SQUIRE SANDERS | LEGAL COUNSEL WORLDWIDE

# UNITED KINGDOM TAX BULLETIN

Squire, Sanders & Dempsey

**August 2010**



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| **CURRENT RATES** | **August 2010** |
|---|---|
| Indexation | |
| Retail price index: July 2010 | 223.6 |
| Inflation rate: July 2010 | 4.8% |
| Indexation factor from March 1982: | |
| to April 1998 | 1.047 |
| to July 2010 | 1.815 |

**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%

## Personal Note: Peter Twiddy

I read with great sadness of the recent death of Peter Twiddy who retired from HMRC in 2006 after a distinguished career of 40 years in the Estate Duty Office and later the Capital Taxes Office. He was a formidable and knowledgeable opponent but unfailingly fair and courteous. He was a real gentleman and served his country, and later his clients, with skill and honour. He will be missed by all who knew him, and the profession is poorer without him.

## Domicile and IHT

HMRC have issued a new guidance note, HMRC Brief 34/2010, dealing with the circumstances in which they will consider an individual's domicile for inheritance tax (IHT) purposes. The previous guidance note in Brief 17/2009 is withdrawn.

Anybody wanting confirmation from HMRC regarding their domicile has an uphill struggle. We are in an era of self-assessment, and it is up to taxpayers to decide whether or not they are domiciled in the UK if this is relevant to their tax liabilities – and they had better get it right because otherwise a liability will bite them should HMRC ever decide to challenge the position.

For a client of means who is living abroad with a foreign domiciled spouse, this is a really serious issue. A husband with a foreign domiciled wife will be very anxious indeed for some certainty regarding his domicile. If he has acquired a foreign domicile, his wife will benefit from the full spouse exemption in the event of his death. However, if he has remained UK domiciled, there will be practically no spouse exemption, and the whole of his estate would be liable to inheritance tax even if it passes to his spouse. No husband would want to leave his widow in such a situation – with the possibility of HMRC claiming 40% of his worldwide estate and leaving her to argue that he was not domiciled at the time of his death. Not really the sort of burden one would want to place on the shoulders of a recently bereaved widow – which makes it essential to clarify the position during his lifetime.

If a transaction is undertaken which would be chargeable to inheritance tax if the client is UK domiciled, then HMRC will usually need to determine the domicile of the taxpayer and therefore whether the tax is payable. However, they will only now do so where there is a significant risk of loss of UK tax. They do not reveal what is "significant" (the £10,000 previously referred to in Brief 17/2009 no longer applies), but they will take into account potential costs of litigation. For this reason they may stop an enquiry if they think it is not cost effective, and this may be on the basis that they will not pursue the collection of any potential tax.

HMRC are consumed by their desire to have a full picture of the taxpayers' affairs (no doubt encouraged by the famous words in *Drevon v Drevon*: "There is no act or circumstance in a man's life however trivial it may be in itself, which ought to be left out of consideration"), and their enquiries into a taxpayer's affairs can be unbelievably intrusive.

I may not be alone in my concern about HMRC discontinuing their enquiries if they are not cost effective. One can of course understand the principle, but it does not seem right for HMRC to say that although tax of (say) £15,000 may be payable, they will not go to the trouble to collect it if it's going to be too difficult – no doubt because the taxpayer believes it is not due and can put up a good fight. I do not see the distinction between that and a self-employed trader who makes a claim for some deductible expense which would save him a similar amount of tax. We all know that he will be pursued with all vigour and there will be no question of HMRC saying that they will not bother about it.

## HMRC Toolkits

HMRC have published a number of toolkits to assist in the completion of personal and company tax returns this year. These are on the following subjects:

- Small Companies Relief
- Capital Gains Tax on Land and Buildings
- Trust and Estates
- Capital Allowances
- Private and Personal Expenditure

And there are more to come.

I think these are really good. They all follow the same format which is an introduction, a checklist and an explanation of the various points in the checklist. You may not agree with the explanations (indeed they can be oversimplified and sometimes maybe not right), but that does not matter – you do not have to agree with them. They are to assist in avoiding errors and indeed have been deliberately designed to focus on those areas where HMRC's experience shows that errors frequently arise.

HMRC explain that following the toolkit will enable you to demonstrate that you have taken reasonable care in dealing with the entries on the tax return, and therefore the client will be protected from any penalty if something goes wrong. You do not have to use the toolkit, of course…

However, they do have to be looked at quite carefully. For example, in the Capital Gains Tax on Land and Buildings toolkit, they say that when looking at valuations "it is important to instruct a qualified independent valuer to make sure the valuation is made for the purposes of relevant legislation and meets RICS or equivalent standards". Surely this is overstating the position. It could obviously be helpful in some circumstances, but it will clearly not be important in most cases relevant to the target audience of these toolkits. Why should the taxpayer have to go to the trouble and expense of a full professional valuation when market value can be established in other ways?

HMRC go on to say that "some issues are sometimes overlooked when instructions are given, for example the potential for development of land". This is even worse. If a lay person instructs a fully qualified independent valuer, surely the professional would know far better than his or her client about the potential for development of the land. It is his or her business. To suggest that the client has to instruct professional experts in the field and then tell them how to do their job is going a bit far.

In the Small Companies Relief toolkit it is explained that in counting associated companies, companies are excluded if they are dormant, i.e. did not carry on any trade or business during the accounting period. HMRC say that a company which receives any income, including that from dividends or interest, may not be considered to be dormant. This is difficult to justify in the light of *Jowett v O'Neill and Brennan Construction* in which the High Court specifically held that the receipt of bank deposit interest was not the carrying on of a trade or business.

I await the issue of further toolkits with interest.

## Double Taxation Treaty Passports

On 1 September HMRC introduced a Double Taxation Treaty Passport Scheme to speed up the provision of treaty relief on UK loan interest payments by UK companies to lenders in other treaty countries. At the moment, interest can only be paid gross with the permission of HMRC, and that requires a claim certified by the tax authority in the lender's country of residence. That tends to take a while.

Overseas companies can now apply for passport holder status which is expected to be granted within 30 days. The passport status will last for five years (unless it is withdrawn of course) and it can be renewed. It effectively authorises the borrower to pay interest gross or at the treaty rate of withholding tax.

Not only will it help with interest payments, but notification by the passport holder enables UK corporate borrowers to enter into loans confident that interest payments will attract exemption from withholding tax either in full, or at the treaty rate.

Further details of the passport scheme are available on request.

## The Ryder Cup

I see that the US and European golfers who will be contesting the Ryder Cup in Wales next month (which they do for no payment) will be subject to enormous liabilities to tax if they play in the competition. One report suggests that Tiger Woods could be charged £1 million by HMRC if he plays in the Ryder Cup.

This is of course bonkers. The fact that the charge to tax can be shown to be in accordance with the Foreign Entertainers legislation does not make it any less bonkers.

I understand HMRC have already said it will waive the rules for participants in the Olympics and there is a specific exemption included in the Finance Act 2010 for foreign footballers and officials involved in the Champions League final in 2011 – after this year's Champions League final was moved to another country because of these tax provisions.

It surely cannot be right for HMRC simply to decide not to enforce this law. Nor is it right to introduce *ad hoc* statutory exemptions for special interest groups. If the law is inappropriate for golfers and footballers (and Usain Bolt), it is inappropriate for everybody else as well. I cannot see how such an imposition can possibly be thought to be in the national interest. The theory that it represents the will of Parliament when they enacted the provisions is surely stretched to the breaking point.

## Income Splitting

The recent case of *Patmore* TC619 provides an interesting variation on the position where shareholdings and dividends are arranged so that a spouse can take advantage of his or her basic rate band. In this case, Mr & Mrs Patmore purchased the shares in a company in which

Mr Patmore previously worked. Part of the consideration was paid in cash (found from a mortgage on their jointly owned property), and the balance was to be paid in instalments. Mr Patmore had 98% of the company and Mrs Patmore 2%. Some non-voting B shares were then issued to Mrs Patmore, and a substantial dividend was paid only on the B shares. The dividend was then immediately paid by Mrs Patmore to Mr Patmore to enable him to pay the deferred consideration to the vendor. HMRC took the view that this was a settlement, precisely following the reasoning in *Arctic Systems*, and that the dividend should be taxable on Mr Patmore.

This reasoning looks rather compelling, and the Tribunal accepted the point – but only to a limited extent.

The Tribunal's reasoning (which was not argued by either side) was that when the shares were purchased, the consideration had really been provided equally by Mr and Mrs Patmore. However, she only received 2% of the shares. The Tribunal decided that there was therefore a constructive trust in Mrs Patmore's favour. She contributed half of the capital to buy the shares, as she was jointly liable with her husband on the loans and the mortgage. She did not intend to give her half to her husband. Accordingly, she was entitled to her full share of the dividends paid on both the A and the B shares. Therefore the amount of dividend effectively diverted to Mrs Patmore beyond the amount to which she was really entitled was relatively small.

The Tribunal found that the issue of the B shares to Mrs Patmore involved no bounty and therefore there was no settlement for the purpose of Section 660A. Accordingly, issues about whether it was excluded as a settlement on the spouse did not arise.

This is an interesting variation on *Arctic Systems*, although perhaps it did not address the point that it was Mr Patmore who did all the work in the company to earn the profits and generate value. I think we may hear more about this.

## Payments in Lieu of Notice

The recent case of *Goldberg v HMRC* TC628 was concerned with a payment in lieu of notice and whether the £30,000 exemption for termination payments applied to it. This is an odd decision as I shall explain.

Mr Goldberg was employed by a company for some years. His contract of employment entitled him to 12 months' notice, but there was no payment in lieu of notice clause giving him any entitlement to receive, or the company any right to make, a payment in lieu of that notice.

In the fullness of time, his contract was terminated. The company wanted him to leave immediately and gave him 12 months' pay in lieu of notice.

The question was whether that payment attracted the £30,000 exemption or whether it was fully chargeable to tax as part of his earnings from the employment.

These are some recent authorities on this point. *EMI v Coldicott* confirmed that where a payment in lieu of notice is made in pursuance of a contractual provision enabling the employer to make such a payment, it is part of the earnings from the employment.

In *SCA Packaging v HMRC* this principle was extended to employees who were entitled to payments in lieu of notice arising from a memorandum of understanding between the parties which supplemented their contracts of employment. However, that is really saying the same thing, as the contractual entitlement arose in a slightly different way.

There is the further case of *Cerberus Software Limited v Rowley* which took the principle a little further by suggesting that where the contract gave the employer a right to make a payment in lieu of notice (but no right for the employee to insist upon it), the payment still arose as part of the contractual arrangements for the employee's services and was therefore earnings.

In 2003 HMRC published a statement on the subject, highlighting that where a contract is terminated in accordance with its terms, any such payment is fully chargeable to tax as earnings. However, they confirmed that compensation for breach of contract does not represent earnings and qualifies for the £30,000 exemption.

Returning to Mr Goldberg, the Tribunal said that:

> "The payment was a payment in lieu of notice and we dismiss the appeal… The only hard evidence before us is [a letter] to the effect that the payment was in lieu of notice. There was a further letter [from the company] confirming that to be the position as far as the company was concerned."

They concluded that they had no alternative but to accept that the payment was a payment in lieu of notice.

Well yes. But nobody was disputing that it was a payment in lieu of notice. That does not make it taxable. What matters is whether the employee could insist upon receiving such a payment or

whether the employer could insist on making one so that the payment fell within (and not outside) the terms of the contract.

Although the judgment is not entirely clear on the matter, there seemed to be no evidence that any such contractual entitlement existed and there was a clear breach of contract by the employer. Mr Goldberg was entitled to 12 months' notice and was not given that notice. He received compensation instead.

It may be that there is more to this case than is apparent from the judgment, but it would certainly seem that a payment in lieu of notice was assumed by the Tribunal to be a description of a taxable category without regard to the fact that this applies only where a contractual right exists on one side or the other for the payment to be made.

## IHT Business Property Relief

The case of *HMRC v Executors of the Earl of Balfour* [2010] UK UT 300 has recently been heard by the Upper Tribunal. This is a most interesting and valuable case as it analyses the meaning of business property for the purposes of inheritance tax. This was a Scottish case involving Scots law, but there are important elements relating to inheritance tax which of course applies to the whole of the UK.

Lord Balfour had an interest in a farming partnership and was the proprietor of a landed estate comprising approximately 2,000 acres which consisted of two in-hand farms, three let farms, two sets of business premises and 26 let houses. There were also some parks which were let on a seasonal basis.

Lord Balfour made no distinction between the partnership and the estate. His own view seemed to be that everything was run as a single business. The First Tier Tribunal agreed that the whole of the activities represented a single business and that the entirety qualified for business property relief. HMRC appealed to the Upper Tribunal who confirmed the decision in favour of the taxpayer. The First Tier Tribunal had decided that, as a question of fact, Lord Balfour operated a single composite business, and the Upper Tribunal did not feel able to contradict that finding.

I think that some important implications arise from this judgment particularly in connection with the 26 let properties (and possibly other parts of the estate).

It would generally not have been doubted that the passive holding of 26 let properties and the receipt of rent represented an investment activity. The fact that the properties were situated on land on which other (commercial) activities took place does not make them anything other than pure investment properties. Why then did they not represent excepted assets under Section 112 IHTA 1984? An excepted asset is an asset which is neither:

a) Used wholly or mainly for the purposes of the business concerned, or

b) Required at the time of the transfer for future use in the business.

It would not be difficult to conclude that the 26 let properties did not satisfy these conditions and could therefore be left out of account in calculating the value eligible for business property relief. However, the First Tier Tribunal did not even mention the existence of Section 112 – and neither did the Upper Tribunal on appeal. I suppose if one reaches the conclusion that everything undertaken by Lord Balfour including the ownership of the let properties represented integral parts of a single business, then Section 112 would have no application because they would be assets used wholly or mainly for the purposes of the business concerned.

However, I wonder where this leaves the concept of an excepted asset because if the passive holding of 26 investment properties and the receipt of rents can represent part of an overall business activity, it is difficult to see what could be excluded and treated as an excepted asset. A substantial holding in quoted securities could be such an asset, but what real difference in principle exists between the passive holding of an investment property and the passive holding of a portfolio of quoted securities?

There is perhaps a more helpful analysis. It is well established that when a company carries on a trade and also has some investment assets, one must look at the trading business and the investment business and determine whether the overall businesses carried on by the company are predominantly trading or whether they are wholly or mainly the making or holding of investments. Providing the investment business does not predominate, business property relief applies to the whole of the value of the shares notwithstanding that the investment business may be extremely significant.

It is possible that this reasoning applies to an unincorporated business or businesses in exactly the same way. Could one say that the whole of the activities undertaken by Lord Balfour consisted of one business or a number of different businesses, even though one or more of those businesses were an investment business? If Section 105(3) IHTA 1994 applies equally to a sole trader so that

one may aggregate all his businesses including investment businesses and providing the investment business does not predominates, then business property relief is allowed in full.

This would not seem to be the reasoning upon which the Upper Tribunal found for Lord Balfour, but it may well be a reasonable conclusion to be drawn from the judgment. If so, this would be a most helpful development in connection with entitlement to business property relief – unless of course the case goes further.

## Doormats

I think something has happened to the calendar because 1 April seems to have moved a bit. I have received a Tax News Tariff Notice 18/2010 which is some kind of EU regulation about doormats. I am not joking.

In case you don't know, a doormat is either:

a) A thick semicircular article, with overall dimensions of approximately 75 cm in length x 45 cm in width, made of a woven textile fabric of spun coconut fibres, which forms the majority of the surface, with a rubber backing. The article is surrounded by a decorative rubber border. (classification code 5702 20 00); or

b) A thick rectangular article measuring approximately 60 cm in length x 40 cm in width, made of coconut fibres forming a pile surface. The coconut fibres are bonded to a substrate of poly (vinyl chloride), which forms the backing. The mat is surrounded by a decorative poly (vinyl chloride) border. (classification code 5705 00 90).

The Tariff Notice helpfully provides detailed explanations about doormats. You really don't want to know – but I promise you this is genuine.

**Peter Vaines**
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## Articles and Publications – August 2010

Peter Vaines: TAXline August

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