UK Tax Bulletin

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Latest Rates of Inflation and Interest

The following are the current rates at January 2014

Current Rates	January 2014
Retail Price Index: December 2013	253.4
Inflation Rate: December 2013	2.7%
Indexation factor from March 1982:	
to April 1998	1.047
to November 2013	Not yet published
to December 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

Since 6 April 2010: 4%

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Dividend Waivers and Discovery

The case of *Donovan and McLaren v HMRC TC 3188* involved a series of dividend waivers which had the effect of equalising the dividend income of a husband and wife. The key issues were whether the income tax settlements legislation applied to them and whether HMRC was entitled to raise discovery assessments outside the enquiry window.

Mr Donovan and Mr McLaren each had 40% of the shares in a company and their wives had 10% each. On day 1 the husbands executed dividend waivers, waiving their entitlement to dividends for one day; later that day the company paid dividends all of which went to their wives.

Two days later the wives executed dividend waivers waiving their entitlement to dividend for a period of one day; later that day the company paid an interim dividend all of which went to the husbands. The wives did not file tax returns as they were only liable to tax at the basic rate and that was covered by the tax credit on the dividend.

HMRC argued that all these transactions represented an arrangement, the effect of which was to provide a greater income for their wives than would have been the case had they merely declared dividends on the shares in the normal way.

This is a really difficult argument to defend where the parties are husband and wife. If these arrangements do represent a settlement, then you are doomed - because the fact that the wife received the advantage meant that the settlement was one in which the settlor retained an interest. Nor could there be any defence under Section 626 because in the case of a dividend waiver the whole benefit is a right to income. Accordingly, the only way out is to say this is not a settlement; there was no element of bounty and all that. The Tribunal had no hesitation in finding for HMRC.

The claim by HMRC to raise discovery assessments was challenged by the taxpayer who said that a competent Inspector would have been aware of the dividends and their allocation. The Tribunal did not give this argument any houseroom either. In any event, I do not know how HMRC were supposed to know about the dividends and their allocation because the wives did not submit tax returns and nobody advised HMRC that there had been any dividend waivers. It is true that the hypothetical officer could have examined the company's accounts and compared the dividends shown in the accounts with the size of the shareholdings and have compared that with the dividends shown on the shareholders tax returns. He might have found the figures difficult to reconcile not least because the company's accounts were not coincident with the tax year. However, none of this would be enough for him to be aware of an insufficiency.

These results were hardly surprising but an interesting excursion into these areas. It would have been more interesting had there been a discussion about the validity of the waivers or the mechanics of the interim dividends, all of which would seem to merit some enquiry. However, as it turned out, none of these things mattered anyway.

IHT Business Property Relief

The Tax Faculty of the Institute of Chartered Accountants has published an excellent technical release following discussions with HMRC containing guidance on some questions arising on business property relief - and in particular in relation to interests in partnerships and the holding of surplus cash by trading companies.

Partnerships

The first issue is whether business property relief applies to an interest in a partnership or LLP which owns shares in an unquoted trading company. HMRC are firm in their view that no relief is available even if the shares in the company would otherwise have qualified for relief if held directly.

HMRC say that partnerships are not transparent for IHT purposes. It is therefore necessary to consider the actual business of the partnership and if that consists wholly or mainly in holding shares in unquoted companies (even unquoted trading companies), relief is not available.

Where the partnership actually carries on a trade but holds shares in trading companies which also carry on other parts of the trade, relief for the value of the underlying company will still not be available. HMRC will treat them as excepted assets under Section 112 IHTA 1984.

A further possibility is that a business is carried on by a partnership but the partners also own a property from which the trade is carried on. Again there will be no relief in respect of the commercial property. The only circumstance in which HMRC seem to accept that BPR will apply is where the partnership is carrying on a trade and its members are an individual and a company. They confirm that if the partnership is carrying on a trade then the partnership share of the corporate member would qualify for BPR.

Goodness me - this is spectacularly unhelpful. You would have thought with all this stuff about taxpayers avoiding tax by acting contrary to the will of Parliament, HMRC might have noticed the mote in their own eye.

Surplus cash

Where an unquoted trading company holds an amount of cash which is in excess of the amount which is needs for its business, it is likely that the cash will be treated as an excepted asset and excluded from business property relief. The Tax Faculty pointed out that in the current economic climate many businesses are retaining increased cash reserves to protect themselves against any further downtown in trade.

However, HMRC are not impressed. They say that to avoid treatment as an excepted asset there needs to be evidence that the cash is held for an identifiable future purpose. (This may be overstating the position. Section 112 only requires the cash to be required for the future use for the purposes of the business. There may be a number of things in contemplation). HMRC consider that the holding of funds as a buffer to weather the economic climate is not sufficient reason to prevent it being an excepted asset.

HMRC may be viewing the position unsympathetically but the taxpayer is able to protect himself here. The problem is that the holding of cash on deposit is not generally regarded as an investment business

by reason of the decision in *Barclays Bank Trust Co v CIR SpC 158.* It therefore represents an excepted asset if it is not required for the future use in the business.

However, if this surplus cash were to be invested otherwise than on pure cash deposit, then it would become an investment business and providing this investment business was not more important than the overall trading business, then it would not be an excepted asset and no problem would arise. The company would still be wholly or mainly a trading company and the existence of the subservient investment business would not interfere with the business property relief.

Swiss Cooperation Agreement

HMRC (Offshore Coordination Unit) has started sending letters to taxpayers where they have details of interests in Swiss assets or investments. HMRC say that in most cases this will be because the taxpayer has already authorised the release of information to HMRC by the Swiss tax authorities rather than to have a one off charge applied to their accounts.

HMRC insist that the taxpayer must reply within a specified time and if they fail to do so they may start a detailed investigation which could be a criminal investigation. The letter encloses certificates A, B and C. Certificate A applies if the taxpayer has no outstanding UK tax liability in respect of any offshore accounts or investments or assets or has previously included all taxable amounts associated with his Swiss assets or investments in his UK tax return. Certificates B and C apply if the taxpayer is going to make some kind of disclosure to HMRC of their UK tax irregularities.

Given the seriousness of these letters (and the fact that letters from HMRC which include the words "could be a criminal investigation" are likely to frighten the pants off anybody, even a person of reasonable firmness) it is odd that HMRC as a matter of policy will not send copies of the letters to the taxpayers registered agent.

However, the Chartered Institute of Taxation has provided a valuable professional service by issuing an explanatory note explaining what is going on.

Those UK taxpayers who have made a full disclosure of all their income and gains (including those from Switzerland) in their tax return and paid all the appropriate tax might feel a bit cross at receiving such an aggressive letter. They might wonder why it is not reasonable for HMRC to check their tax returns showing that they have made a full disclosure, before sending out a letter of this nature.

Dual Contracts

It was revealed in the pre Budget Report that there will be new rules regarding the remittance basis for foreign domiciled employees with dual contracts.

It is not unusual for somebody to come to work in the UK and also to have significant responsibilities for

other parts of the group elsewhere in the world. It makes sense for him to have one contract for his UK work and another contract for his foreign work. In these circumstances the foreign earnings (in respect of duties performed wholly outside the UK for a foreign employer) will be chargeable to tax on the remittance basis. If he were to have one omnibus contract covering the whole of his worldwide work, all the earnings would be fully taxable notwithstanding that he may spend (say) two thirds (or more) of his time working overseas.

However, from 6 April 2014 the remittance basis will not apply to overseas employment income if the individual has both UK and overseas employments with the same or associated employers (like different members of the same group) and if the foreign tax which applies to the overseas employment is less than 75% of our top rate of 45% - that is to say 33.75%. We are not talking headline rates here. We are looking at real foreign tax paid for which a foreign tax credit is available against the income.

(I am not quite sure how this announcement fits in with the Treasury commitment that there will be no further changes to the remittance basis during this Parliament.)

Furthermore, if the foreign employer has no UK presence or intermediary it will not be possible to operate PAYE against those earnings; Section 689 ITEPA 2003 will not apply in these circumstances to place an obligation on a UK employer. Accordingly, the employee will face the administrative burden of dealing with all the UK tax consequences of this foreign employment. Bienvenue.

The reasoning behind these changes is clear from the HMRC Statement that "in most cases separate contracts will have been artificially arranged in order to obtain a tax advantage". However these proposals go way beyond avoidance and artificial arrangements and will catch many innocent employees. They will be the collateral damage which seems rather unnecessary particularly as HMRC already have plenty of powers under Section 24 ITEPA 2003 to reallocate the earnings from such contracts between the UK and the foreign contracts.

The only relieving feature is that this measure will not apply to overseas income which falls within the three year period for overseas work day relief in Section 26 ITEPA 2003. Where a foreign domiciled individual comes to work in the UK they will continue to be entitled to the remittance basis in respect of the earnings for foreign duties for the year of arrival and the following two years. I doubt whether any significant businessman will want to stay any longer than that.

Negligence

I think that the recent case of *Litman and Newall v HMRC TC 3229* is going to cause some serious anxiety.

In the November Bulletin I made reference to the cases of *Mariner TC 3039* and *Stratton TC* 2967. In *Mariner* the Tribunal said that the taxpayer could not be principally or vicariously liable for the negligence of her professional adviser unless the circumstances indicated that the matter was fraught with difficulty and doubt. It was contrary to the very notion of reasonable care that a person who perceives a need to take professional advice can be said to be negligent if she then relies on that advice - even if it turns out to be wrong.

This was not a get out of jail free card because if the taxpayer had reason to believe that the

professional adviser may not be correct, he cannot just close his eyes to those doubts and hide behind the adviser.

In *Stratton TC 2967*, the Tribunal concluded that where there is no reasonable basis for the professional advice or the advice was based on a simple failure to consider the relevant statutory provisions, the taxpayer could not rely on such defective advice to provide him with a reasonable excuse. I thought that was rather harsh because no lay taxpayer can sensibly know whether the advice was defective or whether the adviser considered the relevant statutory provisions and this would seem to undermine the entire protection which was valued so highly in *Mariner* - and in the rather impressive list of similar authorities.

The decision in *Litman and Newall* has now added a new dimension to the taxpayer's difficulties - at least where they have entered into a tax scheme. In this case, the taxpayers participated in a capital redemption policy scheme and claimed a capital loss to set against their capital gains. They were professionally advised by a firm of tax consultants and a firm of chartered accountants and acted in accordance with their advice, also including in their tax returns the DOTAS number in respect of the scheme.

The Tribunal confirmed that a taxpayer who reasonably relies on a reputable adviser for advice in respect of his tax affairs will not be liable to a penalty. The taxpayer could not be expected to understand the legal and tax implications of the trust arrangements or the capital redemption policy; these are matters upon which a reasonable taxpayer might properly be expected to rely on his professional advisers.

The Tribunal also confirmed that the test to be applied "is what a reasonable taxpayer exercising reasonable due diligence would have done".

The question here of course is the meaning of reasonable due diligence in these circumstances. The Tribunal concluded that the level of due diligence required of a taxpayer in such a scheme is low when professional tax advisers are involved and the matters are technical. However, the Tribunal was less sympathetic in respect of the commercial aspects of the arrangements. It would appear that one of the elements of this scheme involved the advancing of a loan to the taxpayer which was subsequently repaid. There was a lack of evidence that any money was ever lent or that it was ever repaid. The Tribunal concluded that the taxpayers were negligent in signing their tax return which reflected loans which they had no evidence had ever been advanced or repaid. The Tribunal did not think any statements or advice from their advisers could remove the obligation for the taxpayer to consider whether the proposed transactions stood up to some basic level of commercial scrutiny.

The fact that the taxpayer provided a DOTAS number did not protect them. None of the technical analysis relevant to the DOTAS reporting absolved the taxpayers from establishing whether the lending transactions had atually taken place.

Whilst there are clearly some helpful elements to this judgment for the ordinary taxpayer undertaking ordinary commercial transactions, there is clearly a stricter rule for those who participate in tax schemes. The facts of this case may be special in that there was no evidence of any lending or repayment of the money but it is now an open question how much of the arrangements does the taxpayer have to understand for him to be protected from a charge of negligence.

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It would seem that the lay taxpayer is obliged to understand the commercial aspects behind all these complex arrangements so that he can assess whether they stand up to commercial scrutiny. What if he does not understand them? Is he therefore automatically negligent? Or what if he makes specific enquiries of his advisers to confirm that the arrangements have been properly implemented. Of course one can understand that the taxpayer cannot hide behind obviously duff advice but the fact that the taxpayer does not understand the commercial features of a complex scheme surely cannot make him negligent.

I think there is a "playing with fire" agenda here and I have a feeling that this is only the beginning.

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