SQUIRE SANDERS HAMMONDS | LEGAL COUNSEL WORLDWIDE

UNITED KINGDOM TAX BULLETIN

Squire, Sanders & Dempsey

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CURRENT RATES	December 2010
Indexation	
Retail price index: November 2010	226.8
Inflation rate: November 2010	4.7%
Indexation factor from March 1982:	
to April 1998	1.047
to October 2010	1.842
to November 2010	(not yet announced)

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%

Appeals Out of Time

The case of *Legg v HMRC* TC 813 indicates that it is generally not in your interests to ignore communications from HMRC. However, I bet you haven't seen anything like this.

Mr Legg was contacted by HMRC, who suggested that he was party to a bank account which had been credited with £3,000 interest. Mr Legg believed it to be a mistake and ignored it. How much tax do you think HMRC could possibly charge as a result? How about £275,000? You may laugh – and although Mr Legg thought this was a joke and "was waiting for Jeremy Beadle to appear", he should have done something because the result was a statutory demand to make him bankrupt. He made an application to the Tribunal to appeal out of time, but they said:

It is not in the public interest for this matter to proceed; the amount of tax is large and an early resolution of the matter and the payment of the tax is now appropriate.

How on earth do HMRC get to a figure of tax of £275,000 as a result of the possibility that Mr Legg had failed to disclose £3,000 interest (and it was only a possibility because it had not been established that anything was actually received by Mr Legg)? The reasoning of HMRC was simple. Let us assume he did have £3,000 interest. For £3,000 interest to have arisen, we can assume there was a deposit giving rise to that interest. £3,000 interest for a year would indicate a deposit of £250,000; that £250,000 can be assumed to have been undisclosed income, and if we assume he had undisclosed income of £250,000 for that year, we can assume he had it for earlier years as well – so let's assess him on that basis.

If you make enough assumptions you can end up with any figures you like.

Of course Mr Legg was clearly in the wrong. He really should have done something to challenge the assessments, and there must be some sanction for failing to do so. However, it really does HMRC no credit to pursue him to bankruptcy on the basis of a series of assumptions which have no basis other than a fertile imagination. It just damages the reputation of HMRC – and achieves nothing. Whatever Mr Legg's fault in failing to explain that he did not actually have any bank interest, a penalty of £275,000 looks a tad disproportionate.

It could easily be a lot worse. It would be no less unreasonable to suggest that the £3,000 interest arose not for a year but for a shorter period – say six months – in which case a sum of £500,000 would have been required. That would presuppose an income of £1 million a year – and concealing £1 million worth of income a year is really serious and must represent fraudulent or negligent conduct enabling HMRC to go back 20 years and assess him on earnings of £20 million plus interest and penalties.

Actually, if someone has an income of £1 million per year, one might assume he spent a good part of it so that the amount deposited would be only the balance after the amount expended. If we were to assume that he spent half the income, then his undisclosed income must have been £2 million a year …

Ever wondered where the "tax gap" comes from? Well, maybe we know now.

£30,000 Non-Dom Charge

Many people are steeling themselves for the payment of the £30,000 non-dom charge on 31 January so that they can continue to benefit from the remittance basis.

One uncertain aspect of the £30,000 charge is the way it is treated for US tax purposes for those who are liable to US tax on a worldwide basis – and particularly whether it is available for credit against their US tax liability. It has always seemed to me to be quite brilliant for HMRC to introduce a tax and construct it so that it qualifies for credit against US tax, thereby effectively making the US Treasury pay it.

It may be remembered that when the non-dom charge was introduced in 2008, the Budget papers contained a very detailed opinion obtained by HMRC from Skadden Arps to the effect that credit would be available for the £30,000 charge against US tax. Unfortunately, the IRS have yet to say whether they agree. In fact, so far they have specifically declined to do so. A statement from them was expected in the summer – but nothing has appeared and the uncertainty continues. It is hoped that this point will soon be resolved.

Employee Benefit Trusts

Malcolm Gunn writes:

Employee benefit trusts (EBTs) and employer-funded retirement benefits schemes (EFRBSs) have been dealt a crushing blow by the draft clauses for the Finance Bill 2011.

Employee trusts come in various shapes and sizes, all of which have for years been subjected to close scrutiny by HMRC, who regard them as vehicles for unacceptable tax avoidance. The first major case was Dextra Accessories Limited, which appealed against a decision of HMRC that there could be no corporation tax deduction for sums paid into an EBT until such time as those funds were released to employees as emoluments.

HMRC won in the House of Lords, and in the wake of that success they have repeatedly tinkered with the legislation, intending to establish beyond doubt that this principle was firmly rooted in the legislation. Currently, Section 1290 Corporation Tax Act 2009 covers this issue and prevents a deduction for

corporation tax purposes for "employee benefit contributions" until such time as they are paid out to the employees.

Commonly, contributions have been made to an EBT which then makes loans to the employees or to members of their families. These loans give rise to a benefit in kind charge on the employees, but they do not enable any corporation tax deduction to be claimed by the employer company. HMRC have suggested on the flimsiest of grounds that there might be inheritance tax consequences where funds are transferred into an employee trust (despite the contrary decision in *Postlethwaite* in 2007), but anybody who thought that HMRC were otherwise broadly content with the position were sadly mistaken.

It was announced earlier this year that more changes were afoot to deal with "disguised remuneration" from employee trusts and unapproved pension schemes (commonly known as EFRBSs).

The draft legislation published on 9 December can only be described as draconian. It applies to any arrangements where "it is reasonable to suppose that, in essence, the relevant arrangement … is a means of providing" rewards or loans in connection with a person's employment. This nebulous wording is no doubt intended to enable the provisions to be applied very widely, but clearly the main focus is employee trusts and EFRBSs.

Where the trustees of any such trust earmark funds within the trust for anybody's benefit, the earmarked funds are immediately treated as having been distributed to that person and immediately taxable as employment income. It does not matter that the person has no legal right to draw the money from the trust and does not receive any benefit. Furthermore, there is no definition of the word "earmarked", so all sorts of situations can cause liability under this heading. For example, if funds are paid into an EFRBS to provide an unapproved retirement fund for a particular person, it easily could be said that these funds are earmarked for their benefit.

It gets worse. If the trustees make a payment of money to a beneficiary, no matter what the terms of the payment, that too is immediately taxable as employment income. This includes a loan, even a loan at a commercial rate of interest (an exception for commercial loans is very narrowly drawn to apply broadly to financial institutions only). It does not even matter if the loan is later repaid, as there is no provision to recover the tax charged when the loan was made.

If the trustees acquire a property and rent it to a beneficiary of the trust, that equally counts as a taxable event and the full value of the property is liable to be taxed as employment income of that beneficiary.

In the case of EFRBSs, the rules will override the existing tax charges in Section 394 Income Tax (Earnings and Pensions) Act (ITEPA) 2003 on payments from the fund, and in the future all payments will be related

back to the relevant employment. This means there will still be a liability if the EFRBS is offshore and the relevant beneficiary has since left the employment and moved abroad. PAYE will be applied by the trustees, and failing that, HMRC can recover the PAYE liability from the company. This will introduce considerable difficulty on a sale of a company which has already established an EFRBS.

The provisions come into full effect on 6 April 2011, but there are anti-forestalling rules which introduce similar provisions from 9 December 2010. The main difference with the anti-forestalling rules is that the liability does not arise until 6 April 2012, and if the arrangements are unravelled before 6 April 2012 they will escape liability.

EFRBSs will continue to have their uses as unapproved retirement pension funds. However, the tax charge on earmarking will be a serious concern, as sooner or later it could easily be said that the fund is earmarked for a retirement income for a particular person; in that event, there would be an immediate tax charge on the value of the whole fund.

Having regard to the degree of overkill inherent in these proposals, they will surely (please) be toned down before they are finally introduced.

Termination Payments

A Mr Oti-Obihira received a payment of £500,000 from Morgan Stanley pursuant to various claims in connection with the termination of his employment and for racial discrimination and harassment. Unfortunately there was no division of this amount between the taxable and non-taxable elements (*Oti-Obihira v HMRC* TC 819).

There were no PILON issues here, so clearly the first £30,000 of the termination payment was exempt under Section 403(1) ITEPA 2003. The amount representing damages for racial discrimination or injury to feelings was not taxable; the fact that it was paid on the occasion of the termination of the contract of employment did not make it earnings. The question was how much should be attributable to the injury and discrimination elements and how much should be attributable to the employment element.

HMRC took the view that £28,000 was a reasonable amount of damages for the injury elements, and therefore the balance must have been an employment termination payment. The Tribunal said no: this is the wrong way round. It is necessary to identify whether a payment is received in connection with the termination of the employment rather than looking at what can be attributed to another purpose. Mr Oti-Obihira had a basic salary of £74,000 with a modest expectation of bonus. The Tribunal considered that compensation for the termination of his employment in his circumstances would be a payment representing a loss of earnings for 18 months, which they calculated at £165,000. The balance of £335,000 was therefore

not related to the employment and therefore not taxable. The Tribunal also considered that such an amount was consistent with the amount which could be regarded as reasonable for the discrimination and harassment claims.

The principle here is clearly important, although it would obviously be possible to have different views on the amount of the termination payment, for example the estimate of future earnings and the 18-month period for which they were lost.

Plant: Gazebo

The recent case of *Andrew v HMRC* TC 799 decided that a freestanding gazebo in a pub garden qualified as plant for capital allowance purposes. Not a surprising decision perhaps, but it is odd that HMRC argued so vigorously to the contrary, relying on *Dixon v Fitch's Garage Ltd* (where a petrol station canopy was held not to be plant), a decision which was firmly rejected by the House of Lords in *Scottish & Newcastle Breweries* (1982) and does not even feature in the Revenue manuals anymore.

Employee Expenses

I will not dwell on the case of *Peter Gamble v HMRC* TC 815 in which Mr Gamble made a claim for certain expenses to be deducted from his employment income. He claimed that the amounts involved were incurred "wholly, exclusively and necessary in the performance of the duties of employment" under Section 336(1) ITEPA 2003.

Mr Gamble was clearly under the impression that it is possible to make a claim under this section – he probably thought that, seeing as how there is a specific statutory relief, it must be possible somehow to qualify for the relief. Dream on.

The Tribunal explained that it is necessary to distinguish between expenditure incurred in the performance of the duties (which is deductible) and expenditure incurred to put the taxpayer in a position to perform the duties (which is not). I have made this point many times before, but whenever somebody incurs expenditure, they will rarely (if ever) do so "in the performance of their duties"; the expenditure will only (at best) put them in a position to perform the duties.

Mr Gamble incurred various telephone, Internet, printer cartridge and other essential business expenses which were readily acknowledged to have been incurred wholly for business purposes. Mr Gamble reasonably concluded that any expenditure he had made wholly for business purposes ought to be deductible. However, he overlooked that all of these things merely put him in a position to perform the duties of his employment – they were not incurred in performing the duties of his employment.

He might reasonably ask for tax relief for such ordinary and obviously *bona fide* business expenses. Answer: bad luck; he can't.

I renew my plea for the relief under Section 336 to be abolished to avoid taxpayers being given false hope and to save them the considerable trouble, expense and inevitable disappointment in pursuing a doomed claim – and penalties for making such a claim (see *Everest Eze* TC 851). The alternative perhaps is that Section 336 should be revised so that it is capable of being claimed – which I imagine was the intention of Parliament.

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30 December 2010

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