SQUIRE SANDERS

UK Tax Bulletin

March 2013

SQUIRE SANDERS

Introduction

SQUIRE SANDERS

Latest Rates of Inflation and Interest

The following are the current rates at March 2013

Current Rates	February 2013
Retail Price Index: February 2013	247.6
Inflation Rate: February 2013	3.2%
Indexation factor from March 1982:	
to April 1998	1.047
to January 2013	Not yet published
to February 2013	Not yet published

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%

SQUIRE SANDERS

Automatic UK Residence Test

They have done some last minute tinkering with the wording of the Statutory Residence Test in the Finance Bill. Still no definition of "home" and masses of anomalies but these will get resolved in time.

One important area is the Automatic UK Residence Test to which I made detailed reference in January. This has been significantly changed - but the problem has not really been resolved. A crucial component of this test is the existence of a home in the UK (or overseas) - but without a definition of a home, it is a bit difficult to know where you are.

Anway, leaving aside other aspects of this test for the moment, you will satisfy this Automatic UK Residence Test if:

(a) you have a home in the UK - at any time during the year; and

(b) you are present at that home on at least 30 days during the year; and

(c) there is a period of 91 consecutive days (30 of which fall in the tax year) throughout which you have either no home overseas, or if you do, you spend fewer than 30 days there in the tax year.

This can have unexpected consequences (which you will find when you try to apply it to anybody coming to the UK). Someone arriving here on 1 January 2014 and renting a flat may think he has only 1 UK tie and therefore will not be resident for 2013/14 unless he breaches the 182 day test. He is quite likely to find himself resident under the automatic test instead - which could be a very expensive surprise.

Annual Residential Property Tax

Remember this? Well, it is not called this any more. It is now called the "Annual Tax on Enveloped Dwellings" but is seems to be pretty much the same in substance to the draft ARPT Bill which was issued last year.

I have noticed one important modification. There has been concern about the situation where an individual owns a valuable leasehold interest worth (say) £12 million. He is not liable to the ARPT (or ATED) because he is not a company. However, if he (or people connected with him) control a company which owns the freehold (which may be worth only £1,000), the connected party provisions cause the company to be treated as owning both interests in the property - with the result that the company is liable to the annual charge of £70,000. I could not see where this analysis was wrong. The company owns a single dwelling interest and the individual owns a different single dwelling interest in the same property. They are connected persons and the company would be treated as owning both interests - and therefore liable to the charge.

This ridiculous result seems to have been recognised because there has been an amendment. This aggregation of interests in these circumstances will now only apply where the value of the company's freehold interest is more than £500,000.

IHT : Deduction of Liabilities

One of the proposals announced in the Budget is a restriction on the deduction of debts for inheritance tax purposes.

Where somebody borrows money to invest in business property (or perhaps agricultural property or woodlands) qualifying for 100% relief, HMRC will no longer allow a deduction for such borrowings against other assets which do not qualify for such relief. Such borrowings will be deducted first from the assets which were acquired with the borrowings - which will eliminate any effective relief for the borrowings completely.

Where borrowings are charged on a particular property, this will require a modification of the statutory rule in Section 162 IHTA1984 which presently provides that:

> "*a liability which is an encumbrance on any property shall, so far as possible, be taken to reduce the value of that property.*"

It is interesting to contemplate the situation where for example, money is borrowed to acquire an asset qualifying for 100% business property relief which is later given away. In that case there would be no asset to be matched against the borrowings which would presumably then be deducted from the remainder of the estate.

The proposals will also apply to liabilities which have been incurred to acquire property which is excluded from the charge to inheritance tax. So borrowings to acquire excluded property (such as property situated abroad) will no longer be deductible against the UK estate in respect of a foreign domiciled person.

It is not clear whether this would cover the situation where the monies borrowed are held on deposit pending investment. If a non dom individual borrows £2 million charged on his UK property and that money is sitting in a bank account outside the UK pending investment, could it be said that the borrowings had been incurred to acquire property which is excluded from the charge to IHT. Admittedly the offshore deposit would be excluded property but was the borrowing incurred directly or indirectly to acquire the deposit. Clearly this is arguable and the Finance Bill would seem to support such an interpretation.

This whole issue is highly relevant to those who are concerned with the Annual Residential Property Tax because many people have removed expensive properties from a company to avoid the annual charge (and the capital gains tax implications) even though it brings the property into their estate for IHT purposes. They were proposing to protect their IHT position by loan arrangements whereby the UK property is suitably encumbered with debt and the money borrowed is deposited outside the UK as excluded property. If the deposit is regarded as the asset acquired with the borrowed funds, there

would be no deduction from the UK asset. This would deprive the borrower of any relief and the full value of the property would remain within the charge to inheritance tax.

Clearly we now have more work to do in this area.

Principal Private Residence

Everybody will be familiar with the capital gains tax exemption for the only or main residence. Obviously one of the crucial elements is that the property must be a residence and whilst this sounds reasonably straightforward, it has caused all sorts of difficulties lately.

In the recent case of *Susan Bradley v HMRC TC 2560* Mrs Bradley lived in a house owned jointly with her husband. She also owned another small house and a flat, both of which were normally let. She moved out of the matrimonial home in August 2007 and moved into the flat which happened to be vacant. When she moved out of the matrimonial home her intention was to separate permanently from her husband and to seek a divorce. When the tenancy in the small house ended in April 2008 she moved into that house which was more convenient.

When she moved into the house, she repainted it, undertook some improvements and generally made it more of a home. However, although she put the property on the market, the market was very poor and she expected to live permanently in the property. However, in the autumn of 2008 Mr and Mrs Bradley became reconciled and she moved back to the matrimonial home in November 2008; the small house was sold in January 2009.

So during the period April 2008 to November 2008 the small house was her only residence (she did not live anywhere else) and one might have felt reasonably optimistic that this property would qualify not only as her residence, but as her main residence. No less an authority that Lord Widgery has described "a residence" as:

> "… *a place where a man is based or where he continues to live, the place where he sleeps and shelters and has his home. It is imperative to remember in this context that residence implies a degree of permanence. Consequently a person is not entitled to claim to be resident merely because he pays a short temporary visit. Some assumption of permanence, some degree of continuity, some expectation of continuity is a vital factor which turns simple occupation into residence.*"

However, the Tribunal decided that she did not occupy the property as her residence. She had already placed it on the market and if somebody had offered her the asking price she would have sold it. The Tribunal Judge considered that she never intended to live permanently in the property; it was only ever going to be a temporary home and therefore it was never her residence.

The Tribunal were heavily influenced by the Court of Appeal judgment in *Goodwin v Curtis* where it was held that to qualify for the relief the taxpayer must provide some evidence that his occupation of the property showed some degree of permanence and some expectation of continuity. Temporary accommodation at an address does not make someone resident there. However, in *Goodwin v Curtis*,

the taxpayer only occupied the property for 5 weeks. The taxpayer had just separated from his wife and family and he stayed in the property as temporary accommodation. Indeed, 2 days after moving into the property the taxpayer completed the purchase of another property which he intended to be his private residence.

It is a bit of a stretch to suggest that Mr Goodwin occupied the property as his residence in these circumstances; it was the most temporary of accommodation. This seems a long way from the situation of Mrs Bradley who moved into a perfectly suitable home, took steps to make it more of a home and lived there from April to November; without any intention of moving out unless the house were to be sold, which was unexpected.

To apply this case to the circumstances of Mrs Bradley seems a bit tough but the combination of these cases would seem to give HMRC a serious weapon to deny the exemption in many cases where previously there would have been little doubt that the relief was available. Any indication that the occupier had in mind moving out (at almost any time in the future) would demonstrate that the accommodation must be temporary and not qualify as a residence. I guess that even if you have lived somewhere for ages it might cease to be a residence once it is put on the market - or once you decide you might like to move. I cannot see many claims for PPR surviving this test.

Not so fast Mr Inspector. Reinforcements have arrived in the shape of *David Morgan v HMRC TC 2596*. Mr Morgan was purchasing a property where he intended to live when he and his fiancée were married. He had sold his own flat and moved in with his fiancée's family but unfortunately 2 weeks before the purchase, the relationship ended. He went to live with his parents. He carried on with the purchase of the property and he moved in for two weeks specifically to prepare the house for renting and then moved back to live with his parents. The property was let and eventually sold.

Under the circumstances one might think that Mr Morgan was completely doomed. However, after considering all the authorities the Tribunal decided that Mr Morgan had lived in the property for 2 weeks before making serious enquiries about letting and this was enough for the property to qualify as a residence.

Quite apart from the fact that Bradley and Morgan are in hopeless conflict, it is difficult to avoid the conclusion that they were both wrongly decided. Mrs Bradley should obviously have been allowed her relief and Mr Morgan equally should not. But what do I know?

What is clear is that unless there is an appeal on either or both of these cases, the whole subject will be in utter confusion - a situation which is bad for everybody.

Wasting Assets

The recent case in the Upper Tribunal of *The Executors of Lord Howard of Henderskelfe deceased v HMRC [2013] UKUT 0129* was a surprise until you got into it.

The Executors were claiming that a painting by Sir Joshua Reynolds which had been sold for over £9 million was a wasting asset and therefore exempt from capital gains tax.

A wasting asset is one which has a predictable life of less than 50 years and as this painting had been painted prior to 1776 one might imagine that the Executors had an uphill struggle.

However, the argument was a little more subtle. The Executors claimed that the painting which was hanging in the public areas of Castle Howard and represented a genuine attraction to visitors, should be regarded as plant and machinery. How did this help? Because Section 44 TCGA 1992 provides that plant and machinery is regarded as having a predictable life of less than 50 years irrespective of its actual characteristics and is therefore exempt as a wasting asset.

So, this case was nothing to do with capital gains tax or wasting assets - it was another case about plant and machinery and all those famous cases regarding the meaning of plant and machinery were analysed in depth. The upshot was that the Upper Tribunal felt that the painting was used for the promotion of the trade carried on at Castle Howard and was sufficiently permanent (even though it could be taken away at any moment) to be regarded as plant. Accordingly, it was properly regarded as plant and machinery, it was therefore a wasting asset under Section 44 and exempt from capital gains tax.

A nice argument, but one might well ask why the exemption in Section 44 was not overridden by Section 45 which provides that the exemption does not apply when the relevant asset is used for the purposes of a trade and was eligible for capital allowances.

The answer is that the trade (of opening the Castle to the public) was carried on by a company, and the painting was owned by the Duke personally. It was accepted by all concerned that the exemption in Section 44(a)(c) does not contain any requirement that the person owning the plant had carried on the trade in which the object was used.

Upper Tribunal Appeals

For reasons unknown, my eye was drawn to the Upper Tribunal decision in *HMRC v Europlus Trading Limited* which concerned a reclaim of excise duty on the exportation of beer. In essence, the company made a claim for repayment of excise duty and HMRC rejected it. The First Tier Tribunal consisting of Howard Nowlan and Gill Hunter heard the appeal and their decision covered 5 points:

1. HMRC had applied new requirements to the duty claw back conditions
2. The Tribunal had jurisdiction to consider whether HMRC had contravened EU principles
3. HMRC had contravened EU principles
4. HMRC had breached Article 1 of Protocol 1 of the European Convention on Human Rights
5. The Tribunal ordered the payment of the company's drawback claims.

HMRC appealed to the Upper Tribunal. I have no knowledge or interest in excise duty on beer but it is disquieting to find the appeal judge held that the Tribunal had got absolutely everything completely

wrong. They got the facts wrong, their conclusions were wrong, they had no jurisdiction … everything.

I suppose these things happen but it is very dispiriting for the citizen (or the professional adviser) when such a distinguished Tribunal can get everything so completely wrong - assuming of course that the Appeal Court is correct. What chance does the taxpayer have in understanding his obligations when faced with this situation. I do not offer any answers here but would merely observe that it seriously undermines the authority of the First Tier Tribunal if such experienced judges are found to be so comprehensively mistaken.

P S Vaines
Squire Sanders (UK) LLP
31 March 2013

Contact

Peter Vaines
T +44 20 7655 1780
peter.vaines@squiresanders.com