Proskauer

September 2022

For more information, please contact:

Stephen Pevsner
Partner
t: +44.20.7280.2041
spevsner@proskauer.com

Robert E. Gaut
Partner
t: +44.20.7280.2064
rgaut@proskauer.com

Catherine Sear
Partner
t: +44.20.7280.2061
csear@proskauer.com

Richard Miller
Special Tax Counsel
t: +44.20.7280.2028
rmiller@proskauer.com

Welcome to September's edition of the UK Tax Round Up. In addition to the headline-grabbing 2022 Growth Plan announced by the UK Chancellor, there have been a number of interesting cases this month including the First-tier Tribunal's analysis of the principal purpose rule in the UK-Ireland double tax treaty and the Upper Tribunal's decision on the meaning of "market value" in the context of deemed distributions.

UK Case Law Developments

Amounts in settlement of indemnity obligations were not remitted to the UK

In *Raj Sehgal v HMRC*, the First-tier Tribunal (FTT) has decided that the settlement of indemnity obligations involving non-UK domiciled individuals did not give rise to remittances to the UK.

The case centred on a disputed remittance basis tax charge. As a reminder, remittance basis tax treatment can apply to non-UK domiciled but UK tax resident individuals with non-UK income and gains. If taxed on the remittance basis, an individual is liable to UK tax on UK source income and gains but is only liable to UK tax on non-UK income and gains that are remitted to the UK. The key issue for the FTT was the application of section 809L ITA 2007, i.e. the meaning of "remitted to the United Kingdom".

The transactions giving rise to the remittance basis tax charge involved the taxpayers disposing of shares in a company (the target). Under the share purchase agreement, an indemnity was given by the taxpayers (as the sellers) for any failure by a subsidiary of the target (the debtor company) to discharge its outstanding intra-group debt or any waiver of that debt by another group member. The indemnity obligation was subsequently triggered. However, the purchaser's parent company was concerned about the effect on its own financial reporting of a straightforward payment of the amount under the indemnity (the parent company). Under a separate transaction, the debtor company's immediate parent company (SKS) bought clothing goods from a German tax resident subsidiary of a company in the purchaser's group (Miles). The purchase monies used by SKS were contributed by the taxpayers and these were also monies received by them in accordance with the original share purchase agreement. In light of this, a side letter was entered into between the taxpayers and the purchaser where it was agreed that the payment by SKS to Miles would reduce the amounts owed by the debtor company to the target and, significantly, that following receipt of the payment by Miles, the taxpayers were released from all claims under the indemnity in the share purchase agreement. HMRC had issued closure notices for additional capital gains tax, applying section 809L, to the settlement of the indemnities.

Section 809L sets out the meaning of "remitted to the United Kingdom". An individual's income or chargeable gains will be remitted to the UK if certain conditions are met. One condition is that money or other property is brought to, or received or used in, the UK by or for the benefit of a relevant person (section 809L(2)(a)). The FTT discussed the background to section 809L itself: that it was introduced to close loopholes in the UK's remittance legislation, amounting to an anti-avoidance provision. Looking at the definition of "property" in 809L(2)(a), the FTT held that, given the legislative intent of closing a loophole, there was nothing to suggest that a narrow definition of property was intended to apply. It was clearly established that as a result of the side letter being entered into, the rights and obligations of the various parties changed, including that the taxpayers lost their obligation to make a payment under the indemnity. The first question for the FTT was therefore whether the changes of legal position gave rise to property, money or services in the UK. The FTT sided with the taxpayers in holding that their rights to have their indemnity obligations settled by a third party under the side letter, and debtor company's rights to have its debts settled by a third party, should not be treated as "property" for the purposes of section 809L because of the conditional nature of those rights. The next question was whether, once the parties' rights under the side letter were crystallised by the payment between SKS and Miles, the taxpayer or the debtor company obtained "property" rather than merely a right. The FTT again agreed with the taxpayer: their obligations under the indemnity were extinguished on payment being made by SKS to Miles and the better view was that this extinguishing of a debt should not be treated as giving rise to property rights. Regarding the debtor company's position, the FTT concluded that the company's rights under the side letter were not "property" because the other terms used in section 809L ("money or other property") suggested that the focus is intended to be on tangible, realisable goods (or services) rather than intangible rights. In any event the FTT did not think it is accurate to suggest that the debtor company has obtained any additional value as a result of the triggering of its rights under the side letter as it was always protected from being pursued for its debts by the purchaser as a result of the indemnity, with only the manner of the protection changing.

Another condition in 809L is that a service is provided in the UK to or for the benefit of a relevant person. Looking at this condition, the FTT held that it was clear that the purchaser had provided something of value to the taxpayers and the debtor company irrespective of the economic effect being the same as if the indemnity had been paid by the taxpayers. The FTT also made clear that an agreement not to take action or pursue a claim can be a "service" and in this case that was the extinguishing of the taxpayers' obligations under the indemnity and the waiving of the debtor company's debt. The FTT concluded that the "service" was provided in the UK. In order to give rise to a tax charge under s 809L the property or service must "derive from the income or chargeable gains". HMRC's position was that the property or services were derived from the chargeable gains generated from the taxpayers' share sale hence its closure notice for the additional capital gains tax payable. The FTT rejected HMRC's position, holding instead that the payments made under the indemnity did not derive from the chargeable gain but were one of the elements that produced the gain (reducing its level). The FTT agreed with the taxpayers' argument that any remittance derived from the indemnity in the UK cannot be derived from the gain arising on the share sale, because a payment under the indemnity would have reduced rather than increased the gain. It did not matter that the payment was from SKS to Miles – as the source was the indemnity itself.

This case is of interest for its analysis of when property or services are remitted into the UK and for the FTT's discussion of the distinction between mere proceeds of a share sale and when such amounts are chargeable gains for capital gains tax purposes, in the context of indemnity obligations.

Market value of benefit should be determined at the time of the transaction

In *HMRC v Pickles*, the Upper Tribunal (UT) has overturned the FTT's decision on the application of section 1020 CTA 2010, holding that the market value of a benefit received by the taxpayers on a business transfer should be assessed at the time of the applicable transaction with the excess treated as a distribution. It also concluded that the amount of that distribution was required to be

calculated by reference to the stated sale consideration, and not by reference to the amount of cash "actually received".

The taxpayers had carried on a business in partnership. They later established a company to incorporate the partnership, subscribing for shares in it, and an agreement was entered into between the company and the partnership under which the company agreed to purchase the assets of the business. The consideration was an agreed sum plus the company's assumption of the business's trading liabilities at that time. The consideration amount for the goodwill was credited by the company to the taxpayers' loan account (as directors of the company). In their tax returns after the sale, the taxpayers failed to declare their share of the capital gain on the sale of the goodwill. HMRC issued enquiries into those tax returns and issued assessments to tax that included a much lower figure for goodwill than that which was attributable to goodwill under the sale contract (£450,000 rather than nearly £1.2m). As well as the extra capital gains tax payable (on the sale of the goodwill), an income tax charge was also levied by HMRC under section 1020 CTA 2010 on the excess £750,000. Section 1020 provides that if, on a transfer of assets or liabilities by/to a company to/by its members, the amount of the benefit received by the member is greater than the amount of new consideration given by the member, then that excess will be treated as a distribution by the company to the member. The excess is therefore subject to income tax treatment as a distribution.

The FTT initially held that there had not been a transfer of assets from the company to its members (i.e. the taxpayers) for the purposes of section 1020. This was because of the creation of the directors' loan account. However, to the extent that the company paid the debt and that amount exceeded the value of the goodwill then the FTT held that such amount was a benefit and therefore a distribution. HMRC appealed the FTT's original view and in its supplementary decision, the FTT set aside its original decision. Its conclusion, however, was the same: that the amount of the distribution was the amount of cash actually received by the taxpayers less the value of the goodwill. The updated reasoning was that although no new consideration was given by the members there was still a transfer of assets under section 1020 comprising the goodwill and other assets transferred by the taxpayers and that the benefit was the amount actually received. The FTT also held that section 1020 does not on a literal reading take into account the value of the assets transferred by the members, but that on a purposive approach that section does not intend to leave out of account the value of the assets transferred in determining the benefit.

The UT firstly considered whether the goodwill should have been identified as "new consideration". The UT accepted HMRC's submission on this point: that the FTT had erred in its analysis and that the consideration provided was the value of the transfer of the goodwill. Accordingly, the value of the asset transferred must be the new consideration or form part of the new consideration.

Secondly, the UT considered the time at which the taxpayers received a benefit. The FTT had held that the cash received and the benefit of a debt owing to the taxpayers were two parts of the benefit received by the taxpayers. The UT held that the taxpayers received a benefit for the purposes of section 1020 at the point when they became entitled to the debt, i.e. when their contractually enforceable rights came into existence.

Thirdly, and most significantly, the UT considered the FTT's approach to the valuation of the benefit received. HMRC argued that the amount of the benefit for the purposes of section 1020 was the face value of the debt with no valuation being required whereas the taxpayers contended that the value of the benefit was its "open market value". The UT confirmed that the market value rule in section 1020 applied in all cases where section 1020 was engaged, although noting that the market value of cash would be its face value subject to currency exchanges if not sterling. The UT also rejected the taxpayers' argument on market value being the "open market value", i.e. a hypothetical willing seller and willing buyer on an arm's length basis (being the capital gains tax methodology). The UT concluded that the market value should instead be determined by reference to the value attributed to the benefit by a member of a company (sharing the attributes and knowledge of the

taxpayers), rather than the value which might be placed on the relevant asset by an arm's length third party trader. This is because the purpose of section 1020 is to prevent shareholders extracting value from a company untaxed. Applying this to the facts of the case, the promise to pay was recorded in the sale agreement as being payable in cash or payable on demand as a debt. On the basis that the benefit should be valued at or around the date on which it came into existence, the market value of the promise to pay cannot be reduced on the basis of a later revaluation of the goodwill transferred by the taxpayers. This meant that the market value of the benefit received by the taxpayers was the full face value of the promise to pay, and not the actual amount received in cash.

This case is of importance for its confirmation that the market value of a promise to pay has to be assessed by reference to the facts as they are known at the time of the transaction.

Taxpayer succeeds in double tax treaty dispute

In *Burlington Loan Management DAC v HMRC*, the FTT for the first time considered the interpretation of a principal purpose rule in a double tax treaty. Here the FTT had to determine whether an exemption from withholding tax on a payment of interest received by Burlington Loan Management DAC (BLM), an Irish resident company, should be denied in circumstances where HMRC alleged that the main purpose of the assignment of the debt giving rise to the interest payment was to take advantage of the interest article in the UK-Ireland double tax treaty (the DTT).

The case related to a debt of £142 million which was owed by Lehman Brothers International (Europe) (LBIE), a UK resident company to SAAD Investment Company Limited (SICL), a Cayman resident company. LBIE was in administration and whilst the principal amount of the debt claim had been paid in 2016, the interest amount of approximately £90.7 million remained outstanding. SICL was in liquidation and its liquidators assigned the debt to a broker (Jeffries Leveraged Credit Products, LLC) that had been retained to market the debt. On the same day Jeffries assigned the debt to BLM. The interest was paid to BLM subject to withholding tax of 20% which BLM sought to reclaim from HMRC relying on Article 12 of the DTT. HMRC denied the refund, claiming that Article 12(5) of the DTT applied denying the relief if the "main purpose or one of the main purposes of any person concerned was the creation or assignment of the debt-claim in respect of which the interest is paid to take advantage of this article by means of that creation or assignment".

BLM appealed to the FTT and HMRC bore the burden of proof to show that Article 12(5) of the DTT applied. The FTT determined that in assessing whether a person has a main purpose the correct approach is to look at that person's subjective purpose by reference to the evidence. In the tribunal's view Article 12(5) of the DTT only applied if a person has a main purpose to take advantage of the withholding tax exemption in the Irish treaty itself, and that Article 12(5) would not apply if a main purpose was enabling another person to take advantage of the withholding tax exemption. The FTT commented that, on the facts, although BLM took the possibility of a withholding tax exemption into account in assessing the price it was willing to pay for the debt, this did not determine that obtaining the exemption was one of the BLM's purposes. The FTT also noted that at the time SICL sold the debt it did know BLM's entity and that BLM would be relying on the withholding tax exemption in the DTT this was not sufficient to fall within Article 12(5) of the DTT, but that there had been no reflection of that in the purchase price negotiations. The price being paid for the debt was not in any way conditional on the withholding tax exemption applying and the FTT accepted that the sole purpose of BLM acquiring the debt was to make a profit.

Although the interest exemption in the DTT has subsequently been amended, this case is helpful for taxpayers as it reinforces that despite the taxpayer being aware of its entitlement to treaty benefits, this knowledge alone is not sufficient to determine that a main purpose of the transaction is to obtain that benefit.

EU Case Law Developments

Advocate General opines on compatibility of section 171 TCGA 1992 with EU law

The Advocate General (AG) has published his opinion, concluding that the UK's intra-group transfer provisions are not incompatible with the EU principle of freedom of establishment.

In Gallaher Ltd v HMRC, the FTT had held that compatibility with EU law required that the "no gain/no loss" transfer provisions in section 171 TCGA 1992 should apply to a transfer of shares from a UK resident company to its EU parent (in addition to applying to a transfer from a UK resident company to its UK parent) irrespective of the restriction in section 171(1A)(b), as the requirement for the transfer being to a UK resident company (or a non-resident company with a UK permanent establishment) was contrary to the EU freedom of establishment. The relevant transaction was a disposal of shares from the UK resident taxpayer to its Dutch parent company. The key issue was whether the taxpayer company was subject to a tax charge, with no right to defer payment of such tax, in respect of transactions involving an intra-group disposal of assets to companies not resident in the UK. The taxpayer had argued that section 171 should be interpreted so that the exit charge (on transfer of the assets from the UK company to its EU parent) should be payable in instalments, rather than immediately. The FTT, however, held that it could not read any instalment payment provision into section 171 as to do so would go beyond the ability to construe UK legislation in order to make it compatible with EU law. Therefore the FTT decided that in order to ensure section 171's compatibility with EU law the requirement for the transfer to be to a UK corporation tax-paying company should be disapplied. In the UT, the parties had agreed that the FTT's disapplication was incorrect but disagreed as to whether instalment payments or postponement of the tax payment should apply.

The UT referred a number of questions to the European Court of Justice. The key question being whether the UK's intra-group transfer rules – imposing an immediate tax charge on a transfer of shares from a UK tax resident company to a Swiss tax resident company (and does not have a UK permanent establishment) with a common parent tax resident in the Netherlands – are compatible with the EU's freedom of establishment, where there would have been no tax charge if the transfer was from a UK tax resident company to another UK tax resident company.

The Advocate General concluded that the UK's intra-group transfer provisions were not incompatible with the right to freedom of establishment. He recommended that the UK's imposition of an immediate tax charge on the UK company transferring the assets to a non-UK tax resident group company where an equivalent UK to UK transfer would be tax neutral was not incompatible with EU law. The AG confirmed that section 171 does not entail any difference in treatment according to the place of tax residence of the parent company, since they treat a UK tax resident subsidiary of a parent company having its seat in another EU member state in exactly the same way as they treat a UK tax resident subsidiary of a parent company having its seat in the UK. The AG also noted that the UK's rules impose an immediate tax charge on the transfer of assets by a UK tax resident subsidiary of a non-UK tax resident parent company to a third country and they impose the same tax charge in the comparable situation of a transfer of assets by a UK tax resident subsidiary of a UK tax resident parent company to a third country. The AG also concluded that a restriction on the right to freedom of establishment resulting from the difference in treatment between UK and cross-border transfers of assets within a group of companies under UK law which imposes an immediate tax charge on a transfer of assets by a UK tax resident company may, in principle, be justified. This would be on the basis of the need to preserve a balanced allocation of taxing powers, without there being any need to provide for the possibility of deferring payment of the charge in order to ensure the proportionate nature of that restriction, where the taxpayer concerned has realised proceeds by way of consideration for the disposal of the asset equal to the full market value of that asset. Therefore the AG recommended that there was no need for UK law to defer the tax charge to ensure the restriction on tax neutral treatment was proportionate.

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.

Other UK Tax Developments

UK "mini-budget" 2022

On 23 September, the Chancellor unveiled the UK's 2022 Growth Plan which has been described as being "the biggest package of tax cuts in generations". A summary of the main proposed tax changes are set below. For further commentary on the budget, please see our Tax Blog. Whether these proposed measures end up being brought into law, given the severe adverse reaction from the financial markets that they have provoked, remains to be seen.

- **UK corporation tax:** the main corporation tax rate that was due to increase to 25% for companies with annual profits in excess of £250,000 from the start of the 2023/2024 tax year will remain at 19%.

- **Annual Investment Allowance:** the threshold for the annual investment allowance (which allows for a 100% deduction for UK companies on qualifying expenditure on plant and machinery) has been permanently set at £1 million.

- **IR35 (off-payroll working rules):** the Government has confirmed that is repealing the current IR35 regime from 6 April 2023. The current IR35 regime requires the fee-paying party to determine whether its relationship with workers providing services via an intermediary resembles an employment or a self-employment arrangement. The responsibility will now shift back to the service provider to determine their own employment status and ensure that the appropriate amount of tax and national insurance contributions are paid.

- **National Insurance Contributions:** the rate of employee and employer national insurance contributions will decrease by 1.25% from 6 November 2022, reversing the increase introduced in April.

- **Company Share Option Plan (CSOP) options:** the limit for the amount of company share option plan options which qualifying companies can issue to each employee will double from £30,000 to £60,000.