Proskauer

UK Tax Round Up

March 2021

Spring Budget and Tax Day

After months of speculation about the possibility that capital gains tax (CGT) rates would be increased in the Spring Budget, both it and the government's follow up "Tax Day" on 23 March passed without any announcement on the future of CGT (or much else of immediate note).

The headline points from the Budget were:

- corporation tax rate to increase to 25% from April 2023 for companies (or groups) with total profits of more than £250,000 with a reversion to a small companies rate of 19% for companies (or groups) with profits of £50,000 or less and a blended rate for companies between £50,000 and £250,000;
- a 130% super deduction for expenditure on plant and machinery from 1 April 2021 (on which HMRC has published a factsheet; and
- for the next two years UK companies will be able to carry back trading losses to the three prior periods rather than just the prior period, subject to a £2m cap.

As part of the Budget documents, HMRC also published the previously announced anti-hybrid mismatch rules amendments (discussed later in this Round Up).

The Chancellor also announced that a number of consultations on future tax would be published on 23 March. These proved to be focused mainly on simplifying tax administration and strengthening powers to counter tax avoidance.

They did not cover the significant areas of changes to the CGT regime or to the differentiation between employment and self-employment, and further announcements in these areas can be expected at some time in the future.

The Chancellor also announced extensions to the existing COVID-related furlough payment scheme, which will be extended to September 2021.

UK Case Law Developments

Input VAT recovery on deal fees refused when no payment for services

In *Imprimatur Capital Holdings Ltd v HMRC*, the First-Tier Tribunal (FTT) refused Imprimatur's claim to recover VAT incurred on costs associated with its acquisition of target companies where Imprimatur intended to provide services to the target for a consideration.

Imprimatur invested in companies incorporated to commercially exploit intellectual property spun out of educational institutions. Imprimatur invested in the company and provided services to it with the stated objective of assisting its development with a view to a future sale of its shares. Imprimatur claimed investment agreements were concluded which provided for the payment of fees for a range of services, including consulting and management services. It was recognised that the level of fees charged varied and might be less than an arm's length rate to reflect the ability of the relevant company to pay. In addition, the fees were often deferred and sometimes not paid at all.

The question of recovery of input VAT on fees incurred in acquiring shares has been the subject of scrutiny and consideration by the courts in recent years.

The settled position is now that in order to be in a position to recover the input VAT on such fees, the taxpayer must intend to, and actually, carry out an economic activity for consideration in respect of the company or companies acquired.

The FTT upheld HMRC's refusal for input VAT recovery in this case on the basis that Imprimatur did not actually intend to provide its services for consideration evidenced by Imprimatur not charging fees in some cases, and even when it did the fees being set by reference to the ability of the company to pay with some fees being deferred or waived, which broke the direct link between the provision of the services and the payment received. The court stated that Imprimatur had only a "vague intention" to levy an "unspecified charge" and that this was not sufficient to establish an economic activity.

The case shows how important it is for taxpayers wishing to claim recovery of input VAT on share acquisition costs to actually provide their services and to charge (and receive payment) for the services on a reasonable commercial basis.

Discovery assessment refused as HMRC officer had sufficient information

In *Ball Europe Ltd v HMRC*, the FTT has refused to let HMRC pursue a discovery assessment on the basis that it was provided sufficient information with the taxpayer's return.

The taxpayer entered into a debt-related transaction which resulted in it reflecting an unrealised profit in the statement of total recognised gains and losses (STRGL) in its accounts rather than in its profit and loss account. The gain recognised in the STRGL was referred to in the notes to the accounts, in which it was disclosed that the amount related to an intragroup debt transaction. The taxpayer submitted its tax return (which did not reflect tax on the amount) along with its accounts. The amount reflected in the STRGL should have been taxed under the loan relationship rules.

The question was whether HMRC (or the relevant inspector) had sufficient information to determine whether there had been an underassessment of tax so that it should have raised its enquiry into the tax return during the normal 12 month enquiry window rather than relying on a discovery assessment.

HMRC argued that the tax inspector should only be assumed to have a general understanding of the relevant tax law and not an understanding of accounting.

The FTT agreed with the taxpayer that, in the context of the loan relationship rules to which a company's accounting treatment is central, the inspector should be assumed to have a general appreciation of accounting and should have been aware that there might have been an insufficiency of tax where the accounts showed a significant profit (albeit in the STRGL) but the tax return showed no corresponding taxable profit.

Accordingly, the FTT refused HMRC's attempt to raise a discovery assessment and said that HMRC should have challenged the taxpayer's tax return in the normal enquiry window.

While relating specifically to tax provisions that rely heavily on a company's accounting, the case is interesting in considering the information that HMRC should be taken to be aware of when deciding whether new information comes to light sufficient to justify HMRC raising a discovery assessment.

Partnership incentive scheme subject to tax as miscellaneous income

In the *Odey Asset Management LLP v HMRC* and *HFFX LLP v HMRC*, the FTT has determined that certain receipts received by LLP members under a profit deferral scheme were subject to income tax when received by the members as income not otherwise charged to income tax under section 687 ITTOIA 2005.

The two cases involved payment deferral arrangements which were broadly the same and which the two businesses claimed were required as a commercial matter to implement profit deferral structures required to align the firms' and members' long term interests and apply remuneration deferral proposed by the FSA (as then was).

The arrangements involved:

- the LLP in question establishing a UK company as a member (the corporate member);
- an amount of annual profits being allocated and paid to the corporate member;
- the corporate member investing the post-corporation tax receipt back into special capital units in the LLPs which invested the amount in funds managed by the LLP;
- on recommendation of the LLPs' remuneration committees, the corporate member determining to reallocate its special capital interests to the selected individual members (whose profit entitlement had been allocated to the corporate member in the first place); and
- the relevant individual members withdrawing the special capital from the LLP.

HMRC challenged the arrangements and sought to subject to individual members to income tax on the basis of either (i) the profit allocation to the corporate member should have been treated as an allocation to the individual members in the first place under section 850 ITTOIA, (ii) the receipt by the individual members should have been taxed as income not otherwise subject to income tax under section 687 ITTOIA or (iii) the individuals should be subject to income tax under the sale of occupational income rules in sections 773-778 ITA 2007.

The LLPs argued that the profits were properly allocated to the corporate members and that the individuals should not be subject to income tax on their withdrawal of the special capital allocated to them by the corporate member.

The FTT determined that the LLP profits should not be treated as allocated to the individual members under section 850 ITTOIA because the discretionary powers of the corporate member meant that the individuals did not have a “right” to the LLP’s profits and should not be treated as having applying a realistic approach to the facts under the *Ramsay* principle.

The FTT did, however, decide that the individual members were subject to income tax when they withdrew the capital from the LLP as income not otherwise charged (or miscellaneous income) under section 687 ITTOIA. The FTT held that in order for section 687 ITTOIA to apply, the receipt must be in the nature of income and analogous to items that were subject to tax under other heads of income tax charge. In this case the court held that the receipt from the LLP of the special capital was analogous to a bonus and was in the nature of an income receipt given its source.

The decision appears to provide HMRC with another tool to challenge structured remuneration arrangements and is another basis of attack that taxpayers should take into account when assessing the tax consequences of arrangements seeking to deliver capital returns to employees or LLP members, particularly where, as in these cases, the original source of the return is income.

No VAT recovery where invalid VAT invoice

In *Tower Bridge GP Ltd v HMRC*, the Upper Tribunal (UT) upheld the FTT’s decision that the taxpayer could not recover input VAT incurred on the acquisition of carbon credits because the invoices in question did not contain the taxpayer’s name or the seller’s VAT registration number.

The case considered whether holding a valid VAT invoice containing this information was a mandatory requirement for an input VAT claim and whether HMRC acted unreasonably in not using its discretion to allow the taxpayer to offer alternative evidence to validate its input VAT claim.

The decision rested on whether it was sufficient for Tower Bridge to reclaim its input VAT that it met the substantive requirements for VAT recovery of acquiring the carbon credits for its business purposes from a taxable person or whether it also needed to satisfy the formal requirement of having a valid VAT invoice.

The UT agreed with the FTT that Tower Bridge needed to satisfy both the substantive and formal requirements and that it was not unreasonable of HMRC to refuse the VAT recovery claim where there was no valid VAT invoice in place.

The case shows the importance of ensuring that VAT invoices contain all of the information required by the VAT rules so as not to risk HMRC rejecting a VAT recovery claim.

Other UK Tax Developments

Reduction in the beneficial loan interest rate

HMRC has announced that the official rate of interest (the rate of interest that employees have to pay on certain loans provided to them by their employers to avoid a benefit in kind tax charge) will be reduced from 6 April 2021 from its current 2.25% to 2%.

New IR35 rules – HMRC publishes revised guidance

The new rules for private sector clients engaging with off payroll workers comes into force on 6 April. In conjunction with this, HMRC has updated its "Help and support for off-payroll working" guidance, which can be accessed here.

Changes to the anti-hybrid mismatch rules

As part of the Budget papers, the Finance (No. 2) Bill has been published, which contains the promised changes to the anti-hybrid mismatch rules.

Of particular interest to private fund managers will be the changes to the rules related to:

- dual inclusion income, where the rules have been relaxed so that certain anomalous results arising in structures with hybrid entities (particularly, companies elected as tax transparent for US tax purposes) should no longer arise;
- certain tax exempt investors, so that they are treated as if they received "ordinary income" (so that no mismatch arises in respect of them); and
- the "acting together" rules, so that investors in partnerships that are collective investment schemes and which hold less than 10% of the interests in the partnership are not included in the aggregation calculation to determine whether investors are acting together.

The change to the acting together rules should mean that many fewer widely held partnership funds (or their portfolio companies by reason of being owned by a partnership fund) will come within the scope of the anti-hybrid rules by reason of their investors being aggregated to “control” the underlying portfolio company.

The removal of certain (not all) tax exempt investors from being treated as benefiting from a hybrid mismatch by reason of not being taxed on the deductible payments made by a company should reduce the impact of the anti-hybrid rules on disallowing deductions on payments made by portfolio companies to funds with tax exempt investors. It should be noted, however, that this change only applies to investors who are pension schemes, life assurance businesses, sovereign exempt investors, charities, investment trusts, authorised investment funds and exempt unauthorised unit trusts.

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