



# HAARMANN HEMMELRATH

**UK TAX BULLETIN**

**APRIL 2003**

## **MAIN POINTS THIS MONTH**

Current Rates of Inflation and Interest

Wives Shareholdings

IT (Earnings & Pensions) Act 2003

Flip Flops

Employee Benefit Trusts

Distributable Profits

CGT : Hold Over Relief

Pre Sale Reorganisations

Capital Allowances : Football Pitches

Unified Tribunals Service

**A summary of UK tax developments during April 2003**

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**CURRENT RATES****Indexation**

Retail Price Index: March 2003	179.9
Inflation Rate	3.1%

Indexation factor from March 1982:

: to April 1998	1.047
: to March 2003	1.265

**Interest on overdue tax**

Income tax/CGT/NIC	6.5%	from	06.11.01
Inheritance tax	3%	from	06.11.01
VAT	6.5%	from	06.11.01
Corporation tax	6.5%	from	06.11.01
CTSA instalments	4.75%	from	17.02.03

**Repayment Supplement**

Income tax/CGT/NIC	2.5%	from	06.11.01
Inheritance tax	3%	from	06.11.01
VAT	3%	from	06.11.01
CTSA instalments	3.5%	from	17.02.03

**Official Rate of interest**

From 06.01.02 5%

(Frozen for 2003/04)

**Bank Base Rate**

3.75% from 06.02.03

**WIVES SHAREHOLDINGS**

As expected, the Inland Revenue have now published a statement explaining their views about how the settlements legislation in Sections 660A to 660G Taxes Act 1988 apply in a business context.

It may be remembered that the focus was particularly on the position where a husband gives shares in the family company to his non working wife enabling her to receive dividends tax free up to the higher rate threshold. Section 660A provides that where a person makes a settlement (which includes making a gift of property) any income arising from that property will be taxed on him if the income could become payable to him or his spouse. Section 660A(6) provides a special exemption to exclude from these provisions an outright gift by one spouse to another unless the property given is wholly or substantially a right to income.

The sensitivity surrounds the suggestion that where ordinary shares in the company are given by the husband to his wife (particularly in a company where he does most of the substantive work), this represents a gift that is wholly or substantially a right to income. In that case the dividends paid to the wife would remain taxable on the husband.

Whilst this approach is fair enough in the case of preference shares, it cannot sensibly be applied to ordinary shares. Such shares are not wholly or substantially a right to income. Ordinary shares represent a bundle of rights, including the right to capital and the right to income is not the most important.

In their new statement the Inland Revenue explain their position in broad terms and give fifteen examples dealing with various different situations. Most of these examples are entirely unobjectionable covering various ways in which income can be transferred gratuitously from one person to another. However, example 4 is a little different. In this example an IT consultant operating through a company gives 50% of

his shares to his wife who is company secretary. She receives a small salary and the substantial dividends are divided equally between them. In these circumstances the Inland Revenue consider that the gift of the ordinary shares is wholly or substantially a right to income "since the capital value of the company is insignificant". Whatever other arguments there may be available to the Inland Revenue this one must surely be wrong.

Example 4 can be contrasted with example 10 where a husband gives a small shareholding in a public company to his wife who then receives all the dividends. The Inland Revenue acknowledge that this is an outright gift of shares which is not wholly or substantially a right to income because the shares "have a capital value and can be traded, so the settlements legislation does not apply".

Example 11 provides a different take on the situation. In this case the husband owns all the shares in a small manufacturing company and gives half the shares to his wife who plays no part in the business. They receive dividends on the shares equally. The Inland Revenue accept that in these circumstances the shares cannot be regarded as wholly or substantially a right to income. The reasoning is that the shares have capital rights and the company has substantial assets so on the winding up or the sale of the business the shares would have more than in substantial value.

It seems that the Inland Revenue are taking the simple view that unless the company has a value independent of the work provided by the husband, the shares should be regarded as wholly or substantially a right to income. This is an extraordinary approach. A company which makes profits and pays significant dividends is clearly valuable, but for some reason that does not count. Maybe they think that the company would not be so valuable if the husband no longer provided his services. That would be the case with many companies; if they lose their key employee or employees the profits evaporate. So why should it matter if the husband (who will normally be bound to the company by an exclusive contract) is the person whose efforts provide the profits.

This may be relevant to an argument about *bounty* but it is not relevant to whether or not the shares are wholly or substantially a right to income

In any event this is much too simple an approach. A holding of ordinary shares is not wholly or substantially a right to income whatever the nature of the company. It is a bundle of equity rights which includes the capital value on a winding up or sale. Why should a one man band not be extremely valuable; the Inland Revenue certainly argue that it is when shares in such a company are transferred to the next generation, for example for inheritance tax or capital gains tax purposes.

It is also appropriate to remember that we are looking at whether the shares which represent wholly or substantially a *right* to income. The holder of a 50% or less of the shares in a company does not have a lot of rights to receive income; dividends are either paid by the directors or declared by the shareholders in general meeting. A shareholder without control has rather limited rights in trying to obtain income. If she is married to the other shareholder this may make it easier, but this is to introduce a much too subjective test. The question whether shares are wholly or substantially a right to income should not depend upon the holder and the identity or configuration of the other shareholders. It should be a matter which is capable of being determined objectively.

I think the Inland Revenue are going to have some serious difficulties with this argument now that they have articulated it publicly. However, for those wanting an easier life, there is always the possibility of avoiding the problem completely by use of Section 282A TA 1988 as explained in the February bulletin.

### **INCOME TAX (EARNINGS AND PENSIONS) ACT 2003**

This Act came into force on 6 March 2003 and took effect on 6 April 2003. In case you missed it, the new Act completely replaces Schedule E and all the related provisions concerning benefits, expenses, share option, pension etc. A whole new language

has been introduced. We now have "employment income" "general earnings" and "specific employment income" and a whole host of different definitions. This is not going to be easy and the new Act is huge, running to 725 sections and 8 schedules. There are some explanatory notes but they are even bigger running to 671 pages. I dare say that we will get to grips with it before long.

However, it may take longer than usual to make sense of it all because this is a product of the Tax Law Rewrite Team expressed in new easy to understand legislation.

### **FLIP FLOPS**

The recent changes in the capital gains tax rules relating to offshore trusts have highlighted the importance of the recent case of *West v Trennery* [2003] STC 580 which concerned the operation of a flip flop arrangement with a UK trust.

In very broad terms the position was that valuable shares in a UK resident trust were to be sold at a substantial capital gain. The trustees borrowed some money and appointed the cash to a second settlement with the same beneficiaries. The settlor and his spouse were then excluded from any benefit under the first settlement.

The idea was that when the shares in the first settlement were sold, the gain could not be attributed to the settlor because he did not have an interest under the settlement and the transparency rules in section 77 TCGA 1992 could not apply. The gain was therefore charged at a much lower rate of tax and the proceeds were used to repay the borrowings. The settlor received benefits out of the second trust in which he did have an interest, but that trust had realised no gains to be attributed to him.

The Inland Revenue assessed the settlor on the basis that the funds in the second settlement were "derived property" within the meaning of section 77. Their reasoning was that the settlor continued to have an interest in the first settlement because he enjoyed a benefit deriving directly or indirectly from property comprised in the

settlement or any derived property.

The meaning of derived property is:

"income from that property or any other property directly or indirectly representing proceeds of, or of income from, that property or income therefrom".

Accordingly the settlors benefit from the second trust should be taxed as if it had been from the first trust.

The Special Commissioners did not think much of this argument. They said that the definition of derived property is to catch the possibility of the settlor benefiting from the income or proceeds of sale of the property comprised in the settlement - not from property outside the settlement. Unfortunately however the High Court has taken a completely different view - that the section intended that there would be property outside the settlement which could be caught.

It will be interesting to see what the Court of Appeal make of these arguments. Many will feel that this interpretation of "derived property" is unreasonably wide; alternatively that the money enjoyed by the tax payer did not derive from the shares at all. Indeed, if derived property can have such a wide meaning, it would seem to make a good part of the capital gains tax code relating to settlements completely redundant.

This decision being concerned with a UK resident trust is not of direct importance in connection with offshore trusts to which the concept of derived property has no application. (The flip flop arrangements made in connection with offshore trusts are subject to completely difference legislation. However, it may be that the Inland Revenue will feel emboldened to apply the same reasoning to the meaning of "property originating from the settlor" or the purposes of the comparable provisions in section 86 for the taxation of offshore trusts.

### **EMPLOYEE BENEFIT TRUSTS**

It may be remembered that shortly before the pre budget report last November the decision in *Dextra Accessories Limited*

provided substantial encouragement to employee benefit trusts. The Special Commissioners decided that a tax deduction was available for contributions to the trust notwithstanding that the benefits received by the employees may not be taxable in their hands.

The High Court have upheld this decision although unfortunately this is of only historic interest having regard to the changes included in Section 142 and schedule 24 of the Finance Bill which deny relief for deductions for periods ending on or after 27 November 2002 unless the employee is taxed on qualifying benefits within 9 months of the end of the accounting period.

### **DISTRIBUTABLE PROFITS**

Section 263 Companies Act 1985 provides that a company shall not make a distribution except out of profits available for the purpose. There are its accumulated realised profits less its accumulated realised losses. Realised profits and losses are those found from the application of generally accepted accounting principles.

It is with this background that the Institute of Chartered Accountants have issued a technical release (TECH 7/03) providing guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 1985.

It goes on at great length (too long for inclusion here) about what may be regarded as a realised profit or loss, although it is difficult to discern anything new or unexpected.

One aspect of possible interest relates to the decision making process. A company cannot make a distribution out of capital so the directors must consider, both at the time of proposing the distribution, and the time it is made, whether the company has adequate distributable profits. For tax purpose they must consider the "relevant accounts" to see whether the company has incurred losses which may have eroded its profits. For private companies this means such accounts as are necessary to enable a reasonable judgment to be made and are

inclusive in the last accounts, interim accounts or management accounts. (I am bound to say, I do not find this explanation assists very much - particularly as they go on to say that it may not be enough to examine these accounts anyway and further enquiries may need to be made).

A copy of the Technical Release is available on request.

### **CGT : HOLDOVER RELIEF**

The definitions of trading company and holding company for the purposes of hold over relief under section 165 TCGA 1992 have been changed.

Until 5 April 2003 the definitions were those used for retirement relief but with the complete abolition of retirement relief this is no longer appropriate. The definitions which apply for taper relief will now apply to hold over relief with effect from 6 April 2003.

Accordingly, it is not longer enough for the company to be wholly or mainly carrying on trade; it is necessary for the company to carry on trading activities and not to carry on non trading activities to a substantial extent. It will be remembered that this means not breaching the 20% test of assets, turnover or capital employed.

### **PRE SALE REORGANISATIONS**

The Inland Revenue's recent clarification of the rules relating to the substantial shareholdings exemption can cause difficulty for those who thought that a sale of a valuable subsidiary could be undertaken free of tax.

By way of example there may be a group of three companies - a holding company H Limited with a trading subsidiary T Limited and an investment subsidiary I Limited. If T is sold they might feel confident of obtaining the exemption. T is a trading company; it has been held for more than 12 months and the group as a whole qualifies as a trading group.

However, there is one condition which is not satisfied and that is the requirement for the vendor to be a trading company or member

of a trading group *immediately after* the sale. Accordingly, unless the proceeds of sale of T are reinvested in another trading venture within a reasonable time to preserve the group's trading status, this condition will not be satisfied and the exemption will not be available. The gain, instead of being tax free will be charged to tax at 30%. It would have been so much better if the individual shareholders could have made the gain as they would probably have paid tax at only 10% assuming full business asset taper relief applies.

However, if this difficulty is appreciated only at the time when a sale is contemplated, it is a little late to do anything about it - at least not without unbelievable complications. In addition, most reorganisations are subject to a bona fide commercial test and it is very difficult to deny that one of the main reasons for the reorganisation would be to enable the shareholders to dispose of their shares with the benefit of taper relief.

If this situation can be foreseen it would be possible to reorganise the shares perhaps by way of demerger under section 213 TA 1988 or perhaps by an insolvency scheme under section 110 Insolvency Act 1986 so that the shares can be in the appropriate hands long before any disposal is contemplated.

### **CAPITAL ALLOWANCES**

The courts have again had to consider the question of what constitutes plant and machinery for capital allowances, this time in respect of a synthetic football pitch. These cases can be very interesting as they explain how various facilities are created. (I particularly remember the case of Decaux in connection with superloos and Family Golf centres Ltd in 1998 which dealt with the construction of greens).

The recent case Anchor International Ltd v IRC SpC 354 set out all the details relating to excavation, infilling, drilling, geotextile material and sand filled synthetic grass to provide a carpet suitable for playing football. About 30kg of sand was put on each metre of carpet to keep the tufts upright and to anchor it to the base. The carpet would last between 5 and 9 years whereupon it could

be rolled up or cut into strips and possibly used elsewhere.

The Inland Revenue argued that the carpet and the underlying works was a single structure representing the premises at which the company carried on its business, rather than plant with which the trade was carried on. Having regard to Family Golf Centres Ltd, they looked to be on good ground, but the Special Commissioner thought otherwise.

He decided that the carpet could be separated from the underlying works because it could be rolled up and moved. It was not a structure on its own. It may well have been the setting on which the trade was carried on but it was also plant with which the trade was carried on. It was the means by which the company generated profits, not merely the setting, and it therefore qualified for capital allowances.

### **UNIFIED TRIBUNALS SERVICE**

Is it just me or did your heart sink when you read Lord Irvine's announcement about the Unified Tribunal Service.

He said that the Unified Tribunal Service will have at its core the top ten non devolved tribunals and will increase accessibility to tribunals, raise customer service standards and improve administration.

These tribunals bring together the General and Special Commissioners with such natural bedfellows as:

- the Mental Health Review Tribunal
- Special Education Needs and Disability Tribunal
- the Employment Tribunal Service.

Apparently this is seen as "a major step forward, underpinning tribunals independence and paving the way for further improvements". Oh dear!

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**30 April 2003**

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