Proskauer

UK Tax Round Up

January 2025

Welcome to the January 2025 edition of our UK Tax Round Up. This month has seen a very interesting decision of the Court of Appeal on the significant influence test in the salaried member rules and decisions on the tax deductibility of redress payments made instead of penalty payments and the tax treatment of image right payments in the context of IR35.

UK Case Law Developments

Basis of significant influence in salaried member rules

In *BlueCrest Capital Management (UK) LLP v HMRC*, the Court of Appeal (CA) has applied a narrow interpretation to the "significant influence" condition in the salaried member rules (the Rules) and held that the First-tier Tribunal (FTT) and the Upper Tribunal (UT) erred in law in their application of the condition to certain members of BlueCrest Capital Management (UK) LLP (BlueCrest). The CA has remitted the case back to the FTT for reconsideration applying the correct approach to the condition.

The facts of the case and summary of the decision are discussed in our Tax Talks blog. For additional background to the Rules and the prior decisions of the FTT and UT, please refer to our *Tax Talks* blog posts here and here.

As a high-level reminder, the salaried members rules operate to classify certain LLP members as employees for income tax purposes (as salaried members) unless they "fail" at least one of three conditions (Condition A, Condition B and/or Condition C). Condition A considers whether sufficient of a member's remuneration is determined by reference to the LLP's overall profits and Condition B focuses on the member's influence over the LLP's affairs. Condition C was not relevant to this case.

The disputed issue in the case was whether certain “investment managers” were or were not salaried members. The individuals (the senior IMs) in question had investment management responsibility for a pot of at least £100 million of capital managed by BlueCrest. BlueCrest argued that this gave them “significant influence” over BlueCrest’s affairs (or a significant part of them) and that their remuneration meant that more than 20% of it was variable by reference to BlueCrest’s profits (because it would be pared back if BlueCrest made a loss or insufficient profits).

The focus of the CA’s decision was on the FTT’s and UT’s interpretation of the “significant influence” test in Condition B. Each of the FTT and the UT had decided that the senior IMs did have significant influence over the affairs of BlueCrest because the management of each of their portfolios was an important part of BlueCrest’s business and their influence could be ascertained through the way BlueCrest’s business was operated rather than simply by reference to the senior IMs’ responsibilities as set out in BlueCrest’s governing documents (the LLP agreement and, to the extent relevant, the Limited Liability Partnerships Regulations 2001). HMRC disagreed with the former point and argued that the significant influence had to be a management level influence over the affairs as a whole, but did not object to the latter point that the influence did not need to derive directly from BlueCrest’s governing agreements and could be de facto influence.

The test in Condition B is that “the mutual rights and duties of the members of the limited liability partnership, and of the partnership and its members, do not give [the individual member] significant influence over the affairs of the partnership”. The CA concluded that the FTT and the UT had erred in law by adopting an overly broad interpretation of indicators that should be taken into consideration in assessing whether the individual member does have the requisite “significant influence”. The CA took the opportunity to clarify several points: Firstly, the CA determined that “influence” must extend to the “affairs of the LLP as a whole” and should not be limited to individual business areas or divisions, thereby supporting the position that HMRC has always maintained. Secondly, the CA found that the relevant influence must derive from the “mutual rights and duties” established in the LLP’s statutory and contractual framework, particularly the LLP agreement and the LLP Regulations. The CA emphasised that the legally binding rights and duties of members, rather than de facto influence that might be exercised through practice or the informal basis on which the affairs of the LLP in question were carried out, form the foundation for assessing Condition B. Lastly, the CA noted that, while evidence of de facto influence may be relevant, it serves only as a comparison to determine the significance of influence derived from mutual rights and duties. In the context of the case, the informal influence of others (in particular, Michael Pratt who was not a member of the LLP) could be taken into account to assess whether the formal influence of the members in question (here, the senior IMs) was “significant”, potentially because the informal influence of others might dilute the formal influence of the member(s) in question.

As a result, the CA has remitted the case to the FTT for the FTT to reconsider in light of this revised, narrowed basis on which the FTT should determine whether the senior IMs had significant influence. It is quite possible, however, that BlueCrest will appeal the decision so that, if granted, the question of how significant influence should be assessed and whether the “qualifying” influence can only derive from the formal “rights and duties” set out in the LLP’s governing documents will be considered by the Supreme Court before the case is reconsidered by the FTT.

While somewhat surprising that the CA chose to overturn the UT's decision on a basis not argued by HMRC, the decision does reinforce the importance of due consideration being given to the precise statutory wording in cases like this. The narrowing of the interpretation of Condition B will (subject to any appeal) strengthen HMRC's ability to challenge arrangements that might otherwise escape employment tax treatment. The case also provides some critical guidance, although perhaps not welcome guidance, for how to draft LLP agreements to mitigate the risk that members with real influence over the affairs of an LLP will not have the required significant influence because their rights and duties are not suitably documented. All taxpayers with LLP structures which seek to apply the significant influence exception to salaried member status should consider reviewing their governing documents and should continue to monitor the outcome of the case, which is likely to run for a while yet.

Redress payments deductible despite link to penalty payments

In *Scottish Power (SCLP) Ltd v HMRC*, the CA overturned the decisions of both the FTT and the UT, finding in favour of the taxpayer (SCLP). The CA considered the applicability of a longstanding rule of law, applicable to certain statutory penalties, to redress payments made to customers, customer groups and charities following an investigation by Ofgem into SCLP's misselling and other breaches, and opined on whether such payments were deductible when computing SCLP's taxable profits. HMRC had alleged that these payments were not deductible because they should have been treated in the same way as financial penalties.

In this case, SCLP had agreed with Ofgem that it would make redress payments of about £28 million. The payments were agreed with Ofgem to be structured as a £1 penalty and the rest as payments to customers, customer groups and charities. SCLP 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 agreed by Ofgem so that they could directly benefit the people affected by the misselling rather than being paid to Ofgem itself.

In each of the investigations, Ofgem proposed penalties following its investigation. After negotiations with Scottish Power, settlements were 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 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 "[Ofgem] considers it appropriate to impose a penalty on [Scottish Power]. However, [Scottish Power] has agreed to make contributions amounting to £[8.5] million in the form of compensation and payments to vulnerable customers. [Ofgem] 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, [Ofgem] 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.".

SCLP'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 had considered whether a penalty or compensatory payment should be deductible based on 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 claim payments because such claims 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 explained 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 the cost would then be shared with the general population of taxpayers.

The UT had agreed with the FTT that SCLP (and certain other companies in the group) was not entitled to a tax deduction for the payments because they were akin to and in lieu of penalty payments.

The CA, in overturning the UT's decision, acknowledged that, while there is a long-established rule of law preventing the deduction of financial penalties (established in *von Glehn*), there was no such rule of law extending to payments other than penalties, such as the redress payments made by the taxpayer.

The CA considered two separate justifications for the disallowance of penalties. Firstly, the position that penalties are incapable of being incurred "wholly and exclusively for the purposes of the trade" and so are, by their very nature, disallowable under section 54(1)(a) CTA 2009 and, secondly, the existence of the judge made rule of law (established in *von Glehn)* which requires certain statutory penalties to be classified as disallowable.

While the UT had focused on the "wholly and exclusively" requirement in section 54(1)(a), the CA considered the "*von Glehn* rule" as the key to determining the non-deductibility of penalties.

The CA took the position that the *von Glehn* rule was a legally required profit adjustment of the sort referred to in section 46(1) CTA 2009 that operated as an exception to the calculation of trading profits "in accordance with GAAP" and that such adjustment could be required by "judge made" rules if adequately clear in their application. By contrast, the CA found no authority to support an argument for extending the non-deductibility of payments to payments other than penalties, expressly noting that the scope of any such extension would exceed the judiciary's remit and carry a high degree of uncertainty. There was no authority for taking the view that deductibility could be determined by reference to the nature of the payment it replaces. It therefore followed that the judge made rule of law could only apply to penalties and not to amounts paid as alternatives to penalties.

Given that the CA had no difficulty in concluding that the redress payments had been incurred wholly and exclusively for the purposes of SCLP's trade, it held that the settlement, except for the nominal £1 penalty payment, did not include payments of a penalty and that the full amount of the payments (minus the £1 penalty payment) was deductible.

IR35 application to dual purpose contracts with reference to exploitation of image rights

In *Bryan Robson Limited v HMRC*, the FTT has allowed the taxpayer's appeal in part, opining on the application of the IR35 legislation to dual purpose contracts which include payments for both personal services and the exploitation of the individual's image rights and finding that the legislation could not be applied to any payment in respect of the image rights.

The case concerned a December 2019 contract between the personal service company (PSC) of former Manchester United (MU) and England footballer Bryan Robson (BR) and MU. BR, who served as a long-standing ambassador for MU, had previously engaged with the club on many occasions under personal agreements between himself and MU. Those agreements were not in dispute since the intermediaries' rules in IR35 didn't apply to them. It was a later contract, entered into in December 2019 and executed between MU and BR's PSC, that was the subject of the dispute. The contract granted MU the rights to use and commercially exploit BR's image globally while also obliging his company to ensure that he made a minimum of 35 personal appearances every six months. These engagements ranged from hosting at matches to attending sponsor events. The PSC would receive a fixed fee in return.

The case considered two questions, Firstly, whether the IR35 rules applied to the PSC at all or whether the "hypothetical contract" that would have existed between BR and MU had they contracted directly would have meant that BR was not an employee of MU. Secondly, whether the IR35 rules could apply to any remuneration that the PSC received that related to BR's image rights.

The taxpayer (the PSC), put forward two principal arguments. Firstly, it argued that the agreement was solely an image rights arrangement and, as such, fell outside the scope of IR35. Secondly, and in the alternative, even if IR35 were engaged, it should not apply to a portion of the arrangement that was attributable to the image rights.

The FTT rejected the first argument, clarifying that there is no requirement under the IR35 legislation for a contract to be exclusively for personal service to be caught. It is sufficient that such an obligation exists within the contractual framework. However, the FTT did accept the PSC's secondary argument. While the agreement did not provide an express apportionment of the consideration, evidence demonstrated that MU had a genuine commercial interest in BR's image rights and had actively exploited them. As such, the tribunal found that payments related to these rights fell outside IR35. This was notwithstanding the evidence that the amount payable under the contract was approximately equal to the amount that BR said that he would charge for 35 individually remunerated appearances for MU.

The FTT then assessed whether the remaining payments fell within IR35 by applying the well-established three stage test for employment from *Ready Mixed Concrete.* It held that, taking all the factors into consideration and the terms that the hypothetical contract between MU and BR would have contained, BR would have been an employee of MU and the IR35 rules applied to the PSC.

In conclusion, the FTT held that payments under the contract between MU and BR's PSC were subject to employment tax under IR35 but that an assessment should be made of how much, if any, of the payments were attributable to the right to use BR's image rights with those amounts being outside the scope of IR35.

As we have seen with a raft of recent IR35 cases, the decision underscores the difficulty in determining whether an arrangement using personal service companies will or will not fall within the scope of IR35 and how it can turn on details of the arrangement and HMRC's and the relevant tribunal's approach to them. It does, however, provide clarity that payments attributable to the use of image rights rather than to the personal services of the relevant individual should be outside the scope of IR35.

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