What is the true cost?

Management of taxes

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Bill Dodwell considers what the *Hargreaves Lansdown* case means for the tax treatment of costs

Key Points

What is the issue?

The *Hargreaves Lansdown* case asks questions about whether costs can be deducted from investment income and gains.

What does it mean to me?

The Upper Tribunal judges were interested only in what the contracts said – not in economic realities, unless they were directly reflected in the contracts.

What can I take away?

The overall message is that taxation is based on contracts, not economics. Businesses offering discounts to their customers need to make sure contracts are properly drawn up.

One of the wider issues in taxation is the extent to which costs may be deducted from investment income and gains. The answer, of course, is that it all depends…

The decision by then Chancellor George Osborne to limit interest deductions against income from residential rental property was criticised by many, on the basis that borrowing costs were part of the costs of buy-to-let properties. However, other forms of investment don't qualify for interest relief and so the logic of allowing interest against one category but not another remains unclear. If tax policy isn't intended to interfere with economics, then the case for any form of interest deduction is questionable.

The Hargreaves Lansdown decision

The *Hargreaves Lansdown* case asks questions about other types of costs. This is all about payments made by one of the UK's leading online platforms to its investors – and whether those payments should be subject to income tax. Rather oddly, the factual position wasn't especially clear – and First-tier Tribunal Judge Tom Scott criticised HMRC for not providing evidence to support their factual claims when the case came before him.

Lack of evidence turned out not to be a barrier for the Upper Tribunal. Judges Timothy Herrington and Nicholas Aleksander declared:

> 'The members of this Tribunal panel are knowledgeable about the regulation and taxation of investment funds and the manner in which investment funds are structured... We were able to inform the parties … as to the legal position regarding the payment of annual management charges, taking judicial notice of

> the relevant legal and regulatory provisions.'

The annual management charge

The judges were clear that the annual management charge was levied on each investment fund – whether or not it was a corporate open-ended investment company (OEIC) or a unit trust. The charge wasn't levied on the investors, albeit that economically they bore it, in the sense that their overall return was reduced by the costs. What then happened was that the fund manager made a payment to the platform provider out of its annual management charge. The platform provider kept part of the money to pay for the platform but also paid a 'loyalty bonus' to each investor.

What was the nature of this payment? Was this a mechanism for reducing the annual management charge, as Judge Tom Scott originally held:

> 'In my judgment, the evidence makes it plain that the nature and quality of a loyalty bonus payment is that it is not a "profit" to an investor, but a reduction of his net cost… HMRC's analysis seeks to recharacterise and unpick the various payment flows taking place on a fund investment in order to isolate the loyalty bonus and treat it as pure profit. That approach is not the way to establish objectively the nature and quality of the payment.'

The Upper Tribunal made a contractual analysis of the payments. Management charges were normally paid out of the income of the fund. It was clear that the liability to pay the charges rested with the fund alone. The contract between the fund and the investor recorded that the fund would pay charges to the manager. The payment by the fund manager to the platform was judged to be equivalent to a commission.

The loyalty bonus

Counsel for Hargreaves Lansdown argued that the payment of the loyalty bonus delivered a reduction in cost for investors, which achieved the same economic result of there having been a special class of share with a lower management charge thanks to the platform's negotiation.

This economic analysis didn't find favour in the Upper Tribunal. The problem for the taxpayer is that the judges were interested only in what the contracts said – not in economic realities, unless they were directly reflected in the contracts. Marketing material from Hargreaves Lansdown wasn't relevant. As a result, the Upper Tribunal concluded that Judge Tom Scott's ruling was wrong in law, as it wasn't based on the contractual analysis. Since the loyalty bonus wasn't a reduction in costs, the next question was how to characterise it.

The judges decided that they should remake the decision and concluded that:

> 'The correct characterisation of the arrangements is that the investor receives a further income distribution in respect of his investment in the fund as a result of his continuing investment… The term loyalty bonus is therefore a correct description; the payment does what it says on the tin – it rewards loyalty. We therefore conclude that the loyalty bonus is pure income profit.'

This meant that Hargreaves Lansdown should withhold basic rate income tax when making payments to investors.

The impact

The Upper Tribunal clearly convinced themselves that the loyalty bonus had an income character – and that exempting it from tax would have provided an inappropriate tax break. Judge Scott treated it as capital, which reduced the capital gains tax base cost. Provided that the investment was taxable (rather than, say, being held in a tax-exempt ISA), under his analysis the full return from the investment would have been taxable, albeit at different rates.

The overall message is that taxation is based on contracts, not economics. Businesses offering discounts to their customers need to make sure they are properly drawn up, otherwise an unexpected tax charge could arise.