SLAUGHTER AND MAY/

CLIENT BRIEFING

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TAX AND THE CITY REVIEW FOR JUNE

In *Fowler*, an important case on tax treaty interpretation and the limits of deeming provisions, the Supreme Court determines that the taxpayer could not rely on a deeming provision under UK legislation to escape UK tax on his income under the UK/South Africa tax treaty. The Court of Appeal decides in favour of the taxpayers in *NCL Investments and Smith & Williamson* that the accounting debits recognised on the grant of share options to their employees by an employee benefit trust were deductible expenses for corporation tax purposes. The Court of Appeal in *Investec* highlights how complex the taxation of partnerships is, describing HMRC's approach as "work in progress". The Advocate General gives his opinion in the *United Biscuits* case that supplies of fund management services to defined benefit pension schemes are not within the "insurance transaction" exemption from VAT regardless of whether they are supplied by an insurer or a non-insurer.

Fowler: UK deeming rule did not apply to tax treaty

In *Fowler v HMRC* [2020] UKSC 22 the Supreme Court held, overturning the Court of Appeal's decision, that a South African resident diver was taxable in the UK on income from activities carried out in UK waters. This case illustrates the challenges of working out the extent to which a statutory deeming provision should apply and determining whether there is any place for deeming provisions in the interpretation of tax treaties.

Deeming provisions

The deeming provision in question is ITTOIA 2005 s 15(2) which provides that a qualifying diver who would otherwise be taxed as an employee is instead treated as self-employed for 'income tax purposes'.

Mr Fowler had argued this deemed self-employment treatment had to be applied to the construction of the UK/South Africa Treaty with the consequence that he would be taxed as a self-employed person under article 7 of the treaty rather than as an employee under article 14. If article 7 applied, he would be taxable only in South Africa where he was resident, as he did not have a permanent establishment in the UK. Article 14, on the other hand, would tax him only in the UK, where he worked. If Mr Fowler's argument had succeeded, he was unlikely to be actually subject to significant tax in South Africa because of the domestic law.

The Supreme Court followed the guidance on deeming provisions from earlier cases to ascertain the purpose of the statutory provision. According to this guidance, a deeming provision should not be applied so far as to produce unjust, absurd or anomalous results unless the court is required to by clear language.

The First-tier Tribunal (FTT) had established the purpose of s 15(2) is to give divers operating on the UK continental shelf more generous rights for deducting expenses than a normal employee would get (because historically employed divers provided their own equipment), but without taking them outside the UK income tax charge altogether. Accordingly, the Supreme Court concluded that the fiction created by s 15(2) does not decide whether qualifying divers *are* taxable in the UK upon their employment income, but determines *how* that income is to be taxed in the UK by applying a more generous deduction of expenses regime. The UK legislation itself continues to recognise the income as being charged to tax under s 15(2) as employment income (ITEPA 2003 s 6(5)).

The Supreme Court held that to apply the deeming provision to alter the meaning of terms in the treaty with the result of rendering a qualifying diver immune from UK tax would be contrary to its purpose and would produce an anomalous result.

Treaty construction

In order to determine which of articles 7 or 14 applied, those articles need to be read in the context of the purpose of the treaty itself. The Supreme Court concluded the purpose of a tax treaty is to resolve issues of double taxation and not to alter the basis of taxation adopted in each of the Contracting States or to dictate to each Contracting State how it should tax particular forms of receipts. The Supreme Court concluded that nothing in the UK/South Africa treaty requires articles 7 and 14 to be applied to the fictional, deemed world which may be created by UK income tax legislation.

This case shows it is important to bear in mind that a tax treaty is a bilateral, negotiated text. To permit, as the Court of Appeal did, the deeming provision to be applied to the treaty, would result in the UK ceding its taxing rights to the diving income to South Africa rather than those rights remaining with the UK as negotiated under the treaty. The Supreme Court's decision is a good result for HMRC and a useful addition to the cases on treaty interpretation.

NCL Investments: debits required by IFRS 2 were deductible expenses

The Court of Appeal dismissed HMRC's appeal in *HMRC v NCL Investments and Smith & Williamson* [2020] EWCA Civ 663 concerning the deductibility of expenses. The legislation has since been revised to prevent deductions in these specific circumstances but the case is still of wider interest for its approach to the interaction between accounting and tax rules, and the old chestnuts of 'revenue vs. capital' and 'wholly and exclusively'.

This case is the latest in a number of cases where HMRC has challenged the accounting treatment and failed (including before the FTT and Upper Tribunal (UT) in this case). It is also a further example of HMRC arguing (but failing to convince the court) that words in the tax legislation (such as 'expenses' and 'incurred') impose further checks on whether a debit required for GAAP purposes is deductible for corporation tax purposes.

The issue in this case was whether the taxpayers (which were the employing companies) were entitled to a deduction as a trading expense in respect of the accounting debits recognised in their respective accounts on the grant of share options to their employees by an employee benefit trust (the EBT).

Whenever the EBT trustee granted employees of the taxpayers an option to acquire shares in the parent of the taxpayers, SWHL, the taxpayers agreed to pay SWHL an amount equal to the fair value of the options granted to their respective employees. Under IFRS 2, any grant of share options by the EBT Trustee to employees triggered an obligation on the taxpayers to recognise an expense in their income statements equal to the fair value of the options that the EBT trustee had granted. These amounts would not necessarily be recognised immediately, but would be spread over a number of accounting periods and adjusted. No amounts were then recognised in the taxpayers' accounts in respect of the payments made to SWHL. A significant number of the options subsequently lapsed without being exercised.

The Court of Appeal dismissed all of HMRC's arguments concluding that the debits were deductible for corporation tax purposes on the basis that:

- The accounting treatment was a proper accounting treatment as the FTT had found (although David Richards LJ noted that 'this is not the first occasion on which GAAP has produced what may to the non-expert appear surprising results', referring to *Union Castle*).
- The UT was correct in its approach to CTA 2009 ss 46, 48 and 54. The combined effect of ss 46 and 48 is to define allowable expenses as those debits made in accordance with GAAP in calculating the profits of a trade. No further examination is required of whether such accounting debits were 'expenses'. The word 'incurred' in section 54(1)(a) does not have the effect for which HMRC argued (based on obiter in the UT decision in *Ingenious Games [2019]* UKUT 226) – it is sufficient that the debits in respect of the options were required by IFRS 2.
- The debits were wholly and exclusively for the purposes of the taxpayers' trades. They were required to be made in the taxpayers' profit and loss accounts as they represented the consumption of services provided by the employees to the taxpayers for the purposes of their trades. They were revenue not capital items. This will be helpful in any future revenue vs. capital debate with HMRC when trying to claim that one-off share plan related costs merit a corporation tax deduction.
- CTA 2009, s1290 does not apply to deny or defer allowance of the debits: the grant of share options by the EBT Trustee did not amount to an 'employee benefit contribution' within the meaning of s1291. HMRC's contention required a literal reading of s1291(1) which ignores the context created by s1290.

Investec - the complexity of partnership taxation

As the Court of Appeal's decision in *Investec Asset Finance PLC and Investec Bank PLC v HMRC* [2020] EWCA Civ 579 shows, the taxation of partnerships is a complex area, although the principle that partnerships are treated as transparent sounds simple enough. Case law shows that there is clearly a principle of no double taxation which should, in theory, prevent a company partner being taxed, in its own trade, on profits already taxed as part of a partnership trade. Yet the scope of that principle, and what constitutes the same profit or income at both levels, is often still unclear, may depend on the accounting treatment adopted at each level and might possibly depend on the form of any distribution.

It is somewhat surprising that how a partnership interest is accounted for, or whether a pre-sale profit distribution is made, or even possibly whether that distribution is income or capital, could make a difference to a partner's tax position. It could even result in a partner being taxed on more than their economic profit or, conversely, realising a tax loss bigger than any economic loss they might make. This is an unfortunate consequence of a fairly fundamental area of taxation still being 'work in progress' (as per Rose LJ in *Investec*).

There needs to be a proper, overarching review of the taxation of partnerships. The Office of Tax Simplification report in 2015 led to some improvements, including an extension of the guidance on partnerships in HMRC's manual. It would be preferable, however, to have comprehensive, clear legislation, rather than relying on guidance to fill in the blanks. HMRC's consultation on legislative changes launched in 2016 and implemented in FA 2018 tinkered with perceived loopholes and made changes to assessment and reporting to improve transparency but it is clear that this highly complicated area requires more attention.

United Biscuits: pension fund management services

In the latest development in the *United Biscuits* case (C239/19), Advocate General Pikamae (the AG) has given his opinion that pension fund management services provided by non-insurers to defined benefit (DB) pension schemes are not within the VAT exemption. If the CJEU follows this opinion, which seems likely, it will be bad news for United Biscuits and for the other non-insurers with historic claims stood behind this case.

Historically, HMRC had long taken the view that the management of DB pension schemes was taxable except when the management was performed by a regulated insurer. Following a change of practice, from 1 April 2019 the management of a DB scheme by an insurer became taxable, in like manner to the management of a DB scheme by anyone else so there is no longer a difference in treatment.

The previous exception for insurers arose because 'insurance transactions' are an exempt activity for VAT purposes but as this term has no statutory definition, HMRC interpreted this as including all of the activities of an insurer regulated under the Financial Services and Markets Act 2000 (Notice 701/36/13). EU VAT law, on the other hand, allows only pure insurance activity, i.e. the underwriting of specified risk for a premium, to be an exempt supply.

In *United Biscuits (Pension Trustees) Ltd v HMRC* [2017] EWHC 2895 (Ch), the trustee of the United Biscuits' DB pension scheme argued before the High Court that there was a breach of fiscal neutrality given that regulated insurers benefit from an exemption not afforded to others. The trustee claimed a refund of forty years' VAT paid on DB management fees which it argued should have been exempt. The High Court held that non-insurers' fund management supplies fall outside the insurance exemption and therefore should be subject to VAT when supplied to defined benefit schemes. The High Court determined that a referral to the CJEU was not necessary to reach this conclusion.

United Biscuits appealed to the Court of Appeal which did make a referral to the CJEU asking whether supplies of pension fund management services, as are provided to the pension trustees by insurers and/or non-Insurers, are within the meaning of Article 135(1)(a) of the VAT Directive (formerly Article 13B(a) of the Sixth Directive).

The AG's opinion is clear that the fund management activities in this case are not insurance activities and that what is alleged to be unequal treatment cannot bring non-insurance activities within the concept of an 'insurance transaction' that is exempted under EU law.

The UK has frequently adopted a broader interpretation of the scope of VAT exemptions for supplies of insurance services and for supplies of financial services (at least until required by EU pressure to narrow the scope). So this is an area to be watched for divergence from EU law at the end of the Brexit transition period. But, assuming the CJEU follows the AG's opinion, HMRC will be relieved not to have to pay out to non-insurers for their claims based on unequal treatment.

What to look out for:

- **The UK legislation to implement DAC6, the mandatory automatic exchange of information rules, comes into force on 1 July 2020, although the reporting dates may yet be delayed by a minimum of three months if agreement is reached on the EU Commission's proposals and the UK implements these changes.**

- Assuming Finance Bill 2020 is enacted as introduced, new rules will apply from 1 July 2020 extending the corporation tax regime for intangible assets contained in FA 2002 Part 8 to include those created prior to 1 April 2002.

- On 14 July the Court of Appeal is scheduled to hear the taxpayers' appeals against the UT's decision in *Irish Bank Resolution Corporation Ltd and another v HMRC* that the attribution of notional capital required by section 11AA(3)(b) of ICTA 1988 was compatible with the provisions of the UK/Republic of Ireland double tax treaty.

- A response to the call for evidence on insurance premium tax (IPT) is expected to be published this summer. This follows the consultation last summer on ways to improve the administration and collection of IPT and the call for evidence to identify certain practices which may lead to unfair tax outcomes. A consultation to seek further information is expected.

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