Proskauer

UK Tax Round Up

November 2021

Welcome to November's edition of the UK Tax Round Up. This month has seen publication of the Finance Bill 2021-22 (what will become the Finance Act 2022) including draft legislation for the basis period reform, UK asset holding company regime and uncertain tax treatment reporting, as well as an interesting case on the UK source nature of interest payments and withholding tax and another victory for HMRC in a TV presenter IR35 case.

UK Case Law Development

Interest subject to UK withholding tax as UK source and yearly

In *Hargreaves Property Holdings Limited v HMRC*, the First-tier Tribunal (FTT) agreed with HMRC's assessment that interest paid by a UK resident tax company and derived from real property assets in the UK had a UK source, despite provisions in the loan agreement requiring that interest be paid outside the UK and providing that the governing law was that of Gibraltar and not the UK. The taxpayer also sought to argue that the interest was not "yearly" interest and, failing this, that the appellant was entitled to pay interest gross under the UK-Guernsey double tax treaty (DTT) without a direction from HMRC. The FTT rejected both of these arguments as well and held that the interest should have been paid subject to UK withholding tax (WHT).

The taxpayer was the ultimate parent of a group of companies engaged in property investment, development and construction. Crucially, for the period to which the decision related all of the properties held by the group were located in the UK. The group funded many of its acquisitions using loans from various lenders including both financial institutions and various other persons connected with the group. This case related to two loans made by two family Gibraltar resident trusts, settled by directors of the company during the relevant period, and a loan from the sister of one of those directors.

Before 2004, funding from these lenders was informal and undocumented in some cases. In late 2004, the company took tax advice and subsequently took the followings steps with a view to excluding the interest payable on the relevant loans from UK WHT:

- they changed various contractual terms of the loans (place of payment, governing law and jurisdiction of enforcement) so that they were not linked to the UK. This was done with a view to ensuring that the interest was not UK sourced; and
- they implemented of a cycle of interest-stripping and loan extensions under which the interest-payment rights were assigned for consideration to a Guernsey company (and, from 2012 onwards, to a UK resident company) shortly before the interest payment date and entered into a new loan at the time the existing loan matured (less than a year from its advance) using the new loan to repay the existing loan. The intention with this was to ensure that the interest was not "yearly" interest, and so not subject to UK WHT, and, additionally, that the recipients were entitled to gross payment by virtue of the UK-Guernsey DTT and the general UK corporate-to-corporate payment exception.

During the course of the hearing the company's directors admitted that the sole purpose of the restructuring of the loan arrangements was to ensure that the interest would not be subject to UK WHT, while preserving the company's corporate tax deduction for the interest paid, and that there was not a commercial purpose other than obtaining this tax advantage.

The FTT's finding that the contractual provisions mentioned above did not deprive the interest of its UK source is not surprising in light of the 2018 Court of Appeal (CA) judgment in the *Ardmore Construction* case. Applying the multi-factorial test from that case, and following the "underlying commercial reality" of the arrangements in question, the UK residence of the borrower and UK situs of its property investment assets from the money used to pay the interest derived outweighed the other factors and it was held that the interest clearly arose from sources in the UK. The FTT's decision on this point, again like *Ardmore*, underlined how little weight is given to the residence of the lender and the source of the funds used to advance the loan and that the question of source focuses on the circumstances of the borrower and how the interest payments are funded.

On the argument that the interest was not "yearly", the interest was found to be yearly, notwithstanding that in most cases the duration of the loans was under a year, as the loans were held to form part of long-term financing of the company provided by the same lenders using sequential loans.

On the company's point that the interest was not subject to UK WHT under the UK-Guernsey DTT without the company having to obtain a gross payment direction from HMRC, which was purely voluntary, the FTT confirmed that, even if the DTT would fully remove the UK WHT obligation, a claim for relief from UK WHT would need to be made and a direction from HMRC authorising gross payment would need to be received by the borrower, neither of which happened in this case.

Probably the most surprising element of the decision was the FTT's rejection of the company's argument that where the interest payments had been assigned to a UK tax resident company for consideration and received by that company, the interest was "beneficially owned" by it and so payment should not be subject to UK WHT under section 933 of the Income Tax Act 2007, which applies where a UK tax resident company is beneficially entitled to the income. Applying a purposive construction of the exemption to a realistic view of the facts, the FTT found that assigning the right to interest to the UK tax resident company shortly before interest was paid had no commercial purpose and, therefore, that the UK company recipient of the interest was not "beneficially entitled" to it to the extent that it paid for the assignment. This was on the basis of a purposive construction of beneficial entitlement under UK law and not applying an "international fiscal meaning of the sort referred to in the *Indofood* case.

The decision in relation to beneficial entitlement may appear to be somewhat troubling from a taxpayer's perspective as a rare example of a non-fiduciary being deprived of beneficial entitlement. However, it seems likely that this conclusion was influenced by the extreme fact pattern in this specific case and the recognition that the assignment of the interest to a UK resident company for payment was to genuinely commercial transactions.

Another IR35 victory for HMRC

In *Little Piece of Paradise Ltd v HMRC*, the FTT has continued the recent trend and held that Mr Clark, a Sky TV sports presenter was a deemed employee of Sky TV for the purposes of the IR35 intermediaries rule so that the taxpayer (his personal service company or PSC) was liable for PAYE and national insurance contributions on payments that it made to Mr Clark. This is the latest in a number of recent IR35 victories for HMRC where TV and radio presenters have been characterised as deemed employees of their end client organisation.

The basic process required to determine whether IR35 applies to the provision of services by an individual through their PSC is to construct the “hypothetical contract” that would have existed between the individual and end client had they contracted for the work directly rather than through the PSC and determine whether the individual would have been an employee or a self-employed contractor under that hypothetical contract. As has been discussed in those recent cases, in order for that hypothetical relationship to be one of employment, there has to be sufficient mutuality of obligation and control by the end client and no other factors in the relationship that point to the individual operating on a self-employed basis.

In this case, there were three contracts spanning a six-year period and providing a fee each year for services to be performed. These resulted in Little Piece of Paradise (the PSC) providing the presenter to Sky as a lead presenter on professional darts broadcasts. The coverage extended to only 64 days a year, and these represented Mr Clark’s primary working days for the year.

The PSC asserted that there was no mutuality of obligation between Mr Clark and Sky on the basis that if he did not perform the services there was no obligation for Sky to make payment under the contracts. However, this assertion was not supported by the facts, since payments were made on a monthly basis, regardless of whether an event was covered in the month in question. The FTT found that in return for the promise of payment the presenter was obliged to perform the services and that the mutuality of obligation requirement was satisfied. The most significant finding in this regard was that, although the actual contract allowed for the PSC to provide an alternative if Mr Clark was not available, the FTT held that this substitution clause would not be included in the hypothetical contract between Mr Clark and Sky. A similar position has recently been taken by the CA in upholding an Employment Appeal Tribunal (EAT) decision that a courier was a “worker” notwithstanding a substitution clause in his contract because the clause was not unfettered and so did not release the courier from his principal obligation to carry out the work himself. These cases show that substitution clauses will be considered sceptically by the courts when the end client, rather than the individual worker, has effective control over whether or not a substitute will be accepted.

The FTT also held that Sky had ultimate control over what events would be covered and where and how Mr Clark was required to present notwithstanding that it was actually the Professional Darts Corporation (PDC) that decided where and when the events were held. In this regard, the FTT, like previous tribunals, placed emphasis on the fact that Mr Clark had to comply with Sky's and Ofcom's general standards and editorial guidelines.

Having concluded that mutuality and control were indicative of a hypothetical employment relation, the FTT went on to consider the other relevant factors in that context, namely exclusivity, whether the presenter was in business on his own account, lack of entitlement to holiday and sick pay and the right to provide a substitute. None of these factors led to a conclusion that the relationship reflected a contract for services.

The case emphasises that it will be increasingly difficult for individuals providing services over the medium to long term, whether under a single contract or number of contracts, who are not clearly taking financial risk commensurate with operating as a self-employed contractor to resist HMRC's view that they should be treated as a de facto or deemed employee.

Other UK Tax Developments

New Asset Holding Company Regime

One of the more significant developments for the private funds industry this year is the introduction of the new UK asset holding company (UKAHC) regime that will become effective on 1 April 2022. The (nearly) final draft legislation for the regime were included in the Finance Bill 2021-2022 published on 4 November.

The regime is intended to increase the UK competitiveness as a jurisdiction for the establishment, operation and administration of private funds and their investment holding structures following a trend in recent years whereby an increasing number of private funds have been established in Luxembourg or the Channel Islands. The rules aim to establish a more favourable tax regime for UKAHCs where certain eligibility criteria are satisfied.

The rules have been subject to considerable consultation between HMRC and interested representative bodies over the past few months, which is reflected in the draft rules which provide the basis for a reasonably simple and certain regime that should prove attractive to certain fund managers investing in shares, debt and non-UK real estate.

In order to qualify for the regime, the UKAHC must satisfy certain eligibility requirements:

i   the UKAHC's main activity must be carrying on an investment business with any other (e.g. trading) activities being ancillary to the investment business and insubstantial in relation to it;

ii   the investment business must not include acquiring listed securities other than with a view to delisting the relevant company;

iii   the UKAHC must be owned at to at least 70% by "category A investors", which include widely held funds and certain other investors such as local authorities, sovereign entities, pension schemes, UK REITs and their non-UK equivalents and charities; and

iv the UKAHC elects to be within the regime.

There are rules relating to the tax consequences of a company entering the regime (broadly, being treated as selling its relevant assets for market value with a relaxation of the holding period required to claim substantial shareholding exemption (SSE) on the deemed disposal of shares), breaching the qualifying requirements and curing them and leaving the regime (broadly, selling its relevant assets for market value).

While in the regime the UKAHC will benefit from:

1. no corporation tax on sale of shares that it holds for its investment business with no conditions of the sort required for the SSE to apply;

2. no corporation tax on profits from overseas real property to the extent that the property is subject to tax overseas;

3. no withholding tax on payments of interest on the UKAHC's debt instruments;

4. no application of certain of the distribution rules that can convert deductible interest into non-deductible distributions, such as results dependent interest and interest being more than a reasonable commercial return; and

5. no application of the income distribution rules to repurchases or redemptions of the UKAHC's shares for more than their original subscription price, although this rule is not applicable to individuals holding employment-related securities other than individuals involved in providing investment management services to a fund owning the UKAHC (e.g., carried interest holders).

There are other tax simplification rules in relation to the hybrid mismatch rules and corporate interest restriction rules and also rules to treat certain returns from the UKAHC as non-UK source income or capital gains for remittance user purposes.

All in all the rules are clear and comprehensive, if a little long and detailed, and it will be interesting to see how successful the regime is and whether it gets used immediately or funds allow it to bed in for a while before considering the UK as an alternative to other holding company jurisdictions.

Basis Period Reform Consultation

HM Revenue & Customs (HMRC) have released their “Consultation outcome: Basis period reform” and published draft legislation for the new rules. The consultation and draft rules reflect the changes made following discussion and representations, the main change being the delay to the introduction of the rules for 12 months so that they will now become effective in tax year 2024-25 with the transitional year being 2023-24. The rules are expected to be included in Finance Act 2022.

Basis periods are relevant to all individuals carrying on trading activities, whether as sole traders or through a partnership (including an LLP) and are the method by which taxable profits or allowable losses are allocated from a business’s accounts to a specific tax year. Broadly, they seek to align profits of a tax year with the accounting period that ends in the tax year, but this process gives rise to complications and what are known as “overlap profits” in the first year or two years that an individual commences a trade. The proposal to repeal basis periods and align taxable profits with the tax year is intended to simplify the current rules for small businesses, helping them to spend less time filing their tax returns and making the rules fairer, more logical and easier to understand.

The proposed rules will operate so that:

- in the tax year 2023-24 individuals will be taxed on the current basis period basis plus the profits from the end of that period until 5 April 2024. They will also bring any current “overlap relief” into account as a loss in that period;
- if there is an excess profit in the transition year, the tax on it can be spread over 5 years (or can be accelerated in whole or in part at any time);
- if there is an additional loss as a result of the overlap relief it can be carried back for 3 years; and

- from 5 April 2024 the taxable profits will be those arising in each tax year.

Where businesses have an accounting period of 31 March (or 1-5 April) these changes will have no effect. Where they do not there will be some sort of additional profit and overlap relief in the transition year.

The main complications that are likely to arise in the future are around misalignment of accounting years and tax years where a business can’t use a 31 March accounting date, because, for instance, it has a seasonal business or is part of a wider international business with a different required accounting date. These businesses are likely to have to apportion profits from two part accounting periods to each tax year and, depending on when in the tax year their accounting period ends, the individuals might have to file their tax returns with provisional numbers and then amend them later.

There are also likely to be complications for individuals subject to tax in the UK and another jurisdiction (particularly the US) and seeking to claim double tax relief.

HMRC has recognised that there are still some issues to consider in introducing the rules and, hopefully, changes will be made to try to minimise the practical and operational complexities that the rules will lead to in these specific circumstances.

Uncertain Tax Treatment

Finance Bill 2021-2022 includes proposed legislation for the implementation of new notification rules relating to the uncertain tax treatment (UTT) regime applicable to large businesses.

The new UTT rules will only apply to businesses, including partnerships and LLPs with either, or both, a turnover above £200 million and a balance sheet total of more than £2bn. This will include all businesses handled by HMRC's large business division as well as the larger groups in its mid-sized business division. Notably, and importantly, collective investment schemes are excluded from the new regime, although their portfolio companies will, on an individual basis, be subject to them if they qualify as “large”.

Large businesses within the scope of the rules will be required to notify HMRC of “uncertain amounts” in respect of corporation tax, VAT or income tax (including PAYE), subject to a threshold test and specific exemptions. A treatment is defined as being “uncertain” if it falls within one (or more) of the two specified conditions: (i) a provision has been recognised in the accounts of the company (or members of the partnership) in respect of the treatment; or (ii) the treatment relies on an interpretation which is contrary to HMRC’s known interpretation of the law. HMRC’s position is “known” for these purposes if it is apparent from published HMRC documents or from “dealings” with HMRC. “Dealings” in this context means direct interaction between the taxpayer and HMRC, but is not limited to discussions regarding the specific transaction or treatment concerned.

A third condition, which was contained in an earlier iteration of the draft legislation, would have required notification where there was a “substantial possibility” that a court or tribunal would find the treatment to be incorrect. This has now been removed following consultation. The removal of this third condition is a welcome change, as it was a completely novel and untested concept which HMRC’s initial guidance said would fall somewhere below a more than 50% likelihood applicable to a taxpayer’s tax filing position. It was also not aligned with any accounting measure that might result in a provision. Having said this, the government has indicated that it remains committed to further consideration of a third trigger, so it is possible that a modified version of this trigger will be introduced before the rules receive Royal Assent, or at some time after if HMR is unhappy with the level of reports that it receives. Notwithstanding the removal of this “substantial possibility” test, it is concerning that HMRC considered that such a test should be included in the original proposals.

Notification of an uncertain amount will only be required where the “tax advantage” arising from a treatment exceeds a £5m threshold. Where the financial year in respect of which notification may be required is more or less than 12 months, then the £5m threshold will be adjusted proportionately. The threshold applies separately for corporation tax, VAT and income tax. The draft legislation also sets out detailed rules for quantifying tax advantages for these purposes.

The rules provide a number of specific exceptions which, where applicable, mean that an "uncertain amount" will not need to be notified. A "general exemption" will apply where it is reasonable to conclude that all, or substantially all, of the information which would otherwise be required to be notified has already been made available to HMRC.

As the draft rules currently provide, the notification requirement will apply to tax treatments included in "relevant returns" which must be filed on or after 1 April 2022. This means that notification is potentially relevant to transactions and uncertain treatments arising now. As such, affected businesses should begin preparing at the earliest opportunity for the implementation of the regime.

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