SQUIRE SANDERS HAMMONDS | LEGAL COUNSEL WORLDWIDE

UNITED KINGDOM TAX BULLETIN

Squire, Sanders & Dempsey

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CURRENT RATES	February 2011
Indexation	
Retail price index: January 2011	229.0
Inflation rate: January 2011	5.1%
Indexation factor from March 1982:	
to April 1998	1.047
to December 2010	1.875
to January 2011	(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%

UK Residence

The latest decision in the saga of *Grace v HMRC* was published on 1 February, and regrettably the clarification for which we all yearn is as far away as ever.

It may be remembered that (in very broad terms) Mr Grace was a South African pilot who came to the UK in 1986 and was employed by British Caledonian. He had a house near Gatwick. In 1997 his marriage was dissolved and he went back to South Africa. He retained his UK house which he used in order to rest, before or after carrying out his duties as a long haul pilot. In the following three years he visited the UK for 41, 71 and 70 days. HMRC claimed that he remained UK resident. Mr Grace appealed to the Special Commissioners, representing himself, and demonstrated to the Tribunal that he had made a distinct break from the UK and had become non-resident in 1997. A rare and highly commendable success.

After an appeal to the High Court and the Court of Appeal, the case was remitted to the Special Commissioners because the Court of Appeal thought there was a misdirection which may have affected the outcome. Unfortunately the Special Commissioner had retired, and after all this time, Mr Grace found himself back to square one. The new Tribunal judge decided not just to deal with the points which required clarification from the Court of Appeal but to start all over again without regard to the previous findings of fact – and concluded that Mr Grace was UK resident after all.

However irritating that may have been for Mr Grace, we might have all taken comfort from this new decision if it had set out a clear approach both from HMRC and the court. Unfortunately, however, the confusions have only multiplied. I will not dwell too much on all this, but it is important to see how the decision was arrived at and how other important aspects were dealt with.

HMRC argued that you cannot be ordinarily resident but not resident. This was odd because this view is directly contrary to the Revenue Manuals. It is also contrary to HMRC 6, it is contrary to the Special Commissioner's decision in *Gaines-Cooper* and it is contrary to the capital gains tax legislation which is expressly drafted on this basis. It is not clear why or how HMRC felt able to advance this argument at all. It is perhaps a blessing that the Tribunal did not deal with it anyway.

A significant part of the decision related to the issue of a distinct break. The Tribunal judge thought that the Court of Appeal decision in *Gaines-Cooper* did not determine that a distinct break was essential for someone shedding residence under the common law. She concluded that it was not essential to show that a distinct break had occurred for UK residence to be lost. (I think the Court of Appeal may have a rather different view on that, but nevermind.)

Having come to this conclusion, the Tribunal judge said that Mr Grace's move to Cape Town did not demonstrate a sufficient break. It was not enough to amount to a definite break with the UK; he did not sever

his main ties (employment and house) with the UK. I thought she said it was not essential to have a distinct break … but maybe it was essential after all.

What is particularly galling for Mr Grace is that the original Special Commissioner found as a question of fact that he had made a distinct break from the UK. Unfortunately the new Tribunal judge did not find that relevant and decided to consider the matter again herself. She found the change in Mr Grace's life in September 1997 was a distinct decrease in the amount of time spent in the UK and the creation of new ties in South Africa but wondered whether this was a sufficient break with the UK. (I hope everybody is following this reasoning OK.)

A key issue before the High Court, and the basis of the judgment that Mr Grace had retained his UK residence, was that he was working in the UK. Mr Grace could not be regarded as in the UK for some temporary purpose only – he was here for work. That was not a temporary purpose, and therefore he was resident despite the comparatively short periods he spent in the UK. The Court of Appeal did not support that view, and the Tribunal judge concluded that:

> *So (largely) the question before me is not whether Mr Grace was resident in the UK because of his presence here when he was working but whether he was resident in the UK because of his residence here when he was not working.*

It is difficult to draw any conclusions from all this. We were moving towards a position where a distinct break was essential, and although nobody was quite clear what a distinct break was (apart from severing social and family ties – which must be too strict a test), that was at least progress. However, it is now said that a distinct break is unnecessary.

We thought we knew that working in the UK was important, but now we are told it is presence in the UK when not working which is important. I am afraid that the general principles which were being developed in the earlier cases are now up in the air all over again. Let us hope that Mr Grace will appeal – but I would think he is completely fed up with all this now.

Transfers of Assets Abroad

The Transfers of Assets Abroad legislation in and around section 720 Income Tax Act 2007 (probably still better known under its previous incarnation as Section 739 TA 1988) is exceptionally complex, being designed to frustrate plans to avoid income tax by arranging for income to be paid abroad.

In very broad terms, if you make arrangements for income to be received by a company or trust (or indeed anybody) outside the UK, the income arising is automatically treated as yours unless there is no possible way in which you can obtain any benefit from the income. There are also some similar and complementary provisions to enable other people who benefit from the foreign income to be taxed on that income. There is a

bona fide commercial exemption if you can prove that the arrangements were made without any tax saving purpose (which you can imagine is a bit difficult).

So if, for example, you make arrangements whereby income flows into a foreign company or trust by way of dividend, licence fees, investment income or maybe from the performance of services, it all remains taxable on you.

For years there has been a view (never publically accepted by HMRC) that these provisions are contrary to EU law because they discriminate between income receivable by non-residents and income receivable by residents. If you did any of these things through a UK company, there would be no transparency and it would be the company which would be taxed on the income.

The argument is pretty clear. If the company is resident the provisions would not apply; they only apply because the company is non-resident. Therefore the legislation discriminates against the non-resident company, and that is contrary to the EC Treaty.

It is therefore interesting to learn that the European Commission has issued a statement saying these provisions are discriminatory and represent a breach of the Freedom of Establishment rule and the Free Movement of Capital rule, going beyond what is reasonably necessary to prevent abuse. The Commission has formally requested the UK to amend the rules to eliminate the unlawful discrimination.

This is a serious blow to the HMRC anti-avoidance machinery, and I cannot see them agreeing to this without a fight – but maybe we will learn about the HMRC response in the Budget on 23 March.

It is important to appreciate that this development applies only to the EU, and there is no suggestion that there is anything wrong with (or any likely variation in) the provisions as they relate to income arising in jurisdictions outside the EU.

Gains of Non-Resident Companies

The European Commission has made exactly the same point regarding Section 13 Taxation of Chargeable Gains Act 1992, under which capital gains made by a non-resident company may be taxed directly (and proportionately) on any UK resident who has more than 10% of the foreign company.

In case anybody thinks it is a bit tough to have to pay tax on gains made by an offshore company which you do not control and may not be able to get your hands on the gain anyway, it should be remembered that this is intended to be a draconian anti-avoidance provision. In any event, there is a statutory right of reimbursement from the company so that the UK resident need not be out of pocket.

Until 6 April 2008 Section 13 did not apply at all to foreign domiciled individuals, but since that date, where the shareholder is a UK resident but foreign domiciled individual, any gains made by the company can now be attributed to him or her under Section 13. However, foreign domiciled individuals are able to benefit from the remittance basis, but that of course only protects foreign gains; any gains made by the offshore company on UK assets are fully chargeable whatever the domicile of the shareholder.

The European Commission again say that the provisions are wholly discriminatory as they apply only to non-resident companies and not to UK resident companies. They have formally requested the UK to amend the legislation to eliminate the unlawful discrimination.

It is interesting that the press release from the European Commission makes reference only to the attribution of the foreign companies' gains to companies which are resident in the UK. In fact Section 13 applies much more widely and certainly applies to individuals as well.

Inheritance Tax: Foreign Domiciled Spouses

The terms of the inheritance tax spouse exemption are well known – that when one spouse dies, any assets passing to the other spouse are completely exempt from inheritance tax.

There is an exception to this rule under Section 18 Inheritance Tax Act 1984 where the transferor spouse is UK domiciled and the transferee spouse is not. In that case, the exemption is only £55,000 which is really neither here nor there. This can come as a shock (and indeed can cause considerable alarm) where somebody has gone to live abroad, married a foreign spouse but then finds HMRC unwilling to accept that they have acquired a foreign domicile, thereby depriving them of the spouse exemption and creating a (possibly enormous) unexpected liability to inheritance tax on the first death.

These are obviously circumstances where action needs to be taken to avoid some rather unpleasant consequences. Who would want to leave their surviving spouse with a problem like this?

However, I have been reading an excellent article by a Mr Anderson and a Mr Perry who argue that this restriction might also be struck down by the European Court on grounds of discrimination. This is not quite so clear because it is not a discrimination based on residence but on domicile which does not feature in the European tax codes in quite the same way. EU countries tend to use the term domicile as synonymous with residence or ordinary residence.

It is also not very easy to regard this restriction as being relevant to the freedom of establishment or the free movement of capital because UK inheritance tax is charged on a worldwide basis on those domiciled in the UK. However, the recent case of *Veramattner* (C-510/08) provides some real hope in this connection. This was a case about German gift tax which decided that the domestic law of a Member State should not operate

to provide a different allowance to persons who are non-resident from that which would apply if they were resident.

It is by no means certain that arguments on these lines would be successful, but it is a very interesting line of argument should the occasion arise.

Disguised Remuneration

Following Malcolm Gunn's detailed explanation of the draft legislation on disguised remuneration in the December Bulletin, HMRC have published a list of 33 frequently asked questions on the subject. It is presumed that these questions derive from the substantial number of representations which have been received by HMRC on the draft legislation.

It is apparent from these questions (and more particularly from the answers) that the draft legislation had all sorts of unintended consequences which will be put right before it reaches the statute book. The proposals for earmarking were clearly too extreme, and it is also now intended to exclude unfunded, unapproved retirement benefit schemes from the scope of the new rules. Some parts of the draft legislation are not scheduled for change; for example, if you received a loan from an EBT, you will pay tax on it in full – with no relief when it is repaid.

In one way it could be said that this is consultation at its very best; HMRC publish some draft proposals which are reviewed and commented on by an expert community, and the result is legislation which is clearer and free of unintended injustice. Unfortunately, what is wrong with the process is that the ultimate legislation will be backdated to 9 December 2010. This means that for six months nobody knows quite what the law is in this area of considerable emphasis to employers and employees. It is like saying we are going to introduce a congestion charge effective from today if you drive into the city, but we are not going to tell you what the boundaries are for another six months. If you drive in the wrong place during that period you will just have to pay – but it is your own fault because you shouldn't have been on the road in the first place.

However, there is little point in dwelling on all this. Draft rules have been published, some different draft rules will be published soon and there will be more in due course. Who knows what the end result will be? Let us hope that something a little more certain is revealed at Budget time.

Deliberate Tax Defaulters

This is the new buzzword coined by HMRC to describe "tax cheats". They have published a statement about how they are going to manage deliberate defaulters by a new programme of special rules. It seems to me that there is not much new in this programme; they always took a pretty vigorous approach to people who were fraudulent with their tax affairs. What is new is the fact that it has now been codified – perhaps so that nobody

can be under any misunderstanding about how HMRC will react if they deliberately fail to meet their tax obligations.

One can entirely understand and support the vigorous scrutiny and pursuit of those who act fraudulently in tax matters. A recurring theme in the published material is that honest taxpayers need to be reassured that tax evaders will be penalised and their tax affairs closely supervised. Everyone will applaud that – but there is an anxiety that HMRC will punish taxpayers disproportionately for simply making a mistake where there is no element of deliberate default.

The plan is that somebody who is identified as a deliberate defaulter is going to be investigated thoroughly by HMRC. They will be told that they will be placed on the deliberate defaulters programme which means that they will have their tax affairs closely scrutinised – and this scrutiny would carry on for five years – and heaven help them if they do not alter their behaviour.

The danger here of course is that somebody could end up on the defaulters programme by accident. HMRC have become a little more understanding on this subject and seem now to accept that it is possible for taxpayers to make an innocent mistake.

However, I was alarmed to read the recent case of *Alan Kenyon* TC 968 in which Mr Kenyon claimed travelling expenses as a deduction from his self-employed income. HMRC did not consider the expenses were allowable, and the argument ended up before the Tribunal where HMRC claimed that he was negligent simply because he made a claim they disagreed with. Fortunately the Tribunal would have none of it – but this is a very serious and worrying approach. I bet it won't be long before they run this argument again.

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