# UK Tax Bulletin

December 2012

# Introduction

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# Latest Rates of Inflation and Interest

## The following are the current rates at December 2012

| Current Rates | December 2012 |
|---|---|
| Retail Price Index: November 2012 | 245.6 |
| Inflation Rate: November 2012 | 3.0% |
| Indexation factor from March 1982:<br>to April 1998<br>to October 2012<br>to November 2012 | <br>1.047<br>2.092<br>(not yet published) |

### 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%

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# Tidings of Comfort and Joy

Well, it looked like a Budget and sounded like a Budget – and we even got a draft Finance Bill – so I guess it was a Budget. George made it sound so good, you could almost believe everything is OK – and the dark looks from Vince were straight out of Dickens.

The Chancellor obviously wanted to be helpful but it shows how desperate he was when he made a big deal about increasing the inheritance tax nil rate band from £325,000 to £329,000 – from 2015. My heart rather sank.

I see that the higher rate tax threshold is going down next year. I could have sworn that he said that it was going up – and when I checked, I found that he did. Just after the point where he said “I want to be completely clear with people” he said that “the higher rate threshold will be increased …. so the income at which people start paying the 40% rate will go up to £41,865”. However, this figure includes the personal allowance (er … why? Not everybody gets a personal allowance). What he really meant was that the higher rate tax threshold will be *reduced* in 2013.

Mr Osborne has clearly taken on board that high tax rates generate lower tax revenues (HMRC have given him the figures) and there was the merest hint that maybe the reduction in the top tax rate from 50% to 45% is only the beginning - but maybe I am clutching at straws.

However, it was not all doom and gloom. In fact there were some really good bits.

For example, the statement about Enterprise Management Initiative Scheme shares and their eligibility for entrepreneurs relief is huge. In the March Budget it was announced that EMI shares did not have to satisfy the 5% test and now the 12 month ownership period has been relaxed as well. The ownership period will now run from the date of grant rather than the date of exercise. This is an excellent development and will make EMI schemes very popular and extremely valuable. After all, the prospect of paying capital gains tax at only 10% instead of income tax and NIC of 52% is going to attract a good deal of attention. (Without wanting to be too cynical, I can foresee that this will soon appear in the press as a "loophole"; you heard it here first.) These new rules will only apply to EMI shares disposed of after 6 April 2013 so it will be a worrying time for option holders who might be forced to exit before then.

We had to wait a bit to learn more about the proposals for UK residential property worth more than £2 million held by non natural persons. (More on this later). Any thoughts that the Annual Charge might have been withdrawn were soon dispelled. The Annual Charge to be introduced in April 2013 will be a completely new tax, and it will be a tax on property, so when the Chancellor said “we won’t introduce a new tax on property”, I got quite excited. What he meant was that he *will* be introducing a new tax on property. It won’t be a “mansion tax” charging a new tax on expensive property; it will be an “annual charge” imposing a new tax on expensive property. I think he was wanting to be completely clear.

The Statement did contain one really chilling statistic – that the top 5% of earners pay half of the total income tax. I hope this worries Mr Osborne – because it looks seriously dangerous to me.

# High Value Residential Property

We are definitely going to have a new tax known as the Annual Residential Property Tax which will come into force in April 2013. It will apply to UK residential property worth more than £2 million which is held by a company, partnership or collective investment scheme. Whether these entities are resident in the UK or otherwise will not matter. Interestingly, it will not apply to trusts. The charge will start at £15,000 for properties worth more than £2 million on 1 April 2012, £35,000 for properties worth more than £5 million rising to £140,000 on properties worth more than £20 million. It is intended to impose the charge on properties which are kept for occupation and not those which are let or otherwise used for a business purpose. For those years when the property is let commercially to unconnected tenants, the annual charge should not apply.

In addition to this annual charge, capital gains tax is going to be extended to gains made on the disposal of such properties by non resident companies – and the other entities which are within the scope of the annual charge. Trusts have been specifically excluded from this as well. (That is not quite as helpful as it seems because non resident trusts can still have their gains attributed to UK resident beneficiaries by reference to benefits they receive – but we need not worry about that here).

The original proposal was that the whole of the gain made on the disposal of the property would be subject to capital gains tax – not just the gain accruing after the introduction of the new rules. However, this will not now be the case. It is now proposed that capital gains tax will only apply to the gain accruing after April 2013. The rate of capital gains tax will be 28% - which is a bit odd because UK resident companies would pay corporation tax on such gains at a much lower rate. This looks rather discriminatory to me.

So everybody with an offshore company holding a valuable UK company will want to get the property out of the company to avoid both these charges. Rearranging matters so that the property is held by a trust would do the trick – but it would expose the property to inheritance tax on the trustees on each tenth anniversary. Actually, it might be worse – there may be a reservation of benefit, depending on the identity of the settlor, with the result that the property may be treated as forming part of the estate of the settlor.

So the whole of these new property taxes boils down to an entirely different problem which is inheritance tax. Some people (particularly if they are young and married) may not be bothered about the inheritance tax exposure not least because in the event of an unexpected death, the spouse exemption would ensure that there is no inheritance tax charge. Others will be less relaxed about the inheritance tax and that will obviously be their (and our) priority.

It may be possible to improve the situation by the use of a partnership (limited or otherwise) to create excluded property but this is uncertain at the moment. HMRC have made it clear that they are looking carefully at partnerships in this context, no doubt to make sure that they cannot be used to advantage. There is likely to be lots more thinking, and lots of activity, between now and April.

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## IHT - Spouse Exemption

It is not widely appreciated outside the professional sphere that when somebody dies and the whole of their estate passes to their spouse, it is not necessarily exempt from inheritance tax. If the deceased was UK domiciled but the surviving spouse is not, the unlimited spouse exemption does not apply. The exemption is limited to £55,000 (which is really neither here nor there) and this creates a serious anxiety for many married couples when they are told about it. The anxiety is even worse where the domicile position is uncertain because it seems to be impossible to obtain any certainty from HMRC on the matter.

In March, it was announced that the £55,000 limit would be increased to £325,000 and without wanting to look a gift horse in the mouth, in many cases this does not really solve the problem. There is going to be an opportunity for the non domiciled widow faced with a 40% tax charge on the whole of her husband's worldwide estate to make an election to be treated as UK domiciled thereby securing the full spouse exemption. That sounds pretty good – except that it then brings the whole of her estate into charge to tax which makes it merely a deferral – and a rather expensive one, at that.

However, the draft Finance Bill recently published contains a most helpful relief for spouses in these circumstances. It would obviously be absurd for a non domiciled spouse to elect to be UK domiciled, secure the exemption and then elect back to being non domiciled. However, HMRC acknowledge the difficulty here so if a person who has made such an election is not resident for 3 successive tax years following the making of the election, the election will cease to have effect.

This right of election will only apply in respect of deaths on or after 6 April 2013 and naturally enough, the determination of the individual's residence position will be made by reference to the statutory residence test which will be introduced on that date.

This is very helpful indeed and genuinely takes the sting from the unfairness and anxiety which many people feel about their inheritance tax position – although there must still be a serious question whether the discrimination against foreign domiciled spouses is compatible with the EC Treaty.

## Statutory Residence Test

We now have the revised draft legislation and revised guidance notes regarding the statutory residence test which is due to come into force on 6 April 2013. The general framework remains the same:

(a) An automatic non resident test if you satisfy some conditions (unlikely);

(b) An automatic residence test if you satisfy come conditions (also unlikely);

(c) A connecting factors test where the number of days you are allowed in the UK depends upon the number of your connecting factors.

The idea of this statutory residence test was to provide a welcome degree of certainty to taxpayers wanting to know whether they are resident in the UK or not - so that they can properly comply with their tax obligations.

The guidance note says that "*the Government does not believe the test is complicated*" and "*taxpayers will be able to determine their residence status with clarity*". Whoever it is in the Government who has this belief should be found because he is obviously not taking his medication.

One of the central conditions for the determination of UK residence is whether the taxpayer has a home here. It is therefore rather important that we know what this means. The Government said that they could not provide a definition in the legislation about what is meant by a home. OK - but one would expect something helpful in the guidance notes. But that is apparently not possible either. All they do is to say: "*We give some general examples of what a home may or may not be*". The examples are not very helpful. How a citizen is supposed to understand his obligations faced with this degree of clarity is beyond me.

Another important issue is whether the taxpayer is working in the UK. Again this is central to the determination of their tax position. A day of work exists if you work more than 3 hours in the UK. OK - but what constitutes work? Being on your Blackberry while on the train - or being on the phone? Who knows. Does work start when you arrive at the office or the client's premises and what about when you are having lunch, or when you are having dinner? All these uncertainties have been pointed out, and studiously ignored by the legislation or the guidance notes. The only safe conclusion can be that any time at all spent in the UK with any work connection at all is likely to be a working day. You can see how easy it is to fall down a big hole here.

There is a new definition of full time working abroad which includes a new condition that there must be no significant breaks from the overseas work. A significant break occurs if the taxpayer does not do more than 3 hours work overseas for 31 consecutive days (or would have done but for being sick or on holiday). So it is rather important that if you lose your job, you must get another one within 30 days or you will be in serious trouble.

We all know about the day count rule and that a day in the UK is one where you are here at midnight. This certainly provided us all with some welcome clarity. Not any more. There is a new provision. If you have 3 connecting factors and were resident in the UK in any one of the last 3 years then if you are present at any time in the UK for more than 30 days, every day of presence over 30 will count towards the total. So if somebody thinks that because they have three connecting factors with the UK and will therefore not be resident in the UK unless they spend more than 89 nights in the UK, they could be in for a shock. They could quite easily be resident here even though they spent no nights here at all during the year. It is good to be clear.

There are some special rules if you die during the tax year (when else are you supposed to die) but they are really too complicated to get into here. Do they really think that people go round dying in order to get some advantage over HMRC.

This statutory residence test was welcomed because although it is a bit complicated, it was thought to be reasonably certain so that everybody would know where they stood. Whether people like the rules does not really matter; what is important is that the rules are clear so that people can abide by them. Unfortunately these new rules are now shrouded in such uncertainty that we are going to need years of litigation before any reasonable degree of clarity arises. They have just exchanged one lot of uncertainties for another.

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# Losses on Shares : Income Tax Relief

The recent Tribunal Case of *Saund v HMRC TC 2400* dealt with a familiar theme - but with a twist. It related to a claim under Section 574 TA 1988 (now Section 131 Income Tax Act 2007) for income tax relief for losses on shares in trading companies which have been subscribed for by the individual.

Dr Saund had lent £850,000 to a company operating a language college which was run by his wife. The company made losses and there were serious concerns about its financial position. Dr Saund used £742,000 of his loan account to subscribe for 99 ordinary shares but shortly thereafter the company went into liquidation. Dr Saund claimed loss relief on the basis that the company's shares had become of negligible value.

The argument was familiar and the result was no surprise. The shares had not become of negligible value. They were already worthless when Dr Saund subscribed for them. Nor could there be a loss on the shares on liquidation for the same reason. Although he paid £742,000 for them (or at least applied that amount of his outstanding loan in paying for the shares), his acquisition price was market value - which was next to nothing.

However, Dr Saund's claim suffered from a rather more fundamental flaw - that the shares were never issued to him in the first place.

For relief to be claimed under Section 574 (and under Section 131) it is necessary for the shares to be issued by the company to the individual. There is no definition of "issued" in the Taxes Act so the ordinary company law meaning applies. An issue of shares requires something more than the allotment; there must be some subsequent act whereby the title of the allottee is completed. The allotment creates an enforceable contract for the issue of the shares and the issue is completed by entry in the Register of Members. [Nat West Bank v IRC [1995] 67 TC1].

Unfortunately, for one reason or another, no entries were made in the Register of Members of the company; the shares were therefore not issued to Dr Saund so he did not even get to first base.

# Discovery Assessments

The case of *Charlton* published last week is seriously important. I know I am always going on about discovery assessments but this is the most significant case on the matter for some time.

HMRC are only entitled to raise an assessment outside the enquiry window if they discover that an assessment to tax is insufficient. There is a balance here between the taxpayers entitlement to finality which is the cornerstone of self assessment, and the right of HMRC to correct a possible under assessment of tax. This balance was explained by Park J in the case of *Langham v* Veltema as follows:

> "*[Self Assessment] imposed new burdens on taxpayers by requiring them to submit fuller tax returns than had previously been required…. The new burdens were balanced by new protections for taxpayers who conscientiously comply with the*

*system, in particular by new and tighter time limits on the power of the Revenue to make further tax assessments*."

For HMRC to be able to make a discovery assessment without significant regard to the enquiry window deprives the taxpayer of any protection and the whole idea of finality becomes a cruel illusion.

In the case of *HMRC v Charlton [2012] UKFTT 770* the Upper Tribunal reviewed all the relevant issues relating to discovery assessments. They started with the meaning of a discovery and confirmed that a discovery assessment can be made merely when the original officer of HMRC changes his mind or where a different officer takes a different view.

The more important part of the decision related to Section 29(5) Taxes Management Act 1970 which enables HMRC to make a discovery assessment outside the enquiry window if an officer of HMRC could not have been reasonably expected on the basis of the information made available to him before the deadline, to have been aware of the insufficiency in the self assessment. It is this "awareness" test which causes all the trouble.

The first issue to consider is the characteristics of the tax officer. The officer who has to be aware of the insufficiency is not the officer who is in possession of all the information - it is a completely hypothetical officer. (This makes it irrelevant how HMRC decide to organise itself into separate departments and specialist areas - the practices of HMRC cannot affect the proper interpretation of the statute.)

This is a really difficult concept. It is necessary to assume a tax officer of reasonable knowledge and understanding but there is no uniform standard. The test of reasonable awareness must be applied to the particular context in which the question arises. The officer must be assumed to have such level of knowledge and understanding that would reasonably be expected of an officer considering the particular information provided by the taxpayer. We are not looking here at an officer of only general capability and experience nor of an ordinary competent inspector.

What is reasonable for an officer to be aware of will depend upon a range of factors affecting the adequacy of the information provided. This will depend upon the circumstances of the particular case and the complexity of the issues.

This formulation is impossibly subjective and seriously unhelpful to the taxpayer. However, as the subject matter of the dispute in *Charlton* was of extreme complexity - being a tax scheme (with a DOTAS scheme reference number) which needed the attention of one of the very small number of HMRC specialists on the matter - this probably represents the high water mark so maybe all the problems arising from such a subjective test will not arise in the majority of cases.

It is not necessary for the hypothetical officer to understand precisely how the scheme worked. All that is needed is for him reasonably to be expected to be aware of the insufficiency such as to justify an assessment. In this particular case once a DOTAS number had been allocated to the tax scheme, the form concerning the relevant scheme information provided all the information necessary to satisfy this test.

Another important feature regarding this decision is that it conflicts directly with the HMRC practice statement on discovery SP1/06. The statement of practice places much too great a burden on the taxpayer (and much too little on HMRC). In addition, HMRC have always insisted that if the taxpayer takes a view of a matter contrary to the published view of HMRC, this must be highlighted with full relevant particulars if the taxpayer is to be protected from a discovery assessment outside the enquiry window. This view has been the subject of adverse judicial comment before, but in *Charlton* the Upper Tribunal clearly stated that there is no requirement that the taxpayer must specify that the view adopted is different from that taken by HMRC.

Having regard to the robustness of this decision and the clear conflict with established HMRC practice, one can expect this case to go further.

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