Proskauer

UK Tax Round Up

September 2023

Welcome to the September edition of the UK Tax Round Up. This month has seen interesting decisions on the salaried members rules, the scope of arrangements for the CGT rollover main tax avoidance purpose test and the precedence of the employment-related securities option rules over the tax-exempt termination payment rules. In addition, the Government has confirmed the repeal of the stamp duty and SDRT 1.5% charge on the issue and transfer of UK securities into depositary receipt or clearance service systems for capital raising.

UK Case Law Developments

Salaried member rules for asset manager LLPs

In *BlueCrest Capital Management (UK) LLP v HMRC*, the Upper Tribunal (UT) dismissed HMRC's appeal against the First-tier Tribunal's (FTT's) decision (covered in our July 2022 UK Tax Round Up and our Tax Talks blog post from June 2022) that certain members of the LLP were not "salaried members" for tax purposes because they exercised significant influence over the affairs of the LLP.

The case involved three classes of LLP member. The first were senior asset managers who either had control of the management of investment portfolios of, generally, $100 million or more or supervised such senior managers. The second were junior asset managers who did not have control of portfolios. The third were senior managers in BlueCrest's back-office operations. None of them were part of the firm's executive management committee. The FTT had held that the senior portfolio managers were not salaried members because they did have "significant influence" over the LLP's affairs as a result of controlling a significant part of BlueCrest's business, notwithstanding that they were not involved in the top-level decision making about the firm's affairs. It also decided that the other two categories of member were salaried members because they didn't have significant influence and their remuneration arrangements were not sufficiently dependent on the firm's profits to result in variable remuneration for the "disguised salary" limb of the salaried member tests.

The UT's agreement on the latter point was not surprising given the remuneration arrangements, but their agreement on the former will be welcomed by LLPs with members who are important to significant elements of the firm's business as it confirms that HMRC's narrow view of significant influence as being limited to influence over the top level decision making activities is not necessarily correct.

For further analysis on the UT's decision, please refer to our Tax Talks blog post.

Scope of arrangements with a main tax avoidance

In *Wilkinson and others v HMRC*, the FTT has considered which elements of a share for share exchange transaction intended to qualify for rollover relief applying section 135 TCGA constituted the "arrangement" for the purpose of determining whether the arrangement had a main purpose of tax avoidance. The case is interesting in that is comes to a somewhat surprising conclusion in favour of the taxpayer and holds that the relevant arrangements for the purpose of the tax avoidance test in section 137 TCGA are wider than put forward by HMRC.

The broad facts were that Mr and Mrs Wilkinson (the Wilkinsons) held some shares in a private limited company which they intended to sell to another company. If the Wilkinsons had sold all of their shares directly to the purchaser, they may have been eligible for entrepreneurs' relief (ER) (now business asset disposal relief) but the total gain they were expected to generate would have significantly exceeded the lifetime limit for ER so a significant proportion of the gain would have been taxed at the full CGT rates. Instead, the Wilkinsons entered into an arrangement which attempted to make use of their daughters' unused ER lifetime limit on the sale as well their own. This required the daughters to be able to apply section 135 TCGA to the exchange of their shares for shares and loan notes so that they were not treated as disposing of their shares until they had held them for the twelve month period for ER to apply. A simplified summary of the arrangement is:

1. The Wilkinsons gifted some of their shares to their daughters. The parties elected for holdover relief to apply to this transaction so that the Wilkinsons were not subject to CGT and the daughters inherited their parents' base cost.
2. The Wilkinsons sold their remaining shares to the purchaser for cash and paid CGT on the resulting gain (subject to their ER claim).

3. If the daughters had sold their shares for cash at the same time as the Wilkinsons they would not have qualified for ER as they would not have held the shares for the twelve-month qualifying period. As a result, the daughters sold their shares for shares and loan notes issued by the purchasing company in a transaction which was intended to fall within section 135 TCGA and, therefore, allow them to defer their CGT disposal point until their consideration shares and loan notes were disposed of and they could claim ER on the disposal.
4. The shares in the purchaser gave each daughter the 5% rights required to claim ER on their disposal. The loan notes were stated to be repayable one year after issuance and the daughters became directors in a subsidiary of the company until such time. After one year the loan notes were redeemed and the daughters' shares were disposed of to an affiliate of the buyer, in each case for cash. These disposals would trigger gains, but they were intended to qualify for ER using the daughters' lifetime limits, so adding to the ER claimed by the Wilkinsons on the original sale.

HMRC did not dispute that holdover relief was available for step 1 or that ER was available to the daughters at step 4. What HMRC did contend was that section 135 TCGA did not apply to the daughters' original disposal of shares for purchaser shares and loan notes on the basis that the disposal formed part of a scheme or arrangement with a main purpose of avoiding CGT so that the anti-avoidance provision in section 137 TCGA applied to prevent rollover applying to the original sale. Consequently, the daughters would make a fully taxable disposal with no ER on the original sale and would not make a material gain at step 4 which could benefit from ER. This would mean that the daughters would have to pay approximately £1.9 million more in CGT than they had planned for.

The FTT decided that the scheme or arrangement that the daughters' disposal of their shares for purchaser shares and loan notes was part of the overall commercial transaction involving the sale of the company to the purchaser (including the sale by some minority shareholders who were not connected to the Wilkinson family) rather than, as HMRC asserted, the transfer to the daughters of the shares and their sale with a view to increasing the overall ER entitlement of the Wilkinsons and their daughters. Having identified the relevant scheme or arrangement in this broad way, the FTT then concluded that there was not a main purpose of avoiding CGT on the basis that the tax saving was about £3 million on sale proceeds for the Wilkinsons and their daughters of £73 million and that the Wilkinsons would have proceeded with the transaction on the same overall commercial terms regardless of the CGT planning being effective.

The FTT did consider whether “the exchange” could also form part of another scheme or arrangements which did have a main purpose of avoiding CGT, namely steps 1-4 above as they applied to the Wilkinsons and their daughters only. However, it did not accept that the legislation was intended to work in this way and found that section 137 had to apply to the exchange of shares by all the shareholders or none of them, not just to the exchange by the Wilkinsons and/or their daughters. The FTT did accept that, if it was allowed to frame the scheme or arrangements in this narrower way, it would have found that it did have a main purpose of avoiding CGT.

The case is a reminder of how important it can be to determine the relevant arrangements to which “main purpose” tests such as section 137 should apply and is somewhat surprising in finding that the overall commercial transaction should be considered when there is a clear “sub-arrangement” which has been driven with a view to reducing tax, although it does show that the task is always to assess on the terms of the main purpose provision in question exactly what the purpose must be applied to. Historically the term “arrangements” has been given a very flexible definition by the courts, but the decision in this instance focused on the specific terms of section 135 and 137 which requires an examination of the purpose of “the exchange” rather than of any other transaction that forms a part of the preparation for the exchange. Given the leeway that the decision might give to taxpayers to arrange their tax affairs in a more flexible way than HMRC might be happy with, it will be interesting to see whether it is appealed.

Compensation payments not deductible

In *Scottish Power (SCLP) Ltd v HMRC*, the UT has agreed with the FTT that Scottish Power (and certain other companies in the group) was not entitled to a tax deduction for payments that it made following an investigation into its misselling and other breaches by its regulator, Ofgem. The payments, of about £28 million, were agreed with Ofgem to be structured as a £1 penalty and the rest as payments to customers, customer groups and charities. Scottish Power argued that the payments were deductible as being settlement payments rather than a penalty and so were incurred wholly and exclusively for the purpose of its trade. HMRC argued that the payment was all a penalty (although characterised differently) and, therefore, not deductible. The characterisation of the payments was in order that they could directly benefit the people affected by the misselling rather than being paid to Ofgem itself.

In each of the investigations and for each company, Ofgem proposed penalties following its investigation. After negotiations with Scottish Power, settlement was reached. The settlement agreements included acceptance by Scottish Power of the relevant breach, an agreement not to appeal and obligations to make the payments to the relevant customers, customer groups and charities. Each of the payments which were the subject of the Scottish Power's appeal against HMRC's disallowance of the deductions were made under and in accordance with the relevant settlement agreement. Each settlement agreement contained wording along the lines of "The Authority considers it appropriate to impose a penalty on [Scottish Power]. However, [Scottish Power] has agreed to make contributions amounting to £8.5m in the form of compensation and payments to vulnerable customers. The Authority considers that the payments offered by [Scottish Power] to aid consumers will be of greater benefit to energy customers than if a substantial penalty was imposed. Accordingly, the Authority considers that a nominal penalty of £1 should be imposed. Furthermore, the level of the penalty contributions has been reduced to reflect the steps taken by [Scottish Power] to take corrective measures and the agreed settlement of this investigation.".

Scottish Power's argument was based on the assertion that the payments were deductible under GAAP as an accounting matter and the precept that there is a straightforward difference between a penalty payment and a settlement payment, with the latter being tax deductible. HMRC's argument was that the entire payment was a penalty or in the nature of or in lieu of a penalty and so not deductible applying the principle from the *McKnight* case.

The UT provides an interesting discussion on the principle behind whether a penalty or compensatory payment should be deductible based around Lord Hoffmann's judgement in *McKnight*. That judgement distinguishes between: (i) the situation discussed in the Australian case of *The Herald and Weekly Times Ltd. v. Federal Commissioner of Taxation* in which the court decided that the newspaper could claim a deduction for defamation damages claims because such actions and payments were a "regular and almost unavoidable incident of publishing it and the damages are compensatory rather than punitive" and (ii) that in *IRC v von Glehn*, which decided that payments in respect of penalties and associated legal costs for infringements of war-time customs legislation which required the trader to produce evidence that its goods had not reached enemy territory were not deductible. The UT explains that the basis of the decision in *McKnight* was that the damages were payments made "for the purpose of the trade" whereas the payments in *von Glehn* were not. This was not a simple distinction between compensatory and penalty payments but required consideration of why the payments had been incurred and how they related to the taxpayer's trading activities. In addition, Lord Hoffmann had explained that the public policy purpose of a penalty (or similar payment) of punishing the payer would be diluted if such a payment was deductible since then the cost would be shared with the general population of taxpayers.

The case provides a very useful reminder that, while previous cases might provide some distinctions between the tax treatment of certain payments, in trying to apply any such distinction to a general concept such as deductibility and a specific payment it is always necessary to frame the question in the fundamental requirements of the statute and the specific reason for the payment and not get blinded by applying a seemingly broad distinction inappropriately.

Single company can't extend ownership period for SSE

In *M Group Holdings Ltd v HMRC*, the UT has agreed with the FTT that a reorganisation under which M Group Holdings Ltd (MGHL) a standalone company without any subsidiaries, established a subsidiary, transferred its trade to the subsidiary and then sold the subsidiary 11 months after its establishment did not allow MGHL to benefit from the group continuity rules for extending its ownership of the new subsidiary to the twelve months for MGHL to be able to claim substantial shareholding exemption (SSE) on its sale of the subsidiary shares because MGHL had not been a member of a "group" prior to the establishment of the subsidiary.

MGHL was owned by a single individual shareholder. In 2015 its owner started to receive interest from potential purchasers. MGHL had contingent tax liabilities which made it a less attractive company to acquire. Accordingly, MGHL established a subsidiary in June 2015 and transferred its business to it in September 2015, leaving the contingent tax liabilities in MGHL. MGHL disposed of the subsidiary in May 2016. MGHL claimed SSE applying paragraph 15A Schedule 7AC TCGA. In order to qualify for SSE the selling company must have owned the shares that it disposes of for at least 12 months. Its actual ownership period can be extended in certain circumstances applying “group continuity” provisions in the SSE rules. Under paragraph 15A, the selling company (MGHL) is treated as owning its subsidiary shares for any period during which an asset used for the purpose of a trade carried on by the subsidiary and that was transferred to the subsidiary by a member of the relevant group was used by “a member of [the] group” for the purpose of a trade carried on by the member at a time that it was such a member.

The question in issue was whether MGHL was “a member of a group” when it was a standalone company and before the establishment of its subsidiary.

MGHL argued that it was possible for a group to have only one member and that the purpose of the rule was to extend ownership for the period during which the relevant asset was used for the purpose of a trade by companies under common ownership (as here). In support MGHL’s counsel offered the plain language example of a class of children (a group) being divided into two sub-groups, each of which was a “group” and one of which could contain one (or no) children. The UT dismissed this argument saying that it was seeking to apply a colloquial approach to the term “group” and ignored the plain terms of the way in which group is defined in section 170 TCGA (referring to “the principal company and all of its 75% subsidiaries forming a group”) and its use in the raft of capital gains tax provisions that apply to groups.

MGHL also sought to argue that the way in which paragraph 15A is constructed meant that there was not a requirement that MGHL was a member of a group and using the assets throughout the period required to meet the 12 months (taking into account the actual time that the subsidiary owned the assets). Paragraph 15A states that paragraph 15A(3) applies if the conditions in paragraph 15A(2) are met. The condition in paragraph 15A(2)(d) is that “the asset was previously used by a member of the group (other than the company invested in) for the purposes of a trade carried on by that member at a time when it was such a member”. Paragraph 15A(3) states that MGHL “is to be treated as having held the [shares in the subsidiary] at any time during the final 12-month period when the asset was used as mentioned in sub-paragraph (2)(d) (if it did not hold a [shares in the subsidiary] at that time)”. MGHL argued that all that was required in paragraph 15A(3) was that the assets had been used by MGHL for the purpose of its trade at the time that they were transferred to the subsidiary (that being the way in which the assets were used by MGHL as referred to in paragraph 15A(2)(d)) and that MGHL did not have to have been a member of a group during that time (in this case the one month of May 2015 before it established its subsidiary and so became a member of a group). In support of this MGHL argued that this construction would support the policy purpose of the time extension and that, otherwise, the rules created an arbitrary distinction between the situation for MGHL as a standalone company and its situation if, for instance, it had owned a dormant subsidiary.

The UT considered the general requirements of statutory construction and that it was bound to seek to interpret the words of the statute in their plain meaning in the context of the purpose of the statute in question and that where the statute included definitions of terms the starting point would be construing the terms of the definition. This approach should only be deviated from when it would result in an absurd result in which case the courts might consider how the terms of the statute could be construed to avoid such a result. The UT considered, in this case, that the terms of paragraph 15A were clearly intended to apply to transfers between group members and that the words “member at a time when [MGHL] was such a member” were clearly intended to apply to the time at which the relevant assets were used by MGHL and should be read into paragraph 15A(3). The fact that there might be anomalous situations not covered by the construction of the statute, or even that Parliament might have legislated for the anomaly had it thought about it, is not sufficient to override the plain meaning of the legislation. In this case that plain meaning was to extend periods of ownership where assets had been used in a trade carried on by a company in a group at the time that it carried on the trade. While it was unfortunate that MGHL had not delayed the sale of its subsidiary by a month that was not enough to extend the clear meaning of what was a reasonably prescriptive set of rules the result was not absurd or unjust in the context of the rules and their purpose.

The case highlights the risks of seeking to apply seemingly attractive everyday analogies to tax statute, the requirement to always seek to ascertain the purpose of legislation and apply it to the relevant facts and that the more prescriptive the terms of the legislation the less leeway there will be to try to extend its natural, everyday meaning even where that meaning might give rise to what is considered to be an unfair or anomalous result.

Film investment scheme not trading with a view to profit

In *Gala Film Partners LLP v HMRC*, the FTT has considered another film scheme and held that it was not effective because the participants were not carrying on a trade with a view to profit. The scheme involved high net worth individuals (HNWIs) investing in an LLP which was purportedly established to exploit opportunities to distribute films produced by Sony. As is generally the case with this sort of arrangement, the LLP incurred material expenditure in its first year and claimed that there was a possibility that it would then make a profit in later years. Sony had an option to acquire the relevant film distribution rights in three years for an agreed price. The intention was that the HNWIs (who funded most of their investment in the LLP using loans which were secured against effectively guaranteed payments to them from the LLP) could claim relief for their share of the first year losses against their other income and that the profit made on the exercise of the option (if it was exercised) would be taxable as a capital gain at a lower rate than the income tax saved by the loss relief so that the HNWIs made an overall tax profit from their investment in the LLP.

Not surprisingly, and in line with similar recent cases, the FTT agreed with HMRC's argument that the LLP was not carrying on a trade or if it was it was not carrying on a trade "with a view to profit". In broad terms, this was because the FTT felt that, on the facts, there was never a realistic prospect of the LLP exploiting the distribution rights and making an actual profit. The FTT also found that the LLP's expenses were not incurred wholly and exclusively for the purpose of a trade and that, in any event, they were capital in nature so would not have generated a deductible trading loss anyway.

What is more notable about this case is that the judgment runs to over 300 pages and includes a very detailed summary of the facts which are not materially different to the details of similar sorts of loss schemes that have been considered by the courts recently. Given that the points considered are predominantly factual, and given the amounts at stake, it may be that the FTT was presented with a very detailed picture of the facts but there does seem to be an unwelcome trend for the FTT to publish long and detailed decisions, perhaps to try to mitigate against the possibility of a successful appeals, which can make it difficult to extract the pertinent elements of the decision.

Employment related securities regime takes priority over termination payments regime

In *Hemingway v* HMRC, the FTT has dismissed the taxpayer's appeal that a payment made to him in respect of the cancellation of stock options was exempt from tax under section 401 ITEPA as a payment made in connection with the termination of employment, and that instead that the payment was taxable under the employment related securities option rules in Part 7 ITEPA.

Mr Hemingway held options over shares in the US parent of the UK company that he worked for. In February 2016, the group was the subject of a merger and he was paid £19,549 reflecting a payment of £35,228 in respect of his share options which lapsed and a deduction of £15,679 in respect of his PAYE and employee and employer NICs obligations (the share option terms included a joint election for the option holder to be liable for employer NICs although the details of how the election operated were disputed). Mr Hemingway then sought to amend his tax return claiming that the payment was not subject to tax under the employment-related securities options rules in Chapter 5 Part 7 ITEPA, that the employer NICs election did not apply to the payment and that the payment was, instead, a payment in connection with the termination of his employment to which section 401 ITEPA applied so that £30,000 of it was exempt from tax.

The FTT rejected the taxpayer's argument on all points. The FTT accepted HMRC's position, based on the terms of merger agreement and its reference to payment being made for cancellation of the options, that the payment was covered by section 477(3)(c) ITEPA as the receipt of a benefit in connection with the option and that the employment-related securities options charge took priority over section 401 ITEPA because section 401(3) states that it does not apply to a payment or other benefit chargeable to income tax other than under Chapter 3 Part 6 ITEPA (which includes section 401). It was for the taxpayer to show that the payment was not chargeable under the employment-related securities option regime and the FTT accepted that the words "in connection with" in section 477(3)(c) ITEPA were broad in scope and clearly covered the payment received by Mr Hemingway.

Alternatively, the FTT found that the payment made to Mr Hemingway was most closely connected to the loss of the of his share options. He was offered alternative share options under the merger and chose not to take them. Therefore, the receipt of the payment was also held to be paid out in respect of section 477(6) ITEPA as being in consideration with failing to acquire securities in connection with his share option.

The case provides an interesting discussion on the interaction between the two employment-related regimes in Part 6 and Part 7 ITEPA and shows that a careful analysis is required by taxpayers hoping to benefit from the £30,000 exemption in section 401 of the reason why they are receiving a payment that might be in connection with the termination of their employment but might also be in connection with something else.

Other UK Tax Developments

Government confirms repeal of 1.5% stamp duty/SDRT charge

The government has confirmed it intends to amend the stamp duty and stamp duty reserve tax (SDRT) legislation to remove the 1.5% “season ticket” charge on the issue of securities into depositary receipt or clearance systems and on transfers into such systems which are integral to capital raising. The government also intends to remove the 1.5% (or 0.2% charge) on the issue of bearer instruments.

Although these charges have existed in UK tax law for a number of years, taxpayers have not been required to pay them and HMRC have not been collecting them since 2009 as they were judged to be incompatible with the EU Capital Duties Directive, which (until the UK left the EU) has had direct effect in the UK.

As described in our August UK Tax Round Up, the Capital Duties Directive will cease to have direct effect in the UK from 1 January 2024 under the Retained EU Law (Revocation and Reform) Act 2023 and there had been some concern that this would reintroduce the 1.5% charge in full. However, the government has confirmed that it intends to introduce legislation in the Finance Bill 2023-2024 to preserve the status quo by narrowing the scope of the domestic law charges to match the position which has existed in practice for a number of years.

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