the Court of Justice of the European Union (CJEU) about the VAT treatment of payments under a sub-participation agreement relating to a loan which operates so that the sub-participant has no direct relationship with the borrower.

The Advocate General (AG) has published his opinion, stating that the payment by the sub-participant to the original lender in respect of the sub-participation is a payment for the provision of services that is not exempt from VAT by reason of being a payment for the "granting of credit" referred to in Article 135(1)(b) of EU Directive 2006/112 (the VAT Directive).

The AG has opined, broadly, that the payment made by the sub-participant to the loan originator under a standard sub-participation arrangement does not fall within the scope of the VAT exemption for the "granting of credit" because the purpose of that transaction is twofold; being the provision of capital to the loan originator and assisting the loan originator with managing its own

credit risk. This is on the basis that VAT exemptions should be construed narrowly and that the sub-participation arrangement is more analogous to a securitisation transaction than to the actual granting of credit given its tripartite nature.

The AG does state that it is possible that the sub-participation arrangement might fall within the scope of the VAT exemption in Article 135(1)(f) of the VAT Directive covering transactions in shares, interest in companies, debentures and other securities, but the AG does not opine on this since the question was not asked of the CJEU.

To the extent that the CJEU does follow the AG's opinion, and it is not determined in this or another case that the sub-participation arrangement falls within another VAT exemption, this could materially affect the economic viability of sub-participation arrangements given that the loan originators under such arrangements are unlikely to be able to recover all, or very much of, any VAT that is payable in respect of the payment made to the loan originator by the sub-participant. It will be interesting to see what the CJEU says in its decision and whether it provides any further clarity on the overall VAT consequences of sub-participation arrangements.

## Other Developments

### OECD announces Pillar 1 implementation delay

On 26 May, the OECD announced that the agreement needed to finalise the Pillar 1 rules, which are intended to reallocate the jurisdiction in which certain large companies operating on an international basis pay their tax, will be delayed.

The OECD initiated a public consultation on how to implement certain of these rules on 14 April and its current statement refers to the complexities of the technical negotiations required under Pillar 1 and indicates that the introduction of the rules is likely to be pushed back from 2023 to 2024.

### Treasury consultation on reform of the UK's capital allowances regime

On 9 May, the Treasury published a policy paper asking for interested parties to provide written responses on certain areas of support for business investment. This process has been initiated as part of the government's general attempts to increase investment and productivity, including the recently announced super deduction for capital allowances that will be introduced next year.

The government is interested in receiving written responses focused on these specific areas among other things:

- investment decisions;
- the super deduction; and
- the current system of capital allowances.

The requests are set out in [this document](#).

Responses are requested by 5pm on Friday 1 July.