Proskauer

UK Tax Round Up

May 2018

General UK Tax Developments

Enterprise management incentive (EMI) options State Aid approval

We referred in the April UK Tax Round Up to the expiry of the EU's State Aid approval for EMI options. Fortunately, this has been resolved rapidly, and on 15 May the European Commission approved the UK's EMI schemes. The approval will apply until 6 April 2023 or until the UK leaves the EU. This will be a comfort for the many employees and companies with existing EMI schemes in place or who wish to grant further EMI options.

It is not entirely clear whether the new approval covers options granted between 6 April and 15 May, although the expiry date of 6 April 2023 suggests that the approval commenced on 6 April 2018 as approvals are normally effective for 5 years.

UK Consultations

Consultation on PAYE simplification for short-term business visitors

As referenced in our March UK Tax Round Up, HMRC has now published its consultation on possible changes to the current administrative process covering the tax treatment of short-term business visitors ("STBVs") to the UK. STBVs are individuals who are not UK tax resident but make business trips to the UK. When such an individual comes to work in the UK for a UK company, the company must, in principle, operate PAYE on the individual's earnings.

The consultation aims to simplify the tax treatment of STBVs with a view to minimising the administrative cost associated with them and ensuring that the UK is an attractive place to headquarter a business.

Under the current rules, an administrative easement is available for UK companies with STBVs from overseas subsidiaries. This easement, known as "EP appendix 4", allows UK companies to enter into arrangements under which the company does not have to operate PAYE and applies, broadly, where the STBV is not subject to UK tax because he or she benefits from the terms of a UK double tax treaty. This process is not currently available for STBVs coming from overseas branches of a UK company or to certain other STBVs, such as those who are tax resident in a country which does not have a double tax treaty with the UK. Where a STBV is ineligible for an arrangement under EP appendix 4, a PAYE special arrangement, introduced in 2015, allows the UK employer to operate PAYE on an annual, rather than a monthly, basis for a STBV who spends 30 or fewer workdays in the UK in the tax year.

Two main proposals are outlined in the consultation document; one in relation to EP appendix 4 and one in relation to the PAYE special arrangement.

1. EP appendix 4 - introducing a new, specific exemption for STBVs from overseas branches of UK companies. This is intended to align the effective tax treatment of STBVs from overseas branches with those from overseas subsidiaries under the EP appendix 4 arrangements. Such exemption would prevent double taxation of the individual's earnings and remove the need for the UK company to operate PAYE.
2. PAYE special arrangement - extending the UK workday rule from 30 to 60 days. This extension will allow more STBVs who are ineligible for an EP appendix 4 arrangement to benefit from the PAYE special arrangement.

The consultation ends on 6 August 2018.

These changes would not affect the operation of national insurance contributions, which have their own exceptions.

UK Case Developments

Trail commissions – appeal of FTT decision

In our March UK Tax Round Up, we reported that the First-tier Tribunal (FTT) ruled in favour of Hargreaves Lansdown that "loyalty bonuses" (or "trail commissions") paid to investor clients which represented sums rebated by investment fund managers from their management fee were not "annual payments" and so not subject to withholding tax. HMRC has now appealed this decision. As mentioned in our March edition, this decision is of general interest to UK fund general partners and investment managers who might operate management fee rebate arrangements with certain of the fund's investors.

Stamp duty land tax scheme

The recent case of *Geering and others v HMRC* concerned a marketed stamp duty land tax (SDLT) avoidance scheme that relied on the sub-sale rules (previously in section 45 Finance Act 2003) that have since been repealed. There were two separate but similar transactions dealt with together by the case.

The taxpayers (Mr and Mrs Geering and Ms Robinson, referred to as "T") established a new UK unlimited company. T then subscribed for shares equal to the value of the deposit to be paid to the seller. The company subsequently entered into a contract to purchase the property from the seller for the agreed purchase price and paid the deposit. After exchange of contracts, the company resolved to reduce its share capital by way of a distribution in specie of the property to T (the shareholders). The distribution was conditional upon and simultaneous with the completion of the contract between the seller and the unlimited company.

Prior to completion, additional shares were subscribed for by T in the company, the result of which was that T held shares in the company equal to the price to be paid for the property. On completion the property was transferred to the company and immediately transferred on to T by way of the distribution in specie. Sub-sale relief was claimed under the old section 45 Finance Act 2003 to eliminate all SDLT on the transactions.

The FTT found that the scheme failed under section 45, since the share capital contribution paid was found to be consideration given indirectly by T and, as such, was "consideration" as defined by section 45(3)(b)(i). Given that this legislation has since been repealed, this is of historic interest only.

However, the FTT also found that HMRC's alternative argument would have succeeded. This centred on the wide-ranging anti-avoidance rule in section 75A Finance Act 2003. This part of the decision considered the leading case on section 75A (*Project Blue Limited v Revenue and Customs Commissioners*) and found that there is nothing in that case to suggest that the first seller of the chargeable interest in land (in this case the unconnected seller of the property) must be aware of any subsequent transactions. The FTT found that, because the documentation setting out the arrangements entered into clearly contemplated the transfer in specie of the property after, and dependent on, its sale to the company, the onward transfer from the company to T was "in connection with" the disposal by the seller, even though the seller knew nothing about it.

This is an interesting case in relation to section 75A, although as an FTT level case it has little value as a precedent and might have been influenced significantly by the fact that this was a promoted tax avoidance scheme.

No tax on injury to feelings termination payment

The Court of Appeal overturned a decision of the Upper Tribunal (UT) and held that a payment for injury to feelings made to an employee as part of a termination payment was not subject to tax under the pre-6 April 2018 provisions in ITEPA 2003.

Having been made redundant in March 2010, Mr Moorthy began proceedings alleging unfair dismissal and age discrimination against his former employer. A compromise agreement was reached which involved the employer paying Mr Moorthy a £200,000 settlement sum.

The Court considered whether the £200,000 sum was subject to income tax under section 401 ITEPA and, if so, whether any part of the sum was taken out of the charge by section 406 of ITEPA, which provides an exemption for a payment or benefit paid "on account of injury to … an employee".

The Court of Appeal concluded that the full £200,000 sum fell within section 401 as a payment or benefit that had been received directly or indirectly in consideration or in consequence of the termination of Mr Moorthy's employment. Having examined previous case law and considered the natural meaning of the term "injury" in section 406, the Court further concluded that damages awarded for injury to feelings fell within the natural construction of section 406 and thus part of the £200,000 payment (in this case £30,000) was not subject to tax.

This case will only have relevance for pre-6 April 2018 payments as section 5(7) Finance (No 2) Act 2017 amended section 406 to make clear that the meaning of injury does not include injured feelings. Therefore, any such awards for injury to feelings from 6 April 2018 will be fully taxable. That amendment may lead to attempts to apportion larger amounts of lump sum termination payments to psychiatric injury rather than injury to feelings where a personal injury claim will be pleaded.

Capital loss denied on share options

The UT upheld the FTT decision in *Stephen Davies v HMRC* [2018] UKUT 130 (TCC) and denied Mr Davies' claim for a capital loss arising from exercise of a share option.

Mr Davies' employer had discretion under the terms of employee share options granted to Mr Davies to satisfy the options, once exercised, either by the delivery of shares or in cash. Mr Davies filed his tax return on the basis that the exercise of the options generated a capital loss, which he sought to offset against other capital gains he had realised.

Mr. Davies argued that, because the employer was not "bound" to sell (issue) the shares and could instead pay cash, the provisions of section 144ZA TCGA 1992 were not engaged. If that was right, the market value acquisition rule in section 144ZA would have applied and the transaction could have generated a capital loss.

The UT held, however, that section 144ZA TCGA would still apply even where the grantor had a measure of discretion as to the manner in which the grantee's rights were to be satisfied. This is perhaps not surprising given that section 144ZA is an anti-avoidance provision introduced, in parts, to prevent the generation of capital losses on the acquisition of shares under options.

European Law Developments

Hire purchase contracts – VAT treatment

The opinion of the CJEU's Advocate General (AG) in the *Volkswagen Financial Services* case (Case C-153/17) has been released. In the UK, the exemption for VAT on financial services includes the granting of credit under a hire purchase (HP) contract. Car dealers typically split HP contracts into two supplies. One being a taxable supply of cars and the other an exempt supply of credit. This leads to partial recovery of VAT costs as business overheads. HMRC had claimed that the input tax on overheads should not be recoverable at all since none of the overhead costs related to the supply of cars and all to the exempt supply of credit.

The AG has opined that each HP should instead be treated as an indivisible (and taxable) supply of the underlying assets (here, cars). In other words, the UK's treatment of HP contracts is incorrect.

The CJEU is not bound to follow the AG's opinion but often does so. If it does rule along the same lines, then UK taxpayers who have made supplies of HP should consider whether it would be worthwhile making claims to seek to recover historic VAT input tax treated as irrecoverable.

VAT recovery on failed takeover costs

The AG's opinion in another European VAT case (*Ryanair v Revenue Commissioners (* Case C-249/17)) has also been released.

This case relates to the failed bid by Irish airline company Ryanair to acquire Aer Lingus. The acquisition did not proceed for competition law reasons. During the course of the transaction discussions, Ryanair had incurred a significant amount of VAT input tax cost on professional advisers' fees among other things.

The AG's opinion was that a right to deduct input VAT incurred on a failed acquisition of shares did exist in principle. The AG stated that the (intended) acquirer must intend to engage in an economic activity and the acquisition must be for the purpose of making future taxable supplies as part of its existing business. This was clearly the case for Ryanair, seeking to add to its existing airline business. However, the AG also considered the position regarding acquiring companies which intend to carry on economic activity through supplying management services to the target. The AG's view was that this would also be sufficient for the intended acquirer to recover associated input tax. However, a passive holding company whose only intention was to acquire and hold shares would not be regarded as carrying on a taxable business and so could not recover its VAT costs.

Finally, the AG confirmed that there is no concept of proportionality of recovery by reference to income generated from taxable supplies. All that is needed is the link between the intended acquirer's taxable business and the acquisition of shares. The amount of VAT input tax recovered need not bear any relationship to the amount of onward taxable supplies.

The *Larentia + Minerva* joined case in 2015 (C-108/14 and C-109/14) clarified the law concerning the recovery of input tax associated with acquisitions of shares by companies that carry on an active business of management (or intend to do so). The *Ryanair* case, if determined in line with the AG's opinion, would further extend the scope of recoverability into costs incurred on aborted M&A deals and clarify an uncertain area of VAT law. It is important in evidencing a right to recovery that proper planning is carried out as early as possible in an acquisition process and that management services are genuinely supplied under an agreement for more than a nominal consideration (or the intention to supply such services can be evidenced in aborted deals).

BEPS and the Multilateral Instrument

Draft Orders approved by House of Commons

On 9 May 2018, the House of Commons Delegated Legislation Committee considered the draft Order in Council that the UK will use to ratify its adoption of the OECD's Multilateral Instrument (the MLI).

The Government has confirmed its intention to publish consolidated versions of double tax treaties that have been amended by the MLI prior to the changes taking effect. Two draft orders effecting changes to the UK's treaties with Switzerland and Uzbekistan were also considered by the Committee alongside the Order to ratify the MLI. In relation to Switzerland, the changes reflect those which would have been made by the MLI and so the UK will not list this treaty as one to which the MLI applies. The Government explained that this was due to the unusual domestic law implementation of double tax treaties by Switzerland.

The three draft Orders were approved by the House of Commons on 14 May 2018 and will now be presented to the Queen for approval in Privy Council. The MLI will come into force in the UK three months after the UK ratifies it. Such ratification is currently expected later this summer. In that case, the new provisions applying to withholding tax would operate on payments from 1 January 2019.

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