SQUIRE SANDERS | LEGAL COUNSEL WORLDWIDE

UNITED KINGDOM TAX BULLETIN

Squire, Sanders & Dempsey

November 2010

Current Rates: .... The latest rates of inflation and interest

Holding UK Property: .... How non-doms should hold UK property

Liechtenstein Disclosure Facility: .... A second declaration is signed

Reasonable Excuse: .... Two encouraging successes before the Tribunal

Inducement Payments: .... A curious decision on shares provided as an inducement

Enterprise Investment Scheme: .... The meaning of connected persons

Finance Bill 2011: .... An update following the Chancellor's statement

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CURRENT RATES — November 2010

Indexation

Retail price index: October 2010	225.8
Inflation rate: October 2010	4.5%

Indexation factor from March 1982:

to April 1998	1.047
to September 2010	not yet announced
to October 2010	not yet announced

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%

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Holding UK Property

Advice is often sought about how a resident but foreign domiciled client should hold residential property in the UK. The property is invariably valuable, and because it is situated in the UK it will be vulnerable to inheritance tax in the client's hands. Even foreign domiciled individuals are liable to inheritance tax on assets situated in the UK. The value of a comparatively modest house in central London can create an inheritance tax exposure of millions of pounds, which most non-dom clients find undesirable.

A traditional answer here is to ensure that the UK property is purchased by an offshore company. The individual then owns shares in the offshore company, which is foreign property for inheritance tax purposes and excluded from the scope of inheritance tax. Simple. Problem solved.

However, it is not quite as simple as that. There are some other issues arising which need to be considered.

One issue would be the possibility of a charge to income tax under the benefits in kind legislation on the basis that the client is an employee who is receiving the benefit of living accommodation and is liable to income tax on the annual value in the normal way plus the supplementary benefit calculated at 4% of the cost of the property over £75,000. This will make your eyes water. The argument for HMRC is deceptively simple. The client is a person in accordance with whose instructions or directions the real directors are accustomed to act. He is therefore a shadow director; a shadow director is the same as any other director, so he is an employee and has had living accommodation provided for him by the company, which by definition is provided by reason of his employment. All the building blocks are in place for the benefit in kind charge to arise. It is therefore necessary to ensure that the purchase is structured so as to eliminate this charge.

There is also the question of the company's residence. It will be readily appreciated how easily HMRC might argue that the company is resident in the UK because of the overwhelming influence of the UK-based client on its operations, so that the central management and control of the company would take place where the client is resident. Accordingly, in the event of a sale the capital gain made on the property would be fully chargeable to corporation tax. No private residence relief would be available because the property would be owned by the company and not by the individual personally.

For all these reasons the client is likely to establish a non-resident trust to purchase the property and for the trustees to arrange for the property to be held by an offshore company under their

control. (The trustees would no doubt want to do so as it would protect the trust fund from an unnecessary charge to inheritance tax.) This is likely to be extremely helpful with both the benefit in kind and the residence arguments.

However, there is still one fly in the ointment. The resident non-dom client may be protected from inheritance tax and possibly from any benefit in kind charge, but he is now exposed to a charge to capital gains tax when the property is sold. If the company makes a gain, that gain is attributable to the trustees and is taxed on him to the extent that he has received benefits from the trust – which of course he has because he has occupied the property for many years. The full gain might not be chargeable of course – it depends on the length of time for which he has occupied the property and the precise calculation of the benefit he has enjoyed from the trust property, but a substantial charge will still arise. If his family members also occupy the property, they could have part of the capital gain attributed to them as well.

One might ask why, with this serious capital gains tax disadvantage, has it been traditional for this structure to be used – and the answer is that until 5 April 2008 trust established by a foreign domiciled individual did not give rise to any capital gains being attributed to the beneficiaries if it was established by a foreign domiciled settlor. Unfortunately that exemption has been removed and the beneficiaries are liable to capital gains tax by reference to capital payments under Section 87 in the traditional way. The foreign domiciled beneficiary can still be advantaged by the remittance basis so that benefits received outside the UK and not remitted to the UK are protected, but in these circumstances the benefit is received in the UK and therefore the individual derives no advantage by reason of his foreign domicile. Companies have no equivalent of Section 225 TCGA 1992 whereby trustees can be allowed the main residence exemption if the property is occupied as the main residence of a beneficiary.

Although a company is the clear answer to the inheritance tax problems and the implications regarding the other taxes can perhaps be happily managed, one does have to ask why are we doing all this? Which is the real problem here. It is of course inheritance tax – but how real is that liability, and is it worth all these complications and costs, which can last for decades?

Of course, it may not be a problem at all because the client may simply leave the property to his spouse on his death and the full spouse exemption would be available. She would have the rest of her life to decide what to do with the property having regard to her own tax position. In many cases, the property is sold, being too large for the widow in her new circumstances. The problem therefore disappears.

The risk here is, of course, that if both spouses die in some accident and there is no spouse exemption, the full value becomes immediately chargeable. However, depending upon the age of the client, that is a matter which can perhaps most simply and effectively (and cheaply) be covered by insurance which pays out on the second death.

Liechtenstein Disclosure Facility

A second joint declaration has been signed by the UK and Liechtenstein following the Memorandum of Understanding in August 2009, which created the Liechtenstein Disclosure Facility (LDF).

There is nothing particularly earth shattering in this second joint declaration; it contains some clarification of various issues which have previously arisen – for example, when the property is moved into Liechtenstein to facilitate participation in the LDF, entity classification and circumstances where an individual will be excluded from the LDF.

It has previously been acknowledged that when an individual has property outside Liechtenstein, it could be moved into Liechtenstein and thereby come within the definition of “relevant property” for the purposes of the LDF so that the individual can take advantage of the facility. The new statement makes it clear that any new relevant property (in Liechtenstein) established specifically to facilitate participation in the LDF must be “meaningful and of sufficient value and permanence to reflect the spirit of the memorandum of understanding”. This is a really troublesome development because the meaning of these words is so subjective that they could mean anything, which seems wholly contrary to the purpose and clarity of the LDF. Fortunately, a further public statement is going to be made, and it is hoped this will clarify the position – but anybody waiting for this further clarification is at risk because if a Code 9 investigation is commenced into their affairs in the meantime, that will disqualify them from the LDF.

One rather alarming point is that HMRC say that will not “normally” seek to collect unpaid UK tax from the personal assets of the Financial Intermediaries, providing they comply fully with their obligations and actively assist UK taxpayers in meeting their obligations. They go on to say that it is unlikely to be in the public interest for HMRC to undertake a criminal investigation against the Financial Intermediaries. Quite apart from being a bit over the top (and hardly conducive to cooperation), it is difficult to see how it can work if the Financial Intermediary is not actually in Liechtenstein.

Nevertheless, the LDF remains a really valuable opportunity which nobody who has been in default with their tax obligations should ignore.

Reasonable Excuse

There have been two recent Tribunal decisions which give some encouragement to those who feel they have been assessed or penalised unjustly by HMRC.

The case of *Browne v HMRC* TC 754 related to the failure to deliver a land transaction return for the purposes of stamp duty land tax (SDLT). This case drew heavily on the Special Commissioners' decision in *Rowland v HMRC* [2006], where the taxpayer was able to demonstrate that they were let down by their professional advisers and that was sufficient to relieve her from the relevant penalty.

This was a conveyancing matter, and it was reasonable for Mrs Browne to rely on her solicitor to submit the stamp duty return within the statutory time limit; the Tribunal considered that there was no reason for her to think that the solicitors would fail to do so. Their failure was not a fault of hers, and she therefore had a reasonable excuse for the failure and no penalty arose.

Although this is welcome confirmation that it can be a reasonable excuse to rely on a professional adviser, this defence does not apply in VAT matters because reliance on a third party is specifically precluded from being a reasonable excuse for VAT purposes.

The other case of *Dauti* TC 786 did not look very promising. Mr Dauti was from Bosnia and worked in the UK as a subcontract labourer. He explained to the Tribunal that many of this friends were working in the UK illegally and therefore needed to stay below the radar. He lent them money and they paid him back. These receipts excited HMRC, who claimed that his disclosed earnings were understated and issued discovery assessments.

This was obviously a very difficult challenge to defend – the onus being on him to show that HMRC were wrong – but he clearly impressed the Tribunal. They found his evidence sincere and truthful, sufficient to discharge to onus upon him that the discovery assessments should be discharged. A heart-warming story – and all the better as Mr Dauti represented himself.

Inducement Payments

The recent case of *Barrie Macey* TC 787 is the latest (although probably not the last) in a long series of cases relating to inducements to enter into a contract of employment.

This decision perhaps demonstrates a change in the judicial approach to such inducements and (unless there is a successful appeal) probably consigns decisions such as *Vaughan-Neil* and *Pritchard v Arundale* to the judicial recycle bin.

Mr Macey was a partner in Ernst & Young and was encouraged to take up employment with a bank. He was to be paid a substantial salary, and he received some restricted stock units in the bank which were specifically to compensate him for disadvantages from giving up his partnership with Ernst & Young.

Mr Macey probably took considerable comfort from the case of *Vaughan-Neil v CIR* in which a barrister was paid £40,000 as an inducement to give up his status as a practicing barrister. The Revenue accepted that this payment was not taxable as earnings. In *Jarrold v Boustead*, a rugby player received a signing-on fee for joining a rugby league club as a professional, and the payment was not taxable, being the compensation for loss of his amateur status. Perhaps more relevantly in *Pritchard v Arundale,* a chartered accountant was encouraged to become an employee of a company and received shares in that company as a contractual inducement to do so. (The shares were actually transferred from another shareholder, but there is no doubt they were an inducement for him to take up the employment – and were made under a tripartite contract anyway).

Strangely, none of these authorities was even considered by the Tribunal (although they did appear in a list), the decision being that "the one off award of restricted stock units was granted as an inducement for the appellant to enter into the contract of employment with Morgan Stanley". Well yes – but that was exactly the position with *Pritchard v Arundale*; one of the terms of the contract relating to the employment was that Mr Arundale would receive a specified number of shares in the employer company. Similar considerations apply to the other cases. Of course the payment, or the receipt of shares, was an inducement to take up the employment, but that is not the end of the matter. Mr Vaughan-Neil gave up his status as a barrister; Mr Boustead gave up his status as an amateur rugby player; and Mr Arundale gave up his established position and status as a practising chartered accountant receiving shares in compensation. Mr Macey also gave up his established position and status as a chartered accountant receiving stock units in compensation. However, 1971 was a long time ago, and it is perhaps instructive that the Tribunal did not even trouble to consider any of these cases; maybe they are not relevant anymore.

(One factor which might have distinguished Mr Macey's case from the earlier authorities is that his restrictive stock units were only able to be realised after he had been employed by the bank for two years. This contrasts sharply with Mr Arundale, who received his shares prior to commencing work, and had he died before commencing his employment they would not have been forfeited. However, we do not know whether this is important, as it was not considered by the Tribunal).

Although it was not mentioned and therefore not relevant to the decision, there seems to be a much more compelling argument in favour of HMRC deriving from Part 7 of ITEPA 2003, which brings into charge securities acquired by a person by reason of his employment – including prospective employment. The importance here is that Section 421B ITEPA 2003 provides that when a right or opportunity to acquire securities is made available by a person's employer (or by a person connected with a person's employer), it is deemed to be made available by reason of the employment – and this would seem to trump all arguments on *Pritchard v Arundale* lines.

Under the circumstances, this remains a rather curious decision.

Enterprise Investment Scheme

It may be remembered that the case of *Taylor v HMRC* TC 426 earlier in the year dealt with the question whether an individual is connected with the company for the purposes of the enterprise investment scheme. It is well known that if you have more than 30% of the shares in the company, you are connected with the company and disqualified from the relief.

The precise test is a little more complicated. The individual must not possess more then 30% of:

a) the issued ordinary share capital;

b) the loan capital and issued share capital of the company; or

c) the voting power in the company.

Mr Taylor had an interest in the company, and although he held less than 30% of the shares he held more than 30% of the loan capital of the company. He obviously did not breach condition (a) or condition (c), and he claimed that he did not breach condition (b) because he did not hold more than 30% of the loan capital and more than 30% of the issued share capital.

HMRC said this was not the right interpretation. He possessed more than 30% of the aggregate of the loan capital and the issued share capital, and therefore he was connected with the company.

On Mr Taylor's interpretation, the reference to issued share capital in paragraph (b) is rather redundant because if you have more than 30% of the issued share capital you were caught by (a) anyway. Unless paragraph (b) is intended to aggregate the loan capital and the share capital, there would be no need to make reference to issued share capital in (b) at all.

However, the First Tier Tax Tribunal accepted Mr Taylor's interpretation, although their reasoning was not altogether clear. The Upper Tribunal has now reversed this decision and confirmed the interpretation of HMRC.

As an interesting aside, the Upper Tribunal observed that exactly the same criteria are used to determine connected persons when a company purchases its own shares, and the same meaning must be given to the phrase for that purpose.

Finance Bill 2011

Yesterday the "Not the Pre Budget Report" lived up to its name with nothing substantive on the tax front – although there were some prospective things flagged such as consultations on a (much better) Controlled Foreign Countries (CFC) regime and improved research and development credits as well as a new 10% rate of tax on profits from intellectual property from 2013. I think we have to wait for the rest.

Draft clauses for the Finance Bill 2011 are being published on 9 December, and next year's Budget will be on 23 March. I can't wait.

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Peter Vaines: *New Law Journal*

Chartered Institute of Taxation Seminar: 18 November

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