SQUIRE SANDERS | LEGAL COUNSEL WORLDWIDE

UNITED KINGDOM TAX BULLETIN

Squire, Sanders & Dempsey

May 2010

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CURRENT RATES	May 2010
Indexation	
Retail price index: April 2010	222.8
Inflation rate: April 2010	4.3%
Indexation factor from March 1982:	
to April 1998	1.047
to March 2010	1.778

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 exception: 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 2010 4%

Budget 22 June

Everybody now knows that Mr Osborne will present his emergency Budget on 22 June, and there is unbelievable speculation about what he might do. An increase in capital gains tax is widely predicted, but there are so many different ideas being suggested that it is impossible to come to any sensible conclusion. Nevertheless there seems to be a great deal of selling going on with a view to crystallising gains at the 18% rate. This does rather presuppose that any increase in capital gains tax will take place from Budget Day and not, for example, be introduced next year, or backdated to the beginning of this year. Who knows?

Our traditional nocturnal activities will take place on Budget Day with a view to preparing a *Budget Bulletin*. A Budget Breakfast is being planned for the following morning – Wednesday, 23 June. Further details to follow in due course.

The Chancellor has helpfully published a list of some of his proposals which, although a bit vague, at least come from the horse's mouth. On capital gains tax, for example, it is suggested that they will seek ways of taxing non-business capital gains at rates similar or close to those which apply to income with generous exemptions for entrepreneurial business activities. The generous exemptions sound good – particularly as there has already been an increase in Entrepreneurs Relief to £2 million in the Finance Act 2010.

Other interesting proposals are:

- A review of IR35 with a view to replacing it with something simpler.
- A wholesale review of small business taxation.
- Reduction of the headline rate of corporation tax (they have previously indicated a wish to reduce it to 25%, and this seems still to be on the cards).
- An aim to create the most competitive corporate tax regime in the G20. (Sounds good; I hope they mean it.)
- An increase in personal allowances to £10,000.
- They say that they will "review the taxation of non-domiciled individuals". (This does not sound like a benign review – if I was a non-dom I would begin to feel that I was being

seriously persecuted.) Recent figures published by the Cass Business School reveal that in 2008/09 only 4,200 non-doms paid the £30,000 charge, and they concluded that the overall effect was to reduce the Treasury's tax take by £166 million. Um. The Adam Smith Institute predict the same result from the suggested increase in capital gains tax.

US LLCs

HMRC have published a note following the recent Tax Tribunal decision in *Swift v HMRC* TC 399 regarding the UK tax treatment of US LLCs. HMRC have traditionally taxed UK resident members of an LLC on the profits of the LLC only when they are distributed to its UK members. On this basis, a UK individual is not entitled to any relief or credit for US tax paid on the income in the LLC – although a UK company with more than 10% of the LLC can claim relief as underlying tax.

The Tax Tribunal have decided that the profits of the LLC belong to the individuals as they arise and that the UK member is taxed accordingly. As he is taxed on the same income in both countries, the individual is entitled to double taxation relief for US tax paid on his share of the LLC's profits.

HMRC are appealing this decision and in the meantime are carrying on with their existing practice even though the Tribunal say it is wrong. However, they say that if any member of a US LLC feels they are entitled to relief they should write to HMRC in Nottingham explaining why they believe they are so entitled.

This seems most peculiar to me. It is blindingly obvious why the individual will feel he is entitled to relief; it is because of the decision in *Swift*. But surely HMRC are not going to give relief to anybody who writes in and asks for it. They would surely just reply and explain that this is their view and the taxpayer will have to await the outcome of the appeal.

Repairs and Improvements

The recent case of *Wills v HMRC* TC 479 examined whether expenditure by Mr Wills on an outbuilding attached to one of his rental properties was a repair or an improvement. The distinction was obviously crucial because if it was a repair the expenditure was deductible from the rents, whereas an improvement would be regarded as capital expenditure and not so deductible.

Mr Willis had spent a lot of money on the work. The relevant building had previously been used as a games room and additional living space, but it had become run down and in dangerous disrepair. The architect advised that a substantial repair scheme was necessary – the roof was in a terrible state of decay and could well collapse. The repair scheme required listed building consent. It made sense to bring the interior more up to date, and heating, electricity and water were included. The costs were divided between capital and revenue on the basis of an agreed split between repairs and renewals for VAT purposes. HMRC argued that the whole of the work including the repairs was part of a wider capital scheme to convert the outbuilding into additional living space, and none of it was allowable.

Mr Wills drew attention to the HMRC Manuals which say that where work is undertaken that includes both repairs and improvements, a deduction is allowed for the repairs element. Mr Wills tried to head off a suggestion that HMRC were not bound by their own Manuals (which they certainly have argued in the past) by drawing attention to the Court of Appeal's decision in *Gaines-Cooper* that HMRC were bound by their public statements.

As it happens, this point did not need to be considered because the Tribunal found that the expenditure was tax deductible anyway, but clearly this will be a recurring theme.

Mr Wills claimed that the expenditure was driven by the dangerous state of the building and that the motive was one of repair. (Quite what the taxpayer's motive has to do with it I am not sure. Whether expenditure is a repair or an improvement is not a question of motive; it is a question of fact.) Anyway, he had specifically excluded the improvement element and had only claimed for the cost of repair.

The Tribunal agreed that the amounts claimed were properly regarded as repairs, adding that their decision "was supported" by the HMRC Manual at PIM2020. I could hardly believe my eyes. I do hope they didn't mean it. Let us hope what they meant was that HMRC should not be arguing about it because that is only what they said in their Manuals.

IR35

Having regard to the publication of the government's intention to do away with IR35 or at least replace it with something simpler, it is perhaps unnecessary to dwell much on the recent case of

Novasoft Limited v HMRC TC 456. This was in many ways a classic IR35 case, where the company provided the services of Mr Brajkovic (who was the sole director and major shareholder of the company). The question was, as in all IR35 cases, to consider what the terms would be of a notional contract between Mr Brajkovic and the client and then to consider whether that notional contract was a contract of employment. You can see why this idea needs simplification.

HMRC do not win these cases very often – and they didn't win this one either – but they are all very fact-specific and it is not easy to extract much which is helpful in another case. However, it is perhaps interesting in this case that there was acknowledged to be no likelihood of any substitution – and the Tribunal found that the notional contract would not have permitted substitution.

The Tribunal also dealt with the question of mutual obligations because one of the essential elements of a contract of employment is that the employer is obliged to offer work and the employee is obliged to undertake it. This test is so important that HMRC have done their best to limit its application and have got the occasional Tribunal to agree that the mutuality of obligation need only extend to the work under consideration. I have never understood how this can possibly be right because if somebody undertakes to do work for another person for payment, that obviously gives rise to mutual obligations. That is a matter of contract – but the obligation to do the work and be paid for it exists whether or not the contract is an employment contract. It does not take the argument anywhere – but the result is that the point has been so confused or devalued that it is easily disregarded. The point is that the obligation of the putative employer to provide (and the employee to accept) other (as yet unspecified) work during the period of the relationship makes all the difference. However, I need not get on my high horse about this because the issue may be substantially changed soon.

Share Exchanges

The recent decision by the Upper Tribunal in *Coll v HMRC* UKUT 114 (TCC) 2010 dealt with the circumstances of a taxpayer who sold his business in exchange for loan notes issued by the purchaser and did not dispose of those loan notes until such time as he had become non-resident.

The issue here was reasonably straightforward. Mr Coll disposed of his shares in exchange for loan notes. In principle, that represents a disposal for capital gains tax giving rise to an immediate charge to capital gains tax if he is resident in the UK in that tax year. However, Section 135

Taxation of Chargeable Gains Act (TCGA) 1992 provides that such an exchange of shares is treated as a reorganisation of share capital with the result that there is no disposal of the original shares. The loan notes are treated as having been acquired at the same time and at the same cost as the shares. Accordingly, the capital gains tax consequences do not arise until such time as the loan notes are disposed of.

This treatment is subject to a specific restriction in Section 137 which says that this treatment does not apply unless the exchange:

> "…is effected for bona fide commercial reasons and does not form part of a scheme or arrangements of which the main purpose or one of the main purposes is avoidance of liability to capital gains tax".

It is possible to seek clearance from HMRC under Section 138 that they agree the *bona fide* commercial condition is satisfied and Mr Coll sought such a clearance in this case. Unfortunately HMRC refused clearance, but Mr Coll went ahead with the share exchange anyway.

There was a great deal of evidence about whether and when Mr Coll had intended to become non-resident. It is clear that he subsequently did leave the country to become resident in Belgium following detailed tax advice on that subject. The Special Commissioners and the Upper Tribunal both decided that the exchange of shares for loan notes was not effected for *bona fide* commercial reasons but formed part of an arrangement of which one of the main purposes was the avoidance of capital gains tax by reason of Mr Coll's intention to become non-resident. Accordingly, he could not benefit from Section 135 which treated the exchange as not being a disposal; the disposal took place at a time when he was resident in the UK and it was fully chargeable in that year.

Entrepreneur Relief

Whilst on the subject of share exchanges, The Chartered Institute of Taxation (CIOT) has obtained clarification from HMRC regarding an uncertainty over one of the conditions for Entrepreneur Relief. The issue is whether the 12-month ownership requirement for the relief includes the holding period of the original shares where there has been a share-for-share exchange.

HMRC have confirmed that if both the old and the new holdings were shares in companies which qualify as the personal trading companies by which the individual was employed, then the period

of ownership for the purposes of Entrepreneur Relief starts with the acquisition of the original shareholding. Where there is a reorganisation (which includes an exchange of shares), the new shares are treated as having been acquired at the same time and for the same cost as the original shares.

All the above is subject to the possibility of an election under Section 169Q TCGA 1992 which enables the taxpayer to elect not to apply the no-disposal rule and to treat the share exchange as a being a disposal. At first sight this may sound odd, but it is extremely helpful if your shareholding qualifies for Entrepreneur Relief and the company is acquired by a purchaser in a share-for-share deal. There may be many reasons why the individual may not satisfy the requirements of Entrepreneur Relief in respect of the new holding – so he can elect for the exchange to represent a disposal and crystallise a gain for Entrepreneur Relief.

Capital Gains Tax Avoidance

The Tax Tribunal recently heard the case of *Schofield v HMRC* TC 439 which concerned a complex capital gains tax avoidance scheme involving Gilt Options. It was an unashamed tax scheme whereby various things happened and up popped a loss and a very similar profit (not taxable). The loss was then set against the gains made by the taxpayer on other transactions. (This brief description does not do justice to the intellectual ingenuity of the arrangements, but never mind.)

I do not propose to dwell on the scheme or its merits, but merely to mention that it failed principally on *Ramsay* grounds with the result that the whole thing was a fiscal nullity.

(Historical note: *Ramsay* is a sort of magic code word that is short for Pre-Ordained Series of Transactions and means Your Plan Fails. No further explanations required. I said it was magic.)

Anyway, for those like me who thought that the *Ramsay* doctrine had been sent into the wilderness by the House of Lords in *Westmoreland* and *Barclays Mercantile*, this came as a bit of a surprise. The decision in *Schofield* indicates that there is life in the old doctrine yet.

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