

UK Tax Round Up

April 2019

UK Case Law Developments

Damages on share sales same as on other sales

In *Oversea Chinese Banking Corporation Ltd v ING Bank NV*, the Commercial Court has held that the measure of damages for breach of warranty in a share sale is simply the difference between the amount paid for the shares and their value as a result of the matter giving rise to the warranty claim. That is, there is no different basis for calculating the quantum of damages in respect of breach of warranty on a share sale in contrast to any other damages claim.

While this is not a surprising result, it does highlight the potential limitation in relying on warranties in share acquisitions given the difficulty in determining how much the value of shares has reduced as a result of an unexpected liability in the company. Accordingly, to the extent that purchasers require full compensation for any unexpected costs in the underlying company, they should ensure that the relevant breach is indemnified or that there is other suitable contractual protection available rather than simply relying on a breach of warranty claim.

Territorial restriction on chargeable gains degrouping rules contrary to EU law

In *Gallaher Ltd v HMRC*, the First-Tier Tribunal (FTT) has held that compliance with EU law required that the no gain/no loss group transfer provision 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) notwithstanding the restriction in section 171(1A)(b), since the requirement that the transfer be to a UK resident company or a non-resident company with a UK permanent establishment was contrary to the EU freedom of establishment.

In the case, the taxpayer had requested that section 171 be interpreted in these circumstances so that the degrouping charge on transfer of the asset from the UK company to its EU parents should be payable in instalments rather than immediately. Judge Tony Beare decided, however, that it was not possible to read an instalment payment provision into section 171 in order to make it comply with EU law, since to do so would go beyond the ability to construe UK legislation in order to make it EU law compliant. Specific words would be required to import an instalment payment provision. In these circumstances, therefore, he considered that the only option available in order to ensure that section 171 was compliant with EU law was to disapply in its entirety the requirement that the transfer be to a UK corporation taxpaying company.

The case is interesting in its detailed analysis of the relevant EU law and in highlighting that (at least as long as the UK remains subject to EU law) there is a stringent requirement on UK legislators to ensure that legislation is compliant with EU law to avoid the possibility that aspects of the UK's legislation will simply be struck out.

Entrepreneurs' relief capital test refers to shares' nominal capital

In *Hunt v HMRC*, the FTT came to the unsurprising conclusion that the test in the entrepreneurs' relief (ER) rules requiring an individual to hold at least 5% of the issued ordinary share capital of a company refers to the nominal capital of the shares held and not, if different, the amount subscribed for them or any other amount.

This decision follows the longstanding decision in the *Canada Safeway* case and has reiterated that references to "issued share capital" throughout UK tax legislation should, absent any other explicit indication to the contrary, have the same meaning. There was no room for a purposive interpretation of the test in the ER rules by reference to some broader concept that the 5% issued ordinary share capital test was intended simply to indicate some level of overall economic entitlement.

While unsurprising, this case reiterates the technical requirement of the 5% ordinary share capital requirement for ER to be available and that this will remain the case notwithstanding the recent introduction of the broader economic entitlement tests.

Option granted to a director was not an employment-related securities option

In an interesting decision in *Vermilion Holdings Ltd v HMRC*, the FTT considered the application of the employment-related securities deeming rule in section 471(3) ITEPA 2003, which deems a securities option (or, on an equivalent basis, a security under section 421B(3) ITEPA 2003) to be acquired "by reason of employment" where it is "made available" by an individual's employer or a person connected with their employer.

Since its introduction in 2003, there has been much discussion, but little judicial consideration, on the scope of this deeming provision and the extent to which it should be read literally or to which it should be given a purposive construction in the context of the rules in ITEPA 2003 as a whole.

The basic facts of the case were that, in 2006, the individual in question (Mr Noble) had been given an option over shares in Vermilion in part consideration for services provided by him in relation to the company's fundraising. In 2007, the company and its shareholders decided that it needed to raise further "rescue" funding. As part of that process, Mr Noble agreed both to reduce the scope of his option and to become a director of Vermilion. The mechanism used to reset his option was to cancel the original option and grant him a new one (contemporaneously with him becoming a director).

The question at issue was whether, notwithstanding the circumstances under which Mr Noble was granted his original option, the fact that he received a new option and became a director meant that his new option was an "employment-related" securities option through the application of the deeming provision in section 471(3) ITEPA 2003.

In this case, the FTT considered the extent to which the deeming provision is simply a literal mechanical provision (as argued by HMRC) or whether there is some "purposive" determination that needs to be applied to it that means that its application can be ignored when it is the case that, as a matter of fact, there is no connection between an individual's status as an employee (or director) and their obtaining the option. The FTT decided in favour of Mr Noble on two possible bases.

First, the FTT noted that "the ambit of the deeming provision should be limited where the artificial assumption from deeming is at variance with the factual reason that gave rise to the right to acquire the 2007 option". The FTT did not, however, state whether this was the basis on which they decided in favour of Mr Noble, although they did note that the circumstances around Mr Noble's acquisition for the 2007 option were "unusual" and had nothing to do with his status as a director.

Again, while not explicitly stated, the clearer basis of the FTT's decision appears to be that the 2007 option was not "made available" to Mr Noble by his employer but, rather, by the shareholders who had agreed the refinancing under which the 2007 option was granted.

The decision highlights that HMRC cannot rely on a simple literal interpretation of the deeming provision such that, if there is both a securities option (or security) granted (or issued) by an individual's employer or a person connected with it and an employment, the securities option (or security) will be deemed to have been acquired "by reason of employment" and will be an employment-related securities option (or security). Rather, consideration has to be given to a realistic view of the reason for the right to acquire the option (or security), which may point to the option (or security) having been "made available" by a person other than the employer or a connected party. It also cautions against trying to limit the scope of the deeming provision too narrowly, however, by recognising that the purpose of the deeming provision is to avoid having to ask the question "why was the option (or security) granted (or issued)" when it is made available by the employer or connected person.

IR35 not applicable if insufficient control

In *Atholl House Production Ltd v HMRC*, the FTT determined that IR35 did not apply to a presenter providing services to the BBC through a personal service company because the hypothetical contract between the presenter and the BBC would not have been one of employment. This decision is in contrast to the recent decision in *Ackroyd v HMRC*, but was distinguished on the facts.

The case related to the contract under which Kaye Adams provided her services to the BBC to present the "Kaye Adams Programme", which ran each weekday morning.

The FTT focused on elements of the contract between the BBC and Ms Adams' personal company and the facts of the arrangement between the BBC and Ms Adams, such as that Ms Adams was free to, and in fact did, enter into engagements other than for the presentation of this programme, the amount of her income from the Kaye Adams Programme compared to that from her other engagements, the length of the engagement and the level of control over her activities. Particular significance was placed on factors such as that Ms Adams did not have access to the BBC's IT systems, that she had a history of operating as a freelancer for various clients and the lack of holiday and sick pay, maternity leave and pensions arrangements under the contract, stating that a contract between a service company and a service recipient would not necessarily omit provision for these things.

While the decision is highly fact driven, as is its distinction from the decision in the *Ackroyd* case, it highlights the risk (particularly on the question of employment status) of seeking to apply the decision in one case on an issue to another, seemingly similar, case where the decisions are based on an assessment of the overall facts taken as a whole.

Other UK Developments

Extension of valid period for HMRC EMI valuations

HMRC has published confirmation that its valuations of shares obtained for the purposes of enterprise management incentive (EMI) option arrangements will, from 1 April this year, be valid for 90 days rather than the previous 60 days (always subject to any material change of facts after the valuation is given).

This is a welcome development for companies wishing to put such EMI option schemes in place.

HMRC guidance on new ER economic entitlement conditions

HMRC has updated its *Capital Gains Manual* to include guidance ([link](#) and [link](#)) on the new economic interest conditions that need to be satisfied for an individual to be able to claim ER on the sale of shares that were introduced by FA 2019 and became effective for sales on or after 29 October 2018.

As reported in our [January 2019 UK Round Up](#), FA 2019 has introduced two new alternative requirements for an individual to be able to claim ER which, broadly, require that the individual is entitled at all times over the relevant holding period to either (a) at least 5% of the profits available for distribution and on a winding-up to equity holders or (b) at least 5% of the disposal proceeds that would be payable to the holders of ordinary shares were the entire ordinary share capital of the company to be sold for its market value on the date on which the qualification for ER is tested.

While not entirely comprehensive, the guidance provides some useful indicators of the basis on which these two conditions should be applied.

EU Developments

UK's CFC group financing exemption partly constituted illegal State Aid

On 2 April, the European Commission (EC) published a press release summarising its conclusion that the UK's exemption from its controlled foreign company (CFC) regime for certain finance income of non-UK resident companies, which has been under investigation since October 2017, constituted, in part, illegal State Aid. As a result of this, HMRC will be required to try to assess and recover the relevant exempted CFC tax from any affected UK companies within four months.

The EC considered the exemption from the CFC rules applicable to finance companies in question on two bases. The first basis on which the exemption was considered was where the non-UK company's financing activity derived from UK connected capital without UK activities. This was deemed to be justified and to be compliant with State Aid rules.

The second basis on which the EC considered the exemption was where the non-UK finance company's finance profits were attributable to activities undertaken in the UK. This was deemed to be illegal under the State Aid rules on the basis that the extent of UK activities could be easily determined and the exemption might give a selective advantage to certain multinational companies.

The UK amended its CFC rules effective from 1 January this year in order to align them with the requirements under the EU's anti-avoidance directives such that now only the UK connected capital limb remains in the exemption. The rules are, accordingly, now compliant with EU law.

Notwithstanding this, as stated above, HMRC will now have to assess whether certain UK companies have relied on the CFC exemption where they have had UK activities and, if they have, seek to recover the underpaid CFC tax from them.

Following the EC's statement on this, HMRC has started writing to affected groups to alert them that it will need to recover the State Aid irrespective of whether it intends to appeal the decision.

UK companies that think that they might be affected by this decision of the EC should consider whether and how much tax they might be requested to pay to HMRC.

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