Proskauer

UK Tax Round Up

March 2023

Welcome to March's edition of the UK Tax Round Up. This month's edition features comments on the recent Spring Budget together with a summary of some recent case law involving VAT due on services provided to ex-VAT group members and the application of the miscellaneous income tax provision to a reallocation of funds from an LLP to its members.

Spring Budget Developments

The Chancellor unveiled the Spring Budget on 15 March, with the subsequent publication of the Finance Bill 2023 on 23 March. These are the key measures expected to affect the private funds industry.

Increase in corporation tax rate

The main rate of corporation tax will increase from 19% to 25% for large companies and will apply from 1 April. Companies with profits of £50,000 or less will continue to pay corporation tax at the 19% rate while companies with profits between £50,000 and £250,000 will be subject to corporation tax at the new main rate, reduced by a marginal relief.

QAHC regime

The Finance Bill introduces a number of improvements to the qualifying asset holding company (QAHC) regime that was brought into effect with the last Finance Act and effective for periods starting on or after 1 April 2022.

In order to qualify as a QAHC, the relevant UK holding company must be owned at least 70% by so called Category A investors. One class of Category A investor is a qualifying fund which, among other things, is a collective investment scheme (CIS) that meets the genuine diversity of ownership (GDO) condition contained in Regulation 75 of the Offshore Funds (Tax) Regulations 2009. Concerns had been raised that where investment funds are structured as multi-vehicle funds, that is, with a number of parallel limited partnerships to cater for different classes of investor or where it is structured as a master/feeder arrangement, elements of the structure might fail the GDO test. In order to cater for these structures, the QAHC rules have been amended so that each individual fund vehicle in a multi-vehicle investment fund will be treated as satisfying it where the arrangements as a whole meet the condition. This change will make it easier for entities that are part of multi-vehicle arrangements to satisfy this and so be treated as qualifying funds for Category A investor purposes. This change will have effect from Royal Assent.

The definition of a qualifying fund also has been expanded. At present, only funds that are CISs can be qualifying funds. Any entity that is a closed-ended body corporate will not be a CIS for this purpose. Accordingly, there was a concern that certain non-UK limited partnership entities that are bodies corporate under their local law (including Delaware limited partnerships) would not meet the requirement to be a qualifying fund (and so a good investor for QAHC ownership purposes). The upcoming changes will mean that a fund vehicle which would be a CIS if it was not a body corporate will be treated as if it is a CIS. This change has effect from 1 April 2022.

The investment strategy condition, which must be satisfied for a company to be a QAHC, has been updated so that a QAHC will be able to elect to treat its investments in listed securities as unlisted to meet the investment strategy condition. Under the current investment strategy condition, a QAHC cannot have in investment strategy of investing in listed equities or in interests which derive their value from listed equity positions other than in limited circumstances. If a QAHC makes this election it will be subject to corporation tax on the dividends received by it from its listed securities (including any listed securities that might have qualified under the investment strategy condition before this change to the condition). This change will have effect from Royal Assent.

Introduction of carried interest election for double tax relief purposes

Legislation has been introduced which will allow individuals entitled to carried interest from the funds to which they provide services to elect for carried interest to be taxed on a so-called accruals basis rather than on the arising basis that applies under the carried interest rules in Chapter 5 Part 3 TCGA 1992. From the 2022/2023 tax year onwards, an individual will be able to enter into an irrevocable election in respect of any investment scheme from which they receive carried interest. Where an individual makes the election, a chargeable gain is deemed to arise for each relevant tax year calculated on the basis of amounts actually received by the relevant investment scheme and the amounts that it would have received had all of its investments been sold for their original cost.

The purpose of this election is to seek to address, in a simplified fashion, the issue that can arise for carried interest recipients who are subject to both UK and non-UK tax on their carried interest (for instance, and in particular, UK resident individuals who are also US taxpayers). Such individuals might be subject to their non-UK tax in years prior to the carried interest “arising” to them for UK tax purposes. In that case, and because of HMRC’s position that section 103KE TCGA only permits a UK tax relief claim for different UK taxes charged on an amount of carried interest and not for any non-UK tax, where carried interest is subject to both US tax and UK tax, the US tax is likely to arise before the UK tax. The restrictions in the US tax credit rules mean that problems can arise in claiming credit against an individual’s US tax for their later UK tax. These rules are intended to reflect, in a broad sense, the basis on which US tax is expected to arise so that the US and UK tax are generated in the same year and US tax credit can be claimed against the UK tax. This is a complex area and it is recognised that the rules might not operate perfectly and they are not specifically tailored to any double tax relief rules that might operate between the UK and other taxing jurisdictions.

Any capital gains tax paid on the deemed gain can then be offset against any other UK tax payable by the individual in respect of the carried interest as and when it arises. If it appears that the actual disposals and other receipts by and of the fund mean that the actual carried interest that arises is less than the amount of the gain resulting from the election, a capital loss will arise the individual provided that generating the loss was not the main purpose, or one of the main purposes, of making the election. The loss will be treated as a standard capital loss arising in the relevant tax year and so does not mean that the individual can necessarily reclaim any excess capital gains tax that was paid because of the election.

Any election must be notified to HMRC by no later than 31 January following the end of the first tax year for which the election will take effect.

UK Case Law Developments

VAT due on services invoiced and paid after member leaves VAT group

In *HMRC v the Prudential Assurance Company Limited*, the Upper Tribunal (UT) allowed an appeal from HMRC against a previous decision that had found that no VAT was due on investment management services provided to entities that were part of the same VAT group at the time the services were provided but the supplier of the services had left the VAT group before the invoice for the services was issued.

Prudential was the representative member of a VAT group. Between 2002 and 2007, a company which was member of that group (the Manager) had been providing investment management services to Prudential in return for a management fee and a performance fee. Due to the nature of the investment fund being managed, the performance fee was not expected to be paid until more than 10 years after the services had been provided by the Manager. In 2007, the Manager left the Prudential VAT group and ceased providing the services. Under the terms of the Manager leaving the Prudential group, the Manager stopped receiving any management fee but retained its right to receive the performance fee. In 2014 and 2015 the hurdles for the performance fee were reached which resulted in performance payments of £9.3 million becoming due to the Manager. The Manager provided invoices for the services at that time.

HMRC considered that the Manager should have invoiced the fee plus VAT at 20% because the services were “continuous” and were treated as being supplied when the invoice was delivered, at which time the Manager was not part of Prudential’s VAT group. Prudential disagreed and took the view that the fees were outside the scope of VAT as provided between VAT group members. This was based on Prudential being part of the same VAT group as the Manager at the time the services were carried out.

The question raised by the case is how the VAT grouping rule in section 43 VATA 1994 interacts with the time of supply rules in section 6 VAT 1994 and Regulation 90 of the VAT Regulations 1995.

Section 43 VATA states that where the supplier and recipient are members of a VAT group any supply between them is disregarded. Section 6 and Regulation 90 say that a supply of continuous services is treated as made at the earlier of payment for the services or the issue of an invoice in respect of the services. The parties agreed that the relevant services supplied were continuous services for the purpose of Regulation 90.

The First-tier Tribunal (FTT) had found in favour of Prudential, determining that there was no supply of services applying section 43 VATA because Prudential and the Manager were members of a VAT group at the time that the services were actually supplied. This means that it was not necessary to consider the time of supply rules because section 43 operated by reference to when the services were actually supplied.

The UT has overturned this decision and has allowed HMRC's appeal on the basis that the time of supply deeming provision must be taken into account when assessing the effect of the VAT grouping provisions. The UT has held that section 43 looks at the relationship between the supplier and the recipient at the time that the services are supplied and that section 6 and Regulation 90 then determine, for the purposes of all VAT rules, when the services are supplied. There is nothing in the VAT grouping rules that usurps the effect of the time of supply rules. On that basis, it found that when the part of the continuous supply of services which was invoiced in 2014 and 2015 were supplied (that is, when the invoice was issued) the parties were not members of the same VAT group and that, as a consequence, the performance fee payable was subject to VAT.

This case is important as it highlights that the time of supply deeming provisions must always be considered when assessing the VAT consequence of a supply. It also raises the question of how payment for continuous services that is contingent on a future event could have been invoiced without a VAT charge in these sort of circumstances and that suppliers who are leaving VAT groups should consider carefully how to invoice any payments that might not be due until after they have left the VAT group.

Reallocation of funds from LLP to individual members taxable as miscellaneous income

In *HFFX LLP and others v HMRC*, the UT has rejected an appeal by taxpayers in relation to a scheme whereby certain amounts of income received as fee income by HFFX LLP were reallocated to individual members of the LLP through a corporate member which then contributed the fee amount back to the LLP where the capital was allocated to and withdrawn by the individuals. This case concerned an appeal by HFFX and a cross-appeal by HMRC against the previous FTT decision (for a summary of which see our March 2021 UK Tax Round Up).

The case involved a number of individuals (the Members) who were members of HFFX LLP and were involved with HFFX's automated foreign exchange trading activity which generated significant fee income for HFFX. The Members were entitled to a deferred remuneration arrangement known as the Capital Allocation Plan (CAP). The HFFX profits attributed to the CAP were allocated to a corporate member of HFFX. The corporate member had the discretionary power to contribute the profit to HFFX as special capital and agree to a reallocation of the capital to Members recommended by HFFX's managing partner. Once so allocated, the Members could withdraw their capital over a three year period. The anticipated tax treatment was that the corporate member was subject to corporation tax on the profit allocated to it but that the Members were not subject to tax (income or capital gains) on the HFFX special capital that was allocated to and withdrawn by them.

HMRC argued that the Members were subject to income tax on the amounts withdrawn by them either (i) applying section 850 ITTOIA 2005 on the basis that it was the Members rather than the corporate member that had the ultimate right to the profits and so should be treated as having the profit allocated to them by HFFX LLP, (ii) as miscellaneous income under section 687 ITTOIA 2005 or (iii) applying the sale of occupation income provisions under section 776 ITA 2007. The FTT rejected HMRC's argument under (i) but agreed with it under (ii) and (iii) so that the Members were subject to tax on the amount that they withdrew from HFFX as miscellaneous income.

Following the UT's decision in *Bluecrest Capital Management LP & other v HMRC* in 2022, a case which concerned a similar corporate member and special capital reallocation mechanism, the parties submitted a statement regarding the relevance of that decision to the case in hand. Neither HMRC nor the Members argued that the Bluecrest decision was not relevant, but they did disagree on what points of law derived from it should apply to this case.

In HFFX, following an analysis of HFFX's partnership deed, the FTT had rejected HMRC's argument that the profit-sharing arrangement resulted in the relevant HFFX profit that was allocated to the corporate member being properly allocated to the Members, holding that section 850 ITTOIA 2005 did not operate in that way. The FTT had, however, determined both that the income allocated to the corporate member and used in the CAP to be paid out to the Members should be treated as miscellaneous income of the Members and, if that was wrong, should be treated as income of the Members applying the sale of occupational income rules.

In order for the amount received by the Members to be treated as their miscellaneous income, the amount must be income that derived from a source that is not otherwise charged to income tax. As summarised in the Bluecrest case, this requires that the income must be the recipient's, the receipt must be analogous to one of the heads under the old Schedule D rules and there must be a sufficient link between the source and the recipient. In order for there to be a link between the source and the recipient, there must be a "legal obligation" on the part of the payer to make payment to the recipient.

The case does not really discuss whether or not the amount withdrawn by the Members is income of the sort required for section 687 to apply and accepts that is the case. The main point of discussion is whether there was the required "legal obligation" to make the payment to the Members and what is meant by "a legal obligation to make a payment". The UT determined that the Bluecrest decision made it clear that the focus must be on the obligation of the payer and that previous case law had made clear that, where there was a legal obligation to exercise a discretion to make a payment and that a payment was made following the exercise of such discretion. the payment was made under a legal obligation for the purpose of linking the recipient to the source of the income.

In this case, HFFX argued that the arrangement was different to Bluecrest and that, in particular, there was no legal obligation on anyone to contribute the special capital to HFFX and that the corporate member had an absolute discretion to follow or not follow the HFFX managing partner's recommendation to make a contribution under the CAP. The UT decided, however, that this was not a material distinction and that other applicable case law has shown that an absolute discretion will generally carry an implied term that it will be carried out in good faith, rationally and for the purpose that it has been given. Accordingly, the UT decided that the corporate member was under a legal obligation to make the CAP contribution and that the obligation derived from the terms of the HFFX LLP agreement such that there was a sufficient link between the HFFX income profits and the CAP receipt of the Members to treat the receipt as miscellaneous income of the Members. The UT also decided that, as in Bluecrest, the source of the CAP payment could be the services rendered by the Members under the terms of the HFFX LLP deed.

Further, the UT determined that, if the miscellaneous income provisions did not apply, the reallocated amounts would be taxable under section 776 ITA.

The UT's decision highlights that there are a number of tools available to HMRC to try to ensure that what is in effect remuneration received by employees and/or LLP members under structured arrangements is subject to tax as income rather than as some other sort of receipt and that participants in such schemes should think carefully about how HMRC might seek to attack them before entering into them, as highlighted by the UT's wide interpretation of what can amount to a source of income for the purposes of section 687 ITTOIA.

Relief denied following transfer of intangible assets to an LLP by its members

In *Muller UK & Ireland Group LLP & Ors*, the FTT has denied a tax relief claim made by corporate members of an LLP arising from a transfer of intellectual property and goodwill from those members to the LLP itself, deciding that relief did not apply to the share of amortisation debits accrued in respect of intangible assets and goodwill.

Muller UK & Ireland Group LLP was incorporated on 7 May 2013 with three corporate members, Muller Dairy UK Limited, Robert Wiseman & Sons Limited and TM UK Production Limited. Shortly after the LLP's incorporation, on 1 July 2013, the members transferred their trades, which, prior to the transfer, the members had undertaken individually, to the LLP in return for membership units. The asset transfer agreements for each company included certain intellectual property rights and information, such as brands, licenses and software and goodwill.

The LLP recorded the intellectual property rights and the goodwill at their fair value in its accounts and amortised them over five years with the members claiming a tax deduction under the intangible fixed assets regime in respect of their share of the deductions. HMRC subsequently opened an enquiry into the members' tax returns for the periods up to 2017 and denied the amortisation deductions on the basis that for an intangible or goodwill to fall within the intangible fixed assets regime it must either have been created on or after 1 April 2002 (when the regime was introduced) or have been acquired by the company on or after that date from a person who at the time the asset was acquired was not a related party of the company. HMRC argued that the LLP had acquired the relevant assets from a "related party", being the members, and so denied the relief.

As the LLP was a limited liability partnership, the parties agreed that, pursuant to section 1259 CTA 2009, the LLP was deemed to be a notional UK resident company for the purpose of computing each corporate member's share of the LLP's taxable profits. However, the parties disagreed, on whether the "statutory fiction" that the LLP was a notional company also applied when considering the related party definition in section 835 CTA 2009. Under the rules as they applied at the time of the transfers, each of the members would have been a related party of the LLP if it had been a company owned in the same way as the LLP was owned but would not have been a related party of the LLP if the LLP was treated as a limited liability partnership (and a partnership rather than a company).

The LLP argued that section 1259 CTA 2009 was merely a computational provision and that it did not go so far as to deem the partnership to be a company for all purposes of the rules and, therefore, as it was only a notional, and not a real, company it could not have any related parties. HMRC argued that section 1259 set the framework for determining what tax arose under the intangibles regime and that the requirement for a limited liability partnership with corporate members to be treated as a company should flow through to the other rules relevant in determining what amounts should arise under the regime, including whether the transfers by the members brought the relevant assets into the regime.

The case involves a useful and interesting discussion on the scope of deeming provisions, as discussed in the *Marshall v Kerr* case. This, broadly, says that one should treat the natural consequences of a deeming fiction as being real in the context of the relevant legislation and its purpose unless to do so would result in absurdity or injustice. The FTT stated that the intangibles regime, which applies for the purposes of corporation tax, was quite naturally written by reference to companies and that it was perfectly natural, when determining the taxable profits of corporate members of a limited liability partnership to deem the LLP to be a company, to apply that fiction to all provisions relevant to determining its taxable profits for the purpose of the regime, including the question of whether the members were related parties of the LLP. So, in determining whether the members were related parties of the LLP, the FTT considered that it was impossible to carry out the required notional company intangibles regime computation without treating the LLP as a company in the context of the rules and their purpose.

This case is useful in highlighting the approach to be taken in considering the application of statutory fictions and their interaction with related legislation when applying other provisions. Here, the FTT took a logical approach to the facts of this case and the terms and purpose of the intangibles regime as a whole in determining that the fiction required by one set of computational provisions was applicable throughout the process of determining how the other computational provisions should be applied.

Other UK Tax Developments

HMRC guidance on new mandatory disclosure rules

HMRC has updated its guidance to reflect the introduction of the new mandatory tax arrangement disclosure rules (MDR) which have come into force from 28 March implementing the OECD model mandatory disclosure rules and replacing the UK's implementation of the EU's DAC 6 cross border tax arrangement disclosure rules.

The MDR will only apply to only the two categories of arrangement covered by the OECD's mandatory disclosure rules, being where the arrangement or structure is designed to:

- avoid reporting under the OECD's common reporting standard (CRS); or
- allow the use of an offshore opaque structure to hide the identity of natural persons who are ultimate beneficial owners under the arrangement.

Any reportable arrangements entered into on or after 28 March will need to be reported to HMRC within 30 days of the arrangement being entered into, and pre-existing arrangements (entered into on or after 25 June 2018) will need to be reported within 180 days of the implementation of the MDR (that is, by 25 September).

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