UNITED KINGDOM TAX BULLETIN

Squire, Sanders & Dempsey

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SQUIRE SANDERS | LEGAL COUNSEL WORLDWIDE

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CURRENT RATES — January 2010

Indexation

Retail price index: December 2009	216.0
Inflation rate: December 2009	2.4%

Indexation factor from March 1982:

to April 1998	1.047
to December 2009	1.744

Interest on Overdue Tax

Interest on all unpaid tax is now charged at the same rate with effect from 29 September.

The formula is Bank base rate plus 2.5% which gives a present rate of 3%.

There is one exemption: Quarterly instalments of corporation tax bear interest at only 1.5%.

Repayment Supplement

Interest on all overpaid tax is now payable at the same rate.

The formula is Bank base rate minus 1% but with an overriding minimum of 0.5% which applies at the present time.

Official Rate of Interest: From 1 March 2009 4.75%

Tax Health Plan

The latest tax amnesty – known as the New Disclosure Opportunity – expired on 31 December 2009 and there are indications that the take up from this opportunity was a disappointment to HMRC.

Having regard to the wealth of information now available to HMRC and the "we will be merciless" messages directed at anybody failing to disclose income from offshore accounts, it will be interesting to see how this plays out. One might have thought that everybody who has any such undisclosed income would by now have made the relevant disclosures, but clearly HMRC do not think so.

They obviously like this amnesty idea because they have a new proposal – it is called the "Tax Health Plan". Some people may think this is a rather misleading title. It has nothing to do with health, tax health or health plans. It is a plan to tax doctors and dentists. You have to admire the spin.

The spin does not end with the title. The first line explains that medical professionals are being "encouraged to tell HMRC if they have understated their income". Isn't that lovely? If they make a voluntary disclosure before 31 March they will benefit from the certainty of a reduced 10% penalty.

The threat is that from April, HMRC are planning to use all the information at their disposal (e.g., medical insurance payment records) to investigate medical professionals who have not declared their full income. If they do not come clean now (and save HMRC a great deal of work in investigating them) they will be subject to much higher penalties.

Medical professionals need to consider the terms of this new opportunity very carefully because if such concealed income had been deposited offshore (which must surely be likely) it should have been disclosed already under the Offshore Disclosure Opportunities Mark I and II – in which case they cannot benefit from this new Health Plan.

If the doctors have been watching what has been going on with the disclosure of offshore accounts, they might be forgiven if they conclude that if they do not bother with this one, there will be another amnesty along later.

I am bound to say I find this both odd and extremely unsatisfactory. We are talking here about professional people who have deliberately concealed their earnings from HMRC. There is no misunderstanding or ignorance about this; they would have known exactly what they were doing and invariably would have had professional advisors from whom they also would have concealed this income. I seem to remember this was called fraud. Why then are they being given the benefit of a substantially mitigated penalty when small traders (and even big traders) who have concealed their profits are subject to the full rigour of the HMRC penalty regime?

I simply cannot understand why HMRC are not applying the rules more strictly. They are not famous for adopting a benign approach anywhere else.

Residence

The Tax Tribunal has recently heard another important residence case where a number of the key matters were examined in depth: *Hankinson v HMRC* TC 319. As it happens, the decision is very narrow in its application but there are some features in the judgment which may be of wider application.

In broad terms, Mr Hankinson left the UK in February 1998 to work in Holland, resuming UK residence some time after 5 April 1999. He claimed to be not resident in the UK for the intervening year 1998/99 on the basis of IR20 Paragraph 2.2 – i.e., he left the UK to work full time abroad under a contract of employment; his absence from the UK and his employment abroad lasted for at least a tax year and during his absence he spent an average of 91 days in the UK during the tax year.

HMRC did not agree so Mr Hankinson has had two appeals – one to the Tax Tribunal to argue that as a matter of law he should be regarded as non-resident for 1998/99 and the other to the Administrations Court by way of Judicial Review to the effect that HMRC should have allowed him to have the benefit of IR20, even though it is only a Revenue practice. (For those who have been on an extended visit to Narnia, this is a subject which is continuing to be a source of litigation – and yes, the decisions of the Court of Appeal on similar issues in the cases of *Gaines-Cooper* and *Davies & James* are still eagerly awaited. Stay tuned.)

The Tribunal dealt with the residence position as a matter of law – without regard to IR20. The legal tests for the determination of residence were examined at length; these are the factors which have emerged in recent years and which were last set out in the case of *Grace*. (These have been referred to many times in earlier *Tax Bulletins*, and they are not really relevant to the immediate comments here.)

Because Mr Hankinson was in the UK until February 1998 he was obviously resident for the whole of tax year 1997/98. During his absence, his family continued to reside at the family home Foxlea Manor and in the year 1998/99 he spent only 82 days in the UK. He became resident again in 1999/2000.

It will be remembered that prior to 1993 there was a rule that if a person had a place of abode available for his use in the UK, he would be resident even if he spent one day in the UK. That rule was abolished amid a great fanfare (but actually it was not really abolished – it was just restricted). The key provision is Section 335 TA 1988 which says that if a person works full time abroad and all the duties of the employment are performed outside the UK, the question whether he is resident in the UK is to be decided without regard to any place of abode maintained in the UK for his use.

What this really means is that the whole issue depended upon whether Mr Hankinson was working full time abroad.

Following a detailed analysis of Mr Hankinson's working arrangements, the Tribunal concluded that his employment abroad was not full time so he could not rely on Section 335. The availability of the place of abode in the UK for his use was therefore not to be ignored in determining the question of his residence. They concluded that:

> "*The pattern of his visits in the UK during 1998/99 taken together with a retention of Foxlea Manor where his wife continued to reside throughout that year, is sufficient to demonstrate that he remains resident in the UK for that year.*"

That was their conclusion on the strict legal position – although it is possible that Mr Hankinson may appeal. In the meantime he still has the Judicial Review proceedings in which he is saying that despite the strict legal position he should still be regarded as non-resident because he satisfied the terms of Paragraph 2.2 of IR20 and HMRC should be obliged to honour this statement of practice.

Unfortunately, the Tribunal found as a fact that his employment was not full time abroad which rather knocks out Paragraph 2.2 as well, and this might prove rather troublesome.

We will no doubt hear more about this in due course.

Company Residence

HMRC have published a statement about foreign companies that may have become resident in the UK. It is a bit odd – but I set out the details for what they are worth.

HMRC make it clear (as they do for individuals) that the company must decide for itself where it is resident. That is the nature of self assessment. HMRC will not provide a ruling or any other comfort.

When the relevant tax treaty has the normal residence tie-breaker clause, the company still needs to self-assess its residence. When the tie-breaker clause depends on agreement between the Competent Authorities, the company still has to self-assess its residence.

Whilst this is not particularly helpful, at least it makes the position clear. It is a matter of self assessment and you are on your own. There is no provision for confirmation with HMRC – although they do publish general explanations on the subject on their website.

The odd bit is the final sentence of the statement which says:

> "*Clearly, where a company wishes to achieve certainty regarding its residence status it will need to make representations to the relevant tax authorities.*"

This helpful statement is unfortunately empty. HMRC have made it clear that you can make whatever representations you like, but it is a matter of self assessment and they will not provide any such certainty. They have the right to challenge the self assessment if they disagree, but no conclusions can be drawn from their failure to do so.

Retrospective Legislation

As I write, the judgment in the case of *R (on the application of Robert Huitson) v HMRC* [2010] EWHC 97 appears on my screen surrounded by various news reports. The headlines may not necessarily tell the right story here.

This was an application for Judicial Review by somebody who had entered into a partnership scheme in the Isle of Man whereby a good part of his trading profits were intended to be sheltered by the terms of the UK/Isle of Man Double Taxation Agreement. It would seem that the arrangements, although provocative, were effective – but this was to no avail because in 2008, legislation was introduced to outlaw the arrangements with retrospective effect.

The taxpayer said that this was contrary to the European Convention of Human Rights and should be set aside.

The case was therefore not really about the tax issues at all but whether retrospective legislation is lawful in the UK. The traditional principle is that Parliament is entitled to enact any laws it chooses without any constitutional challenge – but this now has to be subject to European law. Accordingly, the question is whether Section 58 Finance Act 2008 should be rendered void on the grounds that it is incompatible with the European Convention of Human Rights. That was always going to be a tough call – and it is no surprise that the challenged legislation, despite having retrospective effect, was found to be valid.

Leaving all that aside, some rather disturbing comments were made by the court regarding the partnership arrangements. The idea was that the taxpayer entered into a partnership in the Isle of Man; the partnership received all the trading receipts and paid the taxpayer a modest fee, and he received further amounts by reason of his life interest in the trust. Those further amounts were protected from tax by the double taxation implications.

HMRC did not claim that these arrangements were a sham nor that they did not truly reflect the legal rights and obligations of the parties. The arrangements had genuine business efficacy. However, there was no doubt that they were entered into for the purposes of obtaining a tax advantage and not for a commercial purpose. On this basis, the Judge concluded that:

> "*The arrangements can therefore correctly be described as artificial.*"

The implications of such a view are rather alarming. If I am a sole trader paying tax at 40% (soon 50%) I might decide to operate my business through a company (and pay tax at 21%). It may be remembered that not long ago the Treasury were suggesting that this was a really good idea and encouraged small businesses to do so with some particularly favourable tax provisions. However, can it really be said that just because I decide to run my business through the medium of a limited company because this would be advantageous in terms of tax, my arrangements are correctly described as artificial and can therefore be attacked widely by HMRC? Some may regard this as rather an extreme view and maybe the Judge got a bit carried away. But maybe he didn't – and that is what is so alarming.

Tax Penalties on Advisors

It has recently been suggested that the new penalty regime introduced by the Finance Act 2007 could give rise to penalties on advisors. The legislation can be interpreted as meaning that the new rules extend to advisors but fortunately, HMRC have made it clear in correspondence (published by the Chartered Institute of Taxation on 17 December) that the provisions do not apply to advisors.

In particular, HMRC specifically confirm that the person becoming liable to the penalty is the taxpayer and a penalty cannot arise on the agent. The statement by HMRC is rather clearer than the legislation but never mind.

Surcharge

The case of *McMullan v HMRC* TC305 is an interesting case in which HMRC claimed a surcharge in respect of the late payment of tax. A surcharge arises if the tax due on 31 January is still outstanding on 28 February. The surcharge is 5% of the tax due and if the tax is still outstanding on 31 July, a further 5% surcharge arises. The taxpayer had paid the tax on the due date but his tax return was not filed until much later and in the meantime HMRC refunded the money. After he received his tax return they then decided he did owe some tax and imposed a surcharge.

Whatever penalties he may have been liable to for the failure to submit his tax return, it seems extraordinarily perverse for them to seek a surcharge on the basis that he had not paid the tax due within 30 days of the due date. He had clearly done so.

The taxpayer had paid his tax on 30 January and it had not been repaid until 15 August, and so HMRC had the money on 31 January and they still had it on 31 July. It is hardly a surprise that the Tribunal found the argument of HMRC to be misconceived.

Enterprise Investment Scheme

A person who subscribes for shares in a company in circumstances qualifying for the Enterprise Investment Scheme (EIS) can obtain income tax relief at the basic rate on the share subscription up to £500,000; furthermore, on disposal of the shares in the EIS company after a period of three years, the capital gain can be entirely free of capital gains tax.

One of the conditions for the application of the EIS is that 80% of the subscription monies are employed in the qualifying trade within a twelve-month period, and the balance of 20% is employed in the trade within a further twelve months.

The recent Tribunal decision in *Skye Inns v Richards* TC304 examined what is meant by the employment of the funds in the qualifying trade.

Mr Richards subscribed for shares in Skye Inns Limited as the company intended to purchase a particular pub and restaurant. Had the purchase gone through, it seems likely that 80% of the money subscribed by Mr Richards would have been employed in the company's business within the required twelve-month period.

However, the acquisition of the particular pub and restaurant fell through and although the directors continued searching for appropriate further acquisitions, they were unable to find an alternative and eventually reached the conclusion that the money was better used in undertaking improvements to its existing properties.

HMRC argued that when an acquisition was contemplated, the cash actually had to be used in the acquisition; merely reserving or earmarking it for the new purchase was insufficient. They said that even merely entering into a contract to make the purchase was not enough.

The Tribunal did not agree and took the view that exchanging contracts for the new business and binding the company to make the purchase may well be sufficient to satisfy the condition. Unfortunately, neither of these circumstances applied in this case because there was not even a contract to acquire the new business.

The taxpayer also argued that even though Skye Inns had abandoned the intention of acquiring a new property, they were employing the money in the trade because they were holding the funds to meet anticipated losses and to make capital improvements to the existing properties.

Unfortunately, there was no evidence to show that the company had decided to use the money in this way until after the twelve-month period had expired, and in any event working capital requirements had not resulted in sufficient funds being employed in the business to meet the 80% condition.

HMRC accepted that funds held on deposit could be said to be employed in the business only if it could be shown that the funds were required to meet business requirements within one month.

The Tribunal thought this was unrealistically and unjustifiably short and that whether or not it was held for this purpose was a question of fact to be determined by reference to the particular business.

Transfers to Offshore Companies

HMRC have published a technical note setting out a change in the rules where a UK resident company carries on trade outside the UK through a permanent establishment and that trade is transferred to a non-resident company in consideration for securities issued by the transferee company. There would normally be a charge on the gain arising from the transfer of the assets but such a gain is postponed until the disposal of the new shares or if the assets are disposed of within six years.

However, where the UK company receives consideration in the form of qualifying corporate bonds, they are not chargeable to tax on disposal and there is no mechanism to bring the postponed gain back into charge.

Accordingly, in these circumstances, there will be a special additional gain brought into charge to tax on the disposal of the qualifying corporate bonds.

Foreign Currency Bank Accounts

Further to the note last month on the capital gains tax treatment of foreign currency bank accounts, HMRC have published a new bit of guidance for remittance base users. A foreign currency bank account is a chargeable asset for capital gains purposes and any movement on that account will represent the disposal of the currency at the exchange rate prevailing on that date giving rise to a gain or a loss. HMRC have extended Statement of Practice SP10/84 to allow foreign-domiciled individuals to treat offshore bank accounts in a particular foreign currency as a single account.

HMRC also acknowledge that the cost of establishing the gains may be high when there are many transactions, so they say that when the gains from such bank accounts remitted to the UK are less than £500 in any tax year, it will not be necessary to report such gains on the tax return. I am sure this is welcome, but it does not help – you still have to do all the work to identify whether or not the amount of the net gains is below the limit.

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Articles and Publications – January 2010

Peter Vaines: IBC Offshore Tax Conference: 21 January 2010

New Law Journal: Article on Tax Matters

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