Proskauer

UK Tax Round Up

June 2021

UK Case Law Developments

Income tax consequences of pension-related payments in E.ON v HMRC

E.ON v HMRC concerned a large UK power and gas supplier, which paid certain lump sum payments, called “facilitation payments”, to some of its employees in return for them agreeing to changes that E.ON then made to their future pension scheme rules and employment terms. These facilitation payments could be received in cash or elected to be paid into the Group Additional Voluntary Contribution (AVC) pension facility.

E.ON argued that the facilitation payments were exempt from income tax and national insurance contributions because they were not “from” employment within the meaning of section 9 of the Income Tax (Earnings and Pensions) Act 2003 and section 3 of the Social Security Contributions and Benefits Act 1992. As HMRC did not agree with this position, the case proceeded to the First-Tier Tax Tribunal (“**FTT**”).

The FTT held against the company, ruling that the facilitation payments were subject to income tax and national insurance contributions because they were “from” employment. The main reasons for this conclusion can be summarised as follows:

i the payments were made as an inducement to employees to agree to a change in their future conditions of employment,

ii the payments were not made as compensation for the loss of pension rights (which the company argued was not related to employment) because the existing pension entitlements remained in place – all that had changed in essence was the ratio of employer and employee contributions to the pot from which the pension benefits were paid, and iii the payments were part of a deal between E.ON and employees whereby E.ON agreed not to make any changes to the pension arrangements for five years and a set of “employment commitments” lasting for two years. As such, the facilitation payments replaced the lower earnings which the employees would suffer if they wanted to maintain the same level of pension benefits. Under that characterisation, the facilitation payments replaced earnings, and were taxable as such and subject to NICs.

It was clear to the Court that the payments made could not be separated from the rest of the package that included specific commitments made on behalf of E.ON concerning employment terms and thus were “from” employment.

Mixed partnership rules examined by the Upper Tribunal on appeal

The FTT decision in Walewski v HMRC was upheld by the Upper Tribunal (“**UT**”), which confirmed that the mixed partnership rules in section 850C of the Income Tax (Trading and Other Income) Act 2005 (“**ITTOIA**”) should apply. We reported on the FTT decision in our February 2020 Tax Round Up.

By way of a reminder of the facts in this case, Mr Walewski set up a Luxembourg equity fund which was managed by two UK limited liability partnerships (AAM and AF) in which he was a member. A UK company (W Ltd) was also a member of AAM and AF. Mr Walewski was the only employee and director of W Ltd. Mr Walewski appealed against HMRC's decision to reallocate profits of AAM and AF to him under section 850C of ITTOIA, where those profits were paid to W Ltd. The FTT agreed with HMRC and held that the £20 million of profits allocated to W Ltd should be allocated to Mr Walewski as member of AAM and AF because the profits were not earned by W Ltd and were allocated to it only so that Mr Walewski could enjoy those profits (through an offshore trust fund to which W Ltd distributed the money).

Taking this decision to the UT, Mr Walewski argued that section 850C of ITTOIA should not apply because: (i) at the time when profits of W Ltd were allocated to him, Mr Walewski was not a partner in AAM and AF, and (ii) the FTT made an incorrect finding that Mr Walewski provided half of his time through W Ltd.

Having considered the grounds of appeal, the UT dismissed Mr Walewski’s appeal on the basis that:

i	there was no requirement for Mr Walewski to be a partner in a partnership at the time when profits were allocated to W Ltd, so long as Mr Walewski received a share of some profit, and this was consistent with the statutory construction of section 850C of ITTOIA, and

ii	what the FTT found was that Mr Walewski's services were entirely unclear and fluid and that W Ltd was no more than a corporate shell and the UT agreed with this finding.

This is perhaps not a surprising result and it emphasises the importance of having clear evidence of, and cogent explanations for the purpose and activities of all elements in a corporate structure.

UK resident partner in a Delaware limited partnership denied double tax relief

In GE Financial Investments v HMRC, GEFI, a UK resident taxpayer, was a member of a Delaware limited partnership ("**DLP**") that was engaged in credit finance activities. As a result of GEFI's shares being stawpled with the shares of D LP's US-based general partner, GEFI was subject to US tax on its worldwide income in addition to being subject to UK tax on the share of its profits from D LP.

GEFI claimed UK double tax relief for approximately £125 million in respect of the US tax it paid over six tax years. HMRC denied the relief following an enquiry into GEFI's tax returns.

On appeal by GEFI, the FTT held that GEFI was not entitled to the double tax relief because:

i	GEFI was not treated as a US tax resident as required for Article 4 of the UK-US double tax treaty (and as a result, double tax relief under Article 24 was not available to GEFI); and

ii	GEFI was not carrying on a business in the US through a permanent establishment (and, as a result, GEFI could not argue that the UK should not tax the share of its US profits under Article 7 of the UK-US double tax treaty).

In reaching its decision on (i), the FTT explored various tax authorities (including the OECD commentaries) on whether GEFI could be treated as a US tax resident because its shares were stapled with the shares of another US company. However, it concluded that the share stapling mechanism did not impose a sufficient US territorial connection or link to treat GEFI as a US tax resident. Also, it was not enough that GEFI was treated as a US worldwide income taxpayer for these purposes.

In considering (ii), i.e. whether GEFI was carrying on a business in the US, the FTT was referred to several cases on what amounts to a “business”. It was submitted that because GEFI participated in D LP, which made and managed a series of loans in excess of $2.82 billion, received substantial sums by way of interest and made distributions to the partners, it was carrying on an effective business. However, in FTT’s view, these were not the only factors that had to be considered. It was also necessary to consider whether the activities were actively pursued with a reasonable degree of continuity and regularity, had sound and recognisable business principles and whether the activities were of a kind which were commonly carried out by those who sought to profit by them.

Having examined D LP’s activities, the FTT’s view was that, although the activities could be considered as serious, making five affiliate loans (including three of which originated with D LP) over six years was more of a sporadic, passive or isolated activity than a regular and continuous series of activities. FTT also pointed out that there was an apparent lack of participation in the strategic direction of D LP by the directors of its general partner.

This is a highly complex case that drills down into the interpretation of double tax conventions. The complexity of the case is supported by the fact that even the tax administrations in the UK and US could not find common ground under the Mutual Agreement Procedure set out in Article 26 of the UK-US double tax treaty. Although the case has a specific set of facts confined to an international tax framework, it will be a helpful authority on the UK tax court’s interpretation of what amounts to a “business”, as this important term features in other areas of the UK tax law.

Other UK Tax Developments

Pensions tax avoidance – Spotlight 58

On the subject of pension-related payments (something of a theme this month), HMRC published one of its series of “Spotlights” on areas on which it is focusing from a tax avoidance perspective - Spotlight 58. It describes an example of tax avoidance arrangements whereby owner-managed companies make monetary rewards to directors to avoid income tax and national insurance contributions while at the same time claiming corporate tax relief.

These arrangements typically involve a company creating an unfunded pension obligation for the benefit of the company director. This would immediately generate an expense leading to a reduction of corporation tax payable by the company. The company would then transfer the pension obligation to an associate of the director (e.g., a relative). It is then claimed that a payment under this obligation would not trigger income tax and national insurance contributions. In Spotlight 58, HMRC made it clear that it would view these arrangements as tax-avoiding arrangements, and it would seek to challenge them.

Spotlight 58 is a fresh reminder that HMRC will look very closely at, and seek to challenge what it perceives to be, contrived arrangements that are designed to exploit existing tax reliefs.

Review of tax year-end date by Office of Tax Simplification (“OTS”)

As part of the continued UK tax simplification work, the OTS published a proposal on 4 June 2021 to move the tax year-end date for individuals from 5 April to 31 March.

The move to 31 March would seek to modernise the UK tax system by aligning the tax year for individuals with the tax year for UK companies and the UK financial year-end date to which the UK government makes up its accounts.

As part of this review, the OTS will carry out the costs and benefits analysis and consider the practical and administrative implications of this move for HMRC and taxpayers. OTS’ report setting out its findings will be published in the summer of 2021.

Decommissioning of stamp duty press machines

HMRC has announced that from 19 July 2021, they will no longer be using the traditional stamp duty press machines that have been used during UK stamp duty's 300-year-old lifetime. Instead, HMRC will adopt an electronic process for all remaining transactions that require physical stamps, including duty paid on shares transferred by way of a stock transfer form. The change in approach has been prompted by the current pandemic situation during which HMRC operated a digital process. This is generally viewed as a welcome procedural simplification but the end of a piece of British history. Those who are interested can contact HMRC if they would like to rehome one of the 685kg decommissioned stamp presses.

Royal Assent for the Finance Act 2021

On 10 June 2021, the Finance Bill 2021 received Royal Assent and became the Finance Act 2021.

EU Case Law

Tax avoidance and use of shell companies

The EU Commission has launched a new consultation on tax avoidance and the use of shell entities. The consultation's objective is to collect data and evidence that could be used to design new rules in the EU to fight the abuse of shell entities and arrangements for tax avoidance purposes. The consultation is open to all stakeholders, and the EU Commission is particularly interested in the views of the EU tax administrations. The consultation is open for submissions until 27 August 2021.

EU public country-by-country reporting by big multinationals

The EU Council has reached a provisional political agreement on a proposed new directive on disclosing income tax information by certain multinationals.

The Directive would require multinationals with total consolidated revenue of more than €750 million, whether headquartered in the EU or not, to disclose publicly certain information concerning income tax paid in the EU member states and certain non-cooperative jurisdictions. The information will be limited to what is necessary to facilitate effective public scrutiny. The Directive will require reporting within 12 months from the date of the balance sheet of the relevant financial year.

VAT implications of letting property on the concept of “fixed establishment”

In Titanium v Finanzamt Osterreich, the ECJ held that Titanium, a Jersey property management company that let out properties in Austria, did not have a fixed establishment in Austria for VAT purposes.

This decision was referred to the ECJ by the Austrian court in connection with the Austrian tax authority’s claim that Titanium had a fixed establishment in Austria for VAT purposes because it was letting out properties in Austria. Titanium did not have any activities (other than the property lets), physical presence or personnel in Austria but, instead, it hired a local management company that assisted Titanium with the administration of the lets. Titanium was ultimately responsible for taking decisions on whether to let property or to terminate a lease.

In arriving at a decision, the ECJ noted that the concept of “fixed establishment” implies a degree of stability derived from the permanent presence of human and technical resources necessary to provide services. A structure without its staff cannot fall within the scope of a “fixed establishment”. Consequently, the ECJ expressed a clear view that Titanium could not be treated as having a “fixed establishment” if it does not have any human resources in Austria, enabling it to act independently.

This is a helpful decision for businesses that have cross-border activities within the EU as it offers useful guidance on how to determine whether or not a business with limited presence has a “fixed establishment”.

Other Tax Developments

G7 global tax agreement

It was recently announced that G7 finance ministers agreed on a global tax reform. This landmark reform targets large multinational groups of companies to ensure that they pay their fair share into the economies of the countries in which they are based and operate and forms a crucial part of the ongoing OECD BEPS 2.0 initiative.

The reform comprises two Pillars. Under Pillar one, the largest and most profitable multinationals will be required to pay tax in the countries in which they operate (not just where they are headquartered). The multinationals with profit margins above 10% would be affected, and 20% of their profit above the 10% margin would be reallocated and subjected to tax in the relevant country of their operation.

Under Pillar two, the countries would need to apply at least 15% of global minimum corporation tax. The agreement is intended to create a level playing field for international companies and reduce tax avoidance.

The European Tax Observatory ("**ETO**") has since estimated the monetary value of these proposals in its recent report. The ETO report stated that a minimum rate of 15% could generate additional revenue of €50 billion.

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