Proskauer

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Welcome to the August edition of the UK Tax Round Up. August turned out to be not such a quiet month on the UK tax front. We have seen several important and technical case law decisions, some of which we discuss below, and highlight a couple of other developments in UK tax this month.

UK Case Law Developments

Payment of ancillary amounts in litigation taxable as employment income

In *HMRC v Murphy*, the Court of Appeal ruled that sums paid under a settlement agreement in respect of legal fees and an insurance premium, which were not paid directly to the taxpayer, were his taxable income.

Mr Murphy was a police officer employed by the Metropolitan Police Service ("the Met"). Mr Murphy was one of a group of police officers who commenced a group litigation action against the Met in respect of overtime and certain other allowances. All the claims related to duties performed by the claimants whilst working for the Met.

In order to fund the proceedings, the claimants entered into an agreement with solicitors and counsel, which provided for payment of a "success fee" calculated as a percentage of any sum payable by the Met to settle the claim or damages awarded by the court. Each of the claimants also entered into an insurance contract with an insurer (Temple) for insurance against the risk of having to pay the Met's legal costs if they lost all or part of their claim. A premium was payable for that policy.

Following conclusion of a settlement agreement, the claimants' solicitors raised an invoice for the success fee of £1.2 million addressed to their clients (the police officers) but was stated to be payable by the Met. The Met was then required to pay the success fee directly to the solicitors. The insurance premium was to be deducted from the balance of agreed settlement amounts and paid directly by the Met to Temple.

Despite the success fee and the insurance premium not having been paid to the police officers directly, but rather to the lawyers and the insurer, the Met applied PAYE to Mr Murphy's share of those sums. Mr. Murphy filed a tax return claiming that none of those sums constituted his employment income (earnings) and HMRC in response issued discovery assessments against him for that tax. Mr. Murphy appealed. The First Tier Tribunal ("FTT") found that the payment of the success fee and insurance premium arose from Mr Murphy's employment. The principal settlement

sum constituted a payment in settlement of a claim for unpaid allowances and overtime, which it was accepted would have been taxable earnings if they had been paid by the Met in the first place.

The Upper Tribunal ("UT") ruled that the success fee and premium did not constitute profit for Mr. Murphy and were therefore outside the scope of "earnings" for income tax purposes.

The Court of Appeal reversed this decision (reinstating the original decision by the First Tier Tribunal), holding that payments were a reward for services as an employee, regardless of the label applied or the mechanism used to make the payment. The court held that the Upper Tribunal should a have considered whether the reimbursed expenses conferred a financial benefit in return for services. The payment mechanism did not alter the character of the amount paid, nor did the fact that these expenses had been incurred to recover sums due as remuneration make them deductible.

This case reinforces the principle that it is vital, when considering how sums payable in connection with a person's employment might be taxed, to look at the true underlying nature of the sums in question, and the mechanism for payment will not change that analysis.

Partial tax avoidance motive did not prevent availability of share for share exchange treatment

We reported on the FTT decision in the case of *Revenue and Customs Commissioners v Euromoney Institutional Investor plc* in our April 2021 Tax Round Up and the UT decision has now been released.

In short, the facts were that Euromoney sold its shares in a subsidiary company to a third party buyer. The consideration was originally intended to be satisfied by ordinary shares and cash. However, upon the advice of the company's tax director, the cash portion of the consideration was substituted for preference shares so as to allow the transaction to benefit from share for share exchange treatment under section 135 TCGA 1992 (and thus prevent an immediate tax charge). Following a 12 month ownership period, the preference shares could then be redeemed with the benefit of the substantial shareholding exemption (SSE) applying to the redemption given the holding of the ordinary shares so that the disposal of the preference shares would be exempt from corporation tax on chargeable gains.

HMRC denied relief under section 135 TCGA 1992 on the basis that the transaction formed part of a scheme or arrangement of which the main purpose, or one of the main purposes, was the avoidance of liability to tax (section 137 TGCA 1992). The FTT had ruled against HMRC, stating that the arrangements in question were the entire disposal and exchange and not just the substitution of the portion of consideration payable as cash for preference shares. The FTT stated that it did not reflect reality to split the aspects of the exchange in the way that HMRC argued. The FTT further concluded that, although there was a purpose of avoidance of a tax liability in switching the cash for the preference shares, this was not the main purpose, or one of the main purposes, of the transaction (despite the FTT describing it as "more than trivial").

HMRC appealed to the UT on two grounds. First that the FTT should have focused on the isolated element of the transaction that involved the change in the nature of the consideration from cash to preference share, and second that in its evaluation of purpose, the FTT took into account irrelevant considerations, failed to take into account relevant considerations and reached irrational conclusions.

The UT rejected both HMRC's grounds of appeal and ruled that the FTT decision was correct. The UT found that there was nothing in the language of section 137 TCGA 1992 that requires one to identify all possible "candidate" schemes or arrangements of which the exchange could, realistically, form part in order to assess whether there is an intention to avoid a liability to capital

gains tax or corporation tax. Moreover, the UT found that the FTT was correct in the way it analysed what, on these facts, the purpose of the arrangements was. The FTT was entitled to conclude that the relatively modest size of the tax saving, compared with the overall transaction size (less than 5% of the sale consideration) was a relevant consideration in assessing purpose.

The BlueCrest Partnership Cases

Two very complex and lengthy decisions of the UT concerning BlueCrest have been released this month. The full detail of the cases is more than we can cover in this Round Up format but there are some very important themes for those involved in structuring and administering partnership profit allocation arrangements and incentive plans for executives who are LLP members or partners in the business, particularly in the asset management world.

The first of the two cases, *BCM Cayman Ltd and another v Revenue and Customs Commissioners* [2022] UKUT 198 (TCC), centred on how allocations of a partnership's income profit should be treated. In summary, an English limited partnership ("UKLP") carried on the trade of investment management. UKLP allocated profit to one of its limited partners, a Cayman Islands incorporated company ("Cayco"). Cayco was, in addition to being a 19% limited partner in UKLP, the general partner of a Cayman Island limited partnership "(CayLP"). Cayco was subject to UK corporation tax as it was a non-UK resident company trading through a permanent establishment as a member of a partnership. Cayco had agreed to contribute its limited partnership interest in UKLP to CayLP and CayLP had become party to UKLP's amended and restated deed of partnership. However, as a matter of English law, a partnership without legal personality (like CayLP) cannot be a partner in its own right in an English LP (like UKLP) so the partner of record had to remain as Cayco (as the general partner of CayLP).

The UT upheld the decision of the FTT that Cayco was the partner of the UKLP (and the other partners of CayLP were not deemed to be partners of UKLP) and accordingly Cayco was liable to corporation tax on the entirety of the profit allocation. BlueCrest argued that Cayco was not liable to corporation tax on its profit allocation from UKLP on the basis it was not beneficially entitled to the profits due to the existence of the partnership agreement for CayLP and the obligations under that agreement for the partners to share its profits. The UT rejected this argument and held that Cayco was liable to UK corporation tax on the whole of the allocated profits as the actual limited partner in UKLP.

The UT also considered the tax treatment of interest on a loan Cayo had taken out to acquire the 19% limited partnership interest at the outset of the arrangements. The UT overruled the FTT on its analysis of the loan relationships code, confirming that debits for interest on the loan taken out by Cayco were allowable under the loan relationship code and, in particular, under the basic relief mechanism in section 307 CTA 2009. However, the UTT agreed with the FTT that these were non-trading loan relationships because the purpose of the loan was to acquire the capital in the UKLP partnership itself, and not for the purposes of the trade of asset management carried on by UKPLP. The question of whether Cayco could claim relief for the interest as a non-trading loan relationship was, somewhat frustratingly, not argued before the court.

The second case relating to BlueCrest, Revenue and Customs Commissioners v BlueCrest Capital Management LP and others; Dodd and others v Revenue and Customs Commissioners [2022] UKUT 200 (TCC), concerned the tax treatment of a partnership incentive/retention plan ("PIP") implemented by BlueCrest in relation to individual partners in the business. This was conducted in relation to three different partnerships or UK LLPs (referred to collectively as the "Partnership"). The plan worked as follows:

1. A new corporate partner ("the Corporate Partner") was introduced into the Partnership to facilitate the PIP. The Corporate Partner was entitled to be considered for a discretionary allocation of the profits of the Partnership.

2. If such an allocation was made, the Corporate Partner was entitled to withdraw its profit share and use it to acquire Special Capital which could then be used to acquire investments in BlueCrest managed funds.

3. After a period of time the Corporate Partner made individual PIP awards ("PIP Awards") of Special Capital to individual partners based on recommendations made by a special committee of the Partnership. This period varied between a few months and several years provided that the individual partner in question had met certain conditions. If those conditions were not met, the Corporate Partner was entitled to forfeit that partner's PIP Award and put it to some other use (e.g. to reward other partners).

The UT reconsidered the FTT decision in relation to whether anti-avoidance law (the *Ramsay* line of cases) should be applied to these arrangements (such that allocations of profit to the Corporate Partner should be viewed as allocations of profit to the individuals who ultimately received the PIP Awards). The UT found in favour of BlueCrest on this point and decided that the allocation was properly that of the Corporate Partner.

However, the UT upheld the FTT decision on two other points, finding in favour of HMRC. The UT decided that the PIP Award amounts received by the UK partners were taxable either as "miscellaneous income" under section 687 ITTOIA 2005 (the old Schedule D Case VI) or as a sale of occupational income by those partners to the Corporate Partner under section 777 Income Tax Act 2007. This was regardless of the fact that amounts were also taxed in the hands of the Corporate Partner. The UT saw no element of double taxation, however, finding that the Corporate Partner was taxed on its profit allocation from the Partnership, but the individual partners were chargeable to tax under section 687 on the receipts derived from the final PIP Awards based on the decisions made by the Corporate Partner.

Entitlement to Capital Allowances on Succession to Business

The Court of Appeal has published its decision in the case of *Inmarsat Global Ltd v HMRC* [2022] EWCA Civ 1076.

By way of background, IMSO was an international organisation established by the Convention on the International Maritime Satellite Organization (INMARSAT) ("the Convention"). IMSO was headquartered in the UK and was a body corporate for UK tax purposes, but was exempt from taxes on income and gains. Six satellites were leased to IMSO by financial lessors in return for periodic rental payments, and IMSO paid the costs of launching them into space. Since IMSO was exempt from UK corporation tax, it did not claim capital allowances in respect of the launch costs.

Inmarsat Global Limited ("Inmarsat") was the successor to the business of IMSO. Following the succession, Inmarsat sought to claim writing-down allowances in relation to the launch costs which IMSO had incurred, arguing that it (Inmarsat) had incurred qualifying capital expenditure on the provision of the satellites, which it was required to incur under the terms of the leases so that, under what is now section 70 of the Capital Allowance Act 2001 (CAA 2001)), the satellites were deemed to belong (in part) to IMSO.

When Inmarsat succeeded to IMSO's trade, IMSO's assets, including its interest in the satellites, were treated as sold to Inmarsat at market value under what is now section 265 CAA 2001. The company contended that, in paying the costs of launching the satellites, IMSO incurred capital expenditure on the provision of the satellites for the purposes of a trade carried on by it which IMSO was required to provide under the terms of the leases and, hence, that the satellites were to

be "treated … as belonging to [IMSO]" for the purposes of the legislation. When Inmarsat acquired IMSO's business and assets, Inmarsat argued that it succeeded to IMSO's trade, with the result that property used for the purposes of IMSO's trade, including its deemed interest in the satellites, was to be "treated as if … it had been sold to" Inmarsat. That being so, Inmarsat was to be treated as having expended the open market value of the interest on acquiring it, and the interest was to be treated as belonging to Inmarsat in consequence of that expenditure for capital allowances purposes.

The Court of Appeal followed the decision of the Upper Tribunal and rejected Inmarsat's appeal and its claim for capital allowances. The Court held that what is now section 265 CAA 2001 only had a valuation function. It set the deemed value at which property should pass on a business transfer. This meant that a fundamental condition for claiming capital allowances (owning the relevant assets of the business, or being deemed to do so) was not met and Inmarsat could not validly claim the allowances.

This was a case that turned on interpretation of a deeming provision and how widely it could be viewed. The Court was clear that it was right to take a narrow interpretation here, particularly since there was no evidence that Parliament had intended a successor to a trade to qualify for capital allowances in respect of property which it has never owned and on which it has incurred no capital expenditure.

Other Developments

OTS to review tax implications of hybrid and distance working

The Office for Tax Simplification is to carry out a review of the tax implications of hybrid and distance working, with a particular focus on arrangements which involve employees working across borders.

Little further detail is yet available on the scope and depth of this review, but the length of time since COVID-related "lockdowns" were first rolled out (now nearly 30 months) means that there are many instances of organisations with what were intended to be temporary cross-border arrangements in place that are taking on an air of permanence. This can have difficult and unanticipated implications for tax purposes, including foreign permanent establishments being created, and the tax residence of companies being challenged where directors are based abroad for key decisions and meetings.

HMRC increases late-payment interest rates

HMRC has increased the interest rates for late payments of tax following the Bank of England's decision on 5 August 2022 to increase the bank base rate from 1.25% to 1.75%.

For most taxes, this increase means that the rate of late-payment interest is increased to 4.25% and the rate of repayment interest is increased to 0.75% from 23 August 2022.

For underpaid quarterly instalment payments, the rate of late payment interest is increased to 2.75% and the rate of repayment interest on overpaid quarterly instalment payments (and on early payments of Corporation Tax not due by instalments) is increased to 1.50% from 15 August 2022.

The rate of interest for benefients for employees remains at 2.00%.