UNITED KINGDOM TAX BULLETIN

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CURRENT RATES September 2009

Indexation

Retail price index: August 2009	214.4%
Inflation rate: August 2009	(1.29%)

Indexation factor from March 1982:

to April 1998	1.047
to August 2009	1.699

Interest on Overdue Tax

Interest on all unpaid tax is now charged at the same rate with effect from 29 September.

The formula is Bank base rate plus 2.5% which gives a present rate of 3%.

There is one exemption: Quarterly instalments of corporation tax bear interest at only 1.5%.

Repayment Supplement

Interest on all overpaid tax is now 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 2007	6.25%
From 1 March 2009	4.75%

Company Residence

The Tax Tribunal has recently considered the question of corporate residence in the case of *Laerstate BV v HMRC* TC162. (The facts are long and complicated but very interesting as they chronicle the power struggle between Tiny Rowland and Dieter Bock over the control of Lonrho.) Of course, the much more interesting aspect was the discussion about how to determine the residence of a company. Unusually, there was no dispute between the taxpayer and HMRC over the tests to be applied. Having what amounts to an agreed statement of the relevant tests seemed to be so valuable that I thought it may be useful to set out the Tribunal's comments, at least in summary form.

- They started with the classic formulation that a company resides where its real business is carried on, i.e., where the central management and control actually abides.
- There is no assumption that central management and control must be found where the directors meet. It is entirely a question of fact. Normally the location where central management and control abides will be where a company is managed by its directors in board meetings, but if the management is carried out outside board meetings you have to identify who was managing the company by making high level decisions – and where they were doing it. This is the case, even though it may be contrary to the company's constitution.
- You have to look at the particular actions of the company such as the signing of documents and the making of board resolutions but the factual question must be considered following scrutiny of the course of business and trading. A company's residence will not fluctuate merely because individual acts of management take place in different territories. The whole picture must be considered.
- It would be exceptional for a parent company to assume the functional management of its subsidiary because a parent company usually operates through the boards of its subsidiaries. However the position will be otherwise if the parent company effectively usurps what in theory are the functions of the local boards.
- The mere act of signing resolutions or documents does not suffice to create actual management. The local directors must apply their minds to whether or not to sign the documents. There is nothing to prevent a majority shareholder from indicating how the directors of the company should act. If the directors consider those wishes and act on them it is still their decision. The distinction is between directors making the decision and not making any decision at all – for example where an agreement is put in front of the directors opened at the signature page and they sign it regardless.

- Moving up the scale, it is still insufficient for the directors to know what they are signing but to sign it without considering whether or not it will be a good idea. What is needed is a genuine informed decision of whether the resolutions should be passed or the documents signed – merely going through the motions is not enough.
- The directors might follow the wishes of shareholders after considering the position, having at least the absolute minimum information to make a decision. It may be an ill advised decision but it can still be their decision. However if the directors are not in possession of the absolute minimum information necessary then there can be no decision at all. (The paper trail necessary to back up the decision making process will obviously be extremely important.)

These were the principles upon which the case of *Laerstate BV v HMRC* was decided. (This is a useful supplement to other recent decisions such as *Untelrab* and *Wood v Holden* and we are getting close to a fairly comprehensive code on the subject). As it turned out, the majority shareholder in *Laerstate* was the person concerned with strategic policy and management matters throughout his time as a director of the company and also after he ceased to be a director. The Tribunal decided that his activities constituted the real top level management (or the realistic positive management) of the company. Other directors were limited to signing documents when told to do so. Where he was resident was not important – what mattered was where the relevant activities were actually carried out. It was clear that he did them in the UK, and that made the company resident here.

There was some discussion about whether *central control and management* is the same as *the place of effective management* which is the phrase commonly used in double taxation agreements to determine residence. This is significant because although the Tribunal made it clear that you have to look at the whole picture and a company's residence will not move around from one territory to another depending on individual acts of management (which is a relief because of the possibility of exit charges arising on each occasion). However, this could very well be the position with trustees whose residence will fluctuate (and exit charges will arise) by reason of a change in the residence of one of the trustees. If the *place of effective management* is determined on the same basis as central control and management, that could be a useful safety net to trusts which might otherwise be vulnerable to exit charges.

Liechtenstein

Given the amount of press coverage, you would have thought that Liechtenstein was the centre of the universe. A lengthy series of questions and answers have been issued by HMRC for advisors and for taxpayers on the Liechtenstein disclosure facility (this is almost unbelievable – I know it was quite a popular place to deposit money, but not all that popular, the column inches would indicate that most of the UK had their savings there).

Whilst the published questions and answers are sensible and helpful, they do not really say much which is new. The only new point I could find was dealing with the differential between the normal offshore disclosure facility limitation period of 20 years, and that which applies to Liechtenstein which is only 10 years. There had been some suggestion that if you had concealed funds elsewhere which would be subject to a 20 year limitation period, you might be able to benefit from the limited 10 year limitation period by moving those funds to Liechtenstein before making the disclosure. HMRC have explained clearly why this would not be effective.

Property Valuations

HMRC has published a newsletter expressing various views on property valuations in the current uncertain climate. It seems that personal representatives are frequently asking HMRC to reduce or reopen valuations after probate because prices continue to fall. HMRC says that it will only consider a revision if the original valuation was undertaken with incomplete or incorrect information.

They go on to say that personal representatives must instruct valuers to estimate the open market value under normal market conditions with no discounts for a quick sale of the time of year – and that the valuers attention must be drawn to factors which might raise the price such as development potential. Furthermore, in presenting their value, it was suggested that it would be “preferable” to obtain three valuations from different estate agents – or one RICS valuation if a definitive figure is required. (Presumably one valuation from an estate agent who is a member of the RICS would be sufficient).

It seems to me that this goes rather too far. The personal representative is required to take reasonable care to ascertain the value of the property, so he asks a professional estate agent. Why should he have to ask three? In the nature of things, the valuations are likely to be slightly different so what does he do then? Does he take an average (which would not correspond with any of them), or does he take the lowest, the highest or the median. Each can be criticised. What is wrong with just one bona fide valuation?

It also seems to be a bit much to tell the valuer how to do his valuation. Of course it must satisfy section 160 IHTA 1984 which provides that the market value for the purposes of inheritance tax is:

"*The price which the property might reasonably be expected to fetch if sold in the open market at that time; but that price shall not be assumed to be reduced on the ground that the whole property is to be placed on the market at one and the same time*".

We know from *IRC v Clay* that there should be no discount for a quick sale, but why should the time of year be excluded from consideration? That seems to be specifically envisaged by section 160.

I also wonder why the valuer's attention has to be drawn to particular features of the property such as development potential. Surely the valuer would know (or ought to know) far better than the personal representative about what particular features are relevant in his valuation. This all seems to be a bit confused to me.

Capital Gains Tax: Flip Flops

The Tax Tribunal has recently heard the case of *Burton and Others v HMRC* TC156 which concerns a flip flop arrangement in respect of an offshore trust.

What happened was that trustees of a non resident settlement were proposing to make a capital gain on the disposal of an asset. The trustees borrowed an amount broadly equal to the value of the settled property and appointed those funds onto a new settlement for the benefit of Mr Burton and his family. The trustees of Trust 1 then excluded Mr Burton and his family as beneficiaries of the settlement. In the following tax year the trustees made the gain and repaid the loan and that was the end of Trust 1. The settlor and all relevant persons were excluded from benefit from that trust so the gain could not be attributed to them. The funds were all in Trust 2 but that trust did not make a gain and so there was no gain to be attributed to the settlor or his family. Cool idea, but we have seen it before.

This is exactly what they did in the case of *Trennery v West* [2005] UK HL5, but that was a UK resident trust. HMRC claimed that the settlor should be assessed on the gain made in Trust 1 because he continued to have an interest in Trust 1 as the funds in Trust 2 derived from Trust 1. The Special Commissioners rejected HMRC's claim and agreed with the taxpayer that the funds in Trust 2 did not derive from the first settlement; the High Court said they did; the Court of Appeal said they did not; and the House of Lords eventually said that they did. A bit difficult for us ordinary chaps to take a firm view on the matter.

So, *Trennery v West* settled the position regarding UK trusts and the discussion at the time was whether similar reasoning would apply to non resident trusts. It was thought not, because non resident trusts are subject to entirely different rules. There are no similar provisions relating to derived property as far as non resident trusts are concerned and the crucial question for Mr Burton was whether he received a benefit from the first trust. The Tribunal said he did not. Mr Burton's store of assets and value was no greater after the transfer to the new trust than it had been before. HMRC tried to argue that there was a benefit to him by reference to a potential tax saving if certain things happened. (I am glad this argument did not succeed. The result would be absurd. The idea that the settlor has received a benefit now and all the previous gains made by the trustees can therefore be immediately taxed on him just because at some time in the future the trustees might make a gain which might not be taxable on him… this must be going too far.)

The transfer to the new trust was not a capital payment; Mr Burton could not be charged tax on the gain of the first settlement as he was not a beneficiary (and did not have an interest in the settlement) in the year in which the gain was made. He could not be taxed in respect of a gain made by the second settlement because it did not make any gains.

This is generally the way in which flip flops were expected to work and the clarity of the judgment is extremely welcome.

Whilst we might admire the intellectual rigour brought to this issue by the Tribunal, having regard to the see-saw history or *Trennery v West* and HMRC's ultimate success, I cannot see this case ending here.

Mansworth v Jelley Losses

This saga continues. Someone really ought to tell HMRC to stop digging.

Where shares were acquired on the exercise of an option on 10 April 2003, the employee was treated as having acquired the shares at market value for capital gains tax purposes. However, as a result of the decision in *Mansworth v Jelley*, his base cost was enhanced by the amount upon which he paid income tax. In most cases this effectively doubled the amount of the base cost of the shares for capital gains tax purposes. HMRC issued a detailed statement in January 2003 explaining how these bizarre consequences operated and although it was all reversed in the Finance Act 2003, there were a lot of people who banked huge losses on the basis of the HMRC guidance on the matter.

Earlier this year (see the May 2009 UK Tax Bulletin) HMRC decided that they were wrong after all. They now say that the base cost should not be augmented by the amount chargeable to income tax on the exercise of the option. HMRC will apply their new understanding of the law to cases where there is an open enquiry or appeal and that those affected by the change may need to make or amend their self assessment returns.

It is no surprise that this has given rise to a number of problems and HMRC have now issued a Brief 60/09 setting out answers to various questions. For the most part, the answers are entirely fair and reasonable – but it is a mystery why we should be bothered with all this at all. Whatever the merits of the original statement, at least it was based on a judicial decision, however unwelcome. If they did not want to live with the consequences, why did they not appeal the judgment. Bad call perhaps, but issuing a statement, and then five years later issuing a contradictory statement is bound to cause trouble – for HMRC too. The point was dealt with by the Finance Act 2003 so the sensible course was surely to leave well enough alone.

Anyway, the new statement explains pretty clearly that before 1996/97 it was not possible for losses to be determined – they have to be considered when they come to be used. Accordingly if there are any losses arising in respect of a disposal prior to 1996/97 which had been enhanced by the application of the 2003 Revenue statement, that enhancement will be lost. However, that must be extremely rare.

For losses which arose in the era of self assessment in 1996/97 and onwards, the enhanced losses will continue to be available providing the enquiry window has closed. Those losses are available for carry-forward even against gains arising in the current year despite HMRC's new view. But where the tax return is under enquiry and the enquiry window has not closed, the enhancement will no longer be available and the losses brought forward will be accordingly reduced.

It is interesting that HMRC does not accept that its published guidance on 8 January 2003 necessarily created a legitimate expectation for the taxpayer. It is really difficult to understand why not. It would perhaps be fair enough to say that despite the legitimate expectation there may be no loss by the taxpayer because if the losses had not been used, the taxpayer has not suffered any detriment as a result (mere disappointment or upset not being enough). That would not deny the existence of legitimate expectation; it would merely remove any remedy. It would be up to the taxpayer to demonstrate their loss. However, that might prove to be a problem because if there had been opportunities to utilise those gains, no doubt they would have been taken.

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