Proskauer

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Welcome to the April edition of the Proskauer UK Tax Round Up. This month saw changes to the taxation of termination payments and the UK's adoption of the OECD Multilateral Instrument into its double tax treaties coming a step closer.

General UK tax developments

Changes to taxation of termination payments

HMRC has updated its Employment Income Manual to reflect the changes to the taxation of termination payments (including payments in lieu of notice or PILONs) that apply to payments made on or after 6 April in respect of employment ended on or after that date.

The changes cover two areas:

(a) the "post-employment notice pay" (or PENP) element of any termination payment is treated as general earnings subject to income tax and Class 1 NICs; and

(b) the remainder of the termination payment is subject to income tax above the £30,000 exemption threshold (subject to exemptions applying to statutory redundancy payments and approved contractual payments).

The PENP is calculated under a statutory formula but, broadly, equates to the employee's entitlement to basic pay during his or her notice period.

In addition, the amount of all non-PENP termination payments above £30,000 will be subject to Class 1A (employer's) NICs from 6 April 2019.

EMI option schemes – expiry of State Aid clearance

The EU State Aid clearance for EMI option arrangements expired on 6 April and new clearance has not yet been granted by the European Commission.

As a result, HMRC have published a warning that companies considering putting new schemes in place or granting new options under existing schemes might want to delay until new approval has been confirmed by the Commission to avoid the risk that any options granted might be unapproved and so not benefit from the EMI scheme tax advantages.

HMRC have also confirmed that they consider that options granted under EMI schemes up to and including 6 April are covered by the State Aid approval so that exercise of those options will benefit from the EMI scheme tax regime.

UK consultations and guidance

Consultation on preventing tax avoidance through profit fragmentation

On 10 April, HMRC published a consultation on tax avoidance involving profit fragmentation. This follows from the August 2017 Budget announcement on UK traders and professionals that arrange for trading income to be transferred to entities in offshore jurisdictions with no or low tax. The consultation refers specifically to arrangements set up by asset managers amongst others, although it is not focused principally on the asset management business.

The purpose of the overall proposal is to specifically target the sort of profit fragmentation arrangements discussed in it and to remove the perceived cash flow advantages that HMRC consider taxpayers might derive from the arrangement by requiring early notification and, at HMRC's direction, early tax payment.

The consultation contains two elements, each of which HMRC is seeking comment on with a view to their introduction in 2019.

The first part of the proposal is that UK resident individuals or companies will be liable to tax (as trading income) on profits attributable to UK individuals' professional or trading skills which are retained in an offshore entity in which "significantly less tax" is paid if:

(a) the UK resident or a connected person (or persons acting together with any of them) has the "power to enjoy" those profits; and

(b) it is reasonable to conclude that at least some of the offshore entity's profit is excessive and is attributable to its connection to the UK resident individual.

The second part of the proposal would require individuals or companies who entered into relevant arrangements (ignoring the requirement that the offshore entity's pay is excessive) to notify HMRC, who will then consider the facts and issue a charging notice requiring the tax to be paid within a specified period (e.g. 30 days) if they consider that the entity's profits are excessive.

The document recognises that many arrangements that would fall within these rules might also be covered by other anti-avoidance rules, such as the disguised remuneration, disguised investment management fee or transfer of assets abroad rules, but say that the complexity of investigating and assessing taxpayers' arrangements means that timing advantages remain that they want to reduce. This approach to early notification of arrangements to HMRC and possible accelerated tax payments is the same as is used under the diverted profits tax rules and where accelerated payment notices are issued and might be something that becomes a more common feature of anti-avoidance legislation.

The new rules would be included in the Finance Bill 2019 to take effect from April 2019. The consultation ends on 8 June 2018.

Draft guidance on recent tax changes for non-UK domiciles

The ICAEW, CIOT, Law Society and STEP have published some useful draft guidance on the recently introduced changes to the taxation of non-UK domiciles. The guidance is in three parts covering rebasing, changes to the CGT trust protections and other trust issues.

The guidance does not necessarily represent HMRC's views, and will be updated following HMRC's comments.

Case developments

Court of Appeal refers VAT recovery on investment management fee question to ECJ

The Court of Appeal has referred questions relating to Cambridge University's right to recover VAT costs on the management of its investments to the ECJ. The university was allowed to recover the VAT on costs associated with the management of its endowment fund by the First-tier Tribunal (FTT) and the Upper Tribunal (UT) applying the principles in the *Kretztechnik* and *AB SFK* cases on the basis that while the investment activity itself was not an economic activity it was undertaken to benefit the other economic activities of the university. The costs were, therefore, part of the university's general overheads and so it was entitled to recover the VAT in accordance with its partial recovery method.

The Court of Appeal have now decided that the issue in question was unclear and should be referred to the ECJ and have asked the ECJ to opine on:

(a) whether the FTT and the UT were correct to focus on the purpose of the investment activity;

(b) whether they were correct to treat the generation of income to be used for the purpose of the university's economic activity as equivalent to a business raising capital to use for the purposes of its business; and

(c) whether it was correct that no distinction should be drawn between the university's investment activity being not an economic activity or being exempt for VAT purposes in determining its right to recovery.

It will be interesting to see what guidance is provided by the ECJ and what clarity is given to this area of input tax deductibility for operations with a mix of taxable and non-taxable or exempt activities.

Right to deduct VAT unaffected by late invoice

In the *Volkswagen AG v Slovak Republic* case, the ECJ have held that Volkswagen was entitled to reclaim input VAT in circumstances where the VAT was charged and paid several years after delivery of the goods following the late issue of a VAT invoice. The case related to the provision of parts for cars to Volkswagen by a Slovakian supplier which did not charge VAT for a number of years but, in 2010, realised that it should have done so. The supplier then issued VAT invoices to Volkswagen and filed the relevant VAT returns with the tax authority. Volkswagen applied to the Slovak tax authority for a VAT refund and the tax authority permitted the refund for the prior 5 years but refused the claim for earlier years on the basis that it was out of time.

In coming to this decision, the Slovak tax authority asserted that the relevant VAT point was the time of delivery of the goods and not the time of issue of the VAT invoice. The ECJ allowed Volkswagen's recovery for all years and held that EU law must be interpreted as allowing claims for VAT refunds by reference to the time when the VAT is paid and not when the goods were delivered. The Court stated that the right to deduct VAT is an integral part of the VAT system and may not be limited so that in this case, where there was no abuse or fraudulent conduct between Volkswagen and the supplier and Volkswagen had not demonstrated any lack of diligence in making its VAT reclaim, it was entitled to recover the VAT that was paid by reference to the time of issue of the late invoices.

VAT avoidance and abusive transactions

The Court of Appeal has sent the *Newey* case back to the FTT for reconsideration. Previously the FTT and the UT had both decided that the arrangements that Mr Newey had entered into were not abusive and so should not be recharacterised for VAT purposes.

The facts of the case were that, prior to the reorganisation, Mr Newey carried out a loan broking business in partnership in the UK. The business was not registered for VAT and carried out only exempt financial services activities. This meant that the business could not recover any of its input tax, including VAT charged on advertising services provided to the business. In order to try to remove the irrecoverable VAT cost from the business, Mr Newey restructured it by incorporating a company in Jersey which purportedly provided the loan broking services to the customers in the UK and received services to allow it to conduct the business, including the advertising services. The result of this was that the advertising services were no longer subject to VAT and the irrecoverable VAT cost was removed from the structure. HMRC argued that the arrangements were ineffective because either the loan brokerage services continued to be supplied to the customers from the UK and the advertising services received in the UK or that, even if the services were supplied by and to the Jersey company, the introduction of it into the structure was an abuse of rights for VAT purposes applying the *Halifax* principle.

The FTT had decided that the advertising services were supplied in Jersey and that the VAT abuse principle requirements were not satisfied because the Jersey company conducted business activity. It also referred to no exempt activities being supplied from the UK under the Jersey structure. The case was appealed to the UT, who referred it to the ECJ. The ECJ confirmed that while the contractual terms were a factor in determining who was the supplier and who was the recipient for VAT purposes, they were not determinative if they did not reflect the economic and commercial reality and, in addition, said that it was "conceivable" that the structure amounted to an abuse of VAT law such that it could be recharacterised as the supply and receipt of services by Mr Newey from and in the UK. Notwithstanding this, the UT dismissed HMRC's appeal against the FTT's decision on the basis that the FTT had been entitled to reach its conclusions on the facts.

The Court of Appeal has now sent the case back to be reconsidered by the FTT on the basis that both the FTT and the UT erred in law in reaching their decisions. At the original FTT hearing, they had considered that the arrangements did not involve any exempt suppliers in the UK but that had it done so it was arguable that the scheme would have been abusive. The Court of Appeal considered that the conclusion on exempt activities was wrong and so has sent the case back to the FTT for reconsideration. The new judgement might then give some more colour to what is and is not considered to be an abusive arrangement.

Consultant not an employee and IR35 not applicable

In *MDCM v HMRC*, the FTT has decided that an individual, Mr Daniels, who provided construction management services indirectly to construction companies through a company owned by himself and his wife and an intermediary company was not effectively an employee of the intermediary company and so the IR35 rules did not apply to require his company (MDCM) to operate PAYE on its fee income.

The arrangements in question involved MDCM contracting with (and supplying Mr Daniels' services to) the construction company via an independent introductory company (STL). MDCM entered into a contract with STL and STL entered into a contract with the construction company. HMRC argued that Mr Daniels provided his services to STL and if Mr Daniels and STL had contracted directly he would have been an employee of STL.

The FTT considered that although STL had a high degree of control over how Mr Daniels conducted his work, this was dependent largely on the stage that the construction project was at and applied to all workers whether employed or self-employed and, importantly, it was common practice for construction projects to use a large number of self-employed workers. There were other factors, such as no entitlement to employee benefits or to a notice period and being paid on a daily rate, that pointed to self-employment. Weighing up all of these factors, the FTT decided that Mr Daniels was a self-employed contractor and would not have been an employee of STL had he contracted with it directly.

The case highlights the increasing difficulty in distinguishing between employed and self-employed workers where both are common and a business will require a degree of control over its self-employed contractors as well as its employees, and the difficulty that HMRC has in successfully applying the IR35 rules to many modern working practices. This is, at least in part, why the status and tax status of workers is being considered carefully following publication of the Taylor Review last July.

Latest GAAR panel opinion published

The GAAR panel has published its latest opinion, again concluding that a scheme using complex arrangements involving an employer, employee and EFRBS to avoid employment income tax charges (on similar facts to the scheme described in our March edition) was not reasonable since it was not consistent with the principles behind the relevant tax provisions, was designed to exploit a perceived shortcoming in the disguised remuneration rules and was abnormal and contrived.

The conclusion itself is unsurprising. The scheme in question did, however, raise a new question since some of the arrangements in it had been implemented before the GAAR come into effect.

The panel concluded that this did not prevent the GAAR from applying since the relevant payments were made after the GAAR come into effect, the post-commencement transactions were capable of being abusive considered in isolation, the pre-commencement steps were preparatory or could be ignored and even if they were considered material they would not have prevented the post-commencement arrangements from being abusive.

This will be relevant to any arrangements which straddled the introduction of the GAAR and where taxpayers or advisers were relying on the arrangements being treated as outside the scope of the GAAR by reason of their pre-commencement transactions.

BEPS and the Multilateral Instrument

Multilateral Instrument ready for implementation

On 22 March, the fifth country (Slovenia) ratified the OECD's Multilateral Instrument (MLI), so that it has now come into force from 1 July 2018, subject to introduction into law by the individual signatory nations.

In a related development, the UK has laid a draft Order in Council before Parliament to pave the way for the UK's ratification of the MLI. In addition, HMRC have published a document setting out changes to the list of the UK's covered tax agreements, reservations and notifications under the MLI reflecting new tax treaties entered into since June 2017. The related explanatory note states that the UK will only reserve against those provisions which are not part of the minimum standard that it considers unnecessary because of the adoption of the principal purpose test as a new condition to access treaty benefits. These unnecessary provisions include the broadening of the definition of permanent establishment in the MLI which the UK is not adopting.

The MLI will be introduced into UK treaties three months following the UK's ratification of it, which is expected to be during this summer. The principal purpose test will then apply to relevant withholding tax claims from 1 January 2019.