


UK ADVISERS

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UK TAX BULLETIN

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CURRENT RATES**Indexation**

Retail Price Index: January 2003	178.4
Inflation Rate	2.9%

Indexation factor from March 1982:

: to April 1998	1.047
: to January 2003	1.246

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

PURCHASE OF OWN SHARES

Last September I made some rather intemperate comments regarding the case of Strand Options and Futures Limited v Vojak SpC 328. This was an extremely important decision concerning the position of a corporate shareholder where a company purchases its own shares in circumstances where the receipt is treated as a distribution under Section 219 Taxes Act 1988. It is well known that Section 208 provides that corporation tax is not chargeable on distributions from a company resident in the UK. The company not surprisingly said that the amount received was not chargeable to tax. It was an income distribution and could not be charged to tax as a capital gain.

However, the Inland Revenue have for many years taken the view that such a distribution could be included as part of the disposal consideration for capital gains tax purposes. They issued a statement of practice to this effect in 1989. In their view, Section 208 has nothing to do with capital gains and merely excludes the distribution from a charge to tax as income. It does not exempt the distribution from tax as a capital gain. Although Section 37 TA 1988 excludes from the computation of a capital gain amounts actually taxed as income, the receipt was not taxed as income and therefore there was nothing to prevent it being charged as a capital gain.

It has taken a long time for this view to be challenged possibly because if you challenge a Statement of Practice you will be on a crusade. Unfortunately the Special Commissioners agreed with the Inland Revenue.

However the High Court have taken a different view. The Court said that on its true construction Section 208 exempted from corporation tax all distributions of a company whether as income or as giving rise to a capital gain. The language of Section 208 and its historical derivation outweighed all Inland Revenue arguments to the contrary.

This welcome news is tinged with some uncertainty because the decision in the High Court was that of *Etherton J* whose reasoning in the case of *Grimm v Newman* was spectacularly awry giving rise to untold professional anxiety until his decision was reversed by the Court of Appeal.

WIVES SHAREHOLDINGS

Section 660A Taxes Act 1988 provides that where a person makes a settlement (which includes making a gift of property), any income arising from the property will be taxed on him if the income could become payable to him or his spouse. A special exemption is provided by sub section 6 to exclude from these provisions an outright gift by one spouse to the other unless the property given is wholly or substantially a right to income.

Reports are circulating that the Inland Revenue are now starting to argue that where ordinary shares in a family company are given by one spouse to another (particularly in a company where the donor does most of the substantive work) this represents a gift which is wholly or substantially a right to income.

They might take some encouragement from the case of *Young v. Pearce* [1996] STC 743 which supported this view in connection with preference shares. That seems fair enough. Where the shares carry a fixed preference dividend but have no votes and no entitlement to a surplus in a winding up it is easy to see that they could represent wholly or substantially a right to income; they certainly have no other significant rights.

However, ordinary shares are quite different. Of course they carry the right to the income but they carry all the equity rights as well. It is not enough to say that there may be not much prospect of long term growth and the donee has no particular wish to exercise the votes on his minority holding. The test is not what the donor or the donee wants or his motives; the test is whether the property itself is wholly or substantially a right to income. Ordinary shares which rank *pari passu* with the other ordinary shares cannot be said to be wholly

or substantially a right to income. The shares represent a bundle of rights and the right to income is not the most important.

It will be interesting to see what happens with this argument – indeed, whether it even sees the light of day.

None of this applies to companies within the IR 35 personal service company legislation because in those cases most of the profits (and in many cases more than the profits) have to be paid out by way of salary to the relevant worker leaving no opportunity of paying dividends to the shareholders.

Anybody concerned about this argument can always achieve the same objective in a different way. He could transfer the shares in the company into joint names on terms that the shares are held beneficially 99% for the husband and 1% for the wife. Providing no election is made under Section 282B TA 1988, the dividends on the shares will be assessed on the spouses equally despite their disparate beneficial interests, without any implications arising under Section 660A.

COMPENSATION : TAX CREDITS

The recent decision in *Pirelli Cable Holding NV v CIR* [2003] STC 250 was concerned with the fall out from the *Metallgesellschaft* case in 2001 which decided that UK companies who had paid Advance Corporation Tax on dividends to their parent companies in the EU were entitled to compensation. ACT did not have to be paid on dividends to parent companies resident in the UK but the Inland Revenue had insisted it did have to be paid in respect of dividends to a parent resident elsewhere in the EU.

It may not sound much of a big deal because the ACT was recoverable against the company's mainstream corporation tax liability. However the figures were very large and being out of the money for a significant period was important. It is this cash flow disadvantage which was the subject of the compensation.

However, when *Pirelli* made their claim for compensation the Inland Revenue refused

it. They said that the holding company in Metallgesellschaft was in Germany but in Pirelli the holding company was in Italy which did not have an identical double tax treaty with the UK. Under the Italian treaty the Inland Revenue had repaid some tax credits to the Italian parent and they claimed that this should reduce or extinguish their claim for compensation. The High Court said that this was irrelevant and that compensation was payable in full.

GROUP LOSSES : EU SUBSIDIARIES

Marks & Spencer recently became involved in an argument with the Inland Revenue over group loss relief. The issue was comparatively simple and having regard to recent ECJ decisions one would have thought they had a cast iron case.

Marks & Spencer established a number of subsidiaries in Belgium, France and Germany. These companies were not resident in the UK and traded only in their respective states. They made substantial losses and the parent company claimed group relief against their profits in the UK. The Inland Revenue refused the claims because the companies were not UK resident as required by Section 413(5) Taxes Act 1988 (this requirement was repealed in 2000, but it was important at the time).

Marks & Spencer said that denying loss relief on the grounds of non residence was a breach of Article 43 EC which guaranteed freedom of establishment. However, to everybody's surprise, the Special Commissioners decided that it was not. They made a comparison between a UK company establishing a branch in France, Belgium or Germany compared with operating through a subsidiary. With a branch, the losses would be relievable but with a subsidiary they were not. Accordingly, they could have arranged matters so that they obtained the losses but they simply chose the wrong method of exercising their freedom of establishment.

However, this can surely only be right if you regard operations through a branch as the same as operating through a subsidiary. One obvious distinction is that if the branch

made a profit, it could simply be repatriated to the UK without any tax implications whereas a subsidiary making a profit would repatriate the profits by way of dividend which would be taxable on the UK parent. This results in the absurdity that the subsidiary that makes a profit pays tax in the foreign country on the profits and then in the UK on the dividend whereas if the subsidiary makes losses no relief is due anytime.

Having regard to the decision in Hoechst, ICI v Colmer, and AMID, the Special Commissioners reasoning is very difficult to follow. There seems certain to be an appeal.

SELF ASSESSMENT PENALTIES

The Inland Revenue have announced that they will be taking a much tougher line in seeking penalties for those who do not submit their tax returns on time.

It is revealed by the Tax Faculty that the Inland Revenue will be seeking daily penalties (these are penalties awarded by the Commissioners of up to £60 per day) generally where there are two tax returns outstanding or where large amounts of tax are at risk. The procedure seems to be that a warning letter will be issued and a Commissioners Hearing scheduled at least 30 days later and if the default is not remedied the maximum penalty will be sought.

This ought not to give rise to a serious problem because having received the warning notice, there will be significantly more than one month to bring all the returns up to date. Providing the returns are submitted before the Commissioners hearing there can be no penalty. However, it would be a mistake to think that the taxpayer can turn up at the hearing and plead special reasons before the Commissioners; the taxpayer has no right of appearance at such a hearing.

CGT : DATE OF DISPOSAL

Jerome v Kelly is driving me mad in my quest to understand Section 28 Taxation of Chargeable Gains Act 1992 which sets out

the statutory test for the time of disposal and acquisition for capital gains tax purposes as follows:

"Where an asset is disposed of and acquired under a contract the time at which the disposal and acquisition is made is the time the contract is made (and not, if different, the time at which the asset is conveyed or transferred)".

In *Jerome v Kelly* the High Court analysed these words to death. The issue needing to be resolved was what happens if A sells an asset to B for £1000 with completion in year 3 and then sells the same asset to C for £800 (subject to the existing contract with B) with immediate completion. When the A-B contract is completed C transfers the asset to B. In these circumstances who makes a disposal and where do the gains fall?

The High Court had some very complicated things to say on the subject but as the decision has been reversed by the Court of Appeal it might be better to gloss over them. The Court of Appeal took a much simpler view. In accordance with Section 28 the disposal of the asset for capital gains tax purposes took place when the contractual obligation was created, not when it was performed. In the above example, the contractual obligation on A to complete the contract to B was A's obligation; it was therefore his disposal and he made the gain.

It seems to me that an even simpler approach is to regard the asset sold by A to B as a different asset from the asset sold from A to C remembering of course that a disposal does not actually take place until the contract is completed. So A sells an asset to B for £1000 completion to take place in year 3, and assuming the contract is completed this is a disposal in year 1 by A for £1000.

In year 2 A sells rights in the asset to C for £800 with immediate completion subject to the existing contract with B. A acquired those rights for £1000 under the A to B contract and therefore makes a loss of £200. The timing of the gain and loss is unfortunate because he cannot carry the loss back but that is too bad.

In year 3 the A to B contract is completed and C transfers the asset to B and receives £1000.

C paid A £800 for the rights and receives £1000 from B making a profit of £200 on which he pays the tax.

I may be over simplifying the analysis but it seems to me that this makes sense of the terms of Section 28 without creating the huge anomalies which arose as a result of the High Court judgment.

FINANCE LEASING

It maybe remembered from the July 2002 Bulletin that *Barclays Mercantile Business Finance Limited v Mawson* was an extremely worrying decision by the High Court on the subject of finance leasing.

Barclays purchased a gas pipeline from a foreign company and leased it back to a UK subsidiary. Security arrangements were put in place whereby the whole of the purchase price for the plant and machinery was deposited in the Channel Islands and the vendor was unable to get his hands on the money. Capital allowances were claimed on the basis that Barclays had incurred expenditure on the provision of plant and machinery.

The Inland Revenue rejected the claim on the grounds that the arrangements were all financial engineering and the purpose of the expenditure was not to acquire plant and machinery but to generate capital allowances. The High Court agreed and said that although it may come as a shock to tax advisors, this was not a trading transaction at all because the sharing of fiscal benefits in this way was not normal in finance leasing transactions.

This caused serious anxiety in the leasing industry but fortunately the Court of Appeal has come to the rescue. They said that this was a normal finance lease; Barclays were merely trying to obtain a commercial margin on the purchase of plant and machinery and it was not important that they had the additional object of obtaining capital allowances. There was nothing objectionable about a trader incurring

expenditure on an asset which he did not use himself but would lease to a third party and pass on the benefit of the capital allowances in the form of lower rentals. The possible application of *Ramsay* and *McNiven* were considered but the Court of Appeal found no scope for their application as there was no inserted step with no commercial purpose.

We may not have heard the last of this one either.

WORKING IN THE UK

Employees who are not resident or not ordinarily resident in the UK are chargeable to income tax under Case II or Schedule E on the earnings in respect of duties performed in the UK. The Inland Revenue has recently published their views on how the earnings are attributed between the UK duties and the overseas duties.

The normal method of attribution is time apportionment on the basis of days rather than hours, subject to any contractual variation; the authority for this derives from *Platten v. Brown* 59 TC 408.

Accordingly the revised Inland Revenue practice is to say that where earnings are specifically attributed to UK duties or overseas duties (eg. a bonus paid solely in recognition of the employees work abroad), it will not be treated as part of the earnings to be attributed on a time basis.

It is also necessary to consider the position where work is done at weekends or other non-business days. The test to be adopted will be whether the day has been spent substantially performing the duties of the employment (so it would seem that working for three hours on Saturday and three hours on Sunday would mean that neither day would be counted whereas working for six hours on one of the days would create an extra work day).

It is interesting that in all their explanations the Inland Revenue do not even acknowledge the possibility that rates of pay in the overseas workplace may be higher, or that the days of work in some places may be more than usually long or onerous.

These factors would give grounds for suggesting that although the attribution of duties to UK or overseas locations should be done on the basis of days and by reference to where the duties have in fact been performed, the amount of the earnings attribute to each of those days could well be different.

TURKISH LIRA LOANS

The recent publicity given to beneficial loans in a soft currency such as Turkish Lira has brought counteractive measures from the Inland Revenue.

The idea was great. You lend an employee the equivalent of £100,000 in Turkish Lira which he immediately converts into sterling. In due course when it comes to be repaid (in Turkish Lira) the same amount is worth much less in sterling – say £60,000. This gives the employee a profit but it is not taxable in his hands and the employer makes an allowable exchange loss. The employee would be liable to tax on the beneficial loan at the official rate for the period, but that is a small price to pay for the substantial benefit derived.

This is coming to an end. For accounting periods beginning after 1 October 2002 the exchange loss will be denied by the changes to the unallowable purpose provisions in Schedule 9(13) Finance Act 1996 and this will make the provision of such loans unattractive.

It is ironic that these changes should be made just when the decline in the Turkish Lira may be coming to an end, but no doubt there are plenty of other currencies where an exchange loss could have been assured.

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