SQUIRE SANDERS HAMMONDS | LEGAL COUNSEL WORLDWIDE

UNITED KINGDOM TAX BULLETIN

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CURRENT RATES — January 2011

Indexation

Retail price index: December 2010	4.8%
Inflation rate: December 2010	228.4

Indexation factor from March 1982:

to April 1998	1.047
to November 2010	1.855
to December 2010	1.875

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%

VAT Input Tax

You may wonder why I give this apparently uninteresting item pride of place. Read on. HMRC Brief 02/2011 will take your breath away.

Mr Price made a claim to recover VAT input tax on roller blinds which he said were building materials. HMRC refused the claim, and the matter went to the Tax Tribunal. No problem with that; that is what the Tribunal is for. As it happens, he won.

However, following the Tribunal's decision, HMRC published Brief 02/2011. It says:

> The Tribunal agreed with [Mr Price] that roller blinds were building materials (as defined). As a result [Mr Price] was entitled to treat the VAT incurred on the purchase of the blinds as recoverable.
>
> HMRC's view remains unchanged that roller blinds are not building materials as defined and will not be changing its policy.

Um.

Residence: HMRC 6

HMRC issued a new version of HMRC 6 on 31 December 2010. HMRC say that this new version has not altered the position "in most cases". Actually, the redline version shows thousands of changes with substantial passages being completely rewritten. One wonders why they went to all this effort – but maybe it is just improving the drafting so that it is clearer for everybody. Maybe.

Let me highlight a few of the changes.

Extra-statutory concession A11 (the split-year concession for income tax) will no longer apply where a taxpayer leaves the UK and returns in successive years. That is fair enough. It may be new, but it is clear and HMRC are quite entitled to revise their concessions any way they choose.

Everybody knows the long-standing test that if you come to the UK for 91 days or more on average for four years, you will be resident from the beginning of the fifth tax year. That has been the practice for decades. Not any more. This four-year test has now become a three-year test, and such a person becomes resident from the beginning of the fourth year.

The original HMRC 6 contained some significant variations to IR20 – one of which related to the acquisition of ordinary residence. IR20 said that a person would be treated as ordinarily resident from the tax year *after* the third anniversary of his arrival if he had not originally intended to stay for at least three years. (An interesting reference to *intention*, which we know is specifically irrelevant for the purposes of determination of ordinary residence – but never mind). When the first version of HMRC 6 came out, this was revised to say that you become ordinarily resident from the beginning of the tax year *before* the third anniversary of your arrival. This subsequently (and conveniently) ended up being supported by the case of *Genovese* – or at least it did until the Tribunal later said that they had decided *Genovese* wrongly. So where are we on this point? Not a clue, I am afraid.

HMRC argued in *Tuczka* that if a person comes to the UK to work for less than three years, he will be regarded as resident and ordinarily resident pretty much from the date of his arrival. They say that he will be here for a settled purpose (his work) whether or not he buys or rents accommodation for his occupation. However, if he sells the property and leaves the UK within three years, he will not be ordinarily resident after all. Either there is a three-year test or there isn't. It is hoped that after the Upper Tribunal in Tuczka, this absurdity (and overwhelming deterrent for people to come and work in the UK) will be rectified.

There is a new guidance relating to the UK day count. We have the new statutory test that a day of presence in the UK is one in which you are present in the UK at midnight. However, HMRC say that "this is the general practice but it would not necessarily be appropriate in all cases". What?! This is a statutory test – not one which HMRC can choose not to apply if they do not think it is appropriate. (Imagine what they would say to a taxpayer who argued that a statutory test should be disregarded because in his view it was inappropriate.) However, the statutory rules apply only to the 183-day test and not to the 91-day test – although HMRC did say that they would apply the legislation consistently in respect of the 91-day test. Not any more. For the 91-day test, they are going to have a new approach. They will count every day in which a person spends any time at all in the UK and use that information to decide whether they are resident. Indeed, this is borne out by recent practice which indicates that they are now using this approach for years long before 2008 as well.

I think all this has gotten seriously out of hand. We used to have a settled practice relating to residence which everybody knew, could understand and could rely on. Now we have chaos. Nobody can advise sensibly, or with any assurance, regarding whether a person is resident or ordinarily resident. Taxpayers are entitled to better than this. It is to be hoped that the significant cases which are listed to be heard by the courts at every level during 2011 will provide some certainty on this important subject.

Business Expenses

The recent case of *Azam v HMRC* TC 895 revisited the old question of business expenses incurred wholly and exclusively for the purposes of the business and the traditional difficulty of duality of purpose.

Mrs Azam ran a beauty salon. She had difficulty dealing with issues where she needed to confront her staff. She undertook counselling sessions to assist her in this matter. Mrs Azam was a devotee of the Church of Scientology and the teachings of L Ron Hubbard. Her counsellor provided counselling on these principles.

Mrs Azam said that when an issue arose at work she would seek counselling about it, and after the counselling she would return to work to deal with the problem. She found this very helpful with the business.

You get the picture. One can easily imagine that it would be a hard sell getting HMRC to agree to a deduction for the cost of this counselling. However, it is not a bad argument. The reason given by the Tribunal for disallowing the expenses is that Mrs Azam had in mind (subconsciously) the personal benefit she derived from the counselling. This was a duality of purpose, and the expenses were not deductible.

(Let's be kind and say it was obviously a slip of the pen for the Tribunal to say that Mrs Azam "had in mind" a subconscious benefit. If she had it in mind, it would not have been subconscious. Conversely, if it was subconscious, she would not have had it in mind.)

Be that as it may, there is some powerful authority for the proposition that the conscious state of mind of the taxpayer at the time of the expenditure is not conclusive. If there was another subconscious non-professional purpose, that is sufficient to disallow the expenditure. (The classic case here is *Mallalieu v Drummond* and the sombre clothing purchased by a barrister for wearing exclusively in court.)

However, this subconscious business can be taken too far – because it can always be said that a subconscious non-professional purpose exists for any expenditure. I may feel better in green rather than blue overalls, or my reputation at the golf club may be enhanced if I buy this laptop rather than that. You can ascribe a subconscious non-professional purpose to anything if you want to. This makes the possibility of a tax deduction for any expenditure completely arbitrary, and there must be some limits to the attribution of a subconscious purpose. I wonder what they are.

The House of Lords in *Mallalieu v Drummond* acknowledged that the expenditure may have a personal advantage – such as the doctor who visits a patient in the South of France. If the personal advantage was not a purpose for the expenditure but merely an effect, then the expenditure is fully allowable – as it was in the recent case of *David Parsons* TC 421 where a stunt man successfully claimed medical expenses for injury so that he could return to work more quickly. Clearly Mr Parsons would have had "in mind" (or subconsciously) the existence of this private benefit, but that benefit was an effect and not a purpose.

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Small Companies Rate

A number of developments have occurred in the last few weeks regarding the small companies rate.

HMRC published some guidance on the draft legislation regarding the definition of associated companies which put on a statutory basis the thinking behind extra-statutory concession C9 where some companies are not treated as associated companies despite being under the control of the same persons. Under the concession, the Revenue did not treat companies as being under common control if they merely included the interests of a spouse or minor child unless there was substantial commercial interdependence between the companies.

The draft legislation provides a statutory definition of "substantial commercial interdependence" which includes features of financial, economic and organisational interdependence.

The guidance contains numerous examples and an additional statement which says that for the purposes of determining control, the attribution of rights held by associates is not intended to apply where there is an "accident of circumstance" but rather where there is real interdependence between the parties. Quite what this means is not at all clear. It seems to be little more than a broad description of the new tests rather than any further guiding principle.

There is no indication about when these new provisions would come into force; it could be Budget Day or it could Royal Assent of the Finance Act 2011. This will no doubt be revealed soon.

On the same subject, the case of *Executive Benefit Services (UK) Limited v HMRC* TC 803 dealt with one of the existing rules for associated companies – that relating to control of a company being determined by loan creditors. When determining whether or not a company is an associated company, it is necessary to look at the interests of the participators, and that includes loan creditors. You have to look at who would receive the greater part of the assets of the company which would be available on the winding up for distribution among the participators.

The meaning of "assets available for distribution" in this context has long been the source of uncertainty, but the Tribunal made it clear that the meaning of participator for this purpose is that which applies in accordance with the small companies relief legislation and not the general meaning of participator in a winding up.

Yet another aspect of the small companies rate emerged last month which was the case of *Herts Photographic Bureau Limited v HMRC* TC 868. This was concerned with whether a company was a close investment holding company (and therefore not entitled to the small companies relief) because it had disposed of a property and placed the proceeds on deposit. HMRC argued that the company was not carrying on a qualifying activity – indeed it had filed dormant accounts. However, the Tribunal accepted the company's argument that it was intending to reinvest the sale proceeds in other properties, and that although there had been a long delay in such reinvestment, the company's hesitation was only a result of the financial crisis and it therefore continued to be entitled to the small companies rate.

Penalties: Offshore Income

In Schedule 10 Finance Act 2010, a framework was introduced for the provision of increased penalties for the failure to disclose offshore income. The idea is that where there has been the failure to notify timely and accurate information regarding offshore income, the penalties for these defaults may be increased depending on the territory in which the income or gains arose. These new penalties come into force on 6 April 2011.

There are three categories of penalties:

Category 1: Where the normal penalty applies – 100% of the tax

Category 2: 150% of the tax

Category 3: 200% of the tax

These are of course maximum penalties, and there may be any number of reasons why the income was not disclosed at the right time. The existing defences on the grounds of reasonable excuse will continue to apply.

HMRC have now published a list of the countries in Category 1 and Category 3. They have not published Category 2, but they say that everything which is not in Category 1 or 3 will fall into Category 2.

One can only speculate about the reasons for being in Category 1 or Category 3. Obviously HMRC take a sufficiently unfavourable view of things in those countries in Category 2 to make the failure to disclose income in these countries to be worthy of a substantially increased penalty. I shudder to think about the countries in the Category 3 list.

Category 1 is largely represented by EU countries (but inexplicably not Austria or Luxembourg – what have they done?), and it includes Guernsey but not Jersey. Equally inexplicable are the inclusion of Anguilla, Aruba and Montserrat within Category 1, but not Antigua or Curaçao which are in Category 3. One wonders why poor Tonga is in Category 3, and I don't suppose HMRC have done the UK any diplomatic favours by including the United Arab Emirates in Category 3. (It is also a bit tough on Belize, Brunei, St Lucia and Qatar who have recently been put on the OECD white list.)

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