

# UK Tax Round Up

August 2021

## UK Case Law Developments

### **PPI compensation claim services not VAT exempt**

In *Claims Advisory Group v HMRC*, the Upper Tribunal (UT) has confirmed that the service of claiming compensation on behalf of third parties for mis-sold payment protection insurance (PPI) is subject to VAT and not exempt as Claims Advisory Group Limited (CAG) had argued.

CAG claimed compensation for third parties who had been mis-sold PPI. CAG received a percentage of any compensation received as a fee. The First-tier Tribunal (FTT) had held that the fee was subject to VAT, on the basis that the services did not fall within the VAT insurance exemption. The UT agreed and rejected CAG's appeal.

The insurance VAT exemption applies to (i) insurance transactions and (ii) services performed by an insurance agent (or intermediary) that are related to insurance transactions.

Regarding (i), CAG argued that its services effectively cancelled the underlying PPI insurance obligation and that the cancellation of insurance is itself an insurance transaction. The UT disagreed with this on the basis that the services were clearly of claiming compensation for mis-sold PPI, not cancelling the insurance itself. Furthermore, there is no authority that the cancellation of an insurance contract is itself an insurance contract.

Regarding (ii), CAG argued that it was acting in an agency role between the insured and the insurer and that there was no requirement for it to be facilitating new insurance cover to fall within the "intermediary" limb of VAT exempt insurance transactions. The UT disagreed with this on the basis that CAG was not the agent of a person seeking insurance which was a prerequisite to being exempt under this limb.

The decision is not particularly surprising. It does, however, serve as a reminder both that the VAT treatment of intermediary-style services is particularly fact specific, so that the nature of the services being provided and the scope of the relevant VAT exemptions must be properly understood by taxpayers, and that VAT exemptions will, as a general matter, be narrowly construed.

## **UT finds FTT wrong to infer facts in IR35 hypothetical employment contract**

In *George Mantides Ltd v HMRC*, the latest in a string of cases considering whether individuals should be considered to be employees (or deemed employees in the context of IR35) or self employed, the UT found that the FTT was not correct to infer certain terms into the relevant hypothetical contract. By way of background, in determining whether an off-payroll worker engaging with the end client through an intermediary entity should be treated as an employee for tax purposes, it is necessary to construct the hypothetical contract that would have existed had the worker engaged with the end client directly and then to determine whether the worker would have been an employee applying the terms of that hypothetical contract.

As discussed in our [July 2019 UK Tax Round Up](#), Mr Mantides was an urologist supplying services to two hospitals through his personal service company (PSC). HMRC claimed that he would have been an employee in both cases had he contracted with the hospitals directly under the terms of the appropriate hypothetical contracts.

There was a written contract between the PSC and one of the hospitals. The FTT found that Mr Mantides was, under the terms of the hypothetical contract derived from the contract between his PSC and the hospital, an independent consultant because the contract permitted the services to be supplied by an appropriately qualified substitute and could be terminated with one day's notice.

There was no written contract between the PSC and the other hospital. On the facts, the FTT determined that, if Mr Mantides had contracted directly with the hospital under the terms of the hypothetical contract that the FTT constructed, he would have been an employee. One of the key terms that the FTT decided would have been included in the hypothetical contract was that the hospital had an obligation to use its reasonable endeavours to provide Mr Mantides with a certain number of private clinics a week at the hospital.

Mr Mantides appealed, claiming, in particular, that there was no evidence on which the FTT could have inferred this obligation on the hospital to use reasonable endeavours to provide Mr Mantides with a certain number of private clinics.

The UT agreed with Mr Mantides and determined that there was no basis for the FTT to infer that this term would have been included in the hypothetical contract.

The UT did not, however, consider whether this changed the answer to the question of whether Mr Mantides should be treated as a deemed employee for tax purposes. This is because the extent to which “mutuality of obligation” between parties (that is, an obligation on the “employer” to provide work and an obligation on the “employee” to do it) is necessary for there to be an employer-employee relationship is soon to be considered by the Court of Appeal (CA) in *HMRC v Professional Game Match Officials Limited* (see our [May 2020 UK Tax Round Up](#) for more on that case).

The UT will reconvene to decide whether Mr Mantides was a deemed employee for tax purposes once the CA’s decision in that case is available.

The case shows once again how the fundamentals of this important aspect of the UK tax code are still uncertain, how fact dependent the results of any particular case are and how HMRC’s approach to deemed employment might well ignore important aspects of the correct legal test.

## **High Court considers construction of extra statutory concessions**

In *Murphy and Linnett v HMRC*, the High Court (HC) considered the construction of HMRC’s extra-statutory concession ESC B18 and provided useful general insight on the approach that should be taken to interpreting extra-statutory concessions.

Murphy and Linnett were the beneficiaries of a discretionary Channel Islands trust from which they received a distribution of UK source interest income. They claimed a tax credit under ESC B18 for all UK income tax paid by the trust on that income, which the trust had received over a period of more than six years.

Applying its interpretation of ESC B18, HMRC sought to limit the beneficiaries’ relief to UK tax paid on income received by the trust in the six years prior to the distribution being made. Murphy and Linnett challenged HMRC’s decision by way of judicial review. The HC found in favour of HMRC.

ESC B18 addresses the tax treatment of payments out of UK and non-UK resident discretionary trusts.

ESC B18 firstly gives UK tax relief to the non-UK resident beneficiaries of UK resident trusts by allowing those beneficiaries to treat themselves as though they had directly received any UK source income arising to the trustees on which the trustees have paid UK tax. This relief expressly applies only to the extent that the relevant distribution is paid out of income which was received by the trustees in the six years prior to the end of the tax year in which the payment was made.

ESC B18 goes on to deal with the relief that is available for UK and non-UK beneficiaries of non-UK trusts. This is the part of ESC B18 that was being relied on. There is no explicit reference made to the six year limit in this part of the concession. Instead, the concession states that “a similar concession” to that applying to non-UK resident beneficiaries of UK resident trusts applies. The case hinged on whether ESC B18’s reference to “a similar concession” in the context of non-UK trusts included reference to the six year limit or whether the fact that the six year period was not referred to meant that it did not apply. The HC determined that it the six year limit did apply to receipts from non-UK resident trusts in the same way as to UK resident trusts.

As well as discussing the origins of and reasons for the introduction of ESC B18 and its extension, which were relevant to its construction, the HC provided useful general commentary on the correct approach to the interpretation of extra-statutory concessions. In particular, it was noted that an extra-statutory concession is, by definition, a relief offered by HMRC to taxpayers against liabilities imposed (or which might be imposed) by legislation and that a taxpayer is, effectively, making a claim based on legitimate expectation that HMRC will apply the law based on the stated position in the concession. Accordingly, the relevant principle stated in the *MFK Undertaking* case should apply so that a statement could only be relied on by the taxpayer if it was “clear, unambiguous and devoid of relevant qualification”. In addition, because the taxpayer is seeking to be relieved from tax, any uncertainty in the interpretation of the concession should be resolved in favour of HMRC.

This is a useful note of caution for taxpayers seeking to rely on extra-statutory concessions generally.

## **Realistic view of the facts must be taken into account in determining whether a security is employment-related**

In *Vermilion Holdings v HMRC*, Scotland's Inner House of the Court of Session (IHCS) overturned the UT's prior decision and found that an option granted to a director was not an employment related security.

Where a security is "employment related" certain events in relation to that security (for example, acquiring shares or exercising an option) may be subject to employment taxes which the relevant employer may be obliged to account for to HMRC.

As discussed in our [June 2020 UK Tax Round Up](#), there are two bases on which a security can be "employment related". First, under the so-called "factual test", a security is employment related if the right or opportunity to acquire it was made available by reason of employment. This requires an actual link between the receipt of the security and the employment. Second, under the so-called "deeming" test, a security is treated as being employment related if the right or opportunity to acquire it was "made available by" the employer or a person connected with the employer.

In *Vermilion*, Mr Noble had been granted an option to acquire 2.5% of the ordinary shares of the company in part consideration for services provided by him as an independent contractor and before he was an employee or director. It was common ground that this option was not employment related. It was subsequently decided that the company needed to raise new finance. The provision of the new finance was conditional on Mr Noble becoming a director (and, so, an employee for tax purposes) of Vermilion and the option being reduced to 1.5%. To effect this, Mr Noble's original option was cancelled and he was granted a new one.

The FTT had to decide whether the new option was "employment related" and concluded that it was not.

In relation to the factual test, the FTT found that the new option was granted to replace an earlier option as part of the refinancing and was not granted by reason of Mr Noble's new employment.

In relation to the deeming test, the FTT found that the option was either (i) made available by the shareholders of Vermilion who were participating in the financing (and so was not made available by the employer or a person connected with it) or (ii) was made available by the employer, but that it would be an absurd result to treat the new option as being employment related simply because of this. This conclusion was reached, at least in part, applying the principle from the *Marshall v Kerr* case that a deeming provision should be given its natural consequences unless they led to “absurdity or injustice”.

Overturning this decision, the UT held that, because the grant of the new option was conditional on Mr Noble becoming a director, that created a sufficient connection with employment to say that the new option was granted “by reason of employment” under the factual test. On this basis the UT did not consider the deeming rule in detail.

The IHCS has now overturned the decision of the UT by a majority split decision.

Finding that the new option was not employment related, Lords Malcolm and Doherty considered that both the factual test and the deeming test should be considered in light of a realistic view of the relevant facts. They considered that, on such a view, Mr Noble did not acquire a new option but gave up part of his existing entitlement. The fact that this was effected by Mr Noble surrendering his original option and being granted a new one should not be determinative.

Furthermore, it was noted that whilst the replacement option would not have happened without the directorship, since they were both conditions of the refinancing package, that did not mean that the option had been granted “by reason of” the directorship. The IHCS felt that the UT had erred in concluding that everything was a reason for everything else.

Regarding the deeming test, it was noted that, although on a literal reading it was possible to say that the opportunity to acquire the option was made available by Mr Noble’s employer, citing previous case law the FTT were correct in concluding that the deeming provision should not extend the reach of the factual test so as to bring about an “absurd” result.

This decision provides some welcome comfort to employers regarding the scope of the deeming provision and would seem to confirm that securities which are not awarded for the purpose of rewarding an employee or director for their work should not be regarded as employment related.

Having said this, it should be noted that Lord Carloway agreed with the UT and considered that the new option was employment related and Lord Doherty indicated that this was also his initial inclination. So, the IHCS could easily have decided the case the other way. In particular Lord Carloway considered that, on the plain and ordinary meaning of the words in the deeming provision, the option was employment related because Mr Noble's employer had made the opportunity to acquire it available to him. He considered that the deeming provision was in the legislation to avoid disputes where the answer to the factual question was uncertain, and should be applied as such. This approach does, however, beg the question of what the opportunity was and whether, as considered by the FTT, the grant of the new option was really forced onto Mr Noble and his employer in order to be able to complete the refinancing.

What the case does show is that, whilst the IHCS found in favour of the employer in this instance, the legislation in this area remains uncertain and decisions may be very finely balanced. Employers should continue to proceed with caution in relevant cases where the expectation is that the securities granted are not employment related.

## **FTT has jurisdiction to consider legitimate expectation in VAT appeals**

The UT has held that the FTT did have jurisdiction to consider the public law question of legitimate expectation in an appeal against an assessment to VAT in *KSM Henryk Zeman v HMRC*.

The principle of legitimate expectation is that if someone has a legitimate expectation arising from a statement or practice of a public authority then that public authority may not subsequently frustrate the expectation if to do so would be so unfair as to amount to an abuse of power.

KSM was a Polish company which contracted with another Polish company, Energoinstal, to install a boiler in the UK. Energoinstal was not registered for VAT in the UK.

KSM thought that it needed to register for VAT in the UK on the basis that the place of supply was where the installation work took place (in the UK).

When KSM tried to register for VAT it incorrectly stated that its customer was established in the UK and was VAT registered. For this reason, HMRC refused to register KSM. This was because land related supplies made by a non-UK supplier in the UK to UK VAT registered customers are treated as being made by the customer under the “reverse charge” procedure. Accordingly, KSM was not making taxable supplies in the UK and so was ineligible to be registered for VAT. HMRC set out this reasoning in a letter to KSM.

KSM subsequently reapplied to be VAT registered in the UK, this time correctly stating that Energoinstal was not registered in the UK. This time HMRC registered KSM for UK VAT and issued an assessment for VAT on the supplies it had made to Energoinstal because the reverse charge rule didn't apply and so output VAT was payable by KSM on its supplies.

KSM appealed HMRC's assessment for VAT to the FTT on the basis that HMRC's letter had given it a legitimate expectation that VAT would not be assessed. The FTT considered that HMRC's letter gave KSM a legitimate expectation regarding the contents of its letter. That was that if KSM was supplying construction services solely to business customers who belonged in the UK and who were all registered for VAT in the UK, it would not be making taxable supplies and would not have any UK VAT in respect of its supplies. However, unsurprisingly, the FTT also considered that because KSM did not actually make supplies within the description set out in HMRC's letter it could have no legitimate expectation that it would not be liable to VAT.

KSM appealed against the decision of the FTT to the UT arguing that it did have a legitimate expectation that it was not assessable to VAT based on the letter from HMRC. The UT had to consider, firstly, whether KSM had a legitimate expectation and, secondly, whether the FTT had jurisdiction to take the public law issue of legitimate expectation into account in KSM's appeal against the VAT assessment.

In relation to the first matter, the UT concluded that KSM did not have a legitimate expectation. KSM's supplies were not covered by HMRC's letter because its supplies were made to a customer which was not VAT registered. KSM could not, therefore, have a legitimate expectation that its supplies would not be subject to VAT when the full facts were known by HMRC.



The UT considered the second matter at length, notwithstanding that the KSM case did not hinge on this point. The first thing to note is that the reason the FTT's ability to consider public law matters was in doubt was because it itself is a statutory (rather than judicial) body with a specific role. In this regard, the UT noted that the VAT legislation provided for a long and specific list of VAT matters that taxpayers could appeal to the FTT. For this reason, the UT determined that the FTT did not have a general power to assess legitimate expectation. However, that did not prevent the FTT from considering legitimate expectation if the specific basis on which a taxpayer was making an appeal to it didn't expressly or impliedly prevent the ability to raise a public law defence.

In KSM, the taxpayer was appealing under the specific provision that permitted appeals in respect of an assessment by HMRC for a failure to submit a VAT return or the amount of such an assessment. The UT determined that there were strong arguments for deciding that it would be "artificial and unworkable" to exclude a defence based on the public law principle of legitimate expectation from what the FTT could consider.

This is a significant decision. Although KSM could not show it had a legitimate expectation, the principle that such an argument is available in the FTT is important.

### **Advisers' fees may be deductible in group payment arrangement**

In a welcome development, the UT has overturned the FTT's decision in *Centrica Overseas Holdings Limited v HMRC* and held that advisor fees incurred initially by a parent (Centrica plc) which were charged on to a subsidiary, Centrica Overseas Holdings Limited (COHL), relating to the possible disposal of a subsidiary of COHL (Oxxio) may, in fact, be deductible as expenses of management of COHL under section 1219 of the Corporation Tax Act 2009.

The principal relevant facts of the case were that much of the decision making in respect of the sale of Oxxio (which was eventually effected by certain business sales by Oxxio subsidiaries) was taken by senior employees of Centrica plc who also acted as directors of COHL but without formal documentation of those people taking their decisions as COHL, rather than Centrica plc, personnel.

As discussed in our [May 2020 UK Tax Round Up](#), in broad terms, the reason for the FTT's decision was that it considered that the strategic decisions in respect of the disposals had been taken by Centrica plc and not COHL and that the costs were not, therefore, incurred as part of COHL management of its investments. The FTT considered that in order to obtain relief under section 1219 the expenses must be management expenses of the company claiming the relief.

While holding that the expenses were not incurred by COHL because it considered that the decisions were taken by the group at the level of Centrica plc, the FTT did note that neither (i) the fact that COHL itself did not dispose of anything nor (ii) the fact that COHL paid for services provided to its holding company did not automatically bar the expenditure from being tax deductible for COHL.

On appeal, the UT held that the FTT was wrong to consider that it was necessary for there to be formal evidence that the COHL directors were acting in their capacity as directors of COHL (rather than as Centrica plc personnel) in the decision making process before the relevant expenditure could be treated as expenses of management of COHL. The UT considered it to be sufficient that directors of COHL were involved in the decision making process for the related COHL expenses to be incurred for the management of its investment in Oxxio. There was no need to specifically document decision making processes being conducted at the COHL level in board minutes or otherwise.

The UT also considered a series of related matters which may have prevented the expenses being deductible in any event. These were:

- whether expenses incurred in relation to the disposal of an investment could, as a general matter, be expenses of management or should be treated as capital expense of the disposal itself. The UT considered that there is a distinction between expenses incurred in deciding whether or not to dispose of an asset (which may be expenses of management) and expenses incurred in the 'mechanics of implementation' having made the investment decision (which may not). This is a question of fact of where the distinction between the two activities arises and which expenses are on which side of the line;
- whether an element of a third party fee being structured as a "success fee" on completion of a disposal prevented deductibility as being linked to the disposal rather than the management of the investment. The UT held that a fee being contingent on the disposal proceeding did not necessarily prevent it from being an expense of management. The UT held that the focus should be on the nature of the

expense and not the trigger for it being paid; and

- whether the advisory fees in question were capital in nature (in which case they would not be deductible as expenses of management). The UT considered that the meaning of capital expenditure in the context of expenses of management is necessarily more limited than the meaning in the context of trading businesses and is aimed at expenses which do not normally recur, but which have the effect of creating, enhancing or disposing of a capital investment. It does not exclude expenditure which informs decision-making and the exercise of managerial discretion. The UT considered that the addition of the exclusion for capital expenditure in the predecessor to section 1219 was really for the avoidance of doubt and that if an expense was actually capital in nature it probably wasn't an expense of management on the basis of the cut off line analysis required and discussed above. Consequently, the FTT held that the advisor costs in question were not prevented from deduction on these grounds.

While this decision is welcome from a taxpayer's perspective in the context of deductibility of management of expenses under section 1219 of the Corporation Tax 2009, it remains important for group companies to carefully consider the basis upon which deduction for expenses are sought. It appears that the decision of the FTT in this case turned on the particular facts pertaining to the Centrica group, the basis on which it took group strategic decisions, the relevant transaction and the nature of the expenses incurred. Notwithstanding the conclusion that formal COHL minutes were not required, the fact that the case was litigated shows that it remains prudent for corporate groups to ensure that documentary evidence, preferably in the form of board minutes or resolutions, is available to demonstrate the group entity taking the relevant decisions and the manner in which the decisions are taken. This should help to evidence that costs incurred satisfy the requirements of the relevant tax legislation in the case of a query or challenge by HMRC.

## **Other UK Tax Developments**

### **Update to UK / US double tax treaty following Brexit**

To address the problem discussed below, the UK and US governments have agreed to an amendment to the UK / US double tax treaty (through a Competent Authority Agreement) which will provide comfort that UK resident companies ultimately owned by UK residents which could benefit from the treaty terms before Brexit became final will still be able to do so. In order for a UK resident to be in a position to claim benefits under the treaty, the claimant has to satisfy the “limitation of benefits” (LOB) provision, which seeks to prevent so-called “treaty shopping” by limiting access to benefits under the treaty to persons and entities which are owned by, broadly, persons and entities which would themselves be entitled to benefits under the UK / US treaty or which are resident in certain other jurisdictions and would be entitled to equivalent benefits under their home jurisdiction tax treaty with the US.

Many unlisted UK corporate groups have historically sought to satisfy the LOB condition through the “derivative benefits” limb of the LOB provision. One of the requirements of this is that 95% of the shares in the relevant UK company are ultimately owned by no more than seven persons who are resident in the EU or EEA.

For companies owned by UK residents, this requirement made sense prior to Brexit, and while the UK was a member of the EU there was no reason to separately refer to UK rather than EU or EEA resident owners in this requirement.

However, since Brexit an unlisted UK company seeking to rely on the UK / US double tax treaty may not have satisfied the LOB criteria if was ultimately owned by UK residents rather than EU or EEA residents. This created a counterintuitive result which was clearly not the intended result of applying the LOB to assess whether a UK resident company should be able to claim the benefits of the treaty.

In order to address this issue the UK and US governments have agreed that the reference to EU residents in the relevant part of the LOB provision will continue to include reference to UK residents.

This is a welcome clarification that reinstates the treaty access analysis applied to UK resident companies that applied before Brexit became final.

#### [Related Professionals](#)

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- **Robert Gaut**

Partner

- **Stephen Pevsner**

Partner

- **Catherine Sear**

Partner

- **Richard Miller**

Partner