SQUIRE SANDERS | LEGAL COUNSEL WORLDWIDE

UNITED KINGDOM TAX BULLETIN

Squire, Sanders & Dempsey

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CURRENT RATES	July 2010
Indexation	
Retail price index: June 2010	233.6
Inflation rate: June 2010	5.1%
Indexation factor from March 1982:	
to April 1998	1.047
to June 2010	1.815

Interest on Overdue Tax

Interest on all unpaid tax is charged at the same rate.

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 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%

Residence: *Gaines-Cooper v HMRC*

I am pleased to report that the Supreme Court have granted Mr Gaines-Cooper leave to appeal from the Court of Appeal decision regarding his residence.

It may be remembered that in February the Court of Appeal confirmed that HMRC are bound by their public statements such as those contained in IR20. Unfortunately they also decided that Mr Gaines-Cooper could not benefit from the practice set out in IR20 because he did not satisfy its terms. Although he had done everything in accordance with IR20, he had failed to meet an extra term which was not found in IR20 but had to be implied – that is to say, when he left the UK he did not sever all family and social ties.

This is a very demanding, and some may say impossible, test, and there is a widespread view that it cannot possibly mean what it says. How can anybody leaving the UK sever all family and social ties? But that is what the Court of Appeal said, so nobody in their right mind can say that they did not mean it. However it is hoped that the Supreme Court will provide a definitive test of what is meant by "leaving the UK" within the meaning of IR20.

Although IR20 has been replaced by HMRC 6 and there is supposed to be a more detailed version of HMRC 6 coming out in due course, this does not rob this case of any significance. HMRC 6 contains very similar phraseology, and it will be of fundamental importance for taxpayers and their advisers to know what it means – at least until we have a statutory test. A large number of taxpayers are in a state of complete uncertainty regarding their residence position, and clarification by the Supreme Court will be greatly welcomed.

Company Residence

HMRC have published a guidance note setting out the circumstances in which they will not review a company's residence status. This is a bit unusual. They are not famous for explaining the circumstances in which they will *not* make enquiries – but it is no less welcome for that. They confirm their view that a company is resident where the central management and control of the business actually abides, and they suggest this means where its real business is carried on, where it really keeps house and does business. (Slightly more modern wording perhaps, but the traditional test is still there.)

They go on to express the view that while the location of the directors meetings will be an important factor in determining where the real business is carried on, there is no assumption that central management control is found where the directors meet.

HMRC confirm their view that although the residence of individual directors is sometimes relevant, that is not a crucial determinant – it is the place from which an individual exercises central management control which is the relevant factor in locating the residence of the company.

HMRC put forward some examples of when they will not usually seek to establish that a company is UK-resident; these circumstances are naturally rather limited. The relevant company will of course be incorporated outside the UK (because otherwise it would automatically be UK-resident). HMRC will not seek to review the foreign residence position when all the following conditions are satisfied:

- The company has a non-resident ultimate parent, and the country of incorporation has a double taxation agreement with the UK which contains a residence tiebreaker;
- It is genuinely established in its territory of residence;
- It is not mainly involved in investment business;
- Central management control is at least partly exercised at board meetings; and
- HMRC will not be concerned about the existence of a UK-resident director when the majority of the board are non-resident and the board only meets outside the UK, when the UK directors habitually participate electronically from the UK, or when a small minority (no more than one or two) of the meetings are held in the UK.

However, when the majority of the directors habitually perform a significant part of the duties in the UK and merely leave the UK to attend board meetings, HMRC confirm that they will enquire into the circumstances to identify where central management and control actually abides.

It is a little odd that HMRC should have chosen to come out with this guidance note just as we are waiting for the judgment of the Upper Tribunal in the case of Laerstate BV – but maybe they know something we don't.

Dividends and NIC

This is a really sensitive subject, and the Upper Tribunal decision in *HMRC v P A Holdings Limited* is clearly important. HMRC are not yet claiming that dividends are generally chargeable to National Insurance Contribution (NIC) – but you can see where they are going.

This case involved an arrangement whereby an employee trust was established enabling employees to acquire shares in a company connected with their employer. In principle (although it did not apply at the time) the receipt of the shares by the employees would represent taxable earnings.

The important bit was that the company then declared a substantial dividend on those shares, and HMRC argued that the dividend could reasonably be said to have derived from the employment. However, they could not tax it as earnings because there is a statutory override in Section 20 TA 1988 which provides that dividends are taxable under Schedule F (giving them a tax credit) and this takes priority over a charge under any other provision – for example, as earnings.

HMRC argued that the statutory override in Section 20 should be disregarded because the dividends should not be characterised as dividends at all; they should really be treated only as earnings.

The Tribunal found that the dividends were correctly categorised as dividends and the fact that they could be treated as emoluments as well did not mean that they were precluded from being dividends. They were clearly dividends, and Section 20 specifically dealt with the position where there were alternative heads of charge to tax and provided that dividend treatment should prevail.

HMRC were not finished. They said that even if the dividends could not be taxed as earnings, there was no similar provision in the NIC legislation to exclude dividends from being treated as earnings so that NIC could apply. The Tribunal agreed.

HMRC appealed on the grounds that the dividends should be chargeable to income tax as earnings and that the statutory override should not apply. The taxpayer appealed on the ground that NIC should not apply to the dividends. Both lost, and the Upper Tribunal confirmed the original decision.

I wonder what will happen next because if one looks at the HMRC National Insurance Manual it says at paragraph 2115:

> *"Dividends are derived from a shareholding and not employment. They cannot therefore be classed as earnings and do not attract NIC".*

Again at paragraph 12012 they say:

> "*Directors received dividends as shareholders in the company and not in a capacity as directors. Dividends are therefore not earnings for the purposes of NIC*".

I wonder why the taxpayer is not entitled to rely on these statements – or indeed how it is that HMRC feel able to publish their views, presumably for the benefit of the community, and then argue exactly the opposite when a real case arises.

Qualifying Corporate Bonds

The Upper Tribunal have recently heard the appeal in the case of *Klincke v HMRC* which related to qualifying corporate bonds (QCBs). (A summary of original decision appears in the July 2009 Bulletin.) The significance of this case is that if you have any non-QCBs, you dare not change or vary their terms in any way because that will almost certainly crystallise the gain.

By way of brief explanation, Mr Klincke sold his company and received a mixture of shares and loan notes. The loan notes contained an option for redemption in foreign currency, and this meant that they were not QCBs. Accordingly, the gain on the disposal of his original shares was rolled into the shares, and the loan notes and the gain would become chargeable when the shares and loan notes are eventually realised. All pretty conventional so far.

However, the terms of the loan notes were subsequently varied to remove the option to be redeemed in foreign currency. This meant that the loan notes no longer qualified as non-QCBs and became QCBs. This was seriously important because that meant they became exempt from capital gains tax.

This sounds like magic … but unfortunately not.

HMRC said that the switch from non-QCBs to QCBs represented a disposal of the loan notes (thereby crystallising the gain) because it was a "conversion of securities". A conversion of securities is defined by Section 132(3) TCGA 1992 as including a number of events, none of which

are remotely applicable to these circumstances. However, the definition was not exhaustive and therefore applied to other events, but it certainly indicated that there needed to be a replacement of one asset by another. All that happened here was that one term of the loan notes was varied. The variation was extremely minor and had little or no financial consequences. The First-tier Tribunal considered that the cancellation of the foreign currency redemption option amounted to a conversion of Mr Klincke's loan notes, with a result that the latent chargeable gain crystallised at that moment. The Upper Tribunal agreed and said that this change fell squarely within the words "change in the character, nature or form of the loan notes".

It is difficult to imagine a more trivial variation, but the conclusion must be that any change whatsoever to the terms of a loan note will represent the conversion of one security to another. There is no reason why this thinking should not extend to circumstances beyond merely the definition of a QCB, which is why this decision may be of greater importance that it at first appears.

It was perhaps too much to expect that such a simple change could result in the elimination of the entire capital gain – and one can understand why this was too much for the Upper Tribunal to swallow. They said it could not possibly have been anticipated by Parliament that the mere cancellation of a right to redeem the loan notes in foreign currency could have this effect. However, it can fairly be said that Parliament equally could not reasonably have anticipated that the mere cancellation of a foreign currency option could have the effect of converting the security into another security with a different character, nature or form.

Employee Expenses

I would not want to overstate the position, but I think the case of *Banerjee v HMRC* [2010] EWCA Civ 843 recently decided by the Court of Appeal breaks entirely new ground in connection with employees' claims for expenses.

It is well known that to obtain such a deduction, any expenditure incurred by an employee must be incurred wholly, exclusively and necessarily in the performance of the duties of the employment. This is such a difficult test which is almost impossible to satisfy, and I have often lamented the occasional success of a taxpayer before the Commissioners because it only gave the taxpayer false hope; they were doomed to failure on appeal with an inevitable award of costs against them.

I think I said this about the earlier decision in the case of Dr Banerjee who succeeded in her claim for a tax deduction for training expenses before the Commissioners. However, the Commissioners

decision was upheld by the High Court and now by the Court of Appeal. This is nothing short of breathtaking.

Dr Banerjee was a consultant dermatologist and incurred expenses in attending various training courses which was a requirement of her contract of employment. The traditional reasoning is that she could not possibly have incurred the expenditure in the performance of her duties; the duties of her employment were to treat patients and of course to act in a training role having regard to her seniority. It was not her job to go on training courses. It might have been if her job was an assessor of training courses – but it was not. Attending training courses may have been a requirement of her contract of employment, but that is neither here nor there. One only has to look at the House of Lords decision in *Fitzpatrick v CIR* 66 TC 407 to see that being required to do something by your employer (such as going on training courses) merely puts the person in the position to do their job better – and that is not enough.

In *Fitzpatrick,* a journalist on a newspaper was required by his employment to buy other newspapers and read them, the purpose being to enable him to perform his duties more effectively. The House of Lords decided that no deduction was allowed because a reporter is employed to report – not to read newspapers. More specifically it was said:

> *"A journalist who reads newspapers does so in order to perform his duties to the highest possible standard but he does not read in the performance of his duties"*.

The tax case reports are full of decisions where expenditure which places the employee in a position to perform his duties better was not allowable.

However, it looks like this is all changing. The Court of Appeal said that Dr Banerjee incurred the expenditure on the training courses in the performance of her duties rather than incurring them so as to put herself in a position better to perform them. (This is new thinking.)

All members of the Court of Appeal agreed that she undertook the courses because she was contractually required to do so and failure to do so would result in the termination of her employment. It was concluded that: *"If that was in law her sole purpose then the expenses were deductible"*. (This is new thinking too.)

It was also noted that the purpose of the training was to produce a supply of qualified consultants and thus to improve the specialist knowledge and qualifications of those working in the field of dermatology for the NHS. (Yes, but how is that relevant to the statutory test?)

It may be that the Court of Appeal have at last been persuaded that the very existence of Section 198 TA 1988 implies that there are some expenses which may be allowed – in contrast to the traditional conclusion from a strict reading of the words that no expenses can ever be allowed. A more generous (perhaps more purposive) approach is extremely welcome, and what more meritorious candidate can there be than a doctor incurring expenditure on professional training?

I suspect, however, that this decision, which flies totally in the face of very long standing HMRC policy, will need a further outing to the Supreme Court before we can get too excited.

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