Proskauer

UK Tax Round Up

July 2024

Welcome to the July edition of the UK Tax Round Up. This month features a call for evidence from the government on potential changes to the tax on carried interest and interesting decisions on the application of the carried interest tax regime rules, the non deductibility of costs related to share and business sales, whether a UK company was resident in the US for double tax treaty purposes by reason of domestic US tax rules and a "special capital" scheme on similar terms to the recent BlueCrest case.

UK Government Consultation on Carried Interest Tax

The newly elected UK Labour government has published a call for evidence on the taxation of carried interest. This consultation by HM Treasury, which has been expected following statements made during Labour's election campaign, will remain open until 30 August 2024 during which time the government has committed to discussing the issues raised with interested parties.

In its call to evidence the government has reiterated its commitment to taking action on the taxation of carried interest noting that "this will be an impactful change". The question is what form any change to the current rules will take.

HM Treasury is seeking input from industry, professions, academics and other stakeholders on matters they consider relevant, with a particular focus at this stage on the following three questions:

- How can the tax treatment of carried interest most appropriately reflect its economic characteristics?
- What are the different structures and market practices with respect to carried interest?
- Are there lessons that can be learned from approaches taken in other countries?

While the call for evidence includes the statement that “the current [UK] tax regime does not appropriately reflect the economic characteristics of carried interest and the level of risk assumed by fund managers in receipt of it”, it also states that the government will “seek to protect the UK’s position as a world-leading asset management hub, recognising that the sector channels vital investment across the UK, and will play an important role in this government’s mission to boost economic growth”.

The government’s belief that “there are a range of circumstances in which carried interest is received, and that the characteristics of the reward will not be the same in all cases” is also stated in connection with the first of the questions for consultation.

There will no doubt be considerable engagement with the government on this issue and interest parties should provide any response by 30 August with HM Treasury stating that stakeholders should expect a further announcement on the changes in the Budget on 30 October.

UK Case Law Developments

Carried interest tax regime not applied as investment services not “in respect of” investment scheme

In *Millican v HMRC*, the First-tier Tribunal (FTT) has considered whether the special capital gains tax (CGT) regime applicable to carried interest in section 103KA TCGA 1992 applied to amounts received by the taxpayer. It has held that the special tax regime did not apply because, while the taxpayer did perform “investment management services” and received what was carried interest as a result, he did not perform the investment management services “in respect of” an “investment scheme” as required under section 103KA. This meant that the carried interest was subject to CGT applying the general rules, with the top rate of 20% rather than 28%, and with the so called “base cost shift” applying to reduce his chargeable gain.

Under section 103KA TCGA, the special carried interest tax regime applies if an individual performs investment management services “in respect of” an “investment scheme” under arrangements involving at least one partnership and carried interest arises to the individual under the arrangements. An “investment scheme” is defined for these purposes exhaustively as either a collective investment scheme as defined in section 235 FSMA 2000 or an approved investment trust.

The transaction involved the taxpayer (Mr Millican) providing investment advice to a UK limited liability partnership (EPIC Investor LLP). The members of EPIC Investor LLP (the Fund LLP) were another UK limited liability partnership (Greycoat EPIC Capital LLP (GEC LLP)) and a number of limited partnership fund vehicles managed by Cheyne Capital (the Cheyne funds). Mr Millican was a member of GEC LLP. The other member of GEC LLP was another UK limited liability partnership (Greycoat Real Estate LLP (GRE LLP)) of which Mr Millican was also a member.

The Fund LLP's limited liability partnership (LLP) deed stated that all of its members were responsible for the day-to-day management of its assets. It was accepted by HMRC (and so accepted by the FTT) that this meant that the Fund LLP was not an investment scheme for the purposes of section 103KA TCGA because it fell within an exclusion from being a collective investment scheme as defined in section 235 FSMA. The Cheyne funds that were members of EPIC Investor LLP were collective investment schemes and so investment schemes for the purpose of section 103KA TCGA.

GEC LLP was a party to the Fund LLP's limited partnership deed as a member of the Fund LLP. In its original terms, GEC LLP had agreed to provide "advisory services" to the Fund LLP in consideration for a fee that, it appears from the judgement, was payable by the Cheyne funds. The Fund LLP deed was then amended, in order to reduce the VAT liability on the fee, to state that the advisory services were provided to the Cheyne funds and "where relevant, to [the Fund LLP]". GEC LLP then delegated the provision of the advisory services to GRE LLP.

HMRC argued that the amount received by Mr Millican (which it was accepted was "carried interest") was received by Mr Millican (and "arose" to him) as a result of him (through GRE LLP and GEC LLP) providing investment management services "in respect of" the Cheyne funds, being the party to which the services were stated as being provided to. HMRC also argued that the description of "investment management services" in section 809EZE ITA 2007 was not exhaustive and extended to the advice that Mr Millican provided through GRE LLP. The FTT stated that while the definition was not exhaustive, it was limited to those activities specifically referred to and other activities which were investment management, and not investment advisory, services. However, the service provided by Mr Millican fell within "researching potential investments" as referred to in paragraph (c) of the defined term (in addition GRE LLP's activity of acting as the Fund LLP's nominee on the board of the company that it was invested in amounted to investment management services as a general matter). This interpretation of the term "investment management services" is arguably narrower than that set out in HMRC's *Investment Funds Manual*, which states that "Any activity which supports or facilitates the management of an investment scheme in a meaningful way is considered to be provision of investment management services", although investment advisers are likely to fall within the head of "researching potential investments". So, in practice, the distinction between investment management and investment advice drawn by the FTT might be of limited practical effect.

The FTT then considered whether the services had been performed "in respect of" only the Fund LLP or also in respect of the Cheyne funds. If the former, then section 103KA TCGA would not apply to the carried interest because it was accepted that the Fund LLP was not an "investment scheme".

As stated, the Fund LLP under which GEC LLP provided the services stated that the services were provided to the Cheyne funds and, "where relevant, to [the Fund LLP]" and were paid for by the Cheyne funds. However, the FTT concluded that the services were performed "in respect of" only the Fund LLP since the provision of the services "related" only to the Fund LLP since the only purpose of GEC LLP in providing the services was to enhance the profitability of the Fund LLP (and it was not concerned with the profitability of the Cheyne funds).

HMRC raised a further point, that the provisions in section 59A TCGA deeming a UK LLP to be tax transparent and that the dealing of the LLP should be treated as the dealings of its members meant that GEC LLP should be deemed to provide its services in respect of the Fund LLP's members (that is, the Cheyne funds). The FTT rejected this argument stating that the deeming provisions did not go so far as to treat services provided "in respect of" the Fund LLP, an entity with legal personality capable of receiving services in its own right, to be provided in respect of its members.

The final point of interest was the FTT's statement that, although the parties had accepted that the Fund LLP was not a collective investment scheme because its deed provided for its members to have day to day control over the management of its assets, it was sceptical about that position standing up to scrutiny, noting that had it been argued and decided that the Fund LLP was a collective investment scheme, the carried interest would have been subject to tax under section 103KA TCGA.

So, while the decision in the case revolves around the specific structure being considered, and the acceptance by the parties that the Fund LLP was not a collective investment scheme, it provides interesting commentary on the meaning of "investment management services" and the link required for those services to be performed "in respect of" a particular investment entity.

Expenses incurred in respect of share and asset sale not deductible from early stage

In *Centrica Overseas Holdings Limited v HMRC*, the Supreme Court (SC) has upheld the Court of Appeal's (CA's) decision from November 2022 that certain advisers' fees incurred by Centrica Overseas Holdings Ltd (COHL) in respect of a proposed sale of its Dutch subsidiary, Oxxio, were not deductible as expenses of management because they were capital in nature.

We discussed the CA's decision in the November 2022 edition of the UK Tax Round Up and this SC decision in our TaxTalks blog. In broad summary, the Centrica group decided to sell Oxxio in June or July 2009 and sold the businesses of two of Oxxio's subsidiaries (as an asset sale) and the shares in a third subsidiary in March 2011. Between 2009 and 2011, COHL incurred certain professional advisers' expenses relating to the sale for services ranging from considering how best to realise value from the Oxxio business to advice on structuring and preparing the details of the final transaction.

COHL had claimed all of the expenses as deductible expenses of management under section 1219 CTA 2009. Expenses of a holding company are not deductible as expenses of management under section 1219(3)(b) if they are “of a capital nature”.

Prior to the CA’s decision in this case, it had generally been expected that holding companies’ expenses related to the disposal of their investments would be deductible until a decision had been taken about a specific sale transaction. In that case, COHL had argued that the exclusion for expenses of a capital nature only applied to expenses which were included as an inherent cost of the sale (such as stamp duty) and that the exclusion should be read in the context of the activities of companies with investment business, which related largely to capital transactions. The CA had held that the questions of what was an expense of management and whether such an expense were capital in nature were distinct and that the capital in nature question should be answered applying general law principles rather than being coloured by the activities of investment companies. The capital or revenue question for section 1219 CTA 2009 purposes was the same as the section 53 CTA 2009 test for trading companies which also excludes items of a capital nature.

The SC agreed with the CA and held that the CA was correct both in deciding that the Upper Tribunal (UT) had made an error in law by conflating the expenses of management and capital nature questions rather than considering them separately and in deciding that all of COHL’s expenses incurred from the 2009 decision to sell Oxxio were capital in nature because they related to a capital transaction. It effectively limited an investment company’s deductible expenses of management to the ongoing expenses of managing its investments, such as salaries, rent and administration costs.

As a decision of the SC, this effectively confirms that once a company with investment business (such as a group holding company) has formed a firm idea that it will enter into a capital transaction (such as selling a subsidiary or subsidiary’s business), related costs incurred, even before a decision is made as to what transaction will be entered into, are very unlikely to qualify as deductible expenses because they will be capital in nature.

LLP members’ receipt from a capital allocation plan is miscellaneous income

In *HFFX LLP v HMRC*, the CA has unsurprisingly confirmed the decision of the UT that amounts received by members of HFFX LLP (the LLP) as reallocations of capital originally financed from the income profits of the LLP through a so called capital allocation plan (CAP) were subject to income tax under section 687 ITTOIA 2005 as miscellaneous income. This followed last year's CA decision in the *BlueCrest Capital Management LP v HMRC* case on the same point in respect of a very similar arrangement referred to as a partnership incentive plan (or PIP).

In this case, employees of a company in the GSA group who carried out the group's high frequency currency trading activities set up and became individual members of the LLP. In addition, two companies in the GSA group (GSACP and GSAM) became corporate members of the LLP. The individual members were seconded back to GSACP and, in consideration, the LLP was entitled to 50% of GSACP's profits generated by the team's activities.

The LLP's profits were then split so that the individual members each received £100,000 per year and 50% of the bonus that they would have received if the CAP arrangements were not put in place. The other 50% of residual profit was paid to GSAM which was subject to UK corporation tax on it. GSAM then contributed it to the LLP as "special capital". GSAM invested it into certain funds managed by the group. Then, following a recommendation from the GSA group, GSAM agreed that the relevant amount of capital be reallocated to the relevant individual members and the members extracted the capital as cash. The intention was that the cash withdrawn by the individual members was not subject to tax.

HMRC had argued that the amount received by the individual members should either be taxed as their income, applying the general partnership income tax rule in section 850 ITTOIA, because they were always entitled to it or should be taxed as income under section 687 ITTOIA as miscellaneous income or under the sale of occupational income rules in Chapter 4 Part 13 ITA 2007. The UT had decided against HMRC on the section 850 ITTOIA point, in favour of HMRC on the miscellaneous income point and would have found in favour of HMRC on the sale of occupational income point had it been required.

Since the UT's decision in *HFFX*, the CA had concluded in *BlueCrest* that the members under the PIP in that case were subject to income tax on the capital that they received under the miscellaneous income rules. In order for the amount to be taxed under that rule (applying principles relevant to the old Case VI of Schedule D which the miscellaneous income rules replaced), the receipt had to be "income" in the hands of the recipients and had to derive from a "source". The CA in *BlueCrest* had concluded that the receipt by the individual members of capital contributed by the LLP's corporate member as special capital that was reallocated to and extracted by the individual members was income in their hands (as it derived from the LLP's income receipts) and did have a source (being the combination of the terms of the PIP in the LLP's limited liability partnership agreement and the decision of the administrator of the PIP to reallocate the special capital to the individuals).

In this case, the LLP tried to distinguish the case from *BlueCrest* on the details of the CAP arrangement and also sought to argue that, in order for there to be a "source" of the income receipt, the individual members had to have a legal right to the income. Without further discussion it was accepted by HMRC and HFFX that the amount received by the individuals was income.

The CA discussed the question of source and how GSAM should use its discretion to reallocate the special capital in similar terms to the discussion by the CA in the *BlueCrest* case. Unsurprisingly, the CA came to the same conclusion, that there was no requirement for the individual members to have a legal right to the receipt for it to be linked to a source. It was sufficient that there was an arrangement in place that provided for the payment to them, albeit subject to certain decisions, and that the combination of the terms of the CAP arrangement in the LLP's agreement and the decision by GSAM to reallocate the special capital was a source. This was contrasted with a real, freestanding decision that might be taken to make a gift to someone that would not have a source. The CA also concluded that, in the context of the CAP, in which the trustees had to use their discretion to decide whether or not to agree to the recommendation for reallocation, the general legal principles required them to apply their discretion in a rational, rather than an irrational and capricious, manner.

Given the very similar terms of the CAP in this case to the PIP in the *BlueCrest* case and the CA's decision in the latter, it is unsurprising that the CA came to the conclusion that it did, and this decision might further cement HMRC's current use of the miscellaneous income rule to defeat structured arrangements designed to convert income into capital, or untaxed receipts, in the hands of individuals.

US deemed residence rule not sufficient for UK?US double tax treaty test

In *GE Financial Investments v HMRC*, the CA has overturned the previous decision of the UT and held that a provision in the US tax code that deemed a non-US incorporated (or "foreign") company that had its shares stapled with a US corporation to be a US "domestic" company and so subject to US tax on its worldwide profits rather than only those profits attributable to trade carried on in the US.

GE Financial Investments (GEFI) was a UK incorporated and tax resident member of the General Electrics group. In 2003, it issued some US dollar shares and those shares were stapled with shares in a US incorporated subsidiary of the GE group (GEFI Inc). As a result, GEFI was treated as a US domestic company applying the stapled share rule referred to above. GEFI paid US tax of about $303 million on its profits for the relevant period and also £124 million plus £64 million of tax and interest in the UK.

The appeal was on two points:

- HMRC appealed the UT's decision that GEFI should be treated as "resident" in the US for the purposes of the UK/US double tax treaty (the Treaty) by reason of the stapled share deemed domestic corporation rule; and
- GEFI appealed the UT's decision that GEFI had not been engaged in a "business" through a permanent establishment in the US for the purposes of Article 7 of the Treaty.

The second point arise because GEFI was a limited partner in a Delaware limited partnership which had a US incorporated and tax resident company as its general partner. The partnership held certain USD denominated loans. The UT had determined, and the CA agreed, that this activity was not sufficient to mean that GEFI carried on a business through a permanent establishment in the US for the purposes of the Treaty.

The majority of the judgement considers the first point and whether GEFI should be treated as “resident in” the US for the purpose of the Treaty. Article 4 of the Treaty states that a person is a resident of the US if it is “liable to tax [in the US] by reason of its domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature”.

GEFI argued that the terms of Article 4 were really seeking to differentiate between companies that were subject to tax in the US on their worldwide income and companies that were only subject to tax on income with a US source (such as carrying on business in the US through a permanent establishment). GEFI also referred to the memorandum of understanding accompanying the US/Netherlands double tax treaty which implied that the Netherlands accepted that non-US domestic companies deemed to be US domestic companies under US law were treated as resident in the US for the purpose of that treaty.

The CA started its analysis by stating that it was incontrovertible that GEFI could not “in fact” be regarded as satisfying any of the residence criteria in Article 4. The CA then went on to consider how a double tax treaty should be interpreted applying the relevant domestic (US and UK) law and applicable OECD and model tax convention commentary.

The CA concluded that the terms should be considered on their face in the absence of clear guidance to the contrary and that whatever the US and the Netherlands might have agreed in respect of a different treaty could not simply be read as applying to the agreement between the US and the UK in respect of the Treaty.

Applying these principles, the CA concluded that the deemed US domestic corporation treatment of GEFI, and the consequent US tax on its worldwide income, was not sufficient to make it US resident for the purpose of Article 4, since all of the criteria in Article 4 related to the entity itself and the manner in which it was established or conducted its business whereas the US stapling rule applied by reference to only the terms of its shares. While a key purpose of double tax treaties was to avoid double taxation, the words of the Treaty could not be overlooked in trying to achieve that objective in the light of a particular and specific domestic law provision such as the US stapled share rule. The CA considered the purpose of the Treaty in a slightly different way, saying that it was to agree the apportionment of taxing rights between contracting states and that this was done generally by distinguishing between “active” and “passive” income. In this case, GEFI had no actual “active” US income even though the US domestic law provision deemed it to.

Accordingly, the CA concluded that GEFI was not “resident in” the US for the purposes of the Treaty and so the UK was not required to grant it double tax relief in respect of its US tax.

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