Proskauer

UK Tax Round Up

June 2020

UK COVID-19 Developments

HMRC updates its trading activities guidance

HMRC has updated its guidance at BIM48000 regarding how legislation and case law should be applied where a business makes changes to its trading activities, including in response to the COVID-19 disruption. Of particular interest are HMRC's comments on the possibility of changes to business activities resulting in the commencement of a new trade and that donations received to subsidise loss of income might be taxable.

Businesses may have made COVID-19 related changes to their trading activities, such as changing product lines, providing goods or services to key workers for free or at discounts and donating supplies to charities, hospitals and care homes.

When a company changes its product lines, it is well-established that if a business commences an entirely new trade which is completely unrelated to its previous activities this would usually be treated as the commencement of a new and separate trade rather than the extension of an existing one. In the context of COVID-19, a restaurant starting to manufacture gowns and facemasks is likely to be treated as commencing a separate trade, whereas a clothing manufacturer that begins producing those products (but wouldn't ordinarily) is more likely to be treated as extending its existing trade rather than starting a new one.

HMRC has also confirmed that a temporary break in trading activity (for example, when a business is closed to customers during the lockdown period and intends to continue trading once restrictions are lifted) should not amount to a permanent cessation of the trade.

On the receipts side, the guidance cautions that donations of money from the public and/or employees intended to meet a business's revenue expenditure or to supplement trade income are likely to be taxed as trade receipts and income of a casual nature received in return for services provided will be taxable as miscellaneous income.

Finally, the new guidance has useful information about the consequences for businesses of making donations (charitable and otherwise) of cash or stock and of donating medical supplies or equipment.

Regulations introducing temporary exemption from income tax and NICs for coronavirus related home office expenses

Two sets of regulations came into force on 11 June relating to the temporary exemption of coronavirus related home office expenses from income tax and NICs. The regulations are (a) the Income Tax (Exemption for Coronavirus Related Home Office Expenses) Regulations 2020 and (b) the Social Security Contributions (Disregarded Payments) (Coronavirus) Regulations 2020.

The regulations establish a temporary exemption from income tax and Class 1 NICs for certain expenses that cover the cost of relevant home office equipment (including, for example, a laptop, desk or computer accessories) and are reimbursed by an employee's employer. The relevant expenses are those incurred by the employee on equipment that was obtained for the sole purpose of enabling the employee to work from home during the pandemic where the equipment would have been exempt from income tax if it had been provided directly to the employee by (or on behalf of) the employer. The regulations take effect for equipment reimbursements made on or after 11 June 2020 until the end of the tax year 2020–21.

HMRC states in the Tax Information and Impact Note published with the regulations that it will exercise its collection and management discretion and will not collect tax and NICs due on any reimbursed payments made from 16 March 2020 until 11 June 2020, provided the relevant conditions set out in the regulations are met.

Taxation of coronavirus support payments

The UK government's consultation on draft legislation concerning the taxation of coronavirus business support payments closed on 12 June 2020. HMRC had asked for views on the technical effectiveness of the proposed legislation in ensuring that grants covered by the legislation (including the Coronavirus Job Retention Scheme) are subject to tax.

See our Tax Talks blog published on 2 June 2020 for further details on the draft legislation and the accompanying explanatory note.

UK Case Law Developments

Only loose link to employment required for options to be employment-related

In *HMRC v Vermilion Holdings Limited*¸ the Upper Tribunal (UT) has come to the somewhat surprising decision to overturn last year's First-tier Tribunal's (FTT's) decision (as we reported in the April 2019 edition of our UK Tax Round Up) and hold that an option acquired by the taxpayer as part of the company's (Vermilion's) refinancing was acquired "by reason of employment" and so its exercise was subject to employment tax under section 471(1) ITEPA 2003.

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 initial fundraising. In 2007, the company and its shareholders decided that it needed to raise further "rescue" funding. The provision of the new finance was conditional on both Mr Noble becoming a director of Vermilion and agreeing to reduce the scope of his option. 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) rather than amending the existing option. Vermilion stated that this was because there was urgency to complete the refinancing and it was simpler to cancel and regrant the option than to amend it.

There are two bases on which the 2007 option could be an employment related option (so that its exercise was subject to employment tax). First, under the general provision in section 471(1) ITEPA, if the right or opportunity to acquire it was available "by reason of [Mr Noble's] employment". Second, under the so-called "deeming" provision in section 471(3) ITEPA, if the right or opportunity to acquire the option was "made available by" Mr Noble's employer or a person connected with it.

The FTT had decided that neither of these provisions applied. On section 471(1), the FTT said simply that the 2007 option was not acquired by Mr Noble by reason of his employment but by reason of his owning the 2006 option. On section 471(3), the FTT said that the 2007 option was not "made available" by Vermilion but by its shareholders who were effecting the refinancing.

The UT focused on section 471(1), and has decided that the right or opportunity for Mr Noble to acquire the 2007 option was available “by reason of [his] employment” and so was an employment-related securities option.

The UT relied heavily on the judgement of Denning MR in the Court of Appeal (CA) case *Wicks v Firth*, which considered the meaning of “by reason of employment” in a different context. In that case, the CA took a very broad interpretation of the term, saying that the employment did not need to be the sole or even the dominant reason for the relevant benefit being granted, but just needed to be a condition of the grant.

The UT in this case then linked the grant of the 2007 option (or actually the amendment to the 2006 option effected by cancellation and grant of the new option) to the other requirement for Mr Noble to become a director of Vermilion for the refinancing to take place and held that Mr Noble becoming a director was a condition of him acquiring the 2007 option. That, the UT held, was sufficient conditionality for the 2007 option to be available to Mr Noble “by reason of [his] employment”.

On the basis that the UT found in favour of HMRC applying section 471(1) ITEPA it did not consider the deeming provision in section 471(3).

In addition, the UT placed weight on the fact that the 2006 option had become worthless without the refinancing and said that, while the transaction could have been effected by amending the 2006 option rather than cancelling it and granting the 2007 option, the UT could only consider the transaction in front of it.

Given the finding of the FTT that the acquisition of the 2007 option was by reason of Mr Noble’s holding of the 2006 option and the demands of the Vermilion shareholders it is surprising that the UT have taken such a literal approach to applying section 471(1) and Denning MR’s words in *Wicks v Firth*, which was considering a different statutory provision under different facts. The very loose connection (or conditionality) required between employment and the acquisition of the option for section 471(1) ITEPA to apply is also likely to limit the circumstances in which the deeming provision in section 471(3) will be required, since section 471(3) requires that the option is “made available by [the relevant taxpayer’s] employer”. It appears unlikely that, applying the approach taken by the UT in this case to section 471(1), there would be many (if any) circumstances in which an option was made available by an individual’s employer and was not also available “by reason of” the employment.

It will be interesting to see whether the decision is appealed and, in the meantime, taxpayers should be careful how they grant options (and shares or other securities, since the relevant employment-related tests in section 421B ITEPA are the same as those in section 471) in circumstances when in reality a new grant or an amendment to an old grant is not for the purpose of rewarding an employee or director as such.

Importance of complying with contractual claim notice periods

While not a tax case, the High Court (HC) case of *Towergate Financial (Group) Ltd & Ors v Hopkinson & Ors* has highlighted the importance for people wanting to make contractual claims under indemnities or warranties to pay attention to the detailed terms of any time limitation.

The case related to an indemnity claim by Towergate under a share purchase agreement (the SPA) entered into in August 2008. The relevant clause requiring any claim under the agreement to be made in a particular time stated that the claim must be made “as soon as possible and in any event within seven years of the date of the agreement”.

The FCA started an investigation into the activities of the target companies in July 2014 and identified potential liabilities arising from misselling. Those liabilities were covered by the indemnity in the SPA. Towergate notified the seller that there was a possible claim under the indemnity in July 2015.

The seller resisted the claim, saying that it had not been notified of it “as soon as possible” after Towergate became aware of it. Towergate argued that the only notice requirement was that it was made within seven years of the SPA being entered into and that the seven year time limit effectively overrode the “as soon as possible” by virtue of the claim having to be made “in any event within seven years”.

The HC agreed with the defendant’s claim and held that the claim was invalid because Towergate had not given the defendant notice of it “as soon as possible”. It said that the “as soon as possible” was the first, standalone requirement of the notice provision and that the seven year limit was just a final cut off time for any claim.

This is another important reminder that parties to commercially negotiated contracts should take care to comply with the contract's written terms because the courts are likely to hold claimants to the strict and natural meaning of those terms even if they prevent claimants from successfully pursuing their claims and irrespective of the merit of the claim were it to be pursued.

Taxpayer unable to rely on composite transaction principle to avoid tax

In *Bostan Khan v HMRC*, the UT has upheld a previous FTT decision that the taxpayer could not rely on the principle derived from the *Ramsay* line of cases to avoid a liability to tax.

The case involved an arrangement under which Mr Khan received the proceeds from a buyback of shares by a UK company where he had just acquired those shares from another party for a price that reflected the proceeds to be received by Mr Khan. HMRC sought to tax Mr Kahn on the proceeds from the buy back as a dividend. Mr Kahn sought to argue that his purchase of the shares and their buy back should be treated as a single composite transaction under which the party that he bought the shares from, and not him, should be treated as receiving the buyback proceeds. This was a novel attempt to use the *Ramsay* principle, which is generally invoked by HMRC to challenge tax avoidance transactions, to avoid a liability to tax.

Notwithstanding its novelty, the *Ramsay* principle is now recognised to simply involve the application of a purposive construction of the relevant law to a realistic view of the facts surrounding a particular transaction to determine the correct tax treatment, and so, in principle, should be as available to a taxpayer as to HMRC.

The main facts were that there was a company, Computer Aided Design Ltd, which its three shareholders no longer wished to operate. Mr Khan was the company's accountant and so familiar with its business. The shareholders approached Mr Khan about buying the company and then managing its winding up. Mr Khan thought that he could wind the company up efficiently and benefit from any excess assets available in and the trading profits prior to the winding up. When the shareholders initially approached Mr Khan about buying the company, the intention had been that the company would buy 96 of the 99 shares from them for £1.8 million and Mr Khan would buy the remaining 3 shares for £200,000 to £300,000 (later reduced to £35,000 to £50,000). Following that offer, the shareholders were advised that they could benefit from entrepreneurs' relief if they sold their shares to Mr Khan instead. It is not clear from the judgement what specific tax advice Mr Khan received.

Following discussions, Mr Khan acquired the 99 issued shares in the company for a payment of £1.95 million plus the net asset value of the company above that. The day after his acquisition, the company bought back 98 of the 99 shares for £1.95 million, which Mr Khan used to pay the initial purchase price for the shares. Mr Khan treated his acquisition and the buyback of the shares as a trading transaction. HMRC challenged this and sought to tax him as receiving the £1.95 million less the shareholders' original subscription price for the 98 shares as a distribution subject to income tax.

The FTT rejected Mr Khan's claim that it was a trading transaction. His appeal to the UT was on the alternative ground that the whole arrangement should be treated as a single composite transaction under which he acquired a single share in the company for a small cost. HMRC argued that it was two distinct transactions; Mr Khan's acquisition of the 99 shares followed by the buyback of 98 of them.

The UT considered a number of questions, including whether the FTT's failure to treat the overall arrangements as a single composite transaction as Mr Khan claimed, was an error of fact or an error of law, and then whether the relevant statutory provision (section 385 ITTOIA 2005) was open to such construction. The UT held that the error (if there was one) was one of law, reiterating that the modern basis of construing tax legislation was to apply a realistic view of the facts to a purposive construction of the statute.

Applying this approach, the UT held that it must determine whether the terms of section 385 ITTOIA, that the person liable to income tax on a company distribution was the person to whom the distribution was made or treated as made, meant, in the context of the transaction in question, that Mr Khan was or was not that person. It then stated that its job was to determine whether, applying in realistic view of the facts, Mr Khan was the person who actually received or was entitled to receive the distribution.

The UT decided that, applying a realistic view of the facts, Mr Khan had acquired the shares from the company's shareholders and the company had then bought 98 of the 99 shares back from Mr Khan as their owner. Consequently, it was Mr Khan who actually received the distribution and who was entitled to receive the distribution. Indeed, the transaction as a whole was specifically and deliberately structured to ensure that the selling shareholders did not receive the distribution.

The case raises two important points. First, when considering whether a *Ramsay* type analysis might be applied to a transaction it is not enough to determine that a favourable tax result has been achieved. Rather, the requirement is always to determine what the relevant underlying tax provision means and how it should be applied to the facts. This applies to the taxpayer and HMRC equally. In this case, it was irrelevant whether or not there was a composite transaction of preordained steps since the question was simply who received or was entitled to receive the distribution. The second point is that it might, as a matter of practice, be more difficult for the taxpayer to invoke the principle as a shield against a HMRC assessment than for HMRC to apply it.

High Court refuses to rectify contract for tax purposes because no explicit tax purpose of contract

In *MV Promotions Ltd and Others v HMRC*, the HC has refused to rectify a contract to give one of the parties to it a beneficial tax result notwithstanding that the HC agreed that the parties had made a rectifiable mistake in stating the parties to the contract when it was entered into. This was because the parties had already corrected the position between themselves and, since they had not had a particular tax result in mind when the contract was entered into, the court would not use its discretion to rectify the contract when the only consequence would be to change the position between one of the parties and HMRC.

In this case, MV Promotions Ltd (MVP), a company owned by the cricketer Michael Vaughn, and the *Daily Telegraph* (TMG) had entered into contracts in 2008 and 2011 in relation to Mr Vaughn providing journalistic services to the newspaper. Shortly before the 2008 contract was entered into between Mr Vaughn and TMG it had been amended by Mr Vaughn's lawyer so that it was between MNP and TMG. The 2011 contract was stated between the parties to be an extension of the 2008 arrangement with certain agreed commercial changes. However, the parties were stated to be Mr Vaughn and TMG rather than MVP and TMG. No evidence was adduced as to why this was the case, although it was intimated that it might be because TMG's lawyer had used a prior draft of the 2008 agreement as a base document and Mr Vaughn's agent, who signed the contract for him (or for MVP) had not checked the details properly. As a result of Mr Vaughn signing the 2011 contract (or it being signed by his agent on his behalf), HMRC sought income tax from Mr Vaughn on the fees paid under the contract.

In 2018, TMG, MVP and Mr Vaughn agreed a rectification deed stating that their intention was always that the contract was between TMG and MVP and that had always been its effect between the parties. The HC accepted that the intention of the parties was that the contract was between TMG and MVP and that the 2018 rectification deed was effective between them to set out their respective positions from the time that the 2011 contract was entered into. That position could, however, only be applied to HMRC if the court granted the equitable remedy of rectification of the contract.

The HC then considered the case law on when it would grant rectification for the purpose of giving effect to the tax consequences of a transaction intended by the parties. The court referred to the judgements in *Ashcroft v Barnsdale*, which stated that "the court will not order rectification of a document if the parties' rights will be unaffected, and if the only effect of the order will be to secure a fiscal benefit for one or more of them". The HC went on to say that it would only apply its discretion to rectify a contract to give a particular tax result if obtaining that result had been a stated intention of the parties when entering into the contract. It held that the parties had no such intention when the 2011 contract was entered into (presumably because TMG had no particular interest in whether it contracted with Mr Vaughn or with MVP and simply accepted MVP as the counterparty). Since there was no longer any matter to resolve between the parties (because of the 2018 rectification deed), the HC declined to apply its discretion to rectify the contract.

The case is interesting in explaining what parties to a contract would have to do in order to rectify a contract in a manner that would (or might) be effective against HMRC in a tax dispute. First, they must be granted rectification by the courts (and it is not sufficient for them to simply agree rectification between themselves). Second, they must show that they intended a particular tax result when they entered into the contract. Even if rectification is then granted, this latter requirement might, of course, give HMRC a basis to argue that the transaction did not achieve the intended tax result depending on the facts.

Other UK Tax Developments

UK government's deferral of the first DAC 6 reporting deadlines

Due to be introduced on 1 July, DAC 6 will require certain people involved in reportable cross-border tax arrangements (as specified in the DAC 6 Directive (Council Directive 2018/822/EU)) to report them to HMRC (or their local tax authority). There has been much discussion recently about the administrative difficulties with this reporting as a result of the COVID-19 disruption.

As a result of this, the European Commission proposed a deferral of DAC 6 reporting deadlines, which we reported on in last month's UK Tax Round Up. This proposal was endorsed by the EU Member States.

On 25 June, the UK government confirmed that it will defer the reporting deadlines by six months. The regulations implementing DAC 6 will be amended accordingly. The following reporting deadlines are changed:

1. The date for reporting cross-border arrangements where the first step in the implementation took place between 25 June 2018 and 30 June 2020 is extended from 31 August 2020 to 28 February 2021.
2. The start of the 30-day period for cross-border arrangements which become reportable after 30 June 2020 is changed from 1 July 2020 to 1 January 2021. This will apply to arrangements which were made available for implementation or were ready for implementation or where the first step in the implementation took place, in each case, between 1 July 2020 and 31 December 2020 and arrangements in respect of which a UK intermediary provided aid, assistance or advice between 1 July 2020 and 31 December 2020.

3. The date for the first mandatory exchange of information about reportable cross-border arrangements between member states is now 30 April 2021 (previously 31 October 2020).

LMA publishes note on DAC 6 and its recommended form of facility documentation

On 19 June 2020, the Loan Market Association (LMA) published a note on its recommended forms of facility documentation as a result of the new reporting obligations to be introduced pursuant to DAC 6 and the fact that certain loans might constitute an element of a reportable transaction. In broad terms, the note states that simple general purpose loans, such as investment grade borrowing, are unlikely to be part of a reportable transaction. However, the position may be different for acquisition finance or other special purpose financing depending on the terms of the wider transaction of which the loan forms a part. In such cases the loan might be part of a reportable transaction and, accordingly, the lender or its advisers could be treated as an intermediary or service provider with reporting obligations.

The LMA has not updated its recommended documents with additional wording to account for the above. However, its note includes provisions that lenders might want to add seeking further information from the borrowers and other parties to the wider transaction to which the loan relates, including an additional disclosure permission for inclusion in a confidentiality clause and a supplemental information provision undertaking.

Update on Finance Bill 2020 including draft regulations on HMRC as secondary preferential creditor

The Public Bill Committee has completed its work in considering the Finance Bill and has returned it with amendments to the House of Commons. It is now at the report stage ahead of its third reading in the House of Commons.

We reported on the Finance Bill 2020 provisions which reintroduced HMRC as a secondary preferential creditor in respect of certain debts in the March edition of our UK Tax Round Up. The Treasury has now provided the Public Bill Committee with a draft of the Insolvency Act 1986 (HMRC Debts: Priority on Insolvency) Regulations 2020 which are drafted to come into force on 1 December 2020. The regulations provide that the following debts will have secondary preferential status (a) PAYE income tax, (b) construction industry scheme tax deductions, (c) employee NICs and (d) student loan repayments. The secondary preferential status of VAT is set out in the Finance Bill 2020 itself.

HMRC's preferential status for the debts mentioned will not apply to insolvency proceedings commenced before 1 December 2020.

EU Case Law Developments

ECJ considers that VAT is payable on early termination payment

The ECJ has given its judgment in the so-called Vodafone Portugal case *Comunicações Pessoais SA v Autoridade Tributária e Aduaneira*, holding that payments received by Vodafone from customers for non-compliance with a contractual tie in period were subject to VAT as such amounts constituted consideration for a supply of services under the Council Directive 2006/112/EC (VAT Directive).

The basic facts were that Vodafone entered into service contracts with its customers. Some of these contracts included special promotions with a tie in period providing that customers were committed to a minimum contract period in return for advantageous commercial conditions. If a customer terminated the contract before the expiry of the minimum period that was a termination fee to pay.

Vodafone accounted for VAT on the termination payments, but argued before its domestic court that those payments should not have been subject to VAT. After the Portuguese tax authority rejected Vodafone's appeal, it raised four questions with the ECJ for a preliminary ruling.

The ECJ considered the questions together, summarising the key issue as whether the VAT Directive should be interpreted to mean that amounts received by Vodafone from customers in the event of early termination of a service contract with a tie in period should be considered to constitute remuneration for the supply of services for consideration. In other words, did the fee form part of the consideration for the services (albeit not supplied)? If it did, VAT would be payable on that amount.

The ECJ decided that the termination payments did constitute consideration for the supply of services and, accordingly, VAT was payable on them.

In its judgment, the ECJ considered its earlier decision in *MEO*. In that case, the amount received in respect of the customer's early termination of a contract with a minimum commitment period corresponded to the sum that the operator would have received for the supply if the contract had not been terminated. The ECJ held that that amount was subject to VAT as consideration for a supply even though the termination caused the supply under the contract to cease. Unlike in *MEO*, the fee payable to Vodafone did not automatically correspond to the value of the amounts outstanding on the termination date, with the amount of the fee being calculated in accordance with a formula which, under Portuguese law, could not exceed the costs incurred by Vodafone in the operation of those services and must be proportionate to the benefit granted to the customer. The ECJ found that the consideration for the amount paid by the customer to Vodafone constituted the customer's right to benefit from Vodafone's fulfilment of its obligations under the contract and that this remained the case where the supply was terminated.

The ECJ noted that the amounts due where service contracts were terminated before the end of the tie in period for reasons specific to customers reflected the recovery of some of the costs associated with the supply of the services which Vodafone has provided to those customers and which the customers had committed to reimbursing in the event of termination. Therefore, the ECJ went on to hold that the purpose of those amounts was analogous to that of the monthly instalment payments under the contract which would, in principle, have been payable if the customers had not benefited from the commercial benefits conditional upon compliance with the tie in period (that is, the reduced price). Significantly, the ECJ held that "from the perspective of economic reality, which constitutes a fundamental criterion for the application of the common system of VAT, the amount due upon the early termination of the contract seeks to guarantee the operator a minimum contractual remuneration for the service provided". Accordingly, when customers do not comply with that tie in period, the supply of services must be regarded as having been made because those customers are placed in a position to benefit from those services. The difference between the method of calculating the termination payments in this case and in *MEO* was held to be irrelevant.

The ECJ went on to reject Vodafone's contention that the termination fee was comparable to a statutory payment or compensation payment, holding, in respect of the former, that the payment constituted a contractual obligation for the customer. On the latter point, the ECJ noted that Vodafone's position was not supported by national law since, under Portuguese law, an economic operator is not able to charge its customer amounts by way of compensation or indemnification in the event of early termination. Additionally, the ECJ held that the argument that the payment was a compensation payment did not accord with the economic reality. Rather, the amount payable in the event of early termination must be considered an integral part of the price which the customer committed to paying for the provider to fulfil its contractual obligations.

The case is of particular relevance for businesses which have contracts with customers with similar minimum commitment periods. The case (and *MEO*) show that VAT is likely to be due on such early termination fees, although there is still a question on the VAT treatment of a termination fee if the basis of calculation of the fee is not set out in the contract.

HMRC's guidance in its *VAT Supply and Consideration Manual* (at VATSC06720) on compensation payments for early termination of contracts acknowledges the difficulties of determining the VAT status of such payments. Whether a payment is compensatory or forms part of the consideration for the service may be difficult to determine. HMRC draws a distinction between contracts with a "right to terminate" and contracts which do not have such a right. It will be interesting to see whether HMRC changes its guidance in this regard in the light of the *Vodafone Portugal* decision.

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