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OFFSHORE BUSINESS CENTRES: A WORLD SURVEY

by Felicity Cullen

Eleven years after the seventh edition we are in a new millennium, a new fiscal and regulatory world, and we have a new World Survey. This comprehensive guide to the fundamentals of company, trust and tax law in no less than fifty-one jurisdictions is an invaluable tool to tax practitioners and financial service professionals. Milton Grundy's and Aparna Nathan's book is accessible, informative and relevant. As the reader cruises around the tropics, canters through the deserts or climbs through the Alpine countries, A World Survey informs him about the types of entities that can be formed, as well as the types and rates of taxes and exemptions that he or his entity will suffer or benefit from. The book also provides a flavour of the business environments in various regimes and explains how the respective jurisdictions and their legal or fiscal frameworks are perceived on the international stage.

Part II of A World Survey is new. Each of the "essays" provides a compelling insight into the policy behind the subject matter. Richard Hay describes the expansion of the role of the OECD and the erosion of taxpayer privacy. He provides practical guidance on minimising invasions of privacy and data protection. Stephen Gray shares with the reader his in-depth experience of tax information exchange agreements. Francis Hoogewerf provides a guided tour through Europe and fifteen territories in which one might locate a

holding company; in addition to the traditional territories of the Benelux countries, the reader is introduced to possibilities in Eastern Europe as well as the so-called "rising stars" of Malta and Cyprus. Milton Grundy relates the Smith story and explores the potential complexities of partnerships as planning tools or entities.

A World Survey enables attractive and relevant jurisdictions to be quickly identified, allowing the reader efficiently to narrow down areas (both territorial and technical) requiring detailed local advice. It is a GPS for international tax advisers: those who do not have it will be lost without it!

MARS AND *SECAN*: THERE ILLUSION AND HERE TRUTH; THE COMPUTATION OF PROFIT

by David Goldberg

A trader, in his first year of trade, spends 100 on buying trading stock which, at all times, has a market value of at least 100. Assuming that there are no other transactions in the year, does he:

(a) have a loss of 100;

(b) have a profit of something; or

(c) have neither a profit nor a loss.

The answer is obviously (c). There are no prizes for guessing or even for knowing that. But it raises a critical question: what is the logic that leads to this conclusion?

There are two possible answers:

(1) the trader has an outgoing of 100 (the amount he spent on acquiring stock) which he deducts as an expense of his trade, and also has a receipt of 100, which is the value of his trading stock at the year-end (the value here being taken as cost or lower market value)[1]; or

(2) the trader has nothing to deduct as an expense in the computation of profit and nothing to bring in as a receipt in the year

> but, instead, the cost of unsold stock is "carried over" to be deducted in later periods, when sales occur.

Traditionally, the correct answer was thought to be (1). However, accountants have recently started to think differently about how they draw accounts; and they now say that it is answer (2) which is correct.

On the simple example put at the beginning of this article, (2) is certainly a plausible answer to the critical question. In some ways, it may even be the more attractive of the two possible answers. After all, there have been no actual sales of anything: the only thing that has happened is that cash has been turned into trading stock. Why go to the bother of drawing up a profit and loss account? If there is no expense and no receipt there is nothing to bring in to the account. The result is 0 – 0 = 0. Nothing. In commercial terms, however, something has happened: cash has become trading stock. In the trader's books, entries will have to be made to reflect the use of cash to buy assets and, in circumstances less simple than those being considered, changes may occur in the balance sheet. When the example becomes more complicated, answer (2) – which leads to the conclusion that the cost of unsold stock is not deducted in computing profits – may seem a little less plausible than it does at first glance; and it may seem even less plausible if some stock is sold by the year end and some retained.

Nonetheless, the House of Lords in *Small* v *Mars UK Ltd* and *HMRC* v *William Grant* [2007] STC 680

("*Mars*") has unanimously accepted that answer (2) is correct; and the decision has been greeted with widespread approval by most commentators (including – see the article by Barrie Akin "Depreciation and Trading Stock – Confusion Unconfounded" in GITC Review Volume VII No 1 – one of my colleagues here). That decision raises a large and important issue. Can profits be computed without deducting all the expenses laid out in the year in question and including in those expenses, the cost of both sold and unsold stake? The answer to this question is important: many tax provisions impose consequences where there has been a deduction and do not impose consequences where there has not been a deduction; the question is of high significance in, for example, F (No 2) A 2005 sections 24 and 25, which set out the arbitrage rules in "deduction cases". If analysis shows that the answer to that question is No – so that answer (1), that there are outgoings matched by receipts, is the only sustainable answer to the critical question, it may be dangerous to rely too heavily on the House of Lords' decision in *Mars*, to argue, in other cases, that no deduction has been made for current year expenditure or liabilities. It is part of the normal judicial process that past decisions need to be reviewed and adjusted to meet changing conditions, but the judicial committee of the House of Lords, as presently constituted or led, has a history of deciding cases quickly and then adjusting them, fairly soon, to meet a better understanding of present, rather than changed, conditions. A view different to that expressed in *Mars* may, accordingly, come into vogue sooner rather than later, and the

possibility of that happening certainly cannot be ruled out.

It is as well to start the analysis at the beginning.

The Beginning

The correct approach to the computation of profits for tax purposes is well stated by Pennycuick V.C. in *Odeon Associated Theatres Ltd* v *Jones* 48 TC 257 at 272:

> First, one must ascertain the profits of the trade in accordance with ordinary principles of commercial accountancy. That, of course, involves the bringing in as items of expenditure such items as would be treated as proper items of expenditure in a revenue account made up in accordance with the ordinary principles of commercial accountancy. Secondly, one must adjust this account by reference to the express prohibitions contained in the relevant Statute…

This is now the statutory rule. F.A. 1998 s.42 provides:

> …the profits of a trade must be computed in accordance with generally accepted accounting practice subject to any adjustment required or authorised by law in computing profits for [tax] purposes.

This means that the principles of accounting practice are of very great importance in determining profits. There are, however, four limitations on the role of accountants:

(i) whatever the principles of generally

accepted accounting practice are, they yield to a contrary rule of law. Thus, for example, if there is a rule of law that capital must not be mixed with income, that rule overrides a generally accepted accounting practice which treats capital and income as the same;

(ii) the question "What is the generally accepted accounting practice?" is determined on the evidence: what accountants say about the practice is not conclusive; the court determines the correct practice by reference to the evidence heard in court;

(iii) although accountants describe what they do, it is for the Court to understand what they do. In Court, an accountant is just a witness of fact. If a witness describes a spherical orange object as a tangerine, the Court has a duty (where relevant) to examine the totality of the characteristics of the object and decide, if appropriate, that it is in fact a mandarin. Thus, if an accountant says he is excluding something from a profit and loss account, it is open to the Court to examine the totality of what the accountant is doing and to decide, as a matter of analysis (which may be legal analysis), that he has not described what he does accurately.

(iv) the obligation on a trader, now imposed by

> FA 1998 s.42, is to *compute* profits in accordance with generally accepted accountancy practice. It is not to adjust commercial accounts to arrive at a taxable profit. It may sometimes be easier to arrive at a correct computation by going back to first principles and so build up a computation, bottom up as it were, rather than to adjust the profit and loss account to create a taxable profit from the top down.

What accountants say they do is, accordingly, of very great importance in the computation of profits, but it is not determinative. What is determinative is what they actually do, so long as it accords with generally accepted accounting practice and is not contradicted by any rule of law

The next step in the analysis is to consider how these principles apply to a trader who holds stock-in-trade or work in progress[2] at a year-end.

The Traditional Analysis

Once upon a time, a long long time ago, most accounts used to be drawn on a Mr Micawber cash basis. Until quite recently, barristers were still able to do that; and it seemed to be a system of accounting which had some things to commend it. Nonetheless, accountants became concerned that a cash-based account did not produce a fair picture of profit or loss: in particular, if a trader spent money on buying unsold stock, it did not seem right to treat that as an unmatched outgoing,

deductible in full in the year; after all, the trader had spent the money in acquiring an asset which he still had, so the money spent was not, as it were, wasted. It was necessary for some notice to be taken of the use to which money spent was put, so what are called earnings based accounts became the vogue. Earnings based accounts require notice to be taken of stock in trade.

The way in which accounts of this sort work was explained, with characteristic elegance and lucidity, by Rowlatt J in *IRC* v *Naval Colliery Ltd* 12 TC 1017 at p.1027 where he said:

> Now, one starts, of course, with the principle that has often been laid down in many other cases – it was cited from *Whimster's* case, a Scotch case – that the profits for Income Tax purposes are the receipts of the business less the expenditure incurred in earning those receipts. It is quite true and accurate to say, as Mr Maugham says, that "receipts and expenditure require a little explanation. Receipts include debts due and they also include, at any rate in the case of a trader, goods in stock."[3]

The principles in play can be very clearly seen in the following passage from the judgment of Nolan LJ (as he then was) in *Gallagher* v *Jones* [1994] Ch 107 at pp.135/6:

> The effect of [accountancy] practice, said Mr Glick, is to disallow the deduction of the trader's expenditure on the unsold stock, or so much of it as is represented by the market value, if lower, and carry it forward to be set against the price for which the stock is ultimately sold. That is

> certainly one way of describing the effect of the practice, and comes close to the language of Lord Reid in *Duple Motor Bodies Ltd* v *Inland Revenue Commissioners* 39 TC 539 at p.571, where speaking of stock-in-trade and work in progress, he said:
>
> > "So the question is not what expenditure it is proper to leave in the account as attributable to goods sold during the year, but what expenditure it is proper, in effect, to exclude from the account by setting against it a figure representing stock-in-trade and work in progress."
>
> That is how he described the effect of the practice, but it is I think clear from the earlier part of his speech, at pp.569-571, that as a matter of legal analysis he regarded the practice as involving the deduction of the whole of the expenses incurred during the period but the crediting against them of a closing figure for unsold stock and for work in progress as a notional receipt.[4]

The idea that the computation of taxable profit was made by deducting all expenses of the year (whether incurred on stock or not) and then treating the cost or lower market value of unsold stock as a receipt was, accordingly, sanctioned by judicial decisions and appeared to be accepted by accountants. Indeed, until comparatively recently, accountants thought of unsold stock at the year-end as being "sold" (at cost or lower market value) by the trader to himself, the sale being, as it were, from one period to another. This way of thinking

not only explained why the cost or lower market value of unsold stock came in as a receipt of the year being closed, but it also explained the function of the stock as an asset in the next year, a function which, as will be seen, is essential to the computation of profit in that next year. Of course the "sale" of stock from one year to the next was not an actual sale: it was just a way of explaining the things accountants were doing in drawing up accounts of profit and loss. Nobody was saying that there was actually a sale of stock, but everybody (including accountants) seemed happy to explain things that way.

The New Analysis

However, accountants have, recently, begun to think differently about what they are doing; and, now, they do not think of the computation as involving a deduction of all the expenses of a trade but, instead, as involving a deduction only of the expenses relating to sales in the year and the "carrying over" or "exclusion" of the expenses related to unsold stock from one year to another. So accountants are certainly explaining what they are doing differently from the way in which they used to explain it. Indeed, some of them have been a bit sniffy about the old explanation, calling it "sweet-shop accounting". Nonetheless, the question which arises is whether, although they now describe what they are doing as "carrying over" the expense of unsold stock from one year to another, they are really doing anything fundamentally different from what they have always been doing. In this connection, it is well to remember

that, for something over 80 years now, accountants have been telling courts what they do in computing profits and that courts, having heard the explanation, have said that, no matter how the accountants describe it, upon analysis – legal analysis as Nolan LJ put it in *Gallagher* v *Jones* – the cost of unsold stock is deducted in full in the year and matched with a receipt. Does what accountants now say they are doing change the analysis? Are they truly excluding part of the expenses of the year (those related to unsold stock) from the computation of profit?

Mars

It is important to bear in mind that, while *Mars* concentrates on questions related to depreciation, the depreciation in issue was treated as part of the cost of stock. Accordingly, the case is not limited to depreciation, but, rather, raises much more basic issues: how is expenditure of the year to be treated? Is it all deducted? More particularly, the question in the case was whether the cost of unsold stock at the year-end is deducted in the year or not. That is exactly the question which has been considered and answered in cases like *Duple Motor Bodies* which was referred to, on this express point, in *Gallagher* v *Jones* (see above). Nonetheless, whether because the House was concentrating on the question of depreciation rather than the real issue about the function of stock, or for some other reason, the House did not adopt the traditional analysis set out above but thought that the way accounts are now drawn did change the analysis. Thus Lord Hoffmann, having reviewed Standard Statement of

Accounting Practice ("SSAP") 9 and 12 and Financial Reporting Standard ("FRS") 15 concluded (in paragraph 8 of his speech) that:

> The costs of stocks which remain unsold at year-end are not deducted for the purpose of computing the profit in that year, but are carried forward to be matched against the revenue from their sales in future years.

He supported this conclusion (at paragraph 12 of his speech) by pointing out that the "cost of sales" figure, actually deducted from the figure for turnover in the taxpayer's profit and loss account to compute profit, did not include the cost of unsold stock. (Lord Hoffmann refers only to depreciation on unsold stock not being included as a deduction, but what he says must apply equally to the other costs of unsold stock.) Lord Hope delivered a speech to much the same effect, and both Lord Hoffman (at paragraph 15 of his speech) and Lord Hope (at paragraph 38 of his speech) held that accounting principles had moved on since the principles reflected in *Gallagher* v *Jones* had been expounded.

Have accounting principles truly moved on?

There is no doubt that the presentation of the profit and loss account never now shows a deduction for costs of unsold stock and a receipt for the value of that stock. However, the question which still needs to be answered is not just about stock. It is: "can profits of a period be computed without account being taken of all the expenses of the year?" No matter how profits are computed, the profit and loss account must, of course,

show a figure for the cost of sold stock. It is important to understand how this figure is arrived at. It does not appear in the profit and loss account by magic: it has to come from somewhere. The question: "how is the cost of sold stock arrived at?" is at the heart of the analysis. No proper answer to the issue which arose in *Mars* can be given unless an answer to that question is provided.

The cost of stock is an amalgam of many things: it includes not only the cost of raw materials, but also the costs of the staff who have worked on it and so on. The accounting standards in issue in *Mars* show that, nowadays, the capital cost of machinery used in making stock is, to the extent of any relevant depreciation, included in the cost of that stock and the recognition that that should be so is, no doubt, a significant accounting advance. However, no matter how accurate or advanced accounting techniques are, it is impossible, especially where the stock is, like Mars bars, fungible, to say with exactitude that this piece of stock cost x and that y: the cost of stock sold and of stock unsold is a part of the total relevant expenditure in the year; some form of apportionment of total expenditure in the year has to be made between sold and unsold stock. Once it is seen that an apportionment of expenditure has to be made, it becomes apparent that, in some way or another, all the expenses of a year are relevant in computing profit. It now becomes necessary to see in what way they are relevant and how opening and closing stock function in relation to expenses. In discovering the cost of stock for the year, it becomes necessary to know what the cost of opening stock at the beginning of the year was: that is

because the cost incurred on stock in the year is always the aggregate of the cost or lower market value of the opening stock plus the actual expenditure in the year on acquiring stock. The necessity of taking opening stock into account in this way is unchanged and unchanging: it arose as soon as earnings based accounting was invented and has continued to exist ever since then.

It is worth noting (because Lord Hoffmann says at paragraph 16 of his speech in *Mars* that, while stock is an asset in the balance sheet, it is a cost in the profit and loss account) that, in this context, the cost of opening stock is representative of an asset held at the beginning of the period and so, in a sense at least, functions as an asset, even though it is the cost of the asset which is relevant. And, no matter whether stock functions as an asset or as a cost in a profit and loss account, there is no doubt at all that the cost of opening stock for a year must be brought into account in some way or another as an expense of the year; and, as it would be impossible to incur an expense as it were from nowhere, it is necessary to explain where the expense came from. The old explanation was that it was a "purchase" from the previous year, matched by a "receipt" in the earlier period. The new explanation is that it is an expense carried over from the prior period when it was, presumably, not, on the new theory, an expense at all or was an expense, but one not relevant to the computation of profit when incurred. It might just be that questions of plausibility begin to arise at this stage of the analysis. Nonetheless, the question remains whether closing stock is relevant and, if so, in what way. By this stage of the

analysis, it is, as has been mentioned, apparent that, in some way or another, all of the expenses of a period must be taken into account, including those on sold stock and those on unsold stock. They are – must be – in the first place taken into account as a cost. Is that cost then "cancelled" to the extent of the unsold stock? To answer that, we need to see what the function of unsold stock is in the computation and it is useful to do that by reference to an example.

In his first year of trade, a manufacturer of widgets incurs costs (including the cost of the necessary raw materials) of 300 in manufacturing widgets. He is rather good at the manufacturing process, so that he intends to manufacture and does actually manufacture 300 widgets, none of which he has sold by the year-end. It is easy to see that each widget cost 1 to make and, having been made, is still owned by the manufacturer; and it may be assumed that each widget has a market value of 3. There is no need, really, to draw a profit and loss account: it can be seen that there is no profit and no loss. Year 2 is rather more complicated. The year is uneven; costs rise and fall and rise again in a wholly unpredictable way which cannot be attributed exactly on a widget by widget basis and there are labour problems. Furthermore, the manufacturing process has become a little sloppier than it was: the manufacturer had hoped to make another 300 widgets and had bought the materials to do that, but some of them broke in the process and some of them were not really good enough to be called proper widgets. Some of them were good enough when made, but stopped being good enough before the year-end so that,

although he had hoped to make 300 widgets, he does not actually know, until he takes stock, how many widgets he made in the year. What he does know is that he had an opening stock of 300 widgets which had cost him 300 to make and that he has spent 400 in Year 2 manufacturing widgets. He also knows that he sold 310 widgets in Year 2 for 930, and he needs to work out his cost of sales to find his profit. His total cost of manufacture is 700 over two years. On a simple FIFO basis, he would say 300 of the 310 widgets sold (the 300 widgets made in Year 1 and in stock at the end of that year) cost 1 each to make (he knows this because the results in Year 1 make it easy to know, though it will be appreciated that this is unusual) and so his profit on 300 widgets was 620 (cost 1 each, sale price 3 each (930/310). But how much did the other 10 cost? It can be seen that the other 10 cost a proportion of 400, but what proportion? The answer to that question can only be found by seeing how many widgets are left in stock at the end of Year 2. If there are, say, 190 widgets in stock at the end of Year 2 and 10 of the 310 widgets sold in Year 2 must have been made in Year 2, it is now possible to say that the 400 spent in Year 2 was incurred on manufacturing 200 widgets, so that each widget manufactured in Year 2 cost 2 to make. But none of this can be done without taking account of all of the cost of manufacturing widgets in Year 2, the opening stock of 300, the sale of 310 widgets and the closing stock of 190: the closing stock is an essential element in calculating the cost of the sold widgets and the costs of manufacture during the year.

So it is now possible to see that the total expenditure incurred in the year, the opening and the closing stock are all essential elements in the computation of profit. There is no doubt that accounting methods have advanced and that the way of attributing costs to stock is now much more sophisticated than it used to be. However, despite all the accounting advances, it remains impossible to work out the cost of sold stock without taking into account the cost of opening stock in the year. Accordingly, the cost of opening stock (which, of course, represents unsold stock of the previous period) must always be deducted in arriving at the figures for sold stock in some form or another: it is just not possible to work out the cost of sold stock without taking into account, as a cost of running the business, the cost or lower market value of opening stock. And it is equally impossible to work out the cost of sales without taking account, in some way or another, of the expenditure incurred in the year and of closing stock. It follows from all this that, somewhere or other – it may not now be in the profit and loss account, but somewhere or other – there must be a calculation of cost of sales which will include the cost of opening stock plus additions during the year together creating the expenditure in the year and the value (taken as cost or lower market value) of closing stock.

The evidence given by the accountants in the *Mars* case appears to have been remarkably coy about how the apportionment of costs between sold and unsold stock was made: there was a great deal of evidence about how the cost of stock was to be calculated, but not very much

about how the apportionment of costs between sold and unsold stock was to be made: there was certainly no evidence that the apportionment did not take account of opening and closing stock and it seems inevitable and, indeed implicit in the accountants' evidence to the Special Commissioners in *Mars*[5] that it must do so. Once it is seen that the apportionment must take account of opening and closing stock, it becomes equally inevitable that the cost of unsold stock has to be deducted at some point in the computation. Even if it does not now appear in the profit and loss account there must somewhere – perhaps now in a memorandum account – be a computation of the cost of sales which, as the examples above show, must include opening stock and closing stock.

Now all this can get really quite confusing and it may help to look at the matter in the form of an equation. In the equations which follows P stands for profit, R stands for receipts for the year in question (excluding the value of stock) and CAS stands for cost of all stock, that is the total expenditure incurred on stock in the year which includes both the cost of stock held at the beginning of the year and the cost of stock acquired during the year. CAS may be divided into CSS, which is the cost of stock sold during the year and CUS, which is the cost of stock unsold at the year-end, which forms the opening stock of the next year: indeed, not only may CAS be divided into these two component parts, but it must be, because some division of total expenditure for the year is needed to find the cost of sold stock. Using these symbols, the traditional analysis can be represented

by the equation: P = R + CUS – CAS. The equation clearly shows the cost of unsold stock ("+ CUS")as an addition to the receipts of the business and the deduction of all the expenses of running the business ("– CAS") .

The new analysis can be represented by the equation: P = R – CSS. Here, it looks as if only the cost of sold stock has been deducted. However, before concluding that there has been no deduction for unsold stock, it is necessary to see how the value of CSS has been arrived at: that is done and, as the example of Year 2 above shows, can only be done by an operation which can be represented by the formula CAS – CUS, which can, of course, be expanded to (CSS + CUS) – CUS. When it is recognised that the value for CSS must be arrived at in the way just explained, the equations P = R + CUS – CAS and P = R – CSS set out above can be written out more fully, breaking CAS down into its constituent parts of CUS and CSS.

On this basis, the equation for the traditional analysis is: P = (R + CUS) – (CSS + CUS); and the modern analysis can be set out as P = R – ((CSS + CUS) – CUS). Of course, the working out of "((CSS + CUS) – CUS)" in the equation for the modern analysis is not seen in the profit and loss account: only the result of that formula is carried to the profit and loss account, but the formula still has to be worked out, so that the equation set out above for the new method accurately represents in full what is happening, while the formula P = R – CSS only represents part of what is happening, because it does not explain how CSS is arrived at. When the fuller

form of the equations above is analysed, it can be seen that, in both of them, the cost of unsold stock is both a receipt and a deduction exactly as Nolan LJ said it was in *Gallagher* v *Jones*: in the traditional analysis, the cost of unsold stock is a receipt in the part of the equation "(R + CUS)" and it is a deduction in the part of the formula "– (CSS + CUS)". In the new method, CUS is deducted in the element of the formula "– ((CSS + CUS) and it is an addition in the "– CUS)" part of the formula. In other words, both equations are the same.

It follows that, although accountants are now saying that they are doing something different, they are, in fact, at least so far as stock is concerned, doing the same thing as they have always done. Since that is so, accounting methods have not changed in any material way since (as Nolan LJ said in *Gallagher* v *Jones*) it was decided, in *Duple Motor Bodies* v *Ostime*, that, in computing profits, the cost of opening stock was a deduction and the cost or lower market value of closing stock was a receipt. In *Commissioner of Inland Revenue* v *Secan* 74 TC 1, Lord Millett understood this. First, he distinguished between presentation and computation and so emphasised the need, not emphasised in *Mars*, to compute profits for tax purposes rather than to adjust the commercial accounts. Secondly, he recognised that the cost of stock is always deducted in full in a year, even if some of it is unsold, and that the cost or lower market value of stock unsold at the year-end is a receipt. In other words, Lord Millett, in *Secan*, adopted the traditional analysis, which was, of course, an entirely conventional and judicially approved approach. The House of Lords in

Mars accepted (inevitably) the result of *Secan*, but criticised the reasoning, suggesting that Lord Millett was, in effect, trying to ride two diverging horses at once.

The argument of the taxpayers in *Secan* was that there was a conflict between the tax system in force, which required all expenditure on stock to be deducted in the year in which it was laid out, and the accounting system, which did not deduct expenditure on stock until the stock was sold. It was agreed on all sides (and so was not in issue) that the tax system required deductions to be made as money was laid out for stock. The result was that the actual decision in *Secan* could only be arrived at by an analysis of accounting standards which showed that the cost of unsold stock is deducted year by year, so that there was no conflict between those standards and the tax system. That was the analysis which Lord Millett very clearly used. The criticism of the reasoning in *Secan* made in *Mars* accordingly fails to recognise both that the accountants' current description of what they do in computing profits is, in fact, a description, in new words, of what they have always done and, also, that the reasoning in *Secan* is entirely logical and correct, once it is seen that opening and closing stock do, indeed, function, respectively, as a cost and as a receipt of the year. In so far as the decision in *Mars* is based on the assertion that the cost of unsold stock is not deducted in computing profits, it represents a departure from authority which can be criticised: as demonstrated above, there has been no change (other than one of presentation,

not computation) of accounting principles which justifies the decision.

So the question which then arises is whether the decision in *Mars* can be supported on some other basis from that given by the House of Lords. The answer is that it can be for one of two reasons, one of which is unattractive and the other of which is plainly right. The first possible way of supporting the *Mars* decision is to say that the interpretation of accounting practice relating to unsold stock consistently adopted by the Courts for the last 80 or so years was wrong. The argument here is that since the cost of unsold stock comes in (as part of the expenditure of the year) and is taken out again as a receipt, the deduction and the receipt cancel each other out and are to be disregarded: on that view, the cost of unsold stock is “excluded from the computation”. That has always been a possible view of the matter. It is, however, not the view which Courts have adopted and there does not seem to be any reason why the Courts should depart from their traditional views here. Moreover, the view that the cost of unsold stock is excluded from the computation, while it may have some superficial attraction, does not seem to be an accurate representation of the way in which profit is computed. As Rowlatt J, in the quotation from him set out above, said many years ago: profit is computed by taking the receipts and deducting from them the expenditure of the year. The amount of expenditure “excluded” from the deductions of the year, because it is represented by unsold stock at the year-end, cannot be determined until the actual expenditure for the year has been determined

and the closing stock has been ascertained. Thus it is not a specific identified part of the general expenditure which is excluded from the deductions but, rather, an amount of the general expenditure which happens to be represented, at year-end, by the closing stock.

There is, thus, no doubt that, even expenditure represented by unsold stock is expended in the year and then matched up with the closing stock: but expenditure on closing stock is not matched as it occurs but is only matched up with closing stock after the year-end when that stock is known to be in hand. The necessity to match a part of the general outgoings up with the value of closing stock suggests both a deduction and a receipt. Indeed, that analysis seems a more accurate representation of what the accountant is doing than an exclusion. What is happening does not truly involve an exclusion, but a taking into account of expense and value. The difference is not just semantic or a matter of the mechanics of computation. An accurate account requires all expenditure to be taken into account; and if expenditure is to be taken into account it can, at least in the first place, only be taken into account as a deduction. If some of the expenditure is to be left out of account as not being a deduction, it can only be because something has been set against it – and the thing set against it can only be a receipt. So the end result is the exclusion of a part of the deduction; the only way of explaining the exclusion is to say that there has been a deduction and a receipt, just as every lawyer, up until *Mars*, has always thought. The first reason for supporting the *Mars*

decision is, accordingly, unattractive and cannot be sustained.

The second reason for supporting it is, however, undoubtedly right. As was said long long ago, income tax is a tax on income; and corporation tax, so far as it relates to income, is also a tax on income. Accountants are now drawing accounts which mix up capital and income. That may be good accounting. It is bad law. There can be no doubt that, in making a computation of income for tax purposes, capital elements must be excluded. That means that depreciation of capital assets has to be excluded from the deductions when they are made; and it must also be excluded from the receipts, or else an element of capital will be taxed, contrary to fundamental principles of our tax law. It may, accordingly, be concluded that the result in *Mars* and in *William Grant* is correct. But the reasoning is, sadly, wrong. Whether this really matters or not remains to be seen.

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[1] Modern accounting methods may now require trading stock to be brought into the computation at market value. That raises new problems of computation, especially in the light of FA 1998 s.42. But this accounting requirement is really very recent and, in this paper, the assumption is made that the relevant rule is that cost or lower market value is brought into account. Whether this is an accounting rule or a rule of law may be open to debate, but the better view is that it is a rule of law.

[2] In what follows, references to stock include references to work in progress.

[3] Emphasis added. See also, to the same effect, *Whimster & Co* v *IRC* 12 TC 813 esp at 823 and 826; *Osborne* V *Steel Barrel Co Ltd* 24 TC 293 at 307; *Patrick* v *Broadstone Mills Ltd* 35 TC 44 at 68.

[4] Emphasis added

[5] [2004] STC (SCD) 253 at 268 §§67 to 72.

CASE NOTE

SMALLWOOD V. REVENUE & CUSTOMS COMMISSIONERS[1]

by Milton Grundy

This is a decision about a "round-the-world" scheme: a trustee resident in Mauritius – a jurisdiction having a tax treaty with the United Kingdom – replaced one resident in Jersey – a jurisdiction which does not; it then realised a capital gain and was itself replaced by a UK-resident trustee before the end of the tax year. It was claimed that the capital gain could not be taxed, because it was made by a resident of a treaty country and was accordingly exempt under the treaty. There could be no denying that this was a blatant tax avoidance scheme, and it is no surprise that the Special Commissioners (Brice/Avery Jones) found in favour of the Revenue. What is surprising, however, is the route by which they came to their conclusion.

The route is not altogether easy to follow. The argument is easier to understand if you know how it is going to end. The conclusion is that the Mauritius trust company was a resident of the United Kingdom and not a resident of Mauritius – within the treaty definition in both cases, and that therefore the capital gain in question was not made by an alienator which was a resident of Mauritius and accordingly did not enjoy the exemption provided by Article 13. The stepping-stone to this conclusion is the finding that the residence of the Mauritius trust company required to be determined by

application of the tie-breaker clause. We need first to look at the reasons for that finding.

The Commissioners appear to have accepted that the company was a "resident of Mauritius". It would also be a "resident of the United Kingdom" if it were liable to UK tax because of its residence in the United Kingdom. The Commissioners say that, by virtue of residing in the United Kingdom during the last part of the year, the trustees were liable to tax in the tax year. This is rather an odd statement, because only one of the three consecutive trustees was actually resident in the United Kingdom. But perhaps by "the trustees", the Commissioners intend to refer to the "single and continuing body of persons" (as it was then described) treated as existing by s.69 of TCGA 1992, and they may have considered that, just as a real person who is resident in the United Kingdom for part of a tax year is resident for the whole, so a deemed person who is resident for part of the year is resident for the whole. It may be that the next step in the argument is to say that if the deemed trustee is resident, then the entities which were the actual trustees for the time being, and not resident in the United Kingdom, are to be treated, in that capacity – and in that capacity only – as resident, and liable to tax accordingly on any gain realised during their respective periods of trusteeship. It would follow that the Mauritius trust company, being treated as regards its capacity as trustee of this settlement as resident *in* the United Kingdom and liable to UK tax accordingly, falls to be regarded as a resident *of* the United Kingdom under the treaty.

To apply the tie-breaker clause, the Commissioners had to consider the concept of the "place of effective management" – the *POEM*, as they put it, and they concluded that "the real top management decisions, or the realistic, positive management decisions of the trust" had been taken in the United Kingdom. Whether or not this finding is supported by the evidence may be an issue on appeal (and it is understood that the case is going to appeal), but the phrase itself points to the conclusion that, if I may respectfully say so, the Commissioners were at this point asking themselves the wrong question. A trust does not make decisions, nor does it "alienate" assets. It may be treated as a body of persons for capital gains tax, but I need hardly say that it is in fact no such thing: it is a bundle of obligations owed by the trustee for the time being. The trustee – in this case, the Mauritius trust company – is the person which makes the decisions, and the trustee is the "alienator" within Article 13. The question the Commissioners should have addressed is, "What is the POEM of this trust company?" It seems to me that the POEM of a company carrying on business as trustee is ascertained in exactly the same way as the POEM of a company carrying on the business of constructing airfields. You do not ask how a particular job is managed; you look at the company's business as a whole, and you look at where the directors reached their decisions. It so happened, in this case, that the decision to sell the trust investments was taken at board level, but, as anyone who has attended board meetings of a trust company will know from experience, such decisions are not necessarily – or even usually – taken at board level, and if they are, they have to take their place among

matters of considerably more importance to the management company – the appointment of a new CEO, the review of KYC procedures, a consideration of current marketing strategy, the opening of a new branch, and so on. Whether the Commissioners heard any if so what evidence on this question does not appear from the decision, but it seems unlikely that if the Commissioners had thought that this was the right question, they would have given a similar answer.

This decision highlights a particular hazard of which trustees may not always be aware. If a resident of a country outside the United Kingdom accepts the sole trusteeship of any settlement (whether or not having any connection with the United Kingdom), and a protector or someone else has power to remove him and replace him with a UK-resident trustee before the end of the tax year, he may find himself with a liability to UK taxation for that year, and may not have retained – or have been able to retain – trust assets sufficient to meet that liability.

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[1] 2008 Simons Weekly Tax Intelligence 436.

EVERY SECOND COUNTS: LIMITS ON HMRC's POWER TO RECOVER NICs

by Michael Jones

Introduction

HMRC has at its disposal a considerable array of powers that can be used to collect the tax found to be due following assessment. Among them is the power, found in sections 66 and 68 of the Taxes Management Act 1970, to commence proceedings against the taxpayer in the County Court or the High Court for the recovery of the tax as a debt due to the Crown. Unlike ordinary litigants, however, HMRC is not subject to the usual time limits set down in the Limitation Act 1980. This is made clear by section 37(2)(a) of the Act, which states that, "this Act shall not apply to any proceedings by the Crown for the recovery of any tax or duty or interest on any tax or duty". Accordingly, HMRC is able to recover arrears of tax using this power irrespective of the when the liability to pay arose.

But National Insurance is different. It is not a tax, we are told, but a "contribution"; and in line with that stance HMRC appears to accept that National Insurance is not "a tax or duty" within the meaning of section 37(2)(a). As a result, and since there is no specific provision governing their recovery, proceedings for the collection of National Insurance contributions ("NICs") are subject to the time restrictions of the 1980 Act. In theory, at least, this can provide a taxpayer with a total defence to an otherwise unstoppable claim.

In practice, however, HMRC does not lightly give up its claims to arrears of NICs, and has been known to use several techniques to counter a limitation issue, ranging from a simple demand for payment to more sophisticated arguments based on provisions in the 1980 Act. Some of the more common techniques will be addressed in turn after a brief look at the basic rules.

General Principles – The Six Year Bar

Underlying the concept of limitation periods is the policy that a defendant ought not to have the threat of a stale claim hanging over him indefinitely. The Limitation Act 1980 therefore prescribes the period during which any claim must be brought. The clock starts running from the date on which the cause of action accrues, i.e., from the point at which all the facts establishing the essential elements of the claim exist. The clock is stopped when a claim is 'brought' in respect of that cause of action, and for the purposes of limitation this means the date on which the claim form is issued, rather than the date of its service on the defendant. Once the relevant period has run out, proceedings cannot be begun, giving the defendant a complete technical defence. The effect of expiration is said to be that the right of action itself is left intact; it just cannot be enforced. We shall see below why this distinction is important.

In the case of the collection of NICs the applicable provision of the 1980 Act is section 9(1), which deals with "actions to recover any sum recoverable by virtue of any enactment". It provides that such an action shall

not be brought after the expiration of six years from the date on which the cause of action accrued. Any claim for the recovery of NICs must therefore be issued within six years from the statutory due date, otherwise the action is time-barred.

This is the standard position, but it is not the whole picture because, in certain circumstances, other sections of the 1980 Act can operate so as to extend the relevant period. For that reason these sections can be, and are, used by HMRC to counteract a limitation defence; and it is, therefore, important to have them in mind when faced with an attempt to collect NICs that are, prima facie, irrecoverable.

If You Don't Ask…

The first, and the bluntest, approach employed by HMRC is simply to ask for the arrears, presumably in the hope that the taxpayer will just pay up without realising that there may be a limitation issue. The collectors can do this because, as mentioned above, the right of action survives the expiry of the limitation period: making payment in these circumstances merely satisfies an unenforceable, but otherwise valid, debt. Accordingly, where it looks as though such a demand might relate to debts over six years old, it should be examined with caution to see whether part, or all, of the claim is out of time.

Concealment

Secondly, section 32(1)(b) of the 1980 Act

postpones the commencement of the limitation period where the defendant, or his agent, has deliberately concealed from the claimant any fact relevant to the cause of action. If the collectors can demonstrate such conduct, the six year period will begin to run only from the date on which the concealment is discovered, or could, with reasonable diligence, have been discovered.

This exception exists for obvious reasons, and the central mischief at which it is aimed is clear, although it can become more difficult at the edges. It requires the claimant to show that some fact relevant to the cause of action has been concealed from him either by a positive act or by a withholding of relevant information, but, in either case, with the intention of concealing the fact in question. The need to show intention presents a claimant with a high hurdle, particularly where the alleged concealment involves an omission, and also means that mere ignorance on the part of the defendant ought not to be enough to bring the section into play.

The question of what amounts to “reasonable diligence” in this context adds a further layer of complexity. According to the case law, a claimant is not required to do everything possible to uncover the concealment, just those things that an ordinary prudent person in the position of the claimant would have done, having regard to the particular circumstances of the case at hand.

The relevant HMRC manual (DMBM527140) instructs collectors to investigate NICs arrears over six years old critically, to see if the circumstances of the

particular case can support the advancement of the limitation period under the section. Among the factual aspects commonly examined for this purpose are (1) when the NICs liability arose, (2) whether returns detailing a NICs liability were made, (3) whether any returns made were submitted on time, and (4) when the Department could have first taken action to pursue the debt. If grounds for postponement can be made out collectors are directed to pursue recovery of arrears in the usual way.

Acknowledgement

Taxpayers should also be aware of the acknowledgement provisions in the 1980 Act. Where an outstanding debt is admitted in writing and signed by the taxpayer, HMRC's right of action is deemed to have accrued on the date of the acknowledgement. The effect is to reset the limitation clock, allowing a further six years for collection. Before these provisions can operate, there has to be a sufficiently clear admission of the claimant's rights by the debtor, which will be a question of fact in each case. The acknowledgement need not be express: an implicit admission will do, and there is case law to support the view that a request for time to pay can be enough for these purposes. It is not unknown for HMRC to invite admissions of liability from a taxpayer; and again, if faced with any such invitation, taxpayers and their advisors should consider the position with care before any admission is made.

Part Payments

There are similar provisions that apply where a part payment is made towards the sums due. As with an acknowledgement, a part payment effectively 'restarts' the limitation period from the date of payment, and care should, therefore, be taken where payments on account are being considered. Each case must, of course, be looked at on its own particular facts, but where there are sums due in respect of both income tax and NICs, any payment made on account should be expressly allocated to the outstanding income tax liability, and not the National Insurance arrears, unless to do so would prejudice some other interest of the taxpayer. If this is not done, HMRC is free to appropriate the payment to whatever liability it chooses, although it is arguable that if HMRC does so, it will not amount to a payment for the purposes of these provisions. If neither party makes an allocation, the law will assume that unbarred claims are paid before time-barred ones. Where the taxpayer has outstanding National Insurance liabilities from different tax years, some of which arrears are time-barred and some of which are not, it is prudent, absent other considerations, to allocate any part payment to those claims that are still 'live' and enforceable. If this is not done then it is likely that HMRC will seek to appropriate the payment to the time-barred claims that cannot otherwise be collected and then pursue the recovery of the remainder.

In respect of both acknowledgement and part payment, a current period of limitation may be

repeatedly extended by further acknowledgments or payments, but once a claim is barred by the 1980 Act it cannot be revived in this way.

Conclusions

In the space of this quick guide it has only been possible to highlight a few of the more fundamental aspects of this sometimes difficult area. The issues involved can be far from straightforward and will very often depend on the facts of the individual case at hand. When used correctly, however, a limitation point can provide a taxpayer with a complete answer to a NICs claim brought out of time. It therefore pays to examine each case with care, taking specialist advice where necessary, to see whether a limitation argument is available as either a lever in negotiations with HMRC or as a total defence to an action for recovery.

USING FAMILY TRADING TRUSTS FOR LAND DEALS – STOPPING TAX AT THE BASIC RATE

By Patrick C Soares

Introduction

If the taxpayer wants to do a land-trading deal he could do it in his own name and pay 40% income tax. On the other hand, if it is done by a settlement under which the settlor and the spouse of the settlor and children whilst minor are excluded from all benefit, then only a charge to tax at the basic rate (20%) would apply, assuming the profit as a matter of trust law is on capital account, even though for tax purposes it would be a trading transaction.

The tax position is based on the case of *Carver v Duncan* (1985) STC 356. The subsequent case of *HMRC v Peter Clay* (2008) STC 928 does not affect the analysis.

How it works

The proposal is that a UK trading trust be set up, which carries out a UK land-trading deal. This will be a trading transaction within ITTOIA 2005 s.6(1), which charges to income tax the profits of a trade arising to a UK resident. The person liable to the tax is the person receiving or entitled to the profits (s.8).

Critically the settlor and the spouse of the settlor and the minor children of the settlor will not be capable

of benefiting under the settlement, whether directly or indirectly. Also critically as a matter of trust law the profit made from the trading deal must be made on trust capital account; this is vital to ensure that the trust rate of 40% under ITA 2007 s.9(1) does not become payable.

The trading trust is one under which an individual has an interest in possession. The individual could be a child of the settlor who is an adult. In the alternative there could be a number of persons with interests in possession.

When the 40% Rate Applies

The rules dealing with the application of the trust rate to income are contained in ITA 2007 s.479 et seq. The rules apply to trusts where income is to be accumulated, or which is to be paid out in the discretion of the trustees or any other person (ITA 2007 s.480(1)). The question is, what is income for the purposes of these provisions? After all if a large land-trading gain is made, it may be argued that because the gain is on trust capital account it can be accumulated and furthermore it can be paid out by the trustees on the exercise of a power of appointment over capital.

The conclusion to be drawn from the legislation is income means income for trust law purposes.

Firstly, this is because the section refers to income to be accumulated or paid out in the discretion of trustees. This is indicative of trusts where income such

as dividends arise to the trustees who then accumulate or pay the same out.

Secondly, there is to be deducted from the income in determining the trust rate the expenses of the trustees so far as they are properly chargeable to income, ignoring any express terms of the settlement. Once again this indicates that one is looking to trust law to determine the expenses of the trustees which are properly deductible from the income receipts of the trust.

Thirdly, there are a number of headings in s.482 which specifically provide that gains – which are very likely to be gains of a trust capital nature – are to be charged at the trust rate. For example Type 1 in section 482 will be a share buyback, which under trust law would be a capital transaction.

Finally in the case of *Carver v Duncan* 59 TC 125 the House of Lords had to decide whether payments to upkeep a capital insurance policy could be deducted from the income of a settlement for income tax purposes. The trust deed specifically allowed the deduction. It was held that only income-type deductions determined under trust law would be deducted from the income, which it was accepted was determined under trust law. Lord Templeman at 194h stated, the legislation:-

> "…imposed an additional rate of income tax on the income of accumulation and discretionary settlements remaining after the deduction of expenses "properly chargeable to income tax (or would be so chargeable but for any express provisions of the trust)", the section appears to

> me to allow the deduction of income expenses and to prevent the deduction of expenses which are only chargeable to income as a result of an express provision of the trust."

Thus if an accretion to trust capital is made, this is not the type of income envisaged by the legislation even though for tax purposes such an accretion to capital may be chargeable to income tax as comprising a profit of a trade arising to a UK resident within ITTOIA 2005 s.6(1).

The consequence of the trust rate not being applicable is that the only rate exigible is that under ITA 2007 s.11(1). i.e. the basic rate of charge.

Anti-Avoidance Provisions

Under ITTOIA 2005 s.619 et seq, if income arises to the trustees of a settlement, that income shall be treated for all the purposes of the Income Tax Acts as the income of the settlor and of the settlor alone, if during the life of the settlor the income arises from property in which the settlor has an interest (ITTOIA 2005 s.619 and s.624). ITTOIA 2005 s.625 states that a settlor is treated as having an interest in property if there are any circumstances in which the property is payable to the settlor or the settlor's spouse or civil partner or is applicable for the benefit of the settlor or the settlor's spouse or civil partner or the same will or may become so payable or applicable.

There is no problem in the settlor being a trustee of the settlement. He cannot however benefit from the same

and for good measure he should bear all his own expenses and he must not take any trustee remuneration.

It is appreciated that it is not sufficient just to exclude the settlor from benefit. One must ensure that nothing is applied for his benefit.

If for example the settlor lends money to the settlement, this would offend the legislation, because the repayment of the loan would be a benefit.

If the trustees borrowed money and the settlor provided back-to-back security for this, then this would offend the legislation, because the release of the security would be a benefit (*IRC v Wachtel* 46 TC 543). There can of course be an outright settlement of funds.

Inheritance Tax

The settlement although drafted as an interest in possession trust will for all inheritance tax purposes be treated as a discretionary trust. The settlor and spouse of the settlor would be excluded from all benefit for the purposes of the reservation of benefit provisions. Thus if there is a gift of property into settlement, after the 7 year period the gifted amounts would cease to be within the estate for all relevant purposes of the settlor. The settlor could use up his £312,000 nil rate band or what is left of it. If needs be the spouse of the settlor could put further monies in. These would become “time-discretionary trusts”. The principle here is if the trust is brought to an end before the 10 year anniversary then the funds appointed out would only bear a nil rate of IHT. The

relevant provision is IHTA 1984 s.68. The legislation envisages an IHT transfer which is equal to the value of the property in the settlement when it commenced, and there is an assumption that that amount of property was transferred by the transferor or transferors cumulating in any other transfers which they may have made within the period of 7 years ending on the date the settlement commenced. See s.68(4)(a) and (b) and (5)(a) and (c). The result is that all the funds for example could come out to the life tenants before the first 10 year anniversary without any charges to inheritance tax.

Note also, although the life tenants have interests in possession, no charges to IHT will arise on the death of any of the beneficiaries.

One could review the position near the 10-year anniversary, to determine whether funds could be appointed out to the beneficiaries or indeed left in the discretionary trust bearing the 10-year anniversary charge – which could never be more than 6% of the net value of the fund at the time of the anniversary charge.

Income From Investment

Note that if the project proves successful and the trustees invest the trust capital or if otherwise normal income arises to the trust then this income such as dividend income or bank interest must be paid to the life tenants after the trustees have taken out their expenses if any (the trustee expenses will not reduce the trustee income tax charges on that income). The trustees will be

liable for the basic rate of tax. The life tenants may be liable to tax at the higher rate of tax (ITA 2007 s.10(3)).

Capital Gains Tax

TCGA 1992 s.4(1A)(1A) states that the rate of capital gains tax in respect of gains accruing to the trustees of a settlement in a year of assessment shall be equivalent to the rate which for that year is the rate applicable to trusts (now the trust rate). TCGA 1992 s.77 states that any gains made by the trustees of a settlement shall be treated as accruing to the settlor if the following can benefit under the settlement – the settlor, the spouse of the settlor or the civil partner of the settlor or the minor children of the settlor. Considering the rate at which trusts pay capital gains tax, this section is not of particularly great significance, nevertheless the settlor and the spouse of the settlor and a civil partner of a settlor and the minor children of the settlor are excluded from all benefit under the settlement.

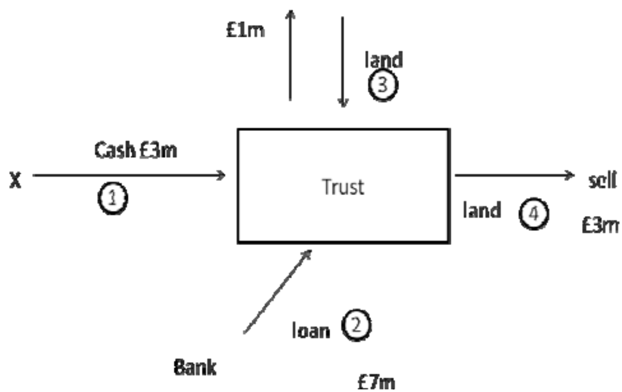
Other Taxes

Other taxes may be relevant depending on all the circumstances. The trustees may have to register for VAT. The trustees may have to bear stamp duty land tax in an appropriate case.

Conclusion

The trading trust is an attractive proposition. The price to be paid for this is the settlor and his spouse or

his civil partner and his minor children cannot benefit from the settlement.



THE CHANGES TO THE REMITTANCE BASIS AND NEW STRUCTURES

by Patrick C Soares

The new provisions dealing with the remittance basis of assessment for individuals who are resident in the United Kingdom but not domiciled therein are contained in Schedule 7 to the Finance Bill 2008 (ordered to be printed on 18/3/08) and this contains 143 paragraphs.

They are a much watered-down version of the pugnacious drafts originally put out.

The New Remittance Basis

Under a new s.809B of ITA 2007, an individual who is resident in the United Kingdom but not domiciled in the United Kingdom may make a claim to be on the remittance basis.

If he is what the legislation calls *a long-term UK resident*, then to have the privilege of the remittance basis he must pay the £30,000 for each year of assessment that he wants to be on this basis.

Monies are remitted to the United Kingdom under s.809K if, broadly, investment income or chargeable gains which arose overseas are brought to the United Kingdom or property derived from them are brought to the United Kingdom (s.809K(1) – (3)(b)).

If the income or chargeable gains are used outside the United Kingdom as security, for example, for monies borrowed outside the United Kingdom, which borrowed monies are brought to the United Kingdom, there is a deemed remittance of the income and gains (s.809K(3)(c)). Note there are important transitional provisions in paragraph 85, which are available if the debt arrangements were set up before the 12th March 2008 and the loan was made for the purpose of enabling the taxpayer to acquire an interest in residential property in the United Kingdom.

Under the new remittance rules the taxpayer is treated as remitting income or gains to the United Kingdom if he or a “relevant person” remits the same to the United Kingdom.

A relevant person is the taxpayer and his spouse or civil partner, his minor grandchildren or children and certain close companies under s.809L(2)(f) and the trustees of a settlement under which the taxpayer or his spouse, etc., is a settlor or a beneficiary (s.809L(2)(g)).

There are new anti-avoidance provisions in s.809K(4) and (5), which seek to ensure that there can still be a taxable remittance even though property is given to the person who is not a relevant person and also where there are gifts to persons who enter into connected transactions designed to ensure that relevant persons receive benefits in the United Kingdom.

Mixed Funds

Section 809P deals with transfers out from mixed funds: broadly the income is treated as coming out first. One can avoid these provisions by ensuring that one does not mix one's funds. In particular, one should ensure that interest on a foreign account accrues to a separate account.

Foreign income

In order to apply the new remittance basis rules to relevant foreign income – offshore investment income etc. – s.832 ITA 2007 is to be amended by paragraph 49 of the new Schedule. The key point to note in this amendment is that there is a charge to tax on a remittance of overseas income "whether or not the source of the income exists when the income is remitted".

Five Year Residence Rule

The remittance rules require the taxpayer to be resident in the United Kingdom in the year the funds are remitted to the United Kingdom, but there is a temporary non-residence anti-avoidance provision in s.832 (para 49) which sets out a five-year period which effectively prevents the taxpayer from breaking his residence in year 1 and remitting the funds to the United Kingdom and then coming back to the United Kingdom in year 2 and claiming the funds are tax-free: he broadly has to be outside the United Kingdom for a five-year period.

Foreign Chargeable Gains

Paragraph 56 sets out the appropriate capital gains tax amendments to TCGA 1992 s.12 ensuring that gains made on the disposal of foreign assets (called "foreign chargeable gains" in the new s.12(4)) are taxable on a remittance basis.

Attribution of gains to shareholdings in non-resident companies

Changes made to TCGA 1992 s.13(2) ensure that one does not escape the application of TCGA 1992 s.13 (which apportions capital gains made by overseas company to UK-based shareholders in the overseas company) by being non-domiciled in the United Kingdom, i.e. a shareholder who is resident or ordinarily resident in the United Kingdom regardless of his place of domicile can have a gain apportioned to him. If the company, however, makes a foreign chargeable gain then the remittance basis applies with regard thereto. These provisions apply with regard to chargeable gains made on or after the 6th April 2008.

There is no rebasing election (see below) available in such situations.

There is no relief on the disposal of UK-located assets by the overseas company.

Offshore settlements and capital gains tax

TCGA 1992 s.86 (settlor interested offshore

settlement) is untouched by the new changes.

Paragraph 97 contains new provisions, however, which can tax beneficiaries (recipients) under offshore settlements to the extent that they receive capital payments. The general rules matching capital payments with capital gains are contained in a new s.87A.

A new s.87B states that chargeable gains treated as accruing to an individual by virtue of a capital payment are foreign chargeable gains within the meaning of TCGA 1992 s.12. *This provision enables one to apply the remittance basis to the capital payment, even though the payment may relate to a gain made on the disposal of an asset located in the United Kingdom.*

Paragraph 108 of the new Schedule ensures that *trust gains realised in the year 2007/08 (and earlier years)* effectively fall out of charge under the matching process.

Paragraph 110 ensures that if gains are made in 2008/09 and subsequent years, and these gains are matched with capital payments of a person not domiciled in the United Kingdom, no charge arises with regard to any capital payments to which the gains are matched *if the capital payments were made before the 6th April 2008.*

Paragraph 112 of the new schedule deals with the new re-basing provisions. These enable the trustees to elect that the assets of the settlement and certain underlying companies have new base costs for CGT

purposes equal to the market value of the assets on 6th April 2008. This is very attractive. An election to rebase is irrevocable. An election may only be made on or before the 31st January which occurs after the end of the first tax year (beginning with the tax year 2008/9) in which an event within either of the following paragraphs occurs:-

(a) a capital payment (including living in a house) is received (or treated as received) by a beneficiary of the settlement, and the beneficiary is resident in the United Kingdom in the tax year in which it is received; and

(b) the trustees transfer part (but not all) of the settled property to another offshore settlement.

Transfers of assets abroad

ITA 2007 s.720 (the old TA 1988 s.739) remains more or less intact. Income arising to the settlement is deemed to be the income of the settlor if he or his spouse can benefit from the same. The remittance basis applies to foreign source income using the new definitions of remittance in sections 809K to 809Q. The settlor is charged to tax if any of the foreign income which is deemed to be his under s.721 is remitted to the United Kingdom, and he is taxed on the full amount of the income so remitted (the new s.726(4)).

Necessary amendments are also made to ITA 2007

s.731 (the old TA 1988 s.740). Here there is a tax charge on beneficiaries who receive benefits from overseas settlements and structures: they are taxed on those benefits under general principles to the extent that there is income arising in the overseas structure. If the beneficiary is not domiciled in the United Kingdom, the benefit which comes out of the structure to him is treated under the new definition of remittance as deriving from the foreign deemed income which arose within the structure: the benefit is thus taxable on a remittance basis. Note that the remittance basis can only apply to the extent that there is foreign income arising in the offshore structure caught by s.731. If there is UK-source income then this can give rise to a tax on the benefit whether or not the benefit is remitted to the United Kingdom (new s.735A).

Optimum Structures under the New Remittance Basis

Property Holdings

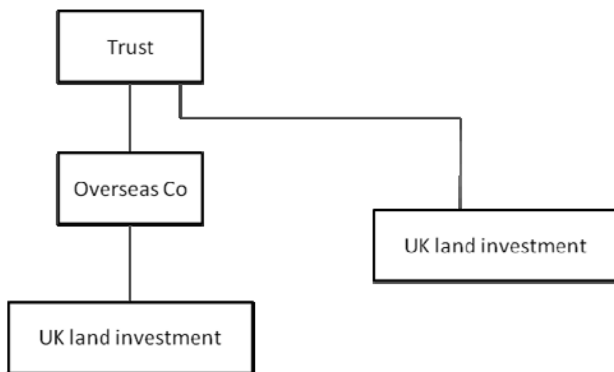
One attractive structure is for the taxpayer who is resident and ordinarily resident but not domiciled in the United Kingdom to set up an overseas settlement, usually with an offshore underlying company, which in turn owns a UK investment property.

When the investment property is sold there is only a tax charge upon the UK resident and ordinary resident but not domiciled beneficiary if the proceeds are made over to him in the form of a capital payment *and the same is remitted to the United Kingdom*.

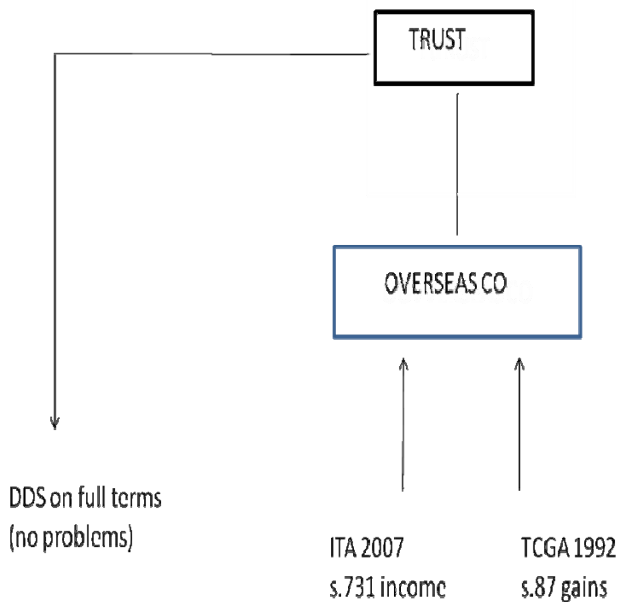
Settlor Excluded Settlement

It will be noted that another new golden structure under the new legislation is if there is a settlement under which the settlor and the spouse of the settlor (who are not domiciled in the United Kingdom) are excluded from all benefit, and this overseas settlement or an overseas company owned by such an overseas settlement makes capital gains and receives income, whether in the United Kingdom or outside the United Kingdom. There can only be a tax charge in this case on the beneficiaries to the extent that they receive benefits, but there can be no charge if what is made over to the beneficiaries, even in the United Kingdom, is on full commercial terms. Thus the issue of a deeply discounted security (DDS) on full commercial terms by a beneficiary avoids all income or capital gains tax charges.

Property Holdings – Golden Structure Under the New Regime



Settlor (Non-UK Domiciled) Excluded Settlement – Golden Structure Under the New Regime



THE TAX TREATMENT OF TERMINATON PAYMENTS: A SHORT REVIEW

by Michael Thomas

In the present economic climate the tax treatment of termination payments is a timely topic. This is also an area where HMRC is frequently known to attack clients' self-assessments. Accordingly, it is also something to watch out for during the due diligence exercise on a company acquisition. This article aims to address the fundamental themes. It does not purport to state the relevant law fully, which the textbooks do very well. When advising in this area, the details, such as the NICs position, should not be overlooked.

The issue is typically whether the termination payment is taxable as earnings or only under s.401 ITEPA (formerly s.148 ICTA). If the latter tax treatment applies, the first £30,000 is exempt, and the payment is not subject to Class 1 NIC. The tax at stake in any one case is therefore very limited. Whilst in absolute terms this is a good thing, it does mean that the employer will not want to devote significant resources to fighting HMRC. The result is that correspondence tends to be dealt with piecemeal, whereas a more comprehensive response at an early stage generally tends to be a better strategy. In consequence, HMRC is likely to become firmly entrenched in its own position, and stalemate is the probable result – with the employer then faced with the unattractive choice of having to pay HMRC to settle or the lawyers to fight, the costs of which will be irrecoverable should it succeed before the Tribunal. It is worth taking extra care at the outset to ensure that the chances of a future dispute are minimised. In short, the

advice is simple: terminate the employment first and agree the financial settlement afterwards.

To explain why this is the best approach it is necessary to review the relevant law. There are essentially three main kinds of payment that might make up a termination award. The first kind is a redundancy payment, which is a payment to reduce hardship. Such payments are not fixed by reference to earnings. HMRC will not normally challenge the status of an enhanced redundancy payment provided that it is computed by reference to the statutory formula. Accordingly, redundancy payments do not need to be discussed further here. The key distinction is between the second and third kinds of payment – earnings and damages for breach of contract.

The test is essentially a legal one: is the payment made under the contract, and therefore earnings, or is it damages paid in compensation for a breach of the contract, in which case it is not earnings? However, commercially and economically these two kinds of payments can appear quite similar, hence the scope for dispute in this area. Nevertheless, when cases have come to court the distinction between earnings and damages has become apparent.

Starting with what is earnings, any right to a payment under the employment contract is an inducement to work and therefore earnings. A right to be paid for working a notice period is clearly earnings. Similarly, if the contract gives the employee the right to receive a *payment in lieu of* (working the) *notice* (period) (a "PILON") then that is earnings, even if it is paid on termination. It does not matter that the right to be paid is

dependent upon an exercise of discretion by the employer, because payment is made under the contract rather than as compensation for its breach. Discretionary PILON payments are therefore taxable as earnings. The chief authorities in this area are *EMI v. Coldicott* [1999] STC 803 CA and *Richardson v. Delaney* [2001] STC 1328. In *EMI* a discretionary PILON was held to be taxable as earnings. In *Richardson* a payment agreed in lieu of notice which brought the contract to an end by mutual consent was taxable as earnings. It was central to Lloyd J's reasoning that there was no breach of contract (see e.g. at p.1342g-j). More recently, in *SCA Packaging Ltd v. HMCE* [2007] EWHC 27 (Ch.) employees who had the benefit of notice periods in their contracts were made redundant. A memorandum agreed by the employees' trade union, which was supplemental to their employment contracts, gave the employees the right to be paid in lieu of notice in the event that their employments were terminated. The relevant employees were made redundant and agreed to the PILONs being made. Lightman J quite correctly decided that these payments were earnings because "[t]he payments were made under and pursuant to the provisions in their contracts of employment." The source of the payments was the employment contract itself rather than any right to damages.

On the other side of the line, where a contract is terminated in breach, for example because the employer fails to honour a notice period and, if appropriate, does not make a PILON, any settlement of damages is not earnings. Economically, there may not be much difference, because damages will typically be calculated by reference to what would have been earned during the

notice period; although an employer should reduce the damages by reference to the Gourley principle to take account of the non-taxable damages being equal to what would have been earned after tax. It is precisely this commercial similarity which tends to lead to disputes with HMRC.

The key to identifying a payment of damages is to find a breach of contract followed by a resulting negotiation of the award. In theory, the employee is under a duty to mitigate his loss, but in a termination situation, unless the notice period is particularly long, this is unlikely to have a practical impact. Another consequence of a breach of contract is that the employee is no longer bound by, for example, the confidentiality obligations in the employment contract. These will need to be re-instated in a damages award and the employee will normally require a payment to accept them, which is not taxable as earnings on general principles[1]. The authority to cite to HMRC is *Cerebus Software v. Rowley* [2001] IRLR 66, which illustrates that a termination payment following a breach of contract is damages even if the employer had a right to make a PILON which it did not exercise.

Finally, it might be asked what can be done on a practical level to ensure that a termination payment is truly damages. First, the employer should make sure that it breaches the employment contract, most obviously by breaching a notice period and not agreeing to pay any PILON. However, the employer must be happy to lose the benefit of confidentiality and other obligations in the employment contract. Secondly, the employer should not offer any money until the employment has been well and truly terminated so that there is no room for confusion.

Preferably the former employee should claim for compensation and this claim should then be settled. Thirdly, the correspondence should make clear that the claim is one for damages. The employer might, for example, raise the issue of the duty to mitigate. Fourthly, the compensation agreement should be suitably drafted. A time gap will also help so that HMRC cannot argue that negotiations must have taken place in advance of termination, which of course they should not. Finally, employers should beware a blanket policy towards payments because of the risk of HMRC arguing for an implied contractual term that PILONs will be paid. This is not an attractive argument but it should be borne in mind.

In summary, the distinction between damages and earnings is a legal one which depends upon whether there is a breach of contract. In practice, this may not always appear so clear because of the facts, so the message to employers is to avoid creating room for argument by ensuring that the tax treatment of a termination process is managed properly from the outset.

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[1] Although note the potential application of s.225 ITEPA (restrictive covenants).