SQUIRE SANDERS HAMMONDS

LEGAL COUNSEL WORLDWIDE

UNITED KINGDOM TAX BULLETIN

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July 2011

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CURRENT RATES	**July 2011**
Indexation	
Retail price index: June 2011	235.2
Inflation rate: June 2011	5%
Indexation factor from March 1982:	
to April 1998	1.047
to June 2011	1.961

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%

Residence

The case of Mr Gaines-Cooper reached the Supreme Court this month. In case you have been away for a while on Voyager, the issue here was whether Mr Gaines-Cooper should properly have been regarded as not resident in the UK on the grounds that he satisfied the terms of the long standing Revenue practice set out in their booklet IR20.

Mr Gaines-Cooper left the UK in 1976 to live abroad. He wrote to HMRC and after four years they enquired about the number of days he had spent in the UK since his departure. He gave them the details which showed he was comfortably below the 91 day limit for these years. He heard nothing further and thought nothing more about it because as everybody knew, that was the practice in establishing non-residence. You leave the UK and do not return for more than 90 days each year and under the HMRC practice you were treated as non-resident. HMRC would often review the position after 3 years to make sure that what you said, corresponded with what you actually did – which was exactly the position in his case.

Twenty years later HMRC decided to tax Mr Gaines-Cooper on the basis that he was UK resident. They explained to everybody that we had completely misunderstood the position. The above was not their practice and IR20 did not say that it was. Er, yes it did. Well, even if it did, it meant something different – and even if it didn't, they were not bound by their published practice anyway.

During the Court of Appeal hearing HMRC conceded that they were bound by their published practice after all – but argued that IR20 still did not apply to Mr Gaines-Cooper because he had not satisfied its terms. Which term did he not satisfy? The one which was not there – the one which should be implied. Quite what this implied term should be was not entirely clear but the Court of Appeal held that the implied term was that he had to sever his social and family ties with the UK.

Mr Gaines-Cooper was naturally upset to have been told this out of the blue. He was keen to abide by the rules – but he did need to be told what the rules were. He objected strongly to HMRC coming along twenty years later and asserting that the rules were somehow different - and saying that such an overwhelmingly onerous condition should be implied.

Nobody has any issue with HMRC changing the rules or their practice; they are perfectly entitled to do that at any time. But in this case HMRC have steadfastly refused to accept that there has been any change of practice, claiming that the understanding of taxpayers, tax experts (and indeed Inspectors of Taxes) has been mistaken for decades.

Their Lordships are taking time to consider this important matter and a decision will probably not emerge until the Autumn.

Inheritance Tax: Domicile

HMRC have recently revised their inheritance tax manual relating to domicile and deemed domicile. This contains general explanations regarding how a person's domicile interacts with the inheritance tax rules. However, there are two points which look a bit misleading.

HMRC consider the position where somebody is deemed domiciled in the UK and therefore liable to inheritance tax on their worldwide assets. Such a person may pay inheritance tax in another country on property situated there. (This does not of course only apply to people who are deemed domiciled here – it applies to anybody who is domiciled here and has assets in another country where they charge inheritance tax). Anyway, HMRC say that in these circumstances, those acting for the deceased can claim tax relief for inheritance tax paid in another country.

I think that could be misunderstood because a claim for tax relief generally means some kind of deduction from the amount chargeable to tax whereas Section 159 IHTA 1984 provides an entitlement to a tax credit for tax which is paid in the other country. That is of course substantially more valuable than a deduction for the foreign tax paid.

They also make reference to the three year rule – that is the rule which says that if you cease to be UK domiciled, you remain fully within the scope of UK inheritance tax on the whole of your worldwide assets for a period of three years after you cease to be domiciled in the UK. (This is entirely separate from the deemed domiciled rule whereby you are deemed to be domiciled in the UK if you are resident here for tax purposes for 17 out of the last 20 tax years). However, this three year period runs from the date when the domicile is lost. In their new pages, HMRC say that a person remains within the scope of inheritance tax if they were domiciled in the UK "at any time within the three calendar years before the relevant event". A natural interpretation of these words would be that if a person dies or makes a gift in 2011, the transfer will be within the scope of inheritance tax if they were UK domiciled "at any time within the three calendar years" before that event. That would be any time in the calendar years 2008, 2009 and 2010. That would not be right – you only have to go back to the third anniversary. I think this is probably what they meant.

HMRC Tool Kit: Directors Loan Accounts

HMRC have published another Tool Kit, this time on Directors Loan Accounts in which they explain the rules generally and set out various areas of risk. Things may go wrong and the tax may fail to be charged for example if a loan to a director or a loan to a participator is incorrectly treated in the accounts. They provide a checklist for reviewing the position which is generally a helpful development.

At the risk of appearing like a total nerd, I would draw attention to one of the items because I think something has gone a bit awry.

They explain that payments to or on behalf of directors (or their family or household) that are rewards for work done or are payments for future work are normally considered to be employment income. Nothing controversial there. However, they go on to say that:

> *"if such payments are posted to the director's loan account when they are in fact part of the remuneration package this can result in an underpayment of tax and national insurance contributions and an incorrect loan account balance".*

This surely cannot be right. Where a payment is made to or on behalf of a director (or a member of his family) which is employment income, how can it be posted to the director's loan account? If the payment is properly regarded as earnings (which is the entire premise here) then it needs to be debited to profit and loss account and not to the director's loan account. Anyway, if it were to be debited to the director's loan account, that would represent a reimbursement so the company would be incurring no expenditure at all. This would not result in any underpayment of tax or NICs. A payment cannot be credited to the director's loan account. Although it is some years since I have devoted myself to double entry things, I think that you need a debit and a credit – not two credits.

I suspect that this is intended to deal with credits and not payments. If a sum representing earnings is credited to a director's loan account (but not paid), then PAYE and NICs ought to be applied because otherwise the director would be receiving earnings gross which is obviously wrong. His loan account would be overstated and the PAYE and NICs would be unpaid.

I know – I should get out more.

Revised Litigation Strategy

In June 2007 HMRC launched their Litigation Settlement Strategy which may be summarised crudely as "no deals". The idea was that if HMRC felt that they had a good case, they would pursue it to a conclusion through the courts – but if they did not feel it was sufficiently strong they would back down. I am sure this must have happened in some cases.

There is now a new litigation settlement strategy which I read in the hope that maybe we may return to the position where taxpayers are able to come to a sensible compromise with HMRC where there are decent arguments on both sides.

A clue perhaps to this "refreshed" strategy is that HMRC say they will consider whether something which initially appears to be an all or nothing issue (where splitting the difference would have no intellectual justification) may in fact be a case where there is a range of possible alternative solutions.

HMRC confirm that they will not compromise on their considered view of the law to seek an agreement – which is obviously quite right. However, for the majority of cases where there is more than one tenable view of the facts, a more flexible approach is welcomed.

Small Profits Rate of Corporation Tax

The recent tribunal case of *Reddleman Properties Limited v. HMRC* TC1250 was concerned with the application of the small profits rate of corporation tax to a property company. The question was whether Reddleman Properties Limited was a close investment holding company and not eligible to benefit from the small profits rate of tax. The company claimed that it was excluded from the definition of a close investment holding company because it existed wholly or mainly for the purpose of letting land to persons not connected with the company.

The company had been working towards achieving its purpose of having mainly unconnected tenants and although this had been achieved in the first few years, the company found itself by reason of economic circumstances with only one major tenant which was a connected company. Was the purpose of the company the activities which the directors intended to carry on?

The Tribunal accepted that the company had an intention of letting to unconnected parties but that did not reflect the purpose of the company which was mainly to provide premises for a connected company.

The Tribunal decided that the word *purpose* needed to be viewed objectively on the basis of the circumstances prevailing in the year but also having regard to the previous background. The purpose of the company in the relevant year was to provide premises for the connected company.

I am not sure I follow the reasoning here as the words *purpose* and *intention* seem to be interchangeable, but in this case the purpose seemed more to be a reflection of its activity during the year rather than the commercial purpose and intentions of the company from the outset.

Goodwill and Synergies

HMRC have issued a Brief 25/2011 on Goodwill and Synergies – which deals with a tax deduction where a company buys the goodwill of a business which was carried on prior to 1 April 2002 by a related company. This is not as obscure as it sounds but obviously as years pass it becomes less relevant.

The HMRC Brief has been issued in response to the Upper Tribunal decision in *Greenbank Holidays Limited v. HMRC* [2001] UK UT155 in which HMRC succeeded in their contentions that:

a) goodwill includes internally generated goodwill;

b) goodwill is not created by the purchase nor by recognition in the accounts;

c) the goodwill recognised by the purchaser is the same asset as that disposed of by the vendor.

What caught my eye about this Brief was the reference to synergy claims – that is to say goodwill which is created through synergies achieved on merging the business which is being acquired with an existing business. HMRC consider that the Greenbank decision also disqualifies those cases where such synergies exist and will continue to challenge past and future claims with a view to litigation.

I wonder whether this view is really justified – and it does not seem to be supported by the references to the decision set out in the Brief.

It is almost self-evident that if one company takes over another company in the same field, with a view to exploiting the economies of scale and the synergies which will naturally develop by the combination of the two businesses, this can obviously create goodwill if none existed before or enhance the value of the goodwill of the business acquired. It seems to be going too far to suggest that goodwill created by the synergies from the combination of two businesses should be disqualified as being attributable to a pre-2002 business just because it was carried on at that time.

By the look of it, we will have some further guidance on this point before too long.

Goodwill: Rollover Relief

Another interesting development relating to goodwill appeared from the case of *Mertrux Limited v. HMRC* TC1253 which concerned a claim for rollover relief under Section 152 TCGA 1992 in respect of the acquisition of goodwill of a Mercedes dealership. HMRC suggested that the amount paid for the acquisition comprised two elements being partly goodwill and partly an amount to reflect compensation for the early termination of the dealership. The latter amount was not an asset of the purchaser which could support a claim for rollover relief.

The tribunal found that the entire claim was made in respect of goodwill, there being no evidence to show that any part of the payment was in respect of compensation for loss of the dealership. Accordingly, the whole of the amount was in respect of goodwill and that the whole of the consequential gain was therefore eligible for rollover relief.

This does not appear particularly earth shattering but the judgment contains an interesting summary of the approach of HMRC to goodwill.

Penalties

I have been struck by the large and disproportionate number of cases which are reported on the subject of penalties. Of course nobody wants to be charged a penalty but few people will regard their sense of grievance on being imposed a penalty of £100 or even £500 as sufficiently strong to take it to the tribunal with all the aggravation and cost which that entails. I think it is possible to draw a conclusion from this.

If substantial numbers of people are saying that the penalty they have been charged is so unfair that they are going to appeal to the courts about it, surely somebody ought to be taking some notice and wondering whether the way the penalties are being applied is indeed fair – and not just dismissing all complaints as being baseless – or indeed base.

The point is perhaps emphasised by recent tribunal decisions. In the case of *Hok Limited* TC1286 the Tribunal explained in clear terms that:

> *"It has long been part of the common law of the country that organs of the state must act fairly and in good conscience with its citizens".*

Regrettably, the Tribunal found that HMRC acted neither fairly nor in good conscience in charging the penalty in that case.

Similarly in *Buxton Rugby Union Football Club* TC1281 the Tribunal took a dim view of HMRC advancing arguments in support of a penalty which had recently been explicitly rejected by another Tribunal, quite apart from the fact that on its merits, the penalties were found not to be payable.

In *Consult Solutions* the Tribunal dismissed a penalty imposed by HMRC because the appellant's conduct was that of a prudent employer exercising reasonable foresight and due diligence and having proper regard for its responsibilities under the Taxes Act.

The wisdom of HMRC in taking all these cases (those referred to above are merely from a recent four week period) to the Tribunal with all the attendant trouble and cost (and acute anxiety to the taxpayer), to collect penalties of a few hundred pounds must surely be questionable. It is hoped that the comments of the Tribunals will be taken on board.

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