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Disclaimer. The *Review* is intended only to stimulate thought. It is not to be taken to be a guide to action in a particular case.

CASE NOTE

MARK HIGGINS RALLYING V HMRC

PARTNERSHIP “RESIDENCE”

Imran S Afzal

Introduction

Mark Higgins Rallying v HMRC TC/2010/1682 is the first case in which the principles governing the place of control and management of a partnership’s activities have been subject to detailed analysis. The author of this case note appeared as junior counsel¹ for the partnership, and the following is a summary of the facts and the First-Tier Tribunal’s decision.

Facts

A partnership was formed in the Isle of Man in 1991. There were two partners: Mr. Dixon and Mr. Higgins. Mr. Dixon had significant commercial experience, e.g. he was a solicitor and had been involved with a number of large businesses. Mr. Higgins was a rally driver, he had no management experience, and he was considerably younger than Mr. Dixon. The aim of the partnership was to combine Mr. Higgins’ rally driving skills with Mr. Dixon’s commercial experience, and thereby to generate income from rally driving and related activities.

At the time the partnership was formed both partners were resident, ordinarily resident and domiciled in the Isle of Man. Subsequently Mr. Higgins moved to the United Kingdom although he remained Manx domiciled.

The appeal related to the 1998/99 to 2004/05 tax years. Throughout that period the partnership's activities were carried on partly inside and partly outside the United Kingdom.

Issue

The question was where the profession of the partnership was controlled and managed during the relevant years. In shorthand one might term this as a question of where the partnership was resident.

The issue was relevant due to ss.111-112 ICTA 1988. Broadly the effect of those provisions was that, if the profession of the partnership was controlled and managed outside the United Kingdom, then the profits of a partner who was UK-resident but non-UK domiciled (i.e. Mr. Higgins) would be taxed on the remittance basis so far as those profits arose outside the United Kingdom. Similar provisions are now contained in s.857 ITTOIA 2005.

Appellant's Contentions

For the partnership it was contended that control and management was outside the United Kingdom. In particular the following arguments were made.

First, reference was made to cases which touched on the place of control and management of a partnership's activities, although the guidance in those cases was limited.

In *Padmore v IRC* 63 TC 352 a Jersey partnership consisted of over 100 partners, who were mostly UK resident. The day-to-day business of the partnership was carried on by two managing partners who were resident in Jersey. General meetings of partners were held in Jersey or Guernsey, about four times a year. Policy decisions taken at these meetings were then given effect to by the managing partners in Jersey. It was not in dispute that control and management was outside the United Kingdom. The key factors appeared to have been the location of the general meetings, and the fact that policy decisions were taken at those meetings. By analogy this was relied upon by the appellant in *Mark Higgins Rallying*.

In *Newstead v IRC* 53 TC 535 a Bahamian company and an individual had entered into a partnership. The General Commissioners found that the activities of the partnership were controlled and managed in the Bahamas. This was not challenged in the courts. The relevant factors included: partnership meetings were held in the Bahamas, decisions relating to the partnership were taken abroad, and all the activities were abroad. There was a lack of clarity as to which of the factors were critical, and their relative weight, but to the extent possible an analogy was drawn between this case and the partnership in *Mark Higgins Rallying*.

Secondly, given the limited judicial guidance in a partnership context, and the fact that the common law test for company residence uses similar wording, i.e. the place of central control and management, reliance was placed by the appellant on company residence case law. It was submitted that the latter case law demonstrated a number of key principles, and in particular:

1. There is a wealth of case law which shows that one looks to the place where directors meet and in particular where they take high level decisions. The focus of the test is on core policy decisions rather than day-to-day management. For example, in *Laerstate BV v HMRC* 2009 SFTD 551 the Tribunal said “*one needs to ask who was managing the company by making high level decisions and where*”.
2. The place where business activities are actually carried on does not matter. For example, in *Cesena Sulphur Company v Nicholson* 1 TC 83 a company was held to be resident in England even though the whole of its business was transacted in India.
3. In *Laerstate BV* the Tribunal held that the facts must be looked at as a whole, such that a small element of high level decision taking in the UK will not *per se* result in UK residence.

Thirdly, against the above background, it was argued that the profession of the partnership was controlled and

managed outside the United Kingdom for the following reasons:

1. No partnership meetings were held in the United Kingdom.
2. The partners had agreed that no important decisions would be taken on the telephone, whilst one of the partners was in the United Kingdom, and instead Mr. Higgins would fly to the Isle of Man.
3. Almost all contracts were negotiated and signed outside the United Kingdom. Although there were a few exceptions, these were due to special circumstances.
4. Mr. Dixon was the dominant partner. He was the one who had the management experience, he was based in the Isle of Man, and he conducted his activities there.
5. Mr. Higgins' decision taking in the United Kingdom was limited to purely ministerial matters, e.g. attending to the practical arrangements relating to his participation in rallies. He would not decide which motoring contracts to enter into himself and instead would discuss this with Mr. Dixon outside the United Kingdom.

HMRC's Contentions

HMRC contended that Mr. Higgins was conducting part of the control and management in the United Kingdom such that the remittance basis would not apply. It made the following arguments:

1. Since coming to the United Kingdom, Mr. Higgins had become more experienced. He was an established rally driver and sought out opportunities for sponsorship, teaching and for the testing of rally cars.
2. The business of the partnership was to exploit Mr. Higgins' rally driving skills. He was the heartbeat of the operation, parties would make first contact with him, and it was from his activities that all the profits were generated.
3. Rallying was a highly technical support and so business contacts must have wanted to deal with Mr. Higgins personally.
4. Although Mr. Dixon could give legal advice and a view on whether contracts with rallying teams were fair, his activities were of a background nature.
5. Although contracts were signed outside the United Kingdom this was not determinative. The important point was the scope of Mr. Higgins' activities in the United Kingdom, and in this respect he would consider opportunities in the

United Kingdom.

6. Mr. Higgins was the main partner and he had the larger share of profits.

The Tribunal's Decision

It was held that the appropriate test for determining the place of control and management of a partnership's activities is the same as that adopted by the courts in relation to company residence.

In particular, the Tribunal stated the following. First, although the place of control and management must be determined on a year-by-year basis, as highlighted in *Laerstate BV* the facts must be looked at as a whole. Secondly, the place where contracts were signed was not a determinative factor: it was an indication of where decisions were being made, but it is the location of decision making not where contracts are signed that is important.

In relation to the facts of the case, the Tribunal held that the purpose of the partnership was to combine Mr. Dixon's business acumen with Mr. Higgins' rallying skills. Further, Mr. Higgins continued to rely on Mr. Dixon's commercial experience and would not enter into significant contracts without referring them to Mr. Dixon for a decision. High level decisions of the partnership were taken outside the United Kingdom because they were determined by Mr. Dixon's views. Therefore control and management was outside the United Kingdom.

Concluding Comments

The decision of the First-Tier Tribunal, which was not appealed by HMRC, is helpful in clarifying the principles that apply in determining the place of control and management of a partnership's activities. The overlap with the common law test for the place of a company's residence is likely to mean that much of the thinking relating to companies can be transported to a partnership context. Equally, in ensuring that a partnership's activities are controlled and managed outside the United Kingdom, much of the practical advice given to companies in ensuring that they are not UK resident is likely to be relevant.

1. Senior counsel was Patrick Soares of Chambers

CASE NOTE

PITT V HOLT – FUTTER V FUTTER

THE RULE IN *HASTINGS-BASS* & MISTAKE

Imran S Afzal

Introduction

It is not infrequently that the question is asked: can something trustees have done be undone? Until recently there has been confusion as to the applicable legal principles. The Court of Appeal in *Pitt v Holt* [2011] STC 809 has clarified the position, and the following is a summary of the Court's decision.

Facts

The case involved two related appeals, and in outline the facts were as follows.

In *Pitt v Holt* an individual, Mr. Pitt, was injured in a road traffic accident in 1990. His wife was appointed as his receiver by the Court of Protection. A personal injury claim was compromised by the payment of a lump sum and an annuity. With the benefit of professional advice, Mrs. Pitt decided to transfer both into a discretionary trust and this was done in 1994. In 2003 it was realised that the trust attracted IHT charges: the disadvantages could have been avoided had a s.89 IHTA 1984 disabled person's trust been used. In 2007 Mr. Pitt died. His personal representatives contended that the

settlement was void, or alternatively voidable, and should be set aside. Reliance was placed on the Rule in *Hastings-Bass* and alternatively on the Court's equitable jurisdiction to set aside voluntary dispositions on the grounds of mistake.

In *Futter v Futter* assets were transferred from two trusts to beneficiaries. The trusts were offshore and had stockpiled capital gains. Inaccurate professional advice was obtained in relation to whether the trust's gains could be set against the losses of the beneficiaries. The trustees sought declarations that the transfers were void, or that they were voidable, and should be set aside. Reliance was placed on the Rule in *Hastings-Bass*.

Issue

The Court of Appeal considered in detail the scope of (a) the Rule in *Hastings-Bass*, and (b) the equitable jurisdiction to set aside transactions on the grounds of mistake. The decision runs to 239 paragraphs. The key principles identified by the Court are summarised below.

The Rule in *Hastings-Bass*

The rule is typically understood to mean the following. When trustees act under a discretion, in circumstances in which they are free to decide whether or not to exercise the discretion, and the effect of the exercise of the discretion is different from that which they intended, a court will interfere with their action if it is clear that they would not have acted as they did, had

they taken into account considerations which they ought to and not taken into account irrelevant considerations.

The Court of Appeal held that it is necessary to distinguish between two categories of case.

The first concerns cases where the issue is whether the purported exercise of a discretionary power was within the scope of the power. If not then the exercise of the power is void and *vice versa*. The following are examples of cases falling within this category:

1. There may be a procedural defect, e.g. use of the wrong type of document or failure to get a necessary consent.
2. There may be a substantive defect, e.g. an appointment to someone who is not within the class of objects.
3. Equally there may be a defect under the general law, e.g. an advancement might be invalid under the rule against perpetuities. In the latter case the impact will depend on the extent of the invalidity. If what remains of the advancement after the impact of the perpetuities rule cannot reasonably be regarded as being for the benefit of the advancee then it was not a valid advancement and the exercise of the power is void. By contrast, if it can be so regarded the exercise of the power was effective (to the extent permissible under the perpetuities rule).

The second category relates to cases where the exercise of a discretionary power is within the scope of the relevant power, but the trustees have breached their duties in respect of that exercise. In such a case the exercise (unless it is a fraud on the power) will not be void but simply voidable at the instance of a beneficiary who is adversely affected. In relation to this category various points were made by the Court of Appeal:

1. Trustees have various fiduciaries duties including a duty to take into account all relevant matters and not to take into account irrelevant matters: therefore acts done in breach of this duty will be voidable.
2. In relation to the matters which trustees ought to take into account, it is not possible to lay down any clear rule – it will depend on the circumstances. However, there will be few instances when it would not be relevant for trustees of a private discretionary trust, with assets, trustees or beneficiaries in England or Wales, not to address tax consequences.
3. Where tax matters are relevant it is likely to be the duty of trustees, under their duty of skill and care, to take proper advice.
4. However if the trustees seek advice from apparently competent advisers, and follow that advice, then, in the absence of any other basis for challenge, the trustees are not in breach of their fiduciary duty to take into account relevant

matters if that failure occurs because the advice was wrong: therefore in such circumstances the act will not be voidable.

5. A practical consequence is that if in the future it is desired to challenge an exercise of discretion by trustees on this basis, it will typically be necessary for beneficiaries to allege and prove a breach of fiduciary duties by the trustees. It will only rarely be appropriate for trustees to take the initiative: it might be necessary if, for example, the trustees need directions from the Court because a beneficiary alleges breach of duty but does not commence proceedings. Proceedings by a beneficiary will generally need to be brought under Part 7 of the Civil Procedure Rules since there is likely to be a substantial dispute of fact, and statements of case will be needed to set out the allegation of breach of trust and to answer that case.

As such, the outcome of the appeals was as follows.

In relation to *Pitt v Holt*, what Mrs. Pitt did was within the terms of the powers conferred on her by the Court of Protection, and therefore it was not void. She owed her husband a fiduciary duty in respect of her exercise of the power conferred on her by the Court of Protection. However, having taken advice from a proper source as to the advantages and disadvantages of the various courses open to her, she was not in breach of fiduciary duty even though, because of the inadequacy of the advice given, she did not take into account the

liability to IHT that would arise. Accordingly what she did was not voidable as having been done in breach of fiduciary duty.

In relation to *Futter v Futter* the trustees' acts were within their powers and therefore were not void. They took tax advice from appropriate solicitors, and acted in accordance with that advice. Therefore they did not act in breach of their duties even though, because the advice was wrong, they were mistaken as to the tax consequences. Therefore their acts were not voidable.

Mistake

The Court stated that the jurisdiction of equity to protect parties against fraud, undue influence, unconscionable bargains and related conduct, including abuse of confidence, is long established and well known. The jurisdiction now in point was of the same type, and must not be confused with common law remedies for mistake.

It was held that the following requirements must be met for equity to set aside a voluntary disposition on the grounds of mistake. First, (leaving aside cases where there is an additional vitiating factor, such as misrepresentation or concealment in relation to the transaction) there must be a mistake by the donor, at the time of the disposition, as to the legal effect of the transaction or as to an existing fact which was basic to the transaction. Secondly, the mistake must be sufficiently serious that it would be unjust for the donee to retain the property.

In the first appeal, i.e. *Pitt v Holt*, mistake was relied on as an alternative ground. The Court held that the legal effects in this case were the creation of trusts, on particular terms, in relation to the lump sum and the annuity. For these purposes the tax liabilities were fiscal consequences not the legal effects of the transactions. Therefore the equitable jurisdiction did not apply.

Concluding Remarks

The scope of the Rule in *Hastings-Bass* may be narrower than previously understood by some. In particular, the effect of relying on professional advice has been clarified by the Court of Appeal. The detail provided by the Court in relation to the applicable legal principles, in relation to both the Rule in *Hastings-Bass* and the equitable jurisdiction to set aside voluntary dispositions on the grounds of mistake, is to be welcomed in the interests of clarity.

THE TAX TREATMENT OF DAMAGES & COMPENSATION¹

by Hui Ling McCarthy

This article summarises some of the main issues concerning the tax treatment of damages and compensation.

The taxation of damages and compensation is both incredibly straightforward and deceptively complicated. It is straightforward because the tax treatment of transactions and arrangements does not *usually* change merely because of the actual or potential existence of litigation. The complexity arises from having to know the tax treatment of the underlying transactions and arrangements in the first place.

For clients involved in litigation and their advisers, the tax treatment of damages and compensation is important in two respects:

1. whether an award of damages should be reduced on account of taxation (the well-known *Gourley* principle); and
2. whether the damages themselves are taxable in the hands of the recipient of an award (typically, the claimant) or deductible in the hands of the payer (typically, the defendant).

The *Gourley* principle²

The principle is that a person must not be placed in a better or worse position as a result of a breach of contract than if the contract had actually been performed. The potential for being placed in a better position will arise in cases where:

- (a) a payment made from one party to another would be subject to tax in the event that the contract had been properly performed; but
- (b) the damages are not themselves subject to tax.

In such a case, the payment of damages must be reduced accordingly.

The most straightforward illustration of the principle is a payment made by an employer to an employee where (1) the employer has failed to give proper notice of termination to an employee and (2) there is no contractual provision or practice relating to payments in lieu of notice.

In such an instance, the amount of damages is first calculated by reference to the pay and benefits that the employee would have received during the notice period if proper notice had been given. Let us say that this would have been £2,000. If the employee had received this £2,000 as ordinary pay during his notice period, this would have been taxed and liable to national insurance

contributions. Let us say that this would have left the employee with £1,500.

As a damages payment, this payment will fall within the Income Tax (Earnings and Pensions) Act 2003 s.401 as a: “payment... received directly... in consequence of, or otherwise in connection with – (a) the termination of a person’s employment” – i.e. a termination payment which, as is well known, is tax-free up to a threshold of £30,000.

To satisfy the *Gourley* principle, the damages must therefore be reduced to £1,500.

The main taxes to consider

The main tax issues that arise for those in receipt of a damages payment are:

- (a) Will the payment be subject to income tax/corporation tax?
- (b) Will the payment be subject to capital gains tax (CGT)?
- (c) So far as VAT is concerned, will output tax need to be accounted for to HMRC?

The questions troubling the payer will be:

- (a) Is this payment deductible for income tax/corporation tax purposes?
- (b) Can input tax be recovered from HMRC?

Income tax - is the recipient chargeable?

Certain types of damages are non-taxable – for example, compensation or damages awarded for personal injury whether received in a lump sum or over a period and whether awarded by a court or agreed in an out of court settlement.

Other types of damages will be taxable – for example, if an accountant successfully sues a former client for non-payment of fees. The fact that the client has been compelled to pay the fees does not change the nature of the receipt in the accountant's hands.

Other cases are more difficult. A good rule of thumb is to look to the factual position determined by the Court on the conclusion of litigation: the tax treatment will typically follow as a consequence.

Contracts set aside

The case of *Spence v IRC*³ is a good illustration of the complications which can arise in a case where a contract is set aside. In a previous action, the taxpayer, Mr. Spence, had successfully sued another individual for rescission of a contract for the sale of shares because of fraudulent misrepresentation. The contract for sale was not void but voidable as a result of the fraudulent misrepresentation and the sale of shares had subsequently been set aside by the Court. The defendant was ordered to pay to Mr. Spence a sum representing the dividends received by the defendant whilst the shares were in the defendant's name. HMRC subsequently

sought to recover from Mr. Spence the tax on the dividends.

Before the Court of Session (Inner House), counsel for the taxpayer argued that Mr. Spence had not received dividends; rather, he had merely received compensation for the dividends – “something in the nature of damages measured by the value of the dividends as they had accrued in the past years”.

Mr. Spence’s difficulty was that he had not sued for damages: rather he had sought to have the contract of sale set aside, and had been successful. Accordingly, from the date on which the contract was set aside, he was to be treated as having been the owner of the shares throughout. Mr Spence was therefore the person entitled to receive the dividends at the time when they were paid. The defendant in the civil claim had initially paid tax to HMRC on the dividends and was subsequently repaid these sums by them.

Payments received subject to a constructive trust

It is not surprising (on the basis of *Spence v IRC*) that where assets are found by the Court to be received subject to a constructive trust in favour of some other party, they are not regarded as being “received” for tax purposes.

Similarly, where tax is charged on payments of money, the tax treatment will not be determined merely by whether there has been a transfer of the legal title to money alone. For example, in *Hillsdown Holdings plc v*

*IRC*⁴, the trustees of a company pension fund, believing it to be in surplus, transferred the surplus to the sponsoring employer. It later turned out that there had been no surplus. Accordingly, the trustees were in breach of the pension fund deed and should not have made the transfer. The employer company therefore held the funds on constructive trust for the fund.

At the material time, the Income and Corporation Taxes Act 1988 s.601 imposed a charge to tax on payments out of a pension fund of the type in issue in that case. HMRC considered that tax was still due on the payment out of the fund, notwithstanding that the distribution had been invalid and had since been reversed. However, Arden J. (as she then was) held that a payment for the purposes of s.601 had to be a “real payment”, not merely the transfer of legal title to cash. Accordingly, no tax was due.

Is there a difference if a settlement is reached outside court?

What is the position if a settlement is reached out of court?

Let us return to the example of an accountant who sues his former client to recover outstanding fees of £10,000. What if the accountant and his client reach an out of court settlement for £1,000? Logically, the tax treatment should be no different to the position where the accountant and client had simply agreed that reduced fees of £1,000 should be paid. Accordingly, the whole

£1,000 is subject to income tax in the accountant's hands in the usual way.

Can it be said that the accountant should somehow be subject to capital gains tax (CGT) instead of income tax? The accountant *could* have sued his client for the whole £10,000 but has instead given up his right to do so for a one-off payment of £1,000. Is he liable to pay CGT in respect of this sum instead? The answer is no.

First, if the quality or nature of the payment is of a professional nature (as is the case in this example) then it will be a taxable receipt. Cases such as *IRC v Falkirk Ice Rink Ltd*⁵ demonstrate that it does not matter whether there has been consideration for the payment (in our example, the accountant's client might consider that his accounts were so poorly prepared as to be unusable and has merely made the £1,000 to guard against litigation risk). It also does not matter that the payment was voluntary. In *Falkirk Ice Rink*, a donation of £1,500 from a curling club to the owner of an ice rink was a taxable receipt in the hands of the owner, notwithstanding that the donation was made voluntarily and over and above the club's usual fees to use the facilities.

Secondly, whilst it is true that the accountant has given up his claim for £10,000 (and that, for the reasons that we shall see later, does constitute the disposal of an asset for CGT purposes), the Taxation of Chargeable Gains Act 1992 s.37 provides that money or money's worth charged to income tax as a receipt is excluded from the CGT computation. In other words, priority is given to income tax. Once it is determined that income

tax is due, that is the end of the matter – it is not possible instead to obtain more favourable CGT treatment.

Income tax - is the payer allowed a deduction?

Any business (or company) which is in the position of having to make a payment of damages or compensation will be concerned to know whether a deduction for income tax (or corporation tax) can be claimed in calculating the profits of a trade, profession or vocation.

This will be particularly important when it comes to considering settlements out of court. After all, if a sole trader subject to the 50 per cent additional rate is being sued for damages, the cost to him at the end of the day may be halved if he can claim a deduction.

Whether a deduction is available depends on whether:

1. The payment is of a capital nature (rather than of a revenue nature). If so, a deduction in arriving at taxable profits will not be allowed;⁶ and
2. Whether the payment is incurred “wholly and exclusively for the purposes of the trade”. If not, a deduction in arriving at taxable profits will not be allowed.⁷

Here are a few examples:

- (a) Damages will typically always be deductible in respect of sums paid by an employer to an employee for unfair dismissal. However, the position may be different in the case of former directors if the purpose of the payment is in part to secure the position of the directors personally.⁸
- (b) In *Knight v Parry*⁹, a solicitor, previously employed as an assistant solicitor, set up practice on his own. Subsequently, in an action in which professional misconduct was alleged but not proved, damages were awarded to his former employer for a breach of his contract of employment. The solicitor could not deduct damages for a breach committed whilst he was an employee against professional profits earned at a later date.
- (c) Damages paid for professional negligence (to the extent that these are not covered by indemnity insurance) will always be deductible.
- (d) But professional fines are not deductible. In *Knight v Sheppard*¹⁰, the Stock Exchange Council imposed fines of £50,000 on a stockbroker for breach of Stock Exchange rules. The taxpayer contended that he was allowed a deduction in respect of the fines since they were paid to prevent his

suspension or expulsion from the Stock Exchange and thus to protect his business. Lord Hoffmann disagreed, holding that the reason why a fine or penalty was not deductible related to the particular character of such a payment - “[i]ts purpose is to punish the taxpayer, and a court may easily conclude that the legislative policy would be diluted if the taxpayer were allowed to share the burden with the rest of the community by reason of a deduction for the purposes of tax.”

- (e) Damages paid for breach of copyright, trademark or passing off would usually be deductible (on the assumption that the subject matter was used to further a company’s profitable activities).
- (f) Damages for libel paid by a sugar broker to a Ministry of Food official were held not to be deductible (*Fairrie v Hall*¹¹). However, in *Herald and Weekly Times Ltd v Federal Commissioner*¹², damages paid by a newspaper company for defamation were deductible!

CGT

As already mentioned, a person who receives a capital sum derived from an asset is treated for the purposes of CGT as disposing of that asset.¹³

An asset for CGT purposes is broadly defined. In particular, *Zim Properties Ltd v Proctor*¹⁴ established that the right to take court action for compensation or damages is an asset for CGT purposes. It follows that a person who receives compensation or damages, whether by a court order or arbitration or by negotiated settlement may be regarded as disposing of the right to sue. A capital gain may arise as a result.

CGT is charged on the difference between disposal proceeds and the acquisition cost. In the case of the disposal of a cause of action, it is pretty straightforward that the amount of the damages or compensation payment equates to the disposal proceeds. But what then is the acquisition cost?

Luckily, litigants and their advisers do not need to be troubled by such concerns owing to HMRC Concession D33 (otherwise known as the *Zim* Concession because it arose as a consequence of the Court's decision in *Zim Properties*). The concessionary relief operates as follows:

1. Where the right of action arises out of an underlying asset, payments of damages or compensation are treated as though the payments themselves derived from that asset.

For example, someone who sold their private residence might have received damages from a professional adviser whose negligence meant that the sale price was less than it should have been. If the client had obtained

the full sale price, no CGT would be due because of principal private residence relief (PPR). However, if the vendor sued his adviser for negligence, any damages received would be treated as deriving from the right of action against the adviser and not from the house. Accordingly, PPR would not be available.

Applying the concession, the damages derived from the cause of action can be treated as if they derive from the house so that PPR would be available.

2. In cases where there is no underlying asset, damages are treated as exempt.

An example would be damages for negligence which were received from a professional adviser as a result of misleading inheritance tax advice.

There is a general exemption at TCGA 1992 s.51(2) for “*any wrong or injury suffered by an individual in his person or in his profession or vocation*”. “Wrong or injury” include breaches of contractual duties and torts; the words “in his person” are to be read as distinct from “in his finances”. But these words embrace more than physical injury, so distress, embarrassment, loss of reputation and so on are also covered. Similarly, the words “in his profession or vocation” refer to loss or damages suffered by an individual in his professional capacity (such as unfair

discrimination). The exemption also extends to compensation received by persons other than the individual who suffered the wrong or injury (for example, bereaved family members).

VAT

VAT is payable on consideration paid in exchange for goods or a service. Broadly speaking, any transfer of the whole property in goods is a supply of goods.¹⁵ VATA 1994 s.5(2)(b) provides that “anything which is not a supply of goods but which is done for consideration (including, if so done, the granting, assignment or surrender of any rights) is a supply of services.”

If there is no direct and immediate link between a payment and a supply of goods or services, no output tax is due.¹⁶ One example is where monies are paid by way of breach of contract for non-performance. In these circumstances, monies are not consideration for a supply of services (and are therefore not subject to VAT) because, by definition, no service has been performed. Conversely, whilst the recipient will not need to account for output tax in respect of the sums received, the payer will not be able to claim an input tax credit in respect of the sums paid.

However, as a number of cases illustrate, determining whether or not there has been a supply is not necessarily easy:

- (a) *Hometex Trading Ltd v CC&E*¹⁷ concerned the VAT treatment of a sum paid from a carpet wholesaler to a company that had supplied yarn. The taxpayer (Hometex) had initially ordered yarn from the supplier (Lawtons). The taxpayer had originally agreed to pay around £25,000 for the yarn. However, before the yarn could be delivered, the taxpayer changed its mind and cancelled its order. Lawtons managed to sell the yarn to a third party at a reduced price and sued the taxpayer for the balance (around £12,000). The question before the VAT Tribunal was whether the taxpayer was entitled to an input tax credit in respect of the payment that it had to make to Lawtons of £12,000. This is a relatively straightforward case since it was clear that there had been no supply of the yarn to the taxpayer – accordingly, the £12,000 that it paid to Lawtons in compensation was outside the scope of VAT.
- (b) In *Financial and General Print Ltd v CC&E*,¹⁸ the VAT Tribunal was asked to determine whether input tax relief was allowed to the taxpayer company in respect of a compensation payment made to a lessor in respect of the early termination of a lease of printing equipment. Again, owing to the early termination of the lease by the lessor, the VAT Tribunal found that there was no supply

by the lessor in respect of the termination payment made by the lessee. The lessor's termination of the lease was not a supply of services – it was simply a unilateral act of the lessor. Accordingly, the lessee could not recover input tax in respect of the sum so paid.

- (c) These cases may be contrasted with *Croydon Hotel & Leisure Company Limited v CC&E*.¹⁹ In that case, the taxpayer entered into a management agreement with Holiday Inns to allow it to manage its hotel for a period of 20 years. Dissatisfied with the quality of management, the taxpayer sought to terminate the management agreement. However, there had been no event of default which allowed the taxpayer to terminate the contract without payment. Holiday Inns required a payment of £2,000,000 before it would agree to early termination. Could the taxpayer recover input tax on the £2,000,000? The VAT Tribunal determined that input tax was recoverable. This was because, on the facts, Holiday Inn had made a supply to the taxpayer namely, the waiver of its right to continue to manage the hotel, thereby restoring to the taxpayer full rights as owner to do with the hotel what it wished.

¹ This article was first published by Thomson Reuters (Professional) UK Limited in Private Client Business [2012] Issue 3 and is reproduced by agreement with the Publishers.

² The principle arises from the House of Lords' judgment in *British Transport Commission v Gourley* [1956] AC 185.

³ *Spence v IRC* (1941) 24 TC 311.

⁴ *Hillsdown Holdings plc v IRC* [1999] STC 561.

⁵ *IRC v Falkirk Ice Rink Ltd* [1975] STC 434.

⁶ See the Corporation Tax Act 2009 s.53 for companies and the Income Tax (Trading and Other Income) Act 2005 s.33 for individuals.

⁷ See the Corporation Tax Act 2009 s.54 for companies and the Income Tax (Trading and Other Income) Act 2005 s.34 for individuals.

⁸ See *Hammond Engineering Co Ltd v CIR* [1975] STC 334.

⁹ *Knight v Parry* [1973] STC 56.

¹⁰ *Knight v Sheppard* [1999] STC 669.

¹¹ *Fairrie v Hall* [1947] 2 All ER 141.

¹² *Herald and Weekly Times Ltd v Federal Commissioner* (1932) 48 CLR 113.

¹³ Taxation of Chargeable Gains Act 1992 s.22

¹⁴ *Zim Properties Ltd v Proctor* [1985] STC 90.

¹⁵ Value Added Tax Act 1994 Sch.5, para.1.

¹⁶ See ((Case C-102/86) *Apple and Pear Development Council v C&EC* [1986] STC 192.

¹⁷ *Hometex Trading Ltd v CC&E* (VAT Decision 13012).

¹⁸ *Financial and General Print Ltd v CC&E* (VAT Decision 13795).

¹⁹ *Croydon Hotel & Leisure Company Limited v CC&E* (VAT Decision 14920).

VODAFONE'S SUPREME COURT VICTORY IN INDIA¹

by Nikhil Mehta and Gareth Miles²

1. Introduction

On 20 January 2012, the Supreme Court of India delivered its eagerly anticipated decision in *Vodafone International Holdings BV v. Union of India* [2012] 17 taxmann.com 202 (SC). In a full reversal of the earlier decision against Vodafone in the Bombay High Court, Vodafone's appeal was unanimously allowed by the 3-judge bench in the Supreme Court. This is a landmark decision for the foreign investment community, particularly given that numerous other transactions are affected, and is of even wider significance given what the judges said about tax avoidance.

The facts in *Vodafone* are both complex in detail and well-known. But the tax issue is relatively simple. When Vodafone International Holdings BV ("VIH"), bought a single share constituting the whole of the issued share capital of CGP, a Cayman company, from a British Virgin Islands subsidiary in the Hutchison Telecom Group, did the seller realise a capital gain which was subject to tax in India, with the result that VIH should have withheld Indian tax from the sale consideration? The Indian nexus arose because CGP, through a complex corporate structure and indirect rights to certain equity options held in that structure, effectively had a 67% interest in Hutchison Essar Limited ("HEL"), which carried on one of India's largest mobile tele-

communications businesses. For that reason, the sale price of CGP was @ US\$11.1bn. If VIH was found liable, its tax bill from the Indian Government would have exceeded US\$2bn.

The transaction was ostensibly the sale by one non-resident to another non-resident of a share in a non-resident company and, as such, was thought to be outside the Indian tax jurisdiction. Moreover, none of seller, purchaser or target had a presence in India. Since Indian capital gains tax (strictly, income tax as capital gains is a separate head of income in the Income Tax Act 1961, but referred to as “CGT” in this article) is only payable by a non-resident on the transfer of a capital asset situated in India, that ought to have been the end of the matter given the Cayman situs of the share in CGP. But the Indian tax authorities (“the Revenue”) thought otherwise and, on the basis of various arguments, looked through the share sale and contended that the parties had effectively transferred a controlling interest in a significant Indian company which was an Indian asset or a bundle of Indian assets. So they claimed CGT. Since withholding by the purchaser was a convenient method of collecting the tax, particularly since the seller group had divested its Indian interests whereas the Vodafone group had a growing Indian presence, the Revenue pursued VIH.

2. The Bombay High Court

The dispute threw into focus issues of tax avoidance such as what was legitimate tax planning and what should be struck down as artificial or colourable devices designed for no reason other than to avoid tax.

For many years, the Indian courts have carefully followed the development of judicial anti-avoidance doctrines in UK tax law and have used, as persuasive authority, decisions of the English courts. In the Bombay High Court, a large part of the decision approved legitimate tax planning and disapproved shams and other devices. That court also found nothing objectionable about the tax planning in the *Vodafone* facts. It upheld the general principle that the courts would not pierce corporate veils unless something objectionable had occurred, be it artificial tax avoidance or, even worse, tax evasion. The logic of its thought process should have meant success for VIH at that stage. However, the Bombay High Court then proceeded to look at the facts and to interpret the transaction documents in ways which led them to conclude that the real bargain between the parties was not a simple share sale and must have included other assets, which were in all likelihood mostly Indian assets for CGT purposes. This was the worst of all worlds since it effectively applied tax avoidance principles to an acknowledged non-tax avoidance scenario. Moreover, the way in which the Bombay High Court interpreted documents set off alarm bells not just for tax advisers, but also for commercial lawyers involved in drafting contracts and related documents.

3. The Supreme Court

There were two judgments delivered in the Supreme Court: the leading judgment of Chief Justice S.H. Kapadia (with whom Swatanter Kumar J agreed),

and a concurring (but much longer) judgment of K.S. Radhakrishnan J. In deciding for VIH, the Supreme Court restored much-needed clarity. Key features of the decision are:

- Legitimate tax planning remains a valid exercise which the Courts will respect. In particular, the principle in *Duke of Westminster v. CIR* [1935] 19 TC 490 is alive and well in India: this point was particularly important as it cleared up some confusion arising from two earlier Supreme Court decisions: *McDowell v CTO* [1985] 3 SCC 230 and *Union of India v. Azadi Bachao Andolan* [2004] 10 SCC 1. The *McDowell* decision was delivered soon after *Furniss v Dawson* [1984] STC 153 in the UK and was the first instance of the “modern” English judicial anti-avoidance doctrine being considered by the Indian Supreme Court. One of the judges indicated that the *Westminster* principle was dead in England, and should be afforded the same status in India. It was not wholly clear if the other judges agreed with him. The judges in the *Azadi Bachao* decision disagreed: in *Vodafone*, the survival of the principle was confirmed.
- The Supreme Court recognised that multinationals used SPVs and holding companies in cross-border structures for tax planning and other (e.g. regulatory) reasons. There was nothing in principle objectionable about this.

- The corporate veil could not be pierced except in exceptional circumstances where companies were used as tax avoidance devices or to perpetrate tax evasion such as round tripping of funds back into India.
- In looking at structures, the courts and the tax authorities should look at transactions as a whole and not dissect them at the outset in search of an unacceptable tax motive. If the exercise of looking at the overall transaction disclosed artificial steps, then it was permissible to ignore these on the basis of the House of Lords decision in *W.T. Ramsay Ltd. v. IRC* [1981] STC 174. In *Vodafone*, the Indian tax authorities had approached the transaction the wrong way in presuming tax avoidance and then taking apart the transaction to look for it. Relevant factors in examining international sales included: (i) the concept of participation in investment (as opposed to participation in a mere tax avoidance exercise); (ii) the duration of time during which the holding structure exists; (iii) the period of business operations in India; (iv) the generation of taxable revenues in India; (v) the timing of the exit; (vi) the continuity of business on such exit.
- The onus is on the Revenue to identify the scheme and its dominant purpose.
- It was not possible to read the tax legislation dealing with transfers of capital assets situated in India as extending to indirect transfers: that would amount to reading words into the

provision (Income Tax Act 1961 s.9(1)) which were not there.

- Even though “transfer” for CGT purposes includes extinguishment, the transaction did not involve the extinguishment of any property rights in India by any entity in the selling group.
- The corporate veil could only be pierced if it could be shown that CGP’s ultimate parent had usurped its authority (and that of lower companies in the chain). That had not happened.

Following its holistic approach, the Supreme Court found that the transaction was exactly as the parties contemplated: an offshore sale between offshore parties of an offshore asset. This was not subject to CGT. *A fortiori*, VIH had no withholding obligation.

K S Radhakrishnan J also discussed the use of the India/Mauritius tax treaty in foreign investment structures. Since the treaty was not relevant to the facts, other than by way of hypothesis if the sale had occurred out of Mauritian sub-subsidiaries below CGP, his comments are obiter dicta.

4. The Impact of the Decision

The decision means that a number of similar share sales which have been challenged by the Indian tax authorities should escape Indian taxation. Some, may, however, still be vulnerable if, for example, SPVs were inserted in the structure as part of the sale planning. The disapproval by the Supreme Court of the Bombay High

Court's approach to recharacterising transactions where there is no tax avoidance is welcome. But care will still need to be exercised in structuring and documenting international sales, having particular regard to the factors which the Supreme Court regarded as important in showing a commercial transaction.

The Indian Direct Taxes Code Bill ("DTC") will reverse some of the impact of *Vodafone* for transactions implemented after it comes into force (currently 1 April 2012, although there is an expectation that it will be delayed). The DTC purports to tax offshore sales of this nature where at least 50% of the fair market value of an offshore SPV consists of Indian assets. In the light of the Supreme Court decision, the current wording in the DTC appears inoperative and will need amendment.

The new charge will throw a greater focus on sellers acting out of treaty countries like Mauritius which enjoy capital gains exemptions. But treaty relief will itself be subject to the new statutory GAAR-also contained in the DTC. While the practical interaction between treaties and the GAAR remains to be seen, the Supreme Court's comments on acceptable foreign investment planning should serve as a marker for the Revenue to exercise prudence in invoking the GAAR where treaty relief is claimed.

¹ This article was first published in *Tax Journal* on 3rd February 2012.

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THE STATUTORY RESIDENCE TEST CONSULTATIVE DOCUMENT¹

by Aparna Nathan

Foreword

In the Spring 2012 Budget the Government confirmed its intention to implement the statutory residence test in Finance Bill 2013 to take effect from 6 April 2013. This was originally announced in a Written Ministerial Statement made by David Gauke MP, the Exchequer Secretary to the Treasury, on 6 December 2011. It is understood that a formal response to the 2011 Consultation document discussed in the article that follows will be published, together with draft legislation, on an unspecified date after the Budget. It is hoped that the publication will allow practitioners sufficient time to scrutinise the draft legislation and to make representations to the Treasury/HMRC either directly or through their representative bodies.

The Statutory Residence Test Consultative Document

In this note the writer reviews the merits of the consultative document (the ConDoc) recently issued by HM Treasury and HMRC on their proposal for a Statutory Residence Test.²

Introduction

Practitioners in the field of UK tax have long recognised the fact that the law for establishing an

individual's residence status is far from satisfactory. The statutory rules contained in section 829 et seq of the Income Tax Act 2007 (ITA 2007) (and its predecessors) do not apply for all purposes and, more importantly, do not set out tests for determining whether an individual is resident in the UK. The task of determining an individual's place of residence for tax purposes has historically been carried out by the courts. However, many of these cases were decided against a background when global travel was not frequent, fast or, generally, of short duration. The relevance of such cases is, therefore, arguably limited. Further, the limitations of the courts' appellate jurisdiction have not been conducive to the formulation of a clear and practical test for determining an individual's residence status: the appellate courts have, in general, been unwilling to disturb the findings of fact made by the courts of first instance (the Special Commissioners, General Commissioners and, latterly, the First- tier Tribunal).

Against this background, HMRC Booklet IR20, "Residents and non-residents: liability to tax in the United Kingdom",³ provided a practical *modus vivendi* for HMRC (or the Inland Revenue as they then were) and for practitioners: it introduced a 91-day test and the "full time employment abroad" concession both of which formed the backbone of many practitioners' advice in this area.⁴ However, the approach taken by HMRC before the Special Commissioners in *Gaines –Cooper v HMRC (Gaines-Cooper)*⁵ cast doubt on practitioners' ability to rely on HMRC's published practice in IR20.

HMRC stated that they continued to apply the published practice set out in IR20.⁶

Judicial review proceedings were instituted by the taxpayer in *Gaines-Cooper* which were heard, on appeal from the Court of Appeal, by the Supreme Court in the summer of 2011. The Supreme Court's judgment is expected imminently. Whatever the judgment of the Supreme Court, the fact remains that IR 20 (and its successor HMRC⁷) cannot safely be relied upon by practitioners. As a result, practitioners have once more been forced to revert to, and rely upon, the case law in this area.

All parties recognise the central importance to an individual of that individual's residence status. It is, therefore, imperative that an individual (or at least his tax adviser) should be able to determine that individual's residence status with some degree of certainty. For the reasons discussed above, the case law does not provide the requisite certainty.

In answer to the clamour from practitioners for greater certainty, HM Treasury and HMRC have put forward (or, perhaps more accurately, have dusted off) their proposals for a statutory residence test (SRT) in a public consultation document.

This note seeks to discuss the merits/demerits of the proposed SRT.

The proposed SRT: stated aims and approach

The aim of the proposed SRT is stated to be to introduce a test “that is transparent, objective, and simple to use”⁸ with the aim of allowing “taxpayers to assess their residence status in a straightforward way”⁹ and of enabling “those who come to the UK on business, as employees or as investors to have a clear view of their tax treatment.”¹⁰

The proposed framework for the proposed SRT is set out in Chapter 3 of the ConDoc.

Paragraph 3.2 of the ConDoc states:

“The SRT is designed to provide a simple process and clear outcome for the vast majority of people whose circumstances are straightforward.”¹¹

Paragraph 3.4 of the ConDoc states:

“To provide a fair way of determining residence for those with more complicated affairs the Government proposes that the SRT should take into account both the amount of time the individual spends in the UK and the other connections they have with the UK. However, to avoid the complexity of current case law:

- the test should not take into account a wide range of connections;
- relevant connections should be simply and clearly defined; and

- the weight and relevance of each connection should be clear.”¹²

Paragraphs 3.5 and 3.6 of the ConDoc clearly indicate the anti-avoidance thinking behind the proposed SRT:

“3.5 The Government wants to ensure that introducing a statutory test does not lead to situations where individuals can become and remain non-resident without significantly reducing the extent of their connection with the UK. Equally, the Government is clear that individuals should not be resident if they have little connection with the UK.

3.6 The Government also believes it is beneficial to encourage individuals to come to the UK and spend a limited amount of time here without necessarily becoming resident, such as investors assessing investment opportunities. The proposed test has been designed so that it is harder to become non-resident when leaving the UK after a period of residence than it is to become resident when an individual comes to the UK. Once an individual has become resident and built up connections with the UK, they should be required to scale back their ties to the UK significantly or spend far less time here or a combination of the two before they can relinquish residence. This is consistent with the principle, reflected in case law, that residence should have an adhesive nature.”¹³

The proposed SRT therefore intends to distinguish between “arrivers” (said to be individuals who were not

UK resident in all of the previous three tax years) and “leavers” (said to be individuals who were resident in one or more of the previous three tax years) and intends to make it more difficult to for a “leaver” to become non-resident than it is for an “arriver” to retain non residence.¹⁴

The proposed SRT: essential features

Paragraph 3.10 of the ConDoc makes it clear that the proposed SRT will supersede all existing legislation, case law and HMRC guidance on determining individual residence, it will only apply to individuals and not to companies¹⁵; it will apply for the purposes of income tax, capital gains tax and inheritance tax but will not apply for National Insurance Contributions purposes.

The test is made up of three parts:

Part A – which lists factors that, when present, conclusively render an individual non-UK resident;

Part B- which lists factors that, when present, conclusively render an individual to be UK resident;

Part C – which lists day counting rules and connection factors that may render an individual UK resident.¹⁶

The framework stipulates clear rules for the priority given to each of Parts A, B and C:

1. Where both Part A and Part B could apply to an individual, Part A takes priority and the individual will be regarded as non-resident¹⁷;
2. If Part A does not apply, the individual is not necessarily UK resident: that would depend on whether he is conclusively resident under Part B or, failing that, under Part C¹⁸;
3. Part C only applies where none of the conditions in Part A or Part B is satisfied.¹⁹

Part A : Conclusive Non-Residence

Paragraph 3.17 of the ConDoc provides:

“Therefore, Part A of the test will conclusively determine that an individual is not resident in the UK for a tax year if they fall under any of the following conditions, namely they:

- were not resident in the UK in all of the previous three tax years and they are present in the UK for fewer than 45 days in the current tax year; or
- were resident in the UK in one or more of the previous three tax years and they are present in the UK for fewer than 10 days in the current tax year; or

- leave the UK to carry out full-time work abroad, provided they are present in the UK for fewer than 90 days in the tax year and no more than 20 days are spent working in the UK in the tax year.”²⁰

Broadly, an individual has “full time work abroad” if:

1. If the individual is employed or carries on a trade or profession abroad; and
2. The hours he works in that employment, trade or profession total at least 35 hours per week²¹; and
3. The employment, trade or profession is carried out for at least one full tax year²²; and
4. That no more than 20 “working days” are “performed”²³ by that individual in the UK (reduced pro rata in cases where the split year rules apply); and
5. The individual must be present in the UK for fewer than 90 days in that tax year (reduced pro rata in cases where the split year rules apply).²⁴

In essence, a “working day” is any day on which an individual works for three or more hours²⁵: the onus is on the individual to prove that he has worked fewer than

three hours in a day if he wishes to have that day excluded as a “working day”.²⁶

Part B: Conclusive Residence

Paragraph 3.22 of the ConDoc provides that:

“Provided Part A of the test does not apply, an individual will be conclusively resident for the tax year under Part B if they meet any of the following conditions, namely they:

- are present in the UK for 183 days or more in a tax year; or
- have only one home and that home is in the UK (or have two or more homes and all of these are in the UK); or
- carry out full-time work in the UK.”²⁷

The term “days of presence in the UK” is defined (subject to an exception for transit passengers at paragraph 4.17) at paragraph 4.16 as:

“...A person will be treated as being in the UK on any day where they are in the UK at midnight at the end of that day.”²⁸

The term “only home” is defined at paragraphs 4.12 and 4.13 as:

“4.12 If a person has only one home and that is in the UK or they have more than one

home and all of these are in the UK, this will constitute an ‘only home’.

4.13 Residential accommodation is not treated as an individual’s home if that accommodation is being advertised for sale or let and the individual lives in another residence.²⁹

Of note, however, is that the term “home” is not defined.

The term “full time work abroad” is defined at paragraphs 4.14-4.15 and requires that:

1. The individual is employed or carries on a trade; and
2. The individual works in the UK for at least 35 hours per week;³⁰ and
3. The work is carried out in the UK for a continuous period of more than nine months (excluding short breaks such as ill health or holidays); and
4. No more than 25 per cent of the duties of the employment, trade or profession are carried on outside the UK in that period.³¹

Part C: Other connection factors and day counts

Paragraph 3.28 of the ConDoc sets out the rationale for the Part C test:

“Part C reflects the principle that the more time someone spends in the UK, the fewer connections they can have with the UK if they want to be non-resident. It also incorporates the principle that residence status should adhere more to those who are already resident than to those who are not currently resident.”³²

Paragraph 3.30 of the ConDoc sets out the five connecting factors that are relevant for determining residence:

“**Family** – the individual’s spouse or civil partner or common law equivalent (provided the individual is not separated from them) or minor children are resident in the UK;

• **Accommodation** – the individual has accessible accommodation in the UK and makes use of it during the tax year (subject to exclusions for some types of accommodation);

• **Substantive work in the UK** – the individual does substantive work in the UK (but does not work in the UK full-time);

• **UK presence in previous year** – the individual spent 90 days or more in the UK in either of the previous two tax years;

• **More time in the UK than in other countries** – the individual spends more days in the UK in the tax year than in any other single country.”

“Family” is defined in paragraph 4.19 -4.20 of the ConDoc as:

“4.19 An individual has family in the UK in a tax year if either of the following applies:

- the individual’s spouse, civil partner or common law equivalent is resident in the UK in that tax year or any part of that tax year. This does not include a spouse, civil partner or common law equivalent if they are separated from the individual under a court order or a separation agreement or where the separation is likely to be permanent; or
- the individual has children under the age of 18 who are resident in the UK and the individual spends time with those children (one to one or with others present), or lives with them, for all or part of 60 days or more during the tax year. It would not matter whether these days were spent with the child in the UK or elsewhere.

4.20 A child will not be treated as being resident in the UK for these purposes if their residence is mainly caused by time spent at a UK educational establishment. This will be when the child spends fewer than 60 days in the UK not present at the educational establishment and the child’s main home is not in the UK.”³³

“Accommodation” is defined at paragraphs 4.21-4.22 of the ConDoc as:

“4.21 An individual has UK accommodation if residential property:

- is accessible to be used by them as a place of residence; and
- is used by them or their family in the year as a place of residence. Family has the same meaning as in paragraphs 4.19 and 4.20.

4.22 The following categories of accommodation are not included as UK accommodation:

- accommodation provided by an individual’s employer where the accommodation is also accessible to, and used by, other employees of that employer who are not connected to the individual. For example, premises owned or rented by the company that is used by all employees visiting the country while on company business;
- any accommodation held on a lease of six months or less, except where there are consecutive leases taking place. For example, if an individual moves from house A, with a six month lease to house B with a six month lease, and there are fewer than six weeks between leaving one house and living in the other, they

will be considered to have UK accommodation;

- accommodation accessible to a child of the individual under the age of 18 where that accommodation is provided in relation to the child being a student at a UK educational establishment;
- short-term accommodation in hotels; and
- lodging with relatives, where staying in the home of a relative is for a temporary short-term visit only.”³⁴

“Substantive work in the UK” is defined at paragraphs 4.23-4.24 of the ConDoc:

“4.23 An individual has substantive employment or self-employment in the UK if they work in the UK for 40 or more days in the tax year.

4.24 The definition of a working day is any day on which more than three hours of work is undertaken. This includes any day where the person is not in the UK at the end of that day.”³⁵

“Days of presence in the UK” bears the meaning it has for Part B (see paragraphs 4.16, 4.17).

Paragraphs 3.34- 3.35 of the ConDoc³⁶ set out the day counts for “arrivers”:

“3.34 If the individual was not resident in all of the three tax years preceding the year under consideration, the following connection factors may be relevant to their residence status, if they occur at any point in the tax year, namely the individual:

- has a UK resident family;
- has substantive UK employment (including self-employment);
- has accessible accommodation in the UK;
- spent 90 days or more in the UK in either of the previous two tax years.

3.35 The way these connection factors are combined with days spent in the UK to determine residence status is as follows:

Days Spent in the UK	Impact of connection factors on residence status
Fewer than 45 days	Always non-resident
45-89 days	Resident if individual has 4 factors (otherwise not resident)
90-119 days	Resident if individual has 3 factors or more (otherwise not resident)
120-182 days	Resident if individual has 2 factors or more (otherwise not resident)
183 days or more	Always resident”

Paragraphs 3.36- 3.37 of the ConDoc³⁷ set out the day counts for “leavers”:

“3.36 If the individual was resident in one or more of the three tax years immediately preceding the tax year under consideration, the following connection factors may be relevant to their residence status, if they occur at any point in the tax year, namely the individual:

- has a UK resident family;
- has substantive UK employment (including self-employment);
- has accessible accommodation in the UK;
- spent 90 days or more in the UK in either of the previous two tax years;
- spends more days in the UK in the tax year than in any other single country.

3.37 The way these connection factors are combined with days spent in the UK to determine residence status is as follows:

Days Spent in the UK	Impact of connection factors on residence status
Fewer than 10 days	Always non-resident
10-44 days	Resident if individual has 4 factors or more (otherwise not resident)

45-89 days	Resident if individual has 3 factors or more (otherwise not resident)
90-119 days	Resident if individual has 2 factors or more (otherwise not resident)
120-182 days	Resident if individual has 1 factor or more (otherwise not resident)
183 days or more	Always resident"

In essence, the same factors are taken into account as connecting factors for “arrivers” and “leavers” except that the “adhesive quality” of residence (at least in HMRC’s view) is reflected in the fact that “leavers” are permitted to spend significantly fewer days in the UK when compared to “arrivers” where both types of person retain/ have the same number of connecting factors.

Split year treatment

This will be put onto a statutory footing.

Anti- Avoidance

It is intended that temporary non residence rules, similar to those that apply for capital gains tax purposes (section 10 (1) (a) of the Taxation of Chargeable Gains Act 1992) will apply to some forms of investment income, e.g. dividends from close companies but will not apply to earnings from employment, self-employment, bank interest or dividends from listed companies.

Transitional Rules

There is no present intention to have transitional rules.

Ordinary Residence

Chapter 6 of the ConDoc deals with the concept of ordinary residence and indicates that, since the Government intends to retain the concept of ordinary residence for “overseas workday relief”³⁸, it does not wish to abolish the concept for other purposes. It proposes, at paragraph 6.16 of the ConDoc, that:

“The Government’s proposed definition is that individuals who are resident in the UK should also be treated as ordinarily resident unless they have been non-resident in the UK in all of the previous five tax years. If they meet this condition, they may be not ordinarily resident. The status of being not ordinarily resident should be available in the tax year in which the individual arrives in the UK and for a maximum of two full tax years following the tax year of arrival.”³⁹

The document sets out two options for reforming ordinary residence:

1. Abolish the concept for all tax purposes except overseas workday relief;
2. Retain the concept for all tax purposes but create a statutory definition.

In the Spring 2012 Budget, the Government announced that it intended to abolish the concept of “ordinary residence” for tax purposes but retain Overseas Workdays Relief. It is understood that Overseas Workday Relief will be put it on a statutory footing.

Comments

General Points

The first general point to make is that it is laudable that the aim of the proposed SRT is to enable “taxpayers to assess their residence status in a straightforward way”.⁴⁰ However, it is somewhat disappointing that the test proposed does not apply for all purposes: note the express exclusion of NICs which will retain their own rules. So, it appears that an employee will have to determine his residence status separately for tax and NICs purposes. In the writer’s view, this hardly creates a straightforward way for a taxpayer to determine his residence status.

Further, the writer wonders whether the proposed SRT will apply for the purposes of determining the jurisdiction of the UK courts. It will be recalled that the jurisdiction cases (e.g. *High Tech and others v Deripaska*⁴¹ and *OJSC Oil Company Yugraneft v Abramovich*⁴²) have hitherto applied the long established residence cases. It would certainly aid simplicity if the same test were to apply for jurisdiction purposes as well or if it were made clear that the jurisdiction jurisprudence was entirely separate from the jurisprudence henceforward relating to tax residence.

Further still, it is disappointing that the consultation document has missed the opportunity of abolishing the nebulous concept of “ordinary residence” given that it adds little to the concept of “residence” and given also the rising trend of litigation to determine its meaning (e.g. *Genovese v HMRC*⁴³, *Tuczka v HMRC*⁴⁴). To the extent that there are tax provisions that include the concept of “ordinary residence”, e.g. the transfer of assets provisions, it would arguably be preferable for those provisions to be amended so that they refer only to “residence”.

What is also disappointing is that HM Treasury and HMRC have missed the chance of achieving true simplicity by replacing the current system with a simple day count rule, i.e. rolling day counts which take into account presence in the UK (other than for closely defined “exceptional circumstances”) over a number of consecutive years. For example, a person would be regarded as resident in the UK if he was present in the UK for 90 days or more in the current year, 45 days or more in the year immediately preceding the current year, and 25 days or more in the year immediately prior to the year immediately preceding the current year.

The rationale behind rejecting this simpler system is, arguably, unconvincing. It has been suggested in the past that there would be loss of revenue if a simple day count were to be introduced. Presumably the fear is that individuals would be able to manipulate their presence in the UK to ensure that their days of presence in the UK were left out of account when determining their statutory

days of residence in the UK. One way of dealing with such avoidance is by reducing the level of days required – e.g. 45 days or more in the current year, 25 days or more in the year immediately preceding the current year, 15 days or more in the year prior to the year immediately preceding the current year. Anti-avoidance measures could also be included to distinguish between “leavers” (who will by definition have greater connections with the UK) and “arrivers”: for instance, as envisaged in the consultation document, the days of presence could be set much lower for “leavers” than for “arrivers”.

Further, it is said that there would be avoidance by persons who retained their connections with the UK while simply reducing their days of presence. It is arguable that an individual who is, in actuality, not present in the UK is not “avoiding” UK residence at all but is in fact not resident. However, the approach adopted by HM Treasury and HMRC is, apparently, to regard residence as something akin to domicile: see the references to the adhesive quality of residence (a concept that is much more familiar in the context of domicile) and the insistence that connecting factors in the UK are strong indicators of residence in the UK. This approach, of muddying the boundary between residence and domicile, has met with success before the courts – see, for example, Moses LJ in *R (on the application of Davies and another) v HMRC*; *R (on the application of Gaines-Cooper) v HMRC (Davies and Gaines-Cooper)*⁴⁵ in which he considered that, in the context paragraphs 2.7-2.9, of IR20 (1999 version), a severance of all ties with the UK was necessary where an individual claimed to

have become non-resident. With respect, the approach taken in both IR20 and in *Davies and Gaines-Cooper*⁴⁶ is, in the writer's view, misguided because it fails to appreciate the distinction between domicile (which is based on where a person intends to make their permanent home/to re-settle) and residence (which is based on where a person is living for the time being).

Specific Points

The three-part design of the proposed SRT is helpful: it gives safe harbours within which an individual is or is not conclusively resident. However, it is arguable that more thought needs to be given to clarify who falls within these parts. For example, it would be appropriate for armed forces personnel on active service abroad to be regarded as conclusively non-resident throughout the tax year concerned. Similarly, diplomats posted abroad could also be regarded as conclusively non-resident for the tax year concerned. Further, Part B (conclusive residence) should expressly include those persons who are regarded as resident for the purposes of the Constitutional Reform and Governance Act 2010 (e.g. Members of Parliament).

The crux of the proposed SRT is Part C. A few points may be made in relation to the list of connecting factors set out in Part C:

1. The list appears to be exhaustive so that only the factors appearing on the list and no other factors are taken into account in

determining an individual's residence status;

2. In the absence of any indication to the contrary, it appears that all the listed factors carry equal weight. This is particularly helpful because it puts to bed the concerns of practitioners that the retention of available accommodation in the UK was *de facto* given more weight by HMRC;
3. The last factor (relating to the factor of spending more time in the UK, etc.) recognises the increasingly mobile nature of life and work. However, this factor (which features in the "leavers" category) arguably focuses on the wrong issue –it is the writer's view that an individual may become non-UK resident (by virtue of spending fewer than the maximum permissible days in the UK) without becoming resident anywhere else. As an indicator it is, therefore, weak.

These points apart, the real concern with Part C is the vagueness of the definitions. Much greater clarity is needed in order to increase ease of application of the proposed SRT.

Terms that could do with greater clarification are "family"⁴⁷, "available accommodation"⁴⁸, "substantive employment"⁴⁹ and "days of presence in the UK."⁵⁰

In relation to “family” it should be noted that there is no definition of “common law equivalent” of a spouse. It is open to doubt whether such a concept exists in other legal fields. Arguably this concept is meant to apply to some cohabitees who operate as a family unit, i.e. not merely boyfriend/girlfriend relationships. In the writer’s view, this concept ought to be statutorily defined in order to avoid uncertainty.

Further, focusing on paragraph 4.20 of the ConDoc: it is helpful that a child whose presence in the UK is mainly caused by time spent at a UK educational establishment is not regarded as UK resident. However, paragraph 4.20 gives no indication whether “child” here refers to a minor child only (reflecting the second bullet point at paragraph 4.19) or whether any child, i.e. offspring of whatever age, is included. Further, since “educational establishment” is undefined, it is not clear whether it includes an establishment providing tertiary education. If it did, and if “child” were not merely restricted to minor children, then a child in full time university education would not be regarded as UK resident. Some clarification would be helpful.

Further, paragraph 4.20 only permits a child to spend fewer than 60 days in the UK “not present” at the educational establishment. Its aim appears to be to require children to spend school holidays outside the UK. Quite apart from the expense involved, this stipulation fails to recognise the modern reality which is that children at secondary school often spend their half term and end of term holidays bolstering their CVs by

undertaking work experience and other extracurricular activities. It seems harsh that time spent on such activities should be included in the 60 day count.

In relation to “available accommodation”, it is not clear:

1. What “short term” in “short term accommodation in hotels” covers: five days, ten days? Presumably, it excludes having a floor or a suite on retainer at a hotel;
2. The term “lodging with relatives” category throws up further uncertainties:
 - a. Who are “relatives” for this purpose?
 - b. Is “lodging” intended to convey payment for staying at the “relatives” home?
 - c. What is a “temporary short term visit”? For example, does it include/exclude the situation where the individual visits the UK for two days a month, for mixed business and non business purposes, and invariably stays in his brother’s home on his visits to the UK? Does it matter if he needs to ask permission to stay before each visit?

Further, the writer questions the inconsistency of approach in paragraph 4.19: on the one hand it recognises alternative family structures, e.g. same sex couples and unmarried co-habitees (first bullet) but yet it ignores the familiar structure of second families (second bullet). This failure could produce harsh outcomes: a parent whose child lives with the estranged spouse in a separate family unit and who spends any time with that child in the UK or elsewhere could be regarded as UK resident. This rule appears to be based on the fact that the ability to see the child and to decide where the child is seen are within the parent's control. In reality, the parent may have no control over where he sees the child.

Turning to the definition of “substantive employment”, further clarification is needed of the term “work”: does it exclude incidental duties or are all duties included? If so, a person who carries out incidental duties (e.g. administration, reporting to the Board) in the UK rather than carrying on any profit earning activities could exceed the permissible work days in the UK. Further, does “work” include a dinner with a client? Does it make any difference if the dinner follows on from a business meeting with the client? Where an individual travels to the UK to attend a client meeting, does “work” include travel time to and from that meeting?

In relation to “days of presence in the UK”, there is a notable lack of “exceptional circumstances” that result in days of presence in the UK being left out of account. The writer suggests that presence in the UK which is

unanticipated/ is outside the individual's control should be disregarded. Examples include the sudden ill health of the individual or a close relative or delays caused by Acts of God, e.g. volcanic ash clouds, or by industrial action.

Conclusion

The proposed SRT is a step in the right direction. However, there are still several aspects that need to be remedied before the test can be said to be simple and straightforward. The simplest system for determining an individual's residence would be one which reposes little discretion in HMRC's hands. However, such a system has clearly been rejected in favour of one which still requires judgment calls to be made by HMRC and the taxpayer. The corollary is that there is a commensurate reduction in certainty.

Until the uncertainties are clarified, the self assessment online tool suggested by the consultation document (paragraph 3.39⁵¹) is unlikely to be of any practical use.

¹ This article first appeared in the *British Tax Review*, Issue 5, 2011

² HM Treasury and HMRC "Statutory definition of tax residence: a consultation" June 2011. Available at: http://www.hm-treasury.gov.uk/d/consult_condoc_statutory_residence.pdf [accessed September 26, 2011].

³ HMRC "IR20 - Residents and non-residents. Liability to tax in the United Kingdom" March 2009. Available at: <http://www.hmrc.gov.uk/pdfs/ir20.pdf> [accessed September 26, 2011].

⁴ HMRC “IR20 - Residents and non-residents. Liability to tax in the United Kingdom”, above fn. 2, Chs 2 (Leaving the UK) & 3 (Coming to the UK) and Ch 1.6.

⁵ *Gaines–Cooper v HMRC* [2007] STC (SCD) 23 *affd* [2007] EWHC 2617 (Ch), [2008] STC 1665.

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“Where an individual has lived in the UK, the question of whether he has left the UK has to be decided first. Individuals who have left the UK will continue to be regarded as UK-resident if their visits to the UK average 91 days or more per tax year, taken over a maximum of up to 4 tax years...There was no change to HMRC practice about residence and the ‘91 day test’...” HMRC Brief 01/07- found as an Appendix to HMRC “IR20 - Residents and non-residents. Liability to tax in the United Kingdom”, above fn. 3.

⁷ HMRC “Residence, Domicile and the Remittance Basis”, June 2010. Available at: <http://www.hmrc.gov.uk/cnr/hmrc6.pdf> [accessed September 26, 2011].

⁸ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Introduction” [1.7].

⁹ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Introduction” [1.7].

¹⁰ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Introduction” [1.8].

¹¹ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Proposed framework for a statutory residence test” [3.2].

¹² HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Proposed framework for a statutory residence test” [3.4].

¹³ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Proposed framework for a statutory residence test” [3.5] and [3.6].

¹⁴ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Proposed framework for a statutory residence test” [3.7].

¹⁵ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Proposed framework for a statutory residence test” [3.10]. Although not expressly stated, the writer assumes that the proposed SRT will not apply to determine trustee residence.

¹⁶ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Proposed framework for a statutory residence test” [3.11].

¹⁷ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Proposed framework for a statutory residence test” [3.13].

¹⁸ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Proposed framework for a statutory residence test” [3.19].

¹⁹ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Proposed framework for a statutory residence test” [3.12].

²⁰ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Proposed framework for a statutory residence test” [3.17].

²¹ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.2].

²² HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.3].

²³ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.4]. This is oddly phrased given that it is more usual to speak of duties being performed rather than days being performed.

²⁴ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.5].

²⁵ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.7].

²⁶ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.10].

²⁷ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [3.22].

²⁸ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.16].

²⁹ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.12] and [4.13].

³⁰ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.14] .

³¹ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.15] .

³² HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Proposed framework for a statutory residence test” [3.28] .

³³ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.19] and [4.20] .

³⁴ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.21] and [4.22] .

³⁵ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.23] and [4.24] .

³⁶ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Proposed framework for a statutory residence test” [3.34] and [3.35].

³⁷ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Proposed framework for a statutory residence test” [3.36] and [3.37].

³⁸ This relief is provided for by the Income Tax (Earnings and Pension) Act (ITEPA) 2003, s.26.

³⁹ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Ordinary residence” [6.16].

⁴⁰ P HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Introduction” [1.17].

⁴¹ *High Tech and others v Deripaska* [2006] EWHC 3276 (QB).

⁴² *OJSC Oil Company Yugraneft v Abramovich and others* [2008] EWHC 2613 (Comm).

⁴³ *Genovese v Revenue and Customs Commissioners* [2009] STC (SCD) 373.

⁴⁴ *Tuczka v Revenue and Customs Commissioners* [2011] STC 1438, [2011] All ER (D) 52 (Apr).

⁴⁵ *R (on the application of Davies and another) v HMRC; R (on the application of Gaines-Cooper) v HMRC (Davies and Gaines-Cooper)* [2010] EWCA Civ 83 at [44]-[47].

⁴⁶ *Davies and Gaines-Cooper*, above fn.45, [2010] EWCA Civ 83.

⁴⁷ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.16] to [4.19]

⁴⁸ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.21] to [4.22]

⁴⁹ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.23] to [4.24].

⁵⁰ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Definitions for the statutory residence test” [4.16] to [4.17].

⁵¹ HM Treasury and HMRC “Statutory definition of tax residence: a consultation” June 2011, above fn.2., “Proposed framework for a

statutory residence test” [3.39]. The prototype is available at:
http://www.hmtesury.gov.uk/consult_statutory_residence_test.htm

LOANS TO PARTICIPATORS: A PRACTICAL POINT

by Laurent Sykes

Issues under the “loans to participators” rules (formerly contained in s.419 ICTA 1988 and now in s.455 CTA 2010) can easily arise unexpectedly, for instance where a close company is treated as making a loan to a participator because the participator incurs a debt to the close company (even where the due date of payment does not arise until a later date). Similarly a loan by a close company to a partnership of which a participator is a partner (or a debt incurred by such a partnership to the close company) can also give rise to a charge even though the loan is to the partnership, and not to the participator.

It may be that there are amounts due from the close company to the participators. It is not axiomatic that they will be taken into account in reducing the debt owed to the close company for the purposes of s.455 and in calculating the net amount outstanding nine months after the end of the accounting period. HMRC sometimes cite an unreported Special Commissioners’ decision summarised in “Taxation” on 26 August 1988 in which the Special Commissioners refused to set undrawn remuneration owed by a close company to its director against amounts owed by the director to the close company for the purposes of working out the unpaid loan or advance. The aim of this article is to explore this a bit further.

In a case where there are amounts owed in both directions there are generally two possible bases for treating the “debt” owed to the close company by the participators as reduced by amounts going the other way, namely where -

- (a) each amount initially represents a separate debt but there is a periodic setting off of one debt against the other;
- (b) the agreement between the parties is that those different amounts should be combined for the purposes of determining the debt due as between the parties at any point in time, and therefore there is only ever a single debt – which is referred to here as an agreement to “combine” accounts.

Periodic set-off

There may be an agreement to set off separate debts which co-exist up until that point (or alternatively the right to do can arise as a matter of a law). It will be important to show that such a setting off has in fact been effected. Until it has been, separate debts continue to exist.

Combination

However an agreement to set off may not be needed because it is always the intention that there is only one debt of the balance. An example of the type of

“open account” involved is described in *Ramsden v CIR* 37 TC 619, where expenses incurred by the taxpayer on behalf of a company reduced the balance due from the company to the taxpayer in respect of the purchase price of shares from the taxpayer.

Halsbury’s Laws (formerly 3rd Edn, vol 34, p396, para 673¹) describes the right of set-off as “the right to plead a debt due from the plaintiff, arising from a separate transaction, in reduction or extinction of the plaintiff’s claim”. The editors go on to note that, in contrast to set-off, “where opposing demands are connected by originating in the same transaction, the balance has always been regarded by the common law as the debt, so that no question of set off arises”. These statements in Halsbury’s were approved by the Court of Appeal in *Henriksens Rederi A/S v P H Z Rolimpex* [1973] 3 All ER 589 (at 593) on the basis of the decision in *Green v Farmer* (1768) 4 Burr 2214. Here Lord Mansfield said (at 2221) that “[W]here the nature of the employment, transaction or dealings, necessarily constitutes an account consisting of receipts and payments, debits and credits, it is certain that only the balance can be the debt...”.

Winn LJ in *Rolls Razor Ltd v Cox* [1967] QBD 552 (at 574), in the context of the Insolvency Act definition of “mutual dealings”, gave a further example of an open account (or alternatively an example of a course of dealing in which it is implicit that set-off will happen periodically):

“...Similarly, producers of such commodities as fruit and vegetables, who market them through selling agents in, for example, Covent Garden, normally, if not necessarily, deal with those selling agents upon a running account in which credits in their favour will arise in respect of proceeds of sales received by the agents, with related debits for commissions and sale expenses incurred by the agents in disposing of the goods or making allowances for quality deficiencies. These are only examples which could be almost indefinitely multiplied by taking into consideration such other relationships as those of a landlord and his rent collectors, or transactions of collection of outstanding debts. The common and essential characteristic of all such dealings, which I regard as the type of mutual dealings contemplated by the section, although many others less comprehensive and of shorter continuity would also be included, is that by the intention of the parties expressed or implied, they each extend to the other credit in respect of individual sums of money until such time as such sums are brought into account and in the account set off against other sums, in totality, in respect of which the other party has given credit...”

The evidence

The question of whether accounts should be combined in ascertaining the debt owed to or by the company is, as noted, a matter of determining the agreement between the parties. As Roskill J put it, in the

first instance decision of *Halesowen Presswork v Westminster Bank* [1970] 2 WLR 754 (at 771) which concerned a number of bank accounts: “The question to be asked in every case is: ‘what was the agreement?’”. If there is no written agreement between the company and the participator, the terms of the agreement in any particular case must be derived from the course of dealing between the parties. Regard must be had to previous dealings, general usage or other relevant facts and circumstances (see *Dodd v Wigley* (1849) 7 CB 105 and the Australian case of *Pioneer Concrete Pty Ltd v L Grollo & Co Pty Ltd* [1973] V.R. 473).

Importantly, the fact that different accounts have been used for internal book-keeping purposes is not determinative of the question of whether each account represents an individual debt. Nor is there a basis in law for the proposition that the use of multiple accounts for internal record-keeping requirements necessarily gives rise to multiple debts – indeed the presumption in the banking context is the very opposite. There is no “short-cut” to ascertaining the agreement between the parties. The first instance decision in *Halesowen Presswork v Westminster Bank* provides clear support for this. The case concerned the question of whether a bank account in debit and a bank account in credit were to be combined or consolidated. Roskill J said (at 770):

“...the existence or absence of the right cannot, in a case such as the present, in my judgment turn upon the actual form in which the book entries in the bank’s books were made or upon the absence from those books

of any physical consolidation or combination.”

It may simply be for convenience that different accounts are used to record aspects of a single debt. Convenience was cited as a ground for the use of different accounts in the case of *In re European Bank* (1872) LR 8 Ch App 41 at paragraph 20 (which concerned a number of bank accounts kept as between bank and customer). Nevertheless, the treatment in the accounts, particularly the statutory accounts, is clearly a relevant factor to be taken into account. The fact that the amounts have not been brought together in a single t-account but are recorded separately is however by no means determinative.

The absence of payment by either party, despite a course of dealing over a prolonged period, raises a “strong presumptive argument of an agreement” to combine or set off amounts - see *Downam v Matthews* (1721) Blackst. Rep. 653. *Downam v Matthews* concerned a course of dealing between a cloth merchant and a cloth dyer (the plaintiffs sold cloths to the defendant and owed money to the defendant in respect of the dying of other cloths) over a course of several years without payment of money on either side. The reported case contains the following:

“But Lord Chancellor said, that though generally stoppage was no payment, and that there were some cases where this could not be done, as a man could not stop his rent for money owing to him, or a bond toward satisfaction of a simple contract debt; yet in

cases of this nature, where it appeared that the mutual dealing between the intestate and the plaintiffs were carried on for several years in this manner, without payment of money on either side, it was a strong presumptive argument of an agreement to this purpose, and that without such liberty of retaining against each other they would not have continued on their dealings; but if it had been insisted upon by either party, that the other should not be allowed to off his debt out of what was owing by him to the other, as they could, that this would have soon broke of all dealings between them.”

That inference might also be said to be present if any payment which *is* made is made by reference to the aggregate balance.

So it will be worth investigating the facts fully before accepting an argument that a s.455 charge arises by reference to the liabilities incurred by the participator to the company without taking into account the amounts owed by the close company to the participator.

¹ The current edition, vol 42, para 421, footnote 3 states “Where there was a running account of connected transactions, the common law regarded the balance as the debt so no question of set-off arose: *Green v Farmer*...”

STRATEGIES FOR TAX LITIGATION (OR TAX AND THE ART OF WAR)

by Michael Thomas

“To fight and conquer in all your battles is not supreme excellence; supreme excellence consists in breaking the enemy’s resistance without fighting” – *Sun Tzu, The Art of War*.

This is the first of two articles which aim to take a look at certain aspects of tax litigation. This piece considers, in a light-hearted way, certain aspects of disputes between taxpayers and HMRC. The follow-up will consider the altogether darker subject of tax-related professional negligence claims.

Frederick the Great of Prussia is credited with attempting to pursue the enlightened idea of getting rid of lawyers. Whether this is such a good idea is a question for another day. The way in which he sought to achieve this was through the enactment of the Prussian Civil Code. The essential concept was that every conceivable situation would be legislated for so that there would no longer be any room for legal disputes. The upshot, of course, was a lengthy code and the lawyers set about arguing over exactly what it all meant.

Over the last few decades, what is now HMRC has been persuading Parliament to follow a very similar course. We now, of course, have a very lengthy tax code. One by-product of this is that UK tax law is disproportionately complicated. This tends to result in

wasted time for advisers together with increased bills for clients, as well as making it all too easy for those of us who are tax advisers to make mistakes. But I digress, and that train of thought will form the basis of the next article. A second result of our voluminous tax code is that there is plenty of scope for disputes. Every tax adviser knows that life throws up strange circumstances that test the legislation in ways which those drafting it could not have anticipated. The tax planning industry of course sets out to deliberately push the boundaries of the statutes to the maximum extent.

Given that there is inevitable scope for conflict between taxpayers and HMRC, how then to obtain the best results?

Before we can consider how to achieve the best outcome, it is necessary to recognise what that outcome actually is. At the risk of being condemned as a heretic by my colleagues at the Bar, the best result is not a victory in the Supreme Court, or indeed any other court. It is much better if HMRC does not make any attack against the taxpayer. Failing that, the next best outcome is for HMRC to be defeated in correspondence before the case reaches the courts. Master Tzu makes this clear in the above quotation. Of course, some cases will reach court, and these must be fought as well as is possible, as discussed further below. However, for present purposes, the key point to emphasise is that having to fight through the courts is very much third best.

How then can we deter HMRC from making attacks? The answer is of course to make the client's

self-assessment position as strong as possible. Whilst this is a statement of what Basil Fawcay memorably called “the bleedin’ obvious”, it is nevertheless important not to overlook it. In other words, it must be recognised that tax advisory work and tax litigation are part of one and the same process. In order to give good tax advice, it is necessary to consider the attacks which HMRC might make against the particular arrangement and to ensure that these are guarded against as best as possible. Master Tzu clearly had the future UK self-assessment tax system in mind when he wrote the following:

“The art of war teaches us to rely not on the likelihood of the enemies not coming, but on our own readiness to receive him; not on the chance of his not attacking, but rather on the fact that we have made our position unassailable.”

How to reach the most strongly defensible self-assessment position is generally outside the scope of this article and will, of course, depend upon the particular facts. Nevertheless, one crucial point is worth emphasising here: any tax planning is only as good as the implementation. The starting point in any case is to examine the facts. HMRC is increasingly known to make factual challenges and its first line of attack is usually to look for a “sucker-punch” based on the facts. For example, if there is an offshore structure in place, HMRC is almost certain to carefully scrutinise the

residence status of the overseas companies. If the correct advice has not been both obtained and followed, the rest of the structure may come crashing down as a result of a very basic attack.

Of course, in the real world, however careful the adviser and diligent the client in following his advice, some clients will inevitably be challenged by HMRC. Hopefully the challenge will have been anticipated, but, whether or not that is so, the attack needs to be dealt with. How best then to proceed?

In order to devise a suitable strategy it is necessary to determine the taxpayer's position and his relative strength in relation to that of his opponent, HMRC. If the taxpayer has obtained very full advice prior to filing his self-assessment return, then it should be relatively straightforward to update that advice and determine the parties' relative strengths. If this is not the case, then it is essential to spend some time ascertaining the taxpayer's position prior to engaging HMRC through correspondence. An important reason for this is that HMRC is most likely to be defeated in correspondence at an early stage by the taxpayer putting forward his arguments in the best way, before HMRC's own case has gathered momentum and their position has become entrenched. A second reason to deal with matters swiftly is that, in my experience, it is easier to settle the case by dealing with an inspector at the early stages of enquiry. Once other parts of HMRC have been brought into play, such as technical specialists and especially HMRC's Solicitors' Office, then responsibility for the matter is

divided, and it becomes very much more difficult to achieve a settlement. More than one client has had cause to regret not accepting a deal which was put onto the table by an inspector at a relatively early stage of a case.

Once a view has been formed as to the relative strengths of the parties, then a strategy can be determined for the taxpayer. The general rule is that cases should be kept out of court. The important point to remember is that a trial is at best a calculated gamble and at worst a shot to nothing. Trials inevitably result in wasted costs, notwithstanding that costs in the First-tier Tribunal can now be recovered under the complex track, which track allocation HMRC may very well resist. In addition, trials also give rise to significant time commitments for clients as well as inevitable stress.

Accordingly, if the client has a strong case, every effort should be made to force an immediate climb-down from HMRC. Letting the case drift along to court is not the best approach. It is necessary to show HMRC that the client means business and will not hesitate to fight in the courts if HMRC does not climb down. It is this willingness to fight, combined of course with a strong case, which is most likely to induce HMRC to settle.

At the other end of the spectrum, if a client has a weak case, then generally he will be unwise, in the current tax litigation climate, to expect any favours from the courts. Whilst there is always hope, and the cases sometimes throw up surprising results, the statistics show that HMRC wins more often than not. Accordingly, a client with a weak case is unlikely to

prevail before the courts. As a general rule, such a client would be well-advised to take best deal which is on offer from HMRC. However, there are, of course, exceptions to every rule, and individual clients ultimately have to make their own minds up whether they wish to fight or not.

In cases where the position is finely balanced, the client may have a difficult decision to make. The factors to consider in deciding how best to proceed will include the relative strengths of the parties' positions, the costs involved in bringing the matter to trial and the attitude of HMRC. For example, if the dispute concerns a tax avoidance scheme, it may be extremely difficult to induce HMRC to settle. Where a scheme is challenged by HMRC, the taxpayer may find himself in a difficult position, because not only is HMRC less likely to be amenable to settlement but the taxpayer's case will be inherently harder to win, as it is more difficult to persuade a court that the taxpayer has the better of the arguments if his position is weak as a matter of policy. In other words, where a tax scheme is in point then any purposive interpretation is almost certainly likely to favour HMRC, and nowadays of course all authorities must be construed purposively.

The finer points of how to negotiate with HMRC are outside the scope of this article. However, experience has taught me that the following rules are to be ignored at the taxpayer's peril.

First, as ever when dealing with a bureaucracy, it is necessary to speak to the right person or persons within

HMRC. As stated above, this can present a real practical difficulty once cases have been transferred to HMRC Solicitor's Office, because responsibility can then be divided between HMRC's Solicitor's Office, their policy team, any Counsel instructed and the original inspector. In these circumstances bringing HMRC to the negotiating table can be a significant victory in itself!

Secondly, it is essential to remember that HMRC employees are human beings, and, like everybody else, are more likely to be co-operative when treated with respect and politeness. Correspondence which indicates emotions such as anger and exasperation or is in any way rude to HMRC is likely to produce a suitably negative reaction.

Thirdly, it is nevertheless important that the taxpayer's arguments are communicated clearly and firmly in the best way. So far as is possible, it should be made clear that the taxpayer has good arguments and will seek to press them home in court.

Finally, whilst it is important to emphasise the taxpayer's areas of strength, it is important to be realistic in terms of what might be achieved. A settlement requires both parties to have sufficiently proximate expectations.

If all else fails, the taxpayer may be faced with the stark choice of either giving up or fighting HMRC. Although most cases will proceed to the First-tier of the Tax Tribunal, it is worth saying something about alternative theatres of engagement. The first point to

make is that HMRC has a very good success rate for the courts in tax appeals. Litigating against the State in its own courts is an inherently difficult exercise. Accordingly, the possibility of an alternative theatre should be considered.

One potential alternative to a tax appeal is to bring a judicial review action. This may be worth considering where HMRC has in some way behaved unfairly or gone back on its published practice. Such actions are notoriously hard to win, because the taxpayer needs to jump the very high hurdle of showing that the State's actions have been perverse in the sense of a grossly unfair abuse of power. A glance through the results of judicial review actions brought by taxpayers swiftly shows that such claims generally tend to fail. A point to note for the future is that the taxpayer probably will stand a slightly better chance in practice if claims are heard by the Tax Tribunal rather than the administrative courts, whose members do not generally have any particular interest in tax. However, the key point remains that the judicial review threshold is notoriously difficult to meet.

Much is currently being talked about of mediation in tax cases. The difficulty in practice is that if HMRC is not prepared to settle then it is unlikely to submit to a mediation. Mediation covers a multitude of different procedures and a full discussion is outside the scope of this article. In practice, the key point is probably that mediation is an alternative way to seek a settlement in cases where HMRC has been reluctant to negotiate. It

may be especially appropriate in cases where the answer is not either a simple yes or no but rather requires an exercise of judgment. An example of such a case might be an argument over any kind of apportionment or quantum.

Finally, a novel choice of theatre, but one which is very much of our time, is the press campaign. In my view, the House of Lords decision in *Arctic Systems* was based on very weak technical grounds. If Mr. A owns the shares in company B equally together with his wife and goes out to work every day on behalf of the company at a vastly reduced salary then surely he is making an ongoing gift to his wife every time he goes out to work. I struggle to see how their Lordships managed to view this as an outright gift of income. My own view of *Arctic Systems* is that the House of Lords was persuaded to take a strained view of the legislation in favour of the taxpayer in order to produce what they saw as the right and fair result. This was partly influenced by the press campaign which had been conducted. Similarly, Lord Justice Moses in the Court of Appeal hearing of *Gaines-Cooper* and *Davies and James* indicated that he had been concerned by the level of reaction about HMRC's apparent change of policy on residence. A press campaign is therefore a useful weapon to consider deploying against HMRC. HMRC of course uses this weapon and has been known to name and shame those who have been carrying out tax avoidance schemes. Such a press campaign of course is typically used alongside more traditional engagements through the courts.

When all else fails, then the taxpayer has no choice other than to litigate through the Tax Tribunal. As stated above, a trial is always a calculated gamble and the outcome can never be guaranteed. The practical question is then how the taxpayer can best swing the odds of success in his favour?

As with most things in life there is no magic formula for successful litigation. The key point is that the taxpayer must be prepared to fight on all relevant issues. The burden is on the taxpayer to both prove his facts and win the legal arguments.

Before considering what happens at trial it is worth saying something about the pre-trial stage. First, the Tribunal will issue more or less standard directions about the preparation of a case. Whilst some slippage is tolerated and is perhaps even expected, it is nevertheless important that the directions are respected. The Tribunal will expect witness statements and in a case where the facts are in dispute, which they usually are these days, then the bulk of the time spent in preparing for the case will be taken up preparing the facts.

It is of course essential that the taxpayer proves the facts on which he seeks to rely. The burden of proof is on him and there are no second chances. The best possible evidence should be obtained in respect of all disputed facts. HMRC will almost certainly seek to make factual challenges wherever possible. An important practical point is that HMRC's expected line of attack should be dealt with in advance by the relevant witness statements. If there are areas of significant weakness

then the taxpayer may want to consider settling rather than hoping that these will not be exposed in cross-examination. In short, preparing the factual aspects of a case can be extremely laborious and time-consuming. It can also create tensions as clients do not enjoy having weaknesses in their case identified by their own legal team. In this scenario it should be pointed out that unhelpful new facts emerging under cross-examination will be very much more unpleasant. In any event, thorough preparation of the facts is essential in order to prepare for trial.

As regards legal submissions, these of course should be made clearly and be summarised in the skeleton argument. A dilemma which sometimes arises is whether to include a bad point in the hope it might succeed. Generally this is not recommended.

Finally, it is important not to overlook the fact that life is unpredictable, or the “chaos of war”. A classic mistake of generals is to think that each war will be like the last one – the Maginot Line is a famous example. Similarly, no two tax cases are alike. Unexpected things happen, and cases tend to throw up unexpected developments. Neither the actions of HMRC nor the decision of the judge is within the taxpayer’s control. Nor can the taxpayer’s own witnesses necessarily be relied upon not to throw up surprises when giving evidence. The increasing lack of control once cases go to trial is another reason to favour settlement. Whatever stage a case has reached it is important both to react

appropriately to the latest developments and to have a larger strategy for ensuring a favourable resolution.

“He will win who knows when to fight and when not to fight.” Sun Tzu.

THE DISGUISED REMUNERATION RULES AND PART 7A ITEPA 2003¹

by Patrick Way

This article explores and considers the new disguised remuneration rules in the context of their history and likely effect for the future

The expression employee benefit trust (EBT) has come to mean a general form of trust created for employees, but without the ability to pay what may loosely be called retirement benefits. An employer-funded retirement benefits scheme (EFRBS) is, strictly speaking, a particular form of EBT which includes a power to pay “relevant benefits” as defined at Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003) s.393B: broadly – “retirement benefits”. This article, however, treats EBTs as pure employee incentive trusts and EFRBS as retirement orientated trusts for employees.

How did we get here?

EBTs became popular in the late 1970s, before a company could buy back shares as a matter of law, as a holding entity for the company’s cash. A company could fund an EBT periodically, and the cash in the EBT could be utilised to acquire shares from a retiring proprietor. The trustees might then use dividend income from the shares to reward beneficiaries of the EBT, or else the trustees might simply transfer some of the shares to such employees outright. So, the rationale of the trust

extended from being a cash box to an incentive arrangement.

Pausing here, until *Dextra Accessories Ltd & Others v. MacDonald*² changed all this, the tax position was straightforward. The capital costs of funding the EBT were not deductible in the hands of the company, taking account of the ratios of the cases of *Atherton v. British & Helsby Cables Ltd*³ and *Heather v. PE Consulting Group Ltd*⁴, but the revenue contributions were. The trustees of the EBT were independent from the company, taking account of trust law and the fact that the EBT's rules governing the trustees' acts were set out in the trust document. This position could be contrasted with a share option scheme, where the company and the trustees did act in tandem with the trustees typically holding shares and waiting for instructions from the company in respect thereof.

Continuing the tax analysis, the beneficiaries of the EBT remained discretionary beneficiaries, and until such time as they received anything from the trust there would be no tax to pay. Until the time of *Dextra* there was no suggestion that trustees were intermediaries: Finance Act 1989 (FA 1989) s.43 was universally ignored, by advisers and the Revenue, in the writer's experience. Employees were taxed only as and when they received cash or assets from the EBT, taking account of the ratio of *Brumby v. Milner*.⁵ So, there was tax asymmetry: a full tax deduction but no taxable receipts.

The final straw for what is now HMRC was the widespread use of loans from the trustees to

beneficiaries. These might be at a rate of interest which was the same as the official rate, in which case no tax would arise (ITEPA 2003, s.175). Alternatively, there might simply be no interest, in which case tax on the amount of interest foregone would arise. Given that interest rates dropped dramatically, lending significant amounts to an individual from an EBT interest-free and possibly for a long period of time proved to be very attractive. Eventually, something had to give, and the case of *Dextra* was the first opportunity for HMRC to challenge matters. *Dextra* involved payments into an EBT and the fact that sums were set aside into separate sub-funds loosely being for the benefit of named beneficiaries and then lent out. So we can see there was an additional issue being the relevance of sub-funds: did they amount to a taxable benefit being received by a beneficiary?

One of the oddnesses about *Dextra* was that the taxpayer won both before the Special Commissioners and the High Court (on the basis that there was full deductibility for the contributions), with the consequence that new legislation was introduced in the interim before the Court of Appeal hearing to ensure that payments into an EBT would not be deductible except as specified. This additional legislation, however, which is now found in Corporation Tax Act 2009 (CTA 2009) ss.1288 and 1289 to 1296 was not necessary, as HMRC won in the Court of Appeal and the House of Lords on the basis that payments into the trust fund represented potential emoluments pursuant to FA 1989 s.43, and the trustees were held to be intermediaries holding those potential

emoluments in the interim. Nevertheless, HMRC lost on two points. First, the creation of sub-funds did not necessarily cause any beneficial ownership of the assets to vest in the relevant individuals; and, secondly, a loan was not an emolument.

In *Sempra Metals Ltd v. HMRC*⁶ the court had to consider the “new” definition of employment benefit contributions (in circumstances where the relevant documentation described a family trust rather than an employee benefit trust) and also the taxation treatment of sub-funds. The ratio in *Dextra* was upheld (no deduction in respect of the contributions, but no tax in respect of the sub-funds), but the particular circumstances of the loans were such that emoluments arose. The case was then settled before the matter could be heard on appeal.

What was required

So it is that we come to HMRC’s requirements underlying the new disguised remuneration rules. Based on the foregoing, we can say that HMRC’s wish list to the Parliamentary draftsman would have included the following:-

- a wide definition of an EBT or an EFRBS perhaps to take account of the sort of arguments that were rehearsed (unsuccessfully) in *Sempra* as to the meaning of the expression employee benefit trust. HMRC’s wishes were certainly granted when one looks at ITEPA 2003 s.554A and the wide definition utilised;

- put a stop to the use of sub-funds. Again, HMRC were successful on this front because we now have the concept of earmarking, principally found at s.554B;
- tax any sort of a loan whatsoever and, to be on the safe side, give a very wide meaning of payments and loans. This is achieved within s.554C, which deals with payments of sums and transfers of assets including loans;
- finally, make sure that any kind of involvement of an EBT or EFRBS or similar which benefits an individual employee is taxed.

There was, however, no kind of motive test. As a result, some fully commercial transactions run the risk of being caught, and, in rather unfortunate modern style, in addition to very complicated legislation we have extremely long “exclusion clauses” in the form of answers to frequently asked questions and in the amended employment income manual. Where the legislation applies PAYE and NICs are due, and it is the obligation of the employer or former employer to operate these.

Where do the new rules apply?

The starting point is that ITEPA 2003, Part 7A, specifically s.554A (being, broadly speaking, a definition of EBTs and EFRBS but covering arrangements generally), is extraordinarily widely worded and therefore is capable, at first blush, of catching very many situations where an employer and an employee have

some sort of arrangement concerning remuneration. HMRC seem to acknowledge that this is the case – and have produced lengthy informal exclusions to the rules. It should be said at the outset of our consideration of Part 7A that the disguised remuneration rules require some kind of trust arrangement and can be avoided by having a direct relationship between an employer and an employee without trusteeship.

The new rules will not apply to the grant of a share award or option, nor to the issue of shares to an employee to satisfy the vesting of an award or exercise of an option. Nor will the rules apply in respect of pension income. In other words, Part 9 of ITEPA takes precedence over Part 7A. Further, under s.554S it is provided that pension payments will be subject to tax under Part 9 in priority over Part 7A. This means that the remittance basis and the ten per cent abatement for foreign pensions will continue to apply where appropriate. To the extent that a pension scheme is not excluded under s.554E, it will, however, be liable to Part 7A charges on any new relevant step which constitutes earmarking (see later) on or after 6 April 2012, with credit given against the Part 9 charge for earlier Part 7A charges.

As mentioned, one of the practices which the legislation was to stop was the use of sub-funds, and this has been implemented through the concept of earmarking – which is an unusual word but seems to be directed at a single act of earmarking. Someone has put to the writer the question, whether once you earmark

something it is continuously earmarked, and therefore there is a whole series of charges, but s.554B does not seem to operate on that basis.

There were also concerns that the new rules in relation to earmarking might apply to hedging arrangements for employee share plans, that is to say where shares are held in an EBT to satisfy awards granted by a company to its employees and directors. However, HMRC has confirmed that in general there will be no such earmarking where the EBT trustees themselves have not granted the awards to employees and do not know the identity of the employees involved. It is rather odd to have some sort of a non-statutory exemption where trustees are “kept in the dark”.

Further, there are provisions dealing with the position if funds or assets are earmarked for a particular individual and then subsequently earmarked for another purpose, so that the employee never has entitlement to the earmarked funds or assets. In this situation, relief is available pursuant to s.554Z14. Relief has to be claimed by the employee within four years. Similarly, the position is covered where income which has arisen on a contribution to a trust is earmarked for a particular employee or their families. In these circumstances, the earmarked income is not subject to an employment income charge under Part 7A, because income arising on funds or assets already earmarked for a particular employee (for example, held within a sub-trust for a particular employee) will be excluded from an earmarking charge by virtue of s.554Q.

It also seems to be the case that if sums are put into some sort of an EBT or EFRBS arrangement for a wide number of beneficiaries, but no further steps are taken, that will not amount to earmarking. Again, the writer has been asked the reasonable question as to how far this applies. It is easy to see that if £10m. is put into an EBT for a discretionary class of 100 employees no earmarking arises; but what about if there are only two employees? (It seems the latter may *not* be earmarking but the position is unclear.)

The next main area of concern, as stated, was the use of loans, and the new legislation at s.554C is draconian. Consequently, a charge arises where a loan is made on whatever terms to an employee, and that charge remains even if the loan is repaid. The rules apply to any loans that are made on or after 9 December 2010, save if any such “new” loans are repaid before 6 April 2012. There have been questions as to whether there really is no credit for repayments of loan, but the legislation is clear: repayment of a loan is irrelevant. The writer has been asked whether an existing loan can be varied without creating a new charge. This seems perfectly satisfactory: no new payment of cash arises; so there can be no new loan even though, under general rules, a variation may create a new loan (see, for example, *British and Beningtons Ltd v. North Western Cachar Tea Co Ltd*⁷). There has not been the necessary new *payment* of a sum of money which seems to be required, and the mere fact that there is a new loan as a matter of law is irrelevant absent a fresh payment of money (ITEPA 2003, ss.554C(1)(a) and s.542(7)).

Employee share schemes

As already mentioned, the absence of any motive test has caused some problems. For example, one needs to look at frequently asked question 22: in connection with employee share schemes one wants to have some sort of satisfactory answer to whether it is a fairly normal commercial arrangement where shares are allocated to named employees to meet future liabilities under an employee share scheme or share option scheme or a long-term incentive plan (LTIP): here – to make a broad observation – no charge will arise under the disguised remuneration provisions. The answer to the question as set out by HMRC turns on the fact that the policy objective was to tackle avoidance. It follows, therefore, that the legislation, as changed following the brief consultation process, provides that arrangements which have certain characteristics in connection with employee share schemes do not give rise to earmarking:-

- the payment for the shares must be subject to conditions which, if not met, will mean that there is no possibility of the employee receiving the shares or retaining any form of current or future entitlement;
- the arrangements must specify a date for the vesting of the shares, which must be at most ten years from the grant;
- the nature of the arrangements must be such that if vesting does occur on or before the vesting there is a charge; and

- the deferral or avoidance of tax must not be the main purpose of entering into the arrangements.

Further, if trustees have earmarked shares to satisfy options that have been granted by the employer, and none of the exclusions arise, the trustees will have taken a relevant step, and income tax will arise merely by the trustees holding the shares involved. However, the value of that relevant step will be reduced by the amount of any exercise price that is payable by the employee, and typically this could reduce the income tax charge to zero. Further, if an employee is granted an option with a market value exercise price, and the earmarking takes place at a time when the market value of the shares is equal thereto, then the charge under Part 7A is nothing. Where, however, shares are earmarked for a nil cost option and none of the exclusions applies, then the disguised remuneration charge will apply in full.

Conclusion

It will take time for the legislation to bed down. Equally, it seems very clear that in relation to what the legislation is really targeted at (EBTs and EFRBS rather than other employer/employee arrangements), the future for EBTs and EFRBS is pretty much curtailed. Some commentators disagree and point out the advantages of EBTs and EFRBS for long-term inheritance tax planning, since the trust assets do not form part of the estate of any individual. The legislation is extremely unsatisfactory where it crosses into share option schemes and corporate incentives in circumstances where the perceived mischiefs of EBTs and EFRBS were never

considered. So, practitioners will need carefully to consider the legislation and the “exemptions” provided for in the FAQs and the employment manual.

It should be said, however, that the recent Supreme Court cases of *R (on the application of Davies and another) v. R&C Commissioners*; and *R (on the application of Gaines-Cooper) v. R&C Commissioners* (SC, [2011] 2249), where taxpayers argued unsuccessfully that they had relied on HMRC clear wording, do not set a very auspicious precedent. Accordingly, it is not wise to rely, in the writer’s view, on the manual or the frequently answered questions when seeking to find an answer, particularly where otherwise significant amounts of tax would be payable, and probably the most prudent course is to obtain a specific clearance in relation to any particular points of concern.

¹ This article was first published by Thomson Reuters (Professional) UK Limited in Private Client Business [2012] Issue 2 and is reproduced by agreement with the Publishers

² *Dextra Accessories Ltd & Others v. MacDonald* (HL 2005, 77 TC 146) (“*Dextra*”)

³ *Atherton v. British & Helsby Cables Ltd* (HL, 10 TC 155) (“*Atherton*”)

⁴ *Heather v. PE Consulting Group Ltd* (CA 1972, 48 TC 293) (“*Heather*”)

⁵ *Brumby v. Milner* (HL 1976, 51 TC 583) (“*Brumby*”)

⁶ *Sempra Metals Ltd v. HMRC* (SpC, [2008] SSCD 1062 (SpC 698).

⁷ *British and Beningtons Ltd v. North Western Cachar Tea Co Ltd* (HL, [1923] AC 48) (“*Cachar*”).

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