SQUIRE PATTON BOGGS

UK Tax Bulletin

June 2014

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Introduction

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Latest Rates of Inflation and Interest

The following are the current rates at June 2014

Current Rates	June 2014
Retail Price Index: May 2014	255.9
Inflation Rate: May 2014	2.4%
Indexation factor from March 1982:	
to April 2014	2.219
to May 2014	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

To 6 April 2014: 4%

From 6 April 2014: 3.25%

McLaren : Deductible Expenditure

It may be remembered that the First Tier Tribunal allowed *McLaren Racing Ltd* a deduction for the fine of £32 million imposed on them by the FIA by reason of some serious impropriety surrounding confidential documents relating to Ferrari. HMRC had denied a tax deduction for this amount but the Tribunal decided that the activities giving rise to the fine were all part of McLaren's trade which included cheating.

It did seem instinctively wrong that conduct so serious that it merited a £32 million fine should be entitled to a tax deduction – and the Upper Tribunal have decided they were not.

This is not an easy argument because on one view, this was just a breach of contract. Many commercial contracts contain penalty clauses for failure to meet certain conditions and these are all in the nature of punishments for failing to meet the agreed terms, or otherwise to encourage performance. The person is still carrying on his trade even if in the course of that trade he fails to adhere to every term of every contract – and thereby exposes himself to a commercial penalty.

The Upper Tribunal did not think that it was right to regard the penalty as simply a matter of contract. The FIA has a regulatory function over the sport and the fine was to be utilised for the benefit of the sport. However, it is difficult to see how this can be other than a contractual matter. If the contracts between the teams and FIA had provided for full disclosure of technical data between all Formula 1 teams, there would have been no issue. Be that as it may, the Upper Tribunal decided that even if the penalty were to be viewed as simply a matter of contract between the FIA and the teams, it was still a punishment and not money wholly and exclusively laid out for the purposes of the trade.

There is considerable authority that a penalty for a breach of the law cannot be tax deductible as a matter of policy, but we are not dealing with any breach of the law here. The reasoning behind the decision of the Upper Tribunal is that cheating – that is to say the deliberate flouting of their contractual obligations - was not an activity carried on in the course of its trade and the payment was not money wholly and exclusively laid out for the purposes of McLaren's trade.

If this argument seems a little circular there may be another approach. It could perhaps be said that this conduct was so egregious and so far outside the four corners of the contract that the payment should fall within the same policy and be disallowed on those grounds. Although this point was not actually decided by the House of Lords in *McKnight v Shepherd* (having already been conceded by the taxpayer below), their Lordships did not make any distinction between fines or penalties imposed by statute and those which arose under the rules and regulations of a body like the Stock Exchange.

There are many points for discussion in this judgment but I imagine that few would argue that no matter how the Tribunal got there, this must be the "right" result.

CGT :Section 162

When an individual transfers to a company a business as a going concern together with the whole of the assets of the business (other than cash), in exchange for shares issued by the company, section 162 TCGA 1992 applies to roll any inherent capital gains on the business assets into the shares. A key issue here is that the activity which is transferred to the company in exchange for the shares must be a *business*.

We know from the Upper Tribunal in the case of *Elizabeth Moyne Ramsay v HMRC* that a business for this purpose can include the letting of property providing it is a serious undertaking earnestly pursued with reasonable continuity on sound and recognised business principles – and the activities were of a kind that are commonly undertaken by those who seek to profit from them.

We know from an increasing number of Tribunal decisions that property letting (no matter how comprehensive the services provided) will not regarded as a business for IHT business property relief, but clearly *business* has a rather different meaning for capital gains tax.

This month, the First Tier Tribunal had another opportunity to consider what is meant by a business for the purposes of Section 162: *Paul Roelich v HMRC TC 3704*. In this case, Mr Roelich carried on an activity described as a property development consultancy business. He advised on projects involving property development and advised on how these may be undertaken or progressed advantageously.

He transferred his business to a company in exchange for shares and claimed that the provisions of Section 162 applied to him on this transfer. HMRC disagreed saying that there was no transfer of a business as a going concern – there was merely the transfer of an income stream which did not amount to a business nor did it include the whole of the assets of the business apart from cash.

HMRC also argued that Mr Roelich's activities included the exploitation of his professional knowledge and experience but these skills were personal to him and incapable of being transferred to the company. (This argument has a clear resonance on the approach of HMRC to the transfer of goodwill).

The Tribunal considered the three key points. Whether there was a business; whether that business was capable of being transferred; and whether it was in fact transferred. The Tribunal were in no doubt that Mr Roelich carried on a business and that the business was capable of being transferred as a going concern to the company. There were one or two evidential difficulties arising from a shortage of documentation but on the evidence of Mr Roelich and the conduct of all the relevant parties, the Tribunal concluded that a transfer had taken place and that Section 162 applied.

There was one point which was touch and go. The company's tax return stated that a particularly important contract "was acquired from Mr Paul Roelich in exchange for the further issue of shares" in the company. HMRC zeroed in on this sentence as evidence that the issue of shares was for that particular contract and not therefore for all the assets of the business (excluding cash) and therefore it did not satisfy the terms of the section. Fortunately for Mr Roelich, the Tribunal concluded that the shares were issued in exchange for all the assets of the business despite this unfortunate wording and his relief was not prejudiced.

Cessation of Trade

There has been another case on this subject of whether a trade has been permanently discontinued: *Keyl v HMRC TC 3619*. It is odd that cases come along in bunches – and I can barely resist a bus analogy.

The importance of the point in this case was that Mr Keyl incurred some expenditure for which he claimed the annual investment allowance, but the allowance would not be available if the expenditure was incurred in the period in which his trade was permanently discontinued. It was obviously therefore important to identify when (and if) Mr Keyl's trade ceased.

At first glance this looks an open and shut case. Mr Keyl carried on business as a sole trader installing air conditioning systems and he transferred his business to a company which then carried on the trade. Under these circumstances, it looks a bit difficult to suggest that his sole trading activity had not ceased.

However, Mr Keyl said that although his trade of installing air conditioning systems ceased, he continued to trade because he had retained the outstanding maintenance obligations in respect of the earlier trade.

(One might say that after the transfer of the trade he was no longer installing air conditioning systems. That trade was discontinued when it was transferred to the company. What he continued to do personally was not the same trade – it was a new trade).

The timing here was crucial. The expenditure was incurred during his accounting year ended 31 March 2009 and on 1 April, the business was transferred to the company.

The Tribunal concluded that Mr Keyl's trade must have ceased immediately before midnight on 31 March and the new trade started immediately after midnight on 1 April. Therefore the trade ceased in the year ended 31 March and the allowance was denied. Wow – that is really tough.

I have previously made reference to the decision in *A Debtor v CIR [1992] STC 549* in which HMRC argued that a business continues until all the debts of the business incurred in the course of trade have been paid. There was not a lot of documentation relating to the commencement of the trade by Mr Keyl's company and it would be a pity if there had been the odd liability which had remained unpaid for a few days.

Fair or Foul

The UK is a member of the EU. It wishes to improve its economy by attracting foreign business. Incentives are given to companies establishing and carrying on business here and the country benefits from increased tax revenues, an increase in employment and the spending boost to its economy - all of which would otherwise go to other countries. This is a good thing and should be encouraged.

Luxembourg is a member of the EU. It wishes to improve its economy by attracting foreign business. Incentives are given to companies establishing and carrying on business there and the country benefits from increased tax revenues, an increase in employment and the spending boost to its economy - all of which would otherwise go to other countries. This is a very bad thing and should be condemned.

Um.

GAAR

It is a little early to expect any judicial guidance on the GAAR so it was interesting to read the recent case of *Spruce Credit Union* where the Canadian Courts considered the Canadian GAAR. Their version is not worded quite in the same way as ours - but it is pretty close. The relevant transaction must give rise to a tax benefit which is an abuse of the spirit or purpose of the legislation. Furthermore, it must be an avoidance transaction, being one which cannot be said to have been reasonably undertaken for a bona fide non tax purpose.

The central theme of the Revenue Canada argument was that if there was an alternative means of undertaking the transaction which gave rise to more tax, then the course of action chosen must have been an avoidance transaction. (Although this sounds instinctively outrageous - it looks like a pretty good argument to me. If there are two courses of action and you deliberately choose the one which gives rise to the smaller tax liability it sounds right to say that this was undertaken for the purpose of avoiding tax. Perhaps you can get away with saying that it was a reasonable course of action).

However, the Canadian Court of Appeal thought this was going too far - mainly on the basis that individuals are permitted to order their affairs to minimise their tax liability under the principle established in the *CIR v Duke of Westminster.* If the possibility of an alternative transaction with greater tax consequences could serve as a litmus test for the presence of an avoidance transaction, this would render the Duke of Westminster principle meaningless. This sounds really encouraging - but I don't' think it will cut any ice here. The GAAR guidance issued by HMRC sets out the Duke of Westminster principle and says that by enacting the GAAR, Parliament has decisively rejected this approach. The taxpayer is not free to reduce his tax bills by any lawful means; only if he does not go beyond anything which could reasonably be regarded as a reasonable course of action.

The HMRC guidance does not suggest that the existence of an alternative course of action giving rise to a higher tax liability would necessarily mean that the actual transaction was unreasonable - but I expect the judgment will be made in that light. However, we can take some comfort from the fact that the guidance contains a number of examples of transactions which are regarded as acceptable - and some of them could clearly be done in another way which could give rise to a greater tax liability. Maybe that is OK then.

Before I get carried away, I would observe that the express purpose of the GAAR was to deal with "egregious" abuse. My dictionary says that is something which is "outstandingly bad, shocking, appalling, monstrous". However, when the rules came to be enacted, we find that they apply to a course of action which is merely unreasonable - and the test of unreasonableness is to be determined largely by HMRC.

Directors Loan Accounts

HMRC has published another of its toolkits. This one is about directors' loan accounts and loans to participators. These are helpful documents which set out areas of risk, where things might go wrong and include an explanation of the underlying reasoning. However, there are some funny bits in this one.

This toolkit is said to cover the payment of expenses which do not form part of the directors' remuneration package. It is explained that if the company pays any personal expenditure of the director it should either be debited to the directors' loan account or treated as earnings and dealt with through the payroll. They confirm that payments of directors' personal expenditure are not allowable as deductions from profits unless they form part of the remuneration package in which case the relevant employment taxes should be operated or a form P11D completed.

So far so good. However, they go on to say that if a payments to or for the benefit of a director is posted to his loan account when it is in fact part of his remuneration package, this results in an underpayment of tax. Er, I don't think so. If a payment by the company is posted to the directors' loan account that means the company is not bearing the expense, it is an expense paid by the director himself and it is not earnings at all.

Later in the document it is suggested that where the company makes payments on behalf of the director for their personal bills they should be debited to the directors' loan account. If they are not debited to the loan account, the loan account balance will be incorrect. Well – not really. As the toolkit explains elsewhere, if the amounts of these personal expenses are not debited to the loan account, they are earnings to which PAYE and NIC will apply.

I do not want to be sniffy about this because despite the confusion, the principles come through clearly. However, in connection with the sections on loans to participators there is a really controversial paragraph. They start off by explaining that where a director who is a participator has an overdrawn loan account, a liability under Section 455 will arise. Quite so. For this purpose a company is regarded as making a loan to a participator if he incurs a debt to the company.

But they go on to say that for commercial or other purposes, different accounts may exist for the same person. Such separate accounts should not be aggregated or netted off. The company is liable to tax under section 455 on the full amount in respect of an overdrawn loan account irrespective of whether the same participator has a credit balance on another account with the company.

I know this is a long standing HMRC view but it has been challenged for just as long. If a participator is owed £100,000 by the company but the company chooses to show this as a number of different accounts some in credit and some in debit, it does not create an indebtedness from the individual to the company. The fact remains the company owes the participator £100,000 – there is no loan to the participators and no Section 455 liability.

It might also be said that accounts are prepared by accountants to record what has happened. The accounts report the facts (and may be evidence of how certain people understand the position), but they do not create the facts.

I expect one could come up with an extreme situation whereby a credit balance and a debit balance would exist and be treated as separate but the toolkit is not dealing with extreme and complicated situations – it is intended to help agents and advisers by providing guidance on errors which commonly occur. This is not one of them.

Source of Income

Whether income has a UK source is relevant for a number of tax purposes, not least the requirement to deduct tax at source at the time of payment. The classic authority on this matter is the House of Lords' decision in *Westminster Bank Executor and Trustee Company (Channel Islands) Limited v National Bank of Greece* 46 TC 472.

A few months ago, the case of *Perrin v HMRC* TC 3363 examined the position where Mr Perrin borrowed money from a trust in the Isle of Man. The law applicable to the loan was that of the Isle of Man; the interest was paid from funds in the Isle of Man; the loan agreement was subject to the exclusive jurisdiction of the Isle of Man Courts and the Tribunal accepted that if any dispute arose in connection with the loan agreement, the Isle of Man would be the proper jurisdiction and that the UK Courts would decline jurisdiction.

In 1988 the Privy Council confirmed that the residence of a debtor is the usual place where the debt would be situated because that is, prima facie, the place where he can be sued. However, if the debtor's country of residence is not the country which has jurisdiction, this prima facie rule does not apply and the obligation would be situated in the country with the jurisdiction – i.e. the place where he can be sued.

There would appear to be no argument here. The loan seems clearly to have an Isle of Man source. However, the Tribunal found that the interest had a UK source. This is because Mr Perrin was resident in the UK and if he had to repay the loan, the assets out of which the loan would be repaid would be mainly found in the UK. Everything else could be disregarded. A bold decision in the face of the House of Lords and Privy Council authorities.

The issue has arisen again in the case of *Ardmore Construction Limited v HMRC TC 3580*.

There were some really important procedural issues in this case – like were HMRC allowed to cite unpublished Special Commissioners' cases in support of their arguments? Is that not a tad unfair? HMRC have details of all tax cases but the taxpayer does not. Not a problem said HMRC. We will of course let you know if there are any unpublished cases which would help you. Anyway, we were allowed to cite unpublished Special Commissioners' cases in *Perrin* so why can't we do so here?

The Tribunal had a little look at the House of Lords' decision in *Monarch Airlines* (the bit where their Lordships said that "*Elementary justice… demands that the rules by which the citizen is bound should be ascertainable by him (or more realistically by a competent lawyer advising him) by reference to identifiable sources that are publicly accessible*") and decided that it would not be proper for HMRC to cite unpublished decisions of the Special Commissioners.

Anyway, back to the main point. Ardmore was resident in the UK and paid interest on loans from entities in Gibraltar. The loan agreements were governed by the laws of Gibraltar and subject to the exclusive jurisdiction of the Gibraltar Courts. The company claimed that in these circumstances and because the credit was provided in Gibraltar, the interest did not have a UK source.

However, the Tribunal concluded that because the debtor was resident in the UK, the funds out of which the interest would be paid were in the UK and the jurisdiction in which proceedings might be brought to enforce the interest obligation meant that the loan should be regarded as situated In the UK.

The enforcement of the debt is a difficult argument because if the loan is subject to Gibraltar law and subject to the exclusive jurisdiction of the Gibraltar Courts, then one might reasonably conclude that it was not enforceable in the UK. The argument is that when enforcement action has been taken and judgment has been obtained in Gibraltar, it would be possible for the judgment to be satisfied out of UK assets. This would seem to be a bit extreme because it would bring all debts into the scope of the UK if the debtor has any UK assets – no matter how far removed all the other factors are from the UK.

It is still quite difficult to see how *Ardmore* and *Perrin* can be reconciled with the Greek Bank and other cases, so I dare say there is still a way to go on all this.

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