SQUIRE SANDERS | LEGAL COUNSEL WORLDWIDE

UNITED KINGDOM TAX BULLETIN

Squire, Sanders & Dempsey

May 2009

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CURRENT RATES — May 2009

Indexation

Retail price index: April 2009	211.9
Inflation rate: April 2009	(1.2%)

Indexation factor from March 1982:

to April 1998	1.047
to April 2009	1.662

Interest on Overdue Tax

Income tax/CGT/NIC	2.5%	from	24 March 2009
Inheritance tax	zero	from	24 March 2009
VAT	2.5%	from	24 March 2009
Corporation tax	2.5%	from	24 March 2009
CTSA instalments	1.5%	from	16 March 2009

Repayment Supplement

Income tax/CGT/NIC	zero	from	27 January 2009
Inheritance tax	zero	from	24 March 2009
VAT	zero	from	27 January 2009
Corporation tax	zero	from	27 January 2009
CTSA instalments	0.25%	from	16 March 2009

Official Rate of Interest

From 6 April 2007	6.25%
From 1 March 2009	4.75%

Financial Institutions

HMRC has continued its pressure to obtain information from financial institutions and we now have a new series of cases before the First Tier Tribunal. They are all nearly identical, being *ex parte* applications seeking documents relating to customers of one particular institution with UK addresses and non-UK bank accounts. The reasoning of HMRC is clear and understandable, but I cannot help feeling it is utterly wrong.

HMRC have obtained information from other institutions from which HMRC have calculated *(sic)* that if they find out about people with offshore bank accounts, 25 percent of these customer accountholders will owe some tax. Therefore, HMRC are seeking financial details of the lives of accountholders of a completely different financial institution, even though 75 percent of them will likely have dealt with their affairs entirely properly.

It was acknowledged that the Revenue have no information suggesting noncompliance by customers of the financial institution in question, but because 25 percent of those of some other institutions had underpaid tax, this is somehow a reason for seeking all this confidential information from them.

In fact, HMRC acknowledge that quite a lot of the details will relate to foreign-domiciled people who have not remitted income from their foreign accounts and are therefore not taxable (but bad luck, HMRC are not prepared to exclude these people from their enquiries), and that actually it will not be 25 percent, but probably only 5 percent, who will have underpaid some tax. So, 95 percent of the relevant population will have all their financial details gratuitously disclosed for no good reason other than that maybe 5 percent of them (and where on earth does the 5 percent figure come from? – it is surely only a guess) might have not paid their taxes properly. I promise, I am not making this up.

The Special Commissioner noted that although not all the information obtained by HMRC was obtained from customers of this particular financial institution, it is statistically likely that there is a significant degree of noncompliance among this institution's customers. Well, yes – but it must be right to say that, having regard to the fact that nearly everybody in the country has a bank account, it must be statistically likely that there is a significant degree of criminal activity among *all* banks' customers, which, on this reasoning, would give the authorities grounds to turn *everybody* over.

In determining whether the Revenue request was justified, the Special Commissioner said he had to weigh the burden imposed on the financial institution against the benefit to the Revenue. That must surely be the wrong equation. The burden to the financial institution would be negligible – it may take some time for the computer databases to be searched for this information, but it is hardly a burdensome exercise. The important issue surely is to balance the rights of the 95 percent of blameless taxpayers against the benefit to the Revenue of identifying the 5 percent who might have underpaid their taxes. In weighing these issues, it might have been useful to use the scales of justice.

And what about the larger issue of the destruction of trust in the financial institutions relating to the security of people's financial affairs? I know it is not popular at the moment to be sympathetic to bank confidentiality, and it is of course absolutely right for those who fail to disclose their income to be brought to account vigorously, but rounding up a hundred people in the hope (even in a confident hope) that you might be able to find five wrongdoers is not the mark of a civilised society – or tax system.

However, there was a deafening silence after the previous four Special Commissioners' decisions on this subject, and I daresay there will be a similar reaction to these four cases.

I cannot resist the observation that "good men doing nothing" or, worse, treading a road paved with good intentions is generally regarded as a flawed approach.

Capital Losses: *Mansworth v Jelley*

Few people can have forgotten the bizarre case of *Mansworth v Jelley* and its extraordinary consequences.

In situations in which shares were acquired on the exercise of an option before 10 April 2003, the employee was treated as having acquired the shares at market value for capital gains tax purposes, but as a result of *Mansworth v Jelley,* the base cost was enhanced by the amount upon which income tax was paid. This was generally the same figure, so the base cost of the shares for capital gains tax purposes became double what it should have been.

This was all reversed in the Finance Act 2003, causing all manner of other problems, but there are a lot of people who banked huge losses on the basis of the extensive and very specific HMRC guidance on the subject prior to the change in the rules.

However, HMRC have now decided that they were wrong after all. In an HMRC Brief 30/09 issued on 13 May, they say that the guidance issued in their press releases of 8 January, 17 March and 8 August 2003 was wrong, and that the base cost should not be augmented by the amount chargeable to income tax on the exercise of the option.

Having regard to the change in the rules in 2003, it is a puzzle why they should have gone to all the trouble to get involved in all this now, but I guess the figures are large.

HMRC say that they will apply their new understanding of the law to cases in which there is an open enquiry or appeal and those affected by the change may need to make or amend their self-assessment return or loss claim, provided they are in time to do so.

I see some difficult issues arising here. However bizarre the interpretation may have seemed at the time, it was the absolutely firm view of HMRC, and their guidance could not have been clearer. Accordingly, even if they are now correct, issues of legitimate expectation must arise in respect of their previous announcements in situations in which people have relied on them in the conduct of their affairs. In situations in which there is an open enquiry or appeal, HMRC intend to adopt their new interpretation of the law and it will be interesting to see whether their initial view, or their current view, is confirmed.

However, what about those people who have a bank of capital losses brought forward who make a capital gain this year, or last year? Are they going to be affected because they will be making a claim for the loss to be deducted from current gains?

The answer may be that if the losses have been claimed in earlier years, they are protected by the enquiry window because the loss claim was made in the self-assessment tax return, or on the basis of a Schedule 1A stand-alone claim.

Food and Drink Expenses

As part of the enactment of Statutory Extra Concessions, there is a new Section 57A of the Income Tax (Taxation of Other Income) Act 2005 to allow a trading deduction for reasonable expenses incurred on food and drink for a trader who is at, or travelling to, a place where he or she is carrying on a trade. This sounds wonderful, except that it applies only to trades that are by their nature itinerant, or if the trader goes to that place only occasionally, in the course of his or her trade, and not as part of a normal pattern of travel.

There are some other conditions as well, and I fear that almost everybody seeking to claim such a deduction will find it simply too difficult to persuade HMRC that all these tests are satisfied and will quickly conclude that a claim is not worth the bother.

Visitors to the United Kingdom

I think I should get out more. All I seem to read these days are strange arguments and views being advanced by HMRC. I saw a note concerning HMRC's Employment Procedures Manual, in which they talk about people coming to work in the United Kingdom who are expected to stay for 183 days or fewer in any 12-month period. (Any 12-month period? What happened to years of assessment?)

It goes on to say that HMRC are changing the way in which the days are counted. Before 5 April 2009, when one counted the 183 days, part of a day counted as part of a day. (I think I can just about grasp that.) However, from 6 April 2009 onward, a partial day counts as a whole day of presence. The awful implications are obvious (and equally obviously damaging to UK Plc), but I suppose it helps to be aware.

Days of Arrival and Departure

Everybody knows that the counting of days of arrival and departure for the purposes of determining UK residence has become a tad controversial. This is no longer the current position (although the arguments for earlier years will continue for ages) because we now have the statutory day-counting rules introduced on 6 April 2008. A day counts only if you are present in the

United Kingdom at midnight – at least as far as the 183-day test in Section 831 ITA 2007 is concerned.

An issue arises about what is meant by "presence in the UK". What about airspace and territorial waters? (A gold star to anybody who notices that this is also relevant to whether a remittance to the United Kingdom of foreign income or gains has been made.)

I find that HMRC have published their view that "the point of arrival in the UK will be when an aircraft lands, a train arrives at the first station in the UK, a boat docks at the quay side or drops anchor in territorial waters" – and the corresponding position applies for the point of departure.

This sounds sensible enough, but it is in direct conflict with the Revenue Manuals, which say quite specifically that for the purposes of the taxation of earnings, the United Kingdom includes territorial waters up to a 12-mile limit and airspace.

If that is not clear enough, Section 830(1) TA 1988 provides that:

> *The territorial sea of the UK shall for all purposes of corporation tax be deemed to be part of the United Kingdom.*

And Section 1013 Income Tax Act 2007 states:

> *The territorial sea of the UK is treated for the purposes of the Income Tax Act as part of the United Kingdom.*

How then, can HMRC simply announce that they will have a different rule – however convenient that might be? At a time when HMRC are so firmly contending that they cannot possibly operate a practice that is contrary to the law, it is bizarre that they should so obviously seek to do so here.

One thing is absolutely certain. If you rely on the latest statement or if you rely on the Manuals to claim that you were not in the United Kingdom because your boat left, or Eurostar departed, shortly before midnight, you will be doomed, because HMRC are very clear in their stance that nobody can possibly rely on any of their statements or practices that are contrary to the law.

Tax Accounting Records

It may be remembered that Mr Darling proposed in his Budget that the senior accounting officer of a company would be obliged to ensure that the accounting systems are adequate for the company to make accurate tax returns. It would be required to certify annually that the accounting systems are up to the job or to confirm any inadequacies to the company's auditors. The senior accounting officer would be personally liable for a penalty if the company failed to comply with their obligations.

Predictably, this has given rise to a degree of concern, and the Treasury have now announced that they are satisfied that a narrower approach would be better. They propose to limit this measure to those companies with a significant business relationship with HMRC. Furthermore, they now "realise" that the requirement to notify the companies' auditors could cause disproportionate difficulties, so that obligation will be removed.

I have a feeling that they might "realise" a few more things soon – so goodness knows how it will end up.

Controlled Foreign Companies

The Court of Appeal has recently found in favour of the Revenue in the controversial case of *Vodafone 2 v HMRC.*

In 2006, in the case of *Cadbury Schweppes v HMRC* (Case C – 196/04), the European Court of Justice (ECJ) decided that the Controlled Foreign Companies (CFC) legislation in the United Kingdom cannot be applied to tax profits of a foreign subsidiary if the CFC is actually established in another EU Member State and carries on genuine economic activity there. The fact that it may have done so for tax reasons is irrelevant. The CFC legislation can be applied only if the CFC is a wholly artificial arrangement intended to escape tax and there is no genuine economic activity.

Vodafone 2 took this argument a stage further last year. The High Court said it was impossible to construe the CFC legislation in a way that enabled it to comply with EC law, even in the absence of an establishment with genuine economic activity. Section 748 Taxes Act 1988 could not be interpreted otherwise, and amending legislation would be necessary for the rules to work.

However, the Court of Appeal has taken a rather less robust view. They said that the issue was whether it was possible to interpret the CFC legislation so that it did not unlawfully restrict the taxpayers' freedom of establishment. HMRC contended that the legislation was cast widely, but was subject to a number of overlapping exceptions and all that was necessary was to introduce an additional exception in respect of companies in EU states that carried on genuine economic activities there.

The Court of Appeal decided that the jurisdiction of the ECJ did not include the interpretation of the legislation of a Member State. The obligation of the National Court was to consider how far the domestic law might be applied so as to conform with EC law. This could be done through an interpretation that removed the hindrance referred to by the ECJ. The Court of Appeal was entitled and bound to consider the whole of the CFC legislation in ascertaining whether it could be interpreted in a manner conforming with EC law. They decided that it was permissible to extend the exceptions to which the CFC legislation was subject to bring this about. The insertion of another exception in Section 748 along the lines suggested by HMRC would leave the impact of the CFC legislation unaffected on those companies to which it was intended to apply. The interpretation advanced by HMRC reflected and excepted from the operation of the CFC legislation precisely that element which the ECJ had found unacceptable.

So we are back to the decision in *Cadbury Schweppes.*

I find this all very puzzling. The powers of the Court to make "an emendation" to a statute are legendary, but inserting a whole new exception to the statutory provision? I will look forward with interest to the analysis of the House of Lords, which will surely be the next step in this saga.

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Peter Vaines: *New Law Journal:* Article on Tax Matters

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