SQUIRE SANDERS | LEGAL COUNSEL WORLDWIDE

UNITED KINGDOM TAX BULLETIN

Squire, Sanders & Dempsey

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CURRENT RATES — April 2010

Indexation

Retail price index: March 2010	220.7
Inflation rate: March 2010	4.4%

Indexation factor from March 1982:

to April 1998	1.047
to February 2010	1.759
to March 2010	not yet published

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 exception: 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 6 April 2010 4%

Finance Act 2010

Before Parliament was dissolved, the Finance Bill was enacted – I believe the phrase is "nodded through". I think there are some serious issues here that a Finance Bill of 168 pages containing 73 clauses and 22 schedules, some of which were extremely complex, received hardly any Parliamentary scrutiny – although there is no doubt unconfined rejoicing that the proposed increase in cider duty was withdrawn. Nevertheless the precise words are now The Law, and their meaning represents the will of Parliament.

Allowable Expenses

By way of light relief, but with a serious tinge, I would direct you to the case of *David Parsons v HMRC* TC 421 which concerned a stunt man who claimed a tax deduction for various medical expenses. Mr Parsons was self-employed, and the test was of course whether or not the expenditure was incurred wholly and exclusively for the purposes of his trade or profession. He had an uphill battle. You only have to think of *Mallalieu v Drummond* – where the purchasing of sober clothing by a barrister for wearing in court was disallowed; it had a duality of purpose because clothing was also required for warmth and decency, and this must have been one of the purposes (although perhaps not a conscious purpose) for the expenditure.

However, Mr Parsons was remarkably successful. (This contrasts interestingly with the recent case concerning Sian Williams, the TV presenter who failed to obtain a tax deduction for clothing and hairdressing costs. She was doomed because she was an employee and had to satisfy the impossibly onerous test that the expenditure was incurred wholly, exclusively and necessarily in the performance of her duties. She did claim that the expenditure was necessary because she was perfectly happy to present the TV programmes without any clothes, but this was just an interesting diversion, and not really a relevant consideration.)

Mr Parsons claimed for medical expenses in respect of an injury sustained during the course of his work. There was no need for him to incur the expense of an operation apart from the need to continue working. He could have ceased work until the operation could be done on the NHS, but he paid to have the operation done privately. The Tribunal was satisfied that to meet his requirements as a human being he could have waited and that the expenditure for having the operation done privately was solely motivated by the requirements of his work. Any benefit he received from the operation was an unavoidable effect (rather than a reason for undertaking the operation), and the medical expenses were allowable.

Exactly the same reasoning applied to expenses incurred on a chiropractor and for massage – and indeed for dental work. This was because he sometimes had to work as a stunt double, performing the role of an actor, and again any personal benefit was merely an unavoidable effect rather than a reason for incurring the expenditure.

Mr Parsons also claimed for expenditure on health and fitness because of the need to maintain a high level of fitness at all times – but this was too general in character and disallowed on grounds of duality of purpose.

Whilst this would appear to be an unusually generous approach to expenses, it is in fact entirely consistent with the House of Lords decision in *Mallalieu v Drummond* and in particular, the judgment of Lord Brightman who explained the position as follows:

> *Expenditure may be made exclusively to serve the purposes of the business, but it may have a private advantage. The existence of that private advantage does not necessarily preclude the exclusivity of the business purposes. For example a medical consultant has a friend in the South of France who is also his patient. He flies to the South of France for a week, staying in the home of his friend and attending professionally on him. He seeks to recover the cost of his air fare. The question of fact will be whether the journey was undertaken solely to serve the purposes of the medical practice. This will be judged in the light of the taxpayer's objection in making the journey. The question will be answered by considering whether the stay in the South of France was a reason, however subordinate, for undertaking the journey, or was not a reason but only the effect. If a week's stay on the Riviera was not an object of the consultant, the consultant's only object was to attend on his patient, his stay on the Riviera was an unavoidable effect of the expenditure on the journey and the expenditure lies outside the prohibition in s 130.*

It is a surprise that it has taken so long for these very helpful words to have appeared again.

Inheritance Tax: Omissions

An interesting decision has been published by the Tax Tribunal relating to the question whether the deferral of retirement benefits by a pensioner represented an omission to exercise a right, giving rise to a transfer of value for inheritance tax purposes: *Fryer (Executor of Patricia Arnold Deceased) v HMRC* TC 398.

It will be well known that inheritance tax applies to transfers whereby the value of the individual's estate is diminished. This concept is extended by Section 3(3) IHTA 1984 as under:

> *Where the value of a person's estate is diminished and the value of another person's estate or of any settled property in which no interest in possession exists, is increased by the first person's omission to exercise a right, he shall be treated as having made a disposition at the time (or the latest time) when he could have exercised the right, unless it is shown that the omission was not deliberate*.

Mrs Arnold had a pension plan. If she died before taking her retirement benefits, the value passed to the trustees of a discretionary trust for her children. She did not take her retirement benefits at the age of 60 in September 2002, the normal retirement date, but died shortly thereafter. She was in fact seriously ill, being diagnosed with cancer in April 2002, but her failure to take her retirement benefits semed to have more to do with the fact that she had no immediate need for the income.

HMRC said that there were three conditions to be satisfied for there to be a transfer of value:

a) A deliberate omission to exercise a right;

b) The taxpayers state is diminished; and

c) The omission caused the value of the settled property to be increased.

There was no suggestion that there was any deliberate tax avoidance. It was simply a matter of reading the legislation, and there was nothing to suggest that these conditions were not satisfied. Mrs Arnold did not fail to exercise her rights by accident; she had expressly rejected the opportunity to exercise the right to take her pension when maturity papers had been sent to her after her normal retirement date, and the value of the pension fund passed to the trust.

The Tribunal decided that the relevant conditions were satisfied and that a transfer of value had been made immediately before Mrs Arnold's death.

However, this conclusion is troublesome because although it is clear that Mrs Arnold's estate was diminished by her failing to exercise her right to claim the value of her pension during her lifetime, the settled property was not increased until after her death. The Tribunal said this did not matter – but many people will think that it matters rather a lot.

The whole idea of a transfer of value in this context is that the diminution and increase occur at the same time. Otherwise it does not make sense. The Tribunal regretted that the taxpayer was not professionally represented, and there was a strong implication that not all of the relevant arguments were canvassed before the Tribunal. Maybe this was one of them – and maybe it will be on appeal.

Anyway, this looks extremely serious because anybody who has reached normal retirement age, has chosen to defer taking their pension entitlement (perhaps because it would put them into higher rate tax, or into the 50% rate – or worse, the 60% rate) and then dies before taking the benefits will make a transfer chargeable to IHT. This must apply to an enormous number of people.

There is a concession published by HMRC which they say means that the overwhelming majority of pension arrangements are not affected by this rule. HMRC say they would only make a claim in cases where there is evidence that the taxpayer's intention of failing to take retirement benefits was to increase the estate of somebody else – for example, having become aware that they are suffering from a terminal illness, they deferred taking retirement benefits. Even then, HMRC say they would not pursue the case where the death benefit is paid to the policy holder's spouse or dependants.

Although HMRC suggest that their practice will cover the overwhelming majority of pension arrangements, it is clear that their statement is in fact rather narrow – although at least we now know that we can rely on it. Anybody who has deferred taking their pension should pay the closest attention to the HMRC concessionary practice to make quite sure they fulfil every condition – otherwise their family will be in for an unwelcome surprise.

Capital v Revenue

Whether an item of expenditure is capital or revenue is crucial in determining whether it is tax deductible, and the distinction has been the subject of numerous cases over the years. The most famous of the principles to emerge from that line of authorities is that capital expenditure arises when it is made:

> *Not only once and for all, but with a view to bringing in to existence an asset or advantage for the enduring benefit of a trade*.
>
> (*Atherton v British Insulated and Helsby Cables Ltd* 10 TC 155)

Another formulation appeared in *Tucker v Granada Motorway Services Limited* where the House of Lords expressed the view that expenditure was of a capital nature if it was a payment on a capital asset designed to make it more advantageous. This is not the same as expenditure on defending or maintaining an existing asset which would be allowable as revenue expenditure.

The recent case of *Market South West (Holdings) v HMRC* TC 432 concerned relief for legal fees incurred on a disputed planning application. It was acknowledged that where a payment can be linked to a capital asset, the payment is more likely to be treated as a capital payment. However, the Tribunal did not consider that to be crucial because the creation of an enduring advantage for the trade was sufficient to establish capital categorisation for the payment.

The taxpayer claimed that there were rights in relation to an earlier planning permission which was an asset and that the costs were merely the maintenance or defence of those rights. The Tribunal thought not. They said that even if it was, the costs related to the enhancement or alteration of that asset and therefore represented capital expenditure.

Redundancy Payments

The recent decision in *Colquhoun v HMRC* TC 348 contains an interesting discussion of the availability of the £30,000 exemption in Section 403 ITEPA 2003.

Mr Colquhoun was made redundant on 31 August 2005, and he received redundancy and other payments totalling £62,000. This amount would normally have been taxable subject to a deduction for the £30,000 exemption.

However, a dispute arose because in 1996 Mr Colquhoun had received a payment of £33,000 representing a "buyout payment" when his employer's contractual redundancy scheme was replaced by a less generous version. Mr Colquhoun accepted the £33,000 as compensation for the change, and no tax was deducted or paid in respect of the first £30,000 of that payment.

HMRC said that Mr Colquhoun was not entitled to this relief twice because payments from the same employment, or from associated employers, have to be aggregated and only one £30,000 is allowed in respect of the total.

The test at the time was found in Section 148 TA 1988 and brought into charge (subject to the £30,000 exemption) payments in connection with:

a) The termination of the holding of the office or employment;

b) A change in its functions or emoluments; or

c) A payment in commutation of annual or periodic payments.

It was claimed by Mr Colquhoun (and apparently conceded by HMRC) that the payment in 1995 did not satisfy any of these conditions. On this basis the £30,000 could not have been used up in 1995, and it must therefore have been available against the payment in 2005.

I think something must have gone wrong here. The starting point is that a lump sum payment to an employee from his employer arising from his employment is taxable in full. Where such a payment satisfies any of the above tests, the first £30,000 is tax free. If the payment is not in connection with the termination of his employment or in respect of any change in its functions of emoluments, then it is fully taxable. Accordingly, it had to be Mr Colquhoun's case that the £33,000 he received in 1996 was not taxable at all. That is really difficult because there is powerful authority for the view that such a payment is taxable as part of a package of emoluments for the future duties of that employment. To put it crudely, he got a lump sum in consideration of working on different terms in the future. Counsel for HMRC advanced exactly this argument, but strangely the Tribunal also records that he conceded there was no change in the functions or emoluments.

The Tribunal concluded that a payment to a continuing employee relating to a change in the employee's contractual redundancy entitlement is not taxable. An interesting conclusion – not least because it seems to conflict with the Court of Appeal decision in *Hamblett v Godfrey* 59 TC 694 where employees of GCHQ received lump sums in compensation for losing their right to join a trade union. The Court of Appeal held that this was a taxable emolument; it was paid because of the employment and because of the change in the conditions of the employment.

I thought that Mr Colquhoun might have succeeded on the basis that the £33,000 was taxable in full in 1996, but that HMRC had given him the benefit of a £30,000 exemption by mistake and it is now too late for them to recover the tax which should have been charged. This would mean that he had not previously been entitled to the £30,000 exemption and it would therefore be available against the 2005 payment. Clearly not. The Tribunal said that the amount was not taxable at all. I think we will hear more about this one.

Enterprise Investment Scheme (EIS)

The recent case of *RJ Taylor v HMRC* TC 426 provides guidance about whether an individual is connected with a company for the purposes of the EIS. It will be well known that if you have more than 30% of the shares in the company, you are connected with the company and disqualified from EIS relief.

Actually, the test is rather more complicated than that. The individual must not possess more than 30% of:

a) The issued ordinary share capital;

b) The loan capital and issued share capital of the company; or

c) The voting power in the company.

Mr Taylor had an interest in Wrapit Plc, and although he held less than 30% of the issued share capital, he held more than 30% of the loan capital of the company. He obviously did not breach condition (a) or (c), and he claimed that he did not breach condition (b) because he did not hold more than 30% of the loan capital and more than 30% of the issued share capital.

HMRC said this was not the right interpretation. He possessed more than 30% of the aggregate of the loan capital and the issued share capital, and therefore he was connected with the company.

The Tribunal drew attention to the many anomalies which would arise on the HMRC interpretation (although anomalies are no stranger to the EIS legislation) and concluded that the taxpayers' interpretation was clear and easy to apply and did not trap the *bona fide* investor.

The Tribunal did not accept HMRC's construction because it was difficult to combine two quite different ingredients to produce a single apportionable amount, and they concluded that condition (b) was not breached.

Whilst not wishing to look a gift horse in the mouth, HMRC did seem to have the better argument. Otherwise, the reference to issued share capital in paragraph (b) is completely redundant because if you have more than 30% of the issued share capital you are caught by (a) anyway. Unless paragraph (b) is intended to aggregate the loan capital and the share capital, there seems to be no need to make reference to issued share capital in (b) at all.

Furthermore, in their explanation of their decision, the Tribunal say that the message for the taxpayer is to watch out. If your holding of shares exceeds 30%, avoid being more than a 30% creditor of the company; if you are a 30% creditor, do not allow your holding of shares to exceed 30%. I cannot see how this can possibly be right. Once the holding of shares exceeds 30%, the holding of a loan capital is irrelevant because the connection is established by paragraph (a).

Unless I have completely misunderstood the position, I think HMRC have been a bit hard done by in this case.

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Articles and Publications – April 2010

Malcolm B. Gunn: Lecture: Institute of Taxation: 14 April

Peter Vaines: Article: *New Law Journal*, Taxing Matters

Article: *Offshore Investment*

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