HAARMANN HEMMELRATH

UK TAX BULLETIN

June 2005

Main Points this Month

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EU Savings Directive

The EU Savings Directive comes into force on 1 July and individuals with accounts in other EU territories will need to provide full details of the account holder or suffer tax deduction at source. However, in these days of super regulation the effect of the directive extends far beyond the EU and a number of countries outside the EU will be adopting similar rules.

The Inland Revenue have issued their own guidance on the matter explaining that these changes will have no impact on anyone who properly declares all their income. They say that in future the Inland Revenue will receive information about savings income received from abroad and this will be compared with what the UK taxpayer tells the Inland Revenue.

There has been considerable uncertainty about the position of individuals who are resident but not domiciled in the UK. Such an individual is only liable to UK tax on savings income from abroad if it is remitted to the UK. The Inland Revenue new guidance attempts to clarify the position by saying the following:

"The directive makes no mention of domicile or remittance. If you are resident in the UK and you receive savings income from the territory covered by the directive (or a related agreement) then details of the payment should be reported to the UK or it should be subject to withholding tax. You may apply for a certificate from HMRC for the income to be paid gross. Alternatively if tax is withheld you may claim credit for the tax on your self assessment return".

It is difficult to see how the guidance can be correct. If a UK resident but foreign domiciled

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Current Rates

Indexation

Retail Price Index: May 2005	192.0
Inflation Rate:	2.9%

Indexation factor from March 1982:

: to April 1998	1.047
: to March 2005	1.417

Interest on overdue tax

Income tax/CGT/NIC	7.5%	from	06.09.04
Inheritance tax	4%	from	06.09.04
VAT	7.5%	from	06.09.04
Corporation tax	7.5%	from	06.09.04
CTSA instalments	5.75%	from	16.08.04

Repayment Supplement

Income tax/CGT/NIC	3.5%	from	06.09.04
Inheritance tax	4%	from	06.09.04
VAT	4%	from	06.09.04
Corporation Tax	4%	from	16.09.04
CTSA instalments	4.5%	from	16.08.04

Official Rate of Interest

From	06.01.02	5%

Bank Base Rate

From	05.08.04	4.75%

individual has interest credited to a foreign account from which no remittance is made to the UK, no UK tax is payable on that income providing the appropriate claim under section 831 ITTOIA 2005 is made. There is no obligation to report such income to the UK tax authorities - and why should that be relevant to whether a bank in another territory deducts tax providing full disclosure is made to the bank of the details of the account holder.

Indeed there seems to be a growing practice that where foreign domiciled individuals can provide evidence of their domicile status some banks will allow the interest to be paid without deduction of tax. Each bank has its own procedures but a letter from the individual's professional adviser confirming their foreign domiciled status (sometimes with supporting documentation or correspondence) is enough to satisfy them and numerous requests have been received for such letters.

Certainly in the Isle of Man Government Guidance Notes on the subject it is specifically stated that tax retention will not apply to interest payments made to individuals who will not be liable to income tax in the state of residence because the interest is not remitted.

A number of territories (some inside the EU and others such as the BVI, Channel Islands, Isle of Man and Switzerland) will be operating an optional withholding tax of 15% although this can be overcome by the individual authorising the payer to make the appropriate disclosures under the EU Savings Directive; it is anticipated that this optional scheme will extend to other territories not presently within its scope.

Credit Cards

The newspapers report a supposed crack down by the Inland Revenue (I cannot get used to calling it H M Revenue & Customs) to identify concealed funds by investigating the use of credit cards connected to offshore bank accounts.

Obviously if you have a secret bank account abroad, one way of accessing the money is by use of a credit or debit card which might not otherwise come to the Inland Revenue's attention. However, it seems to me that if somebody conceals an offshore bank account they are also likely to conceal the existence of the credit card related to it. Even if there is a tax enquiry and the Inland Revenue ask for copies of all credit card statements, those credit card statements are unlikely to be supplied. It would be fraudulent of course but that is only to be expected because the existence of the concealed account is fraudulent in the first place. It is only where the Inland Revenue will be able to get hold of the credit card statements of the foreign credit card company that they will make any progress.

Given the number of banks, credit cards and debit cards, that would be like searching for a needle in a haystack - and anyway, would the overseas institution provide the information. Where a double taxation agreement exists, the information can no doubt be obtained and the procedures under the EU Savings Directive coming into force on 1 July would also be helpful. However, those who conceal offshore accounts are unlikely to maintain them in the EU or in a treaty country.

The taxpayer (perhaps an unfortunate choice of expression under the circumstances) may be able to avoid detection for a while, but he better make sure his UK lawyers or accountants do not get any sniff of the existence of the foreign account or the foreign credit card. Otherwise a report to NCIS will be made without their knowledge giving the authorities exactly the information they need.

Another area of significance in the context of credit cards relates to foreign domiciled individuals resident in the UK who are subject to the remittance basis on their foreign income. Such individuals may feel that they are in some danger as a result of this initiative but that is certainly not the case - unless they are involved in some impropriety, of course. A question often arises whether the use of the foreign credit card for purchasing goods in the UK can represent a remittance or a constructive remittance of their overseas income if the credit card bill is discharged each month out of foreign income.

The Inland Revenue take the view that the use of the foreign credit card in the UK is equivalent to a remittance just as if the taxpayer had instructed his banker to send a remittance to the supplier. This is widely regarded as incorrect.

It is necessary to analyse the contractual relationships which arise in a credit card transaction. The Inland Revenue's argument is based on the premise that the taxpayer incurs a UK debt which is discharged by the foreign credit card company on his behalf; this would represent a constructive remittance under section 833 ITTOIA 2005 (formerly section 65/6) TA 1988). However, the relationship between the taxpayer and the UK supplier is not one which gives rise to a debt between them; the taxpayer has a contract with the overseas credit card company and so does the UK supplier. Accordingly, the credit card company discharges its own debt to the supplier and the taxpayer discharges his own debt to the overseas credit card company. Discharging this debt from foreign income does not give rise to a remittance because this is not a debt for money lent in the UK; the debt is for money lent to him outside the UK.

Unfortunately, the Inland Revenue do not accept this analysis so the taxpayer wishing to avoid detailed negotiations on this point with the Inland Revenue (even if they were to prove successful) would be well advised to ensure that any credit cards used in the UK are discharged from foreign capital and not income.

A&M Trusts

The precise definition of an accumulation and maintenance trust under section 71 Inheritance Tax Act 1984 is often a matter of considerable concern.

One of the conditions for qualification as an accumulation and maintenance trust is that the beneficiaries will become entitled to the trust capital or an interest in possession in the settled property, on or before reaching the age of 25. In many cases this condition will be satisfied by the automatic operation of section 31 Trustee Act 1925 when each beneficiary reaches the age of 18 unless the trust instrument excludes the operation of section 31 expressly or by implication.

The inclusion of the word "will" in this condition implies a degree of certainty and any power of revocation or the continued existence of a power of accumulation (up to its limits) could prevent the beneficiary becoming entitled to an interest in possession.

The principal authority here is Inglewood v IRC [1983] STC 133 where the trustees had a power of appointment exercisable during the beneficiaries minority. Although the trustees did not exercise the power of appointment, the fact that they could have done so and therefore prevented the beneficiaries coming entitled to interests was

sufficient to take the settled property outside the scope of section 71 IHTA 1984.

However, it is obvious that there can be no absolute certainty because the beneficiary could die before becoming entitled to his interest; a distinction must therefore be drawn between powers exercisable by the trustees which may prevent entitlement arising, and events which might occur outside the power of the trustees. It is only where the beneficiary's interest is able to be defeated by exercise of the trustees powers that this condition will be regarded as breached.

These issues have bubbled up again in the recent case of Crawford Settlement v HMRC SpC 473 which concerned an assignment by a beneficiary of the interest to which he would become entitled on or after attaining the age of 21 to another settlement. The Capital Taxes Office took the view that the assignment caused the settled property no longer to be held on trusts satisfying section 71 so that a charge to tax arose - and they issued a determination accordingly. They did not think the reasoning in Inglewood was particularly relevant because Inglewood was concerned with possibilities rather than actual events and in this settlement it was necessary to consider an actual assignment. However, in this case the assignment was irrelevant to the issue of whether the beneficiary would become entitled to his interest on or before the age of 25. Exactly the same position existed after the assignment. Accordingly, it could not be said that the assignment took the settled property outside section 71 and no charge to tax arose.

It is difficult to see what other conclusion could have been reached and one might wonder why on earth this case was taken in the first place. However, it would seem that there was another event critical to the arguments which was unable to be argued. Some time after the assignment, the trustees exercised their powers to vary the interests in the settled property but the Inland Revenues did not make any reference to this variation in their determination. Their case was based wholly on the effect of the assignment. The Special Commissioner declined to allow the Inland Revenue to vary their determination (on which they might well have succeeded) and this robs the case of any real significance - for the moment. It is clear that there are some interesting issues to be resolved in this area and one wonders what might happen on appeal.

Trading Losses

A fundamental principle of loss relief for both income tax and corporation tax is that where a loss is incurred in a trade, it can be carried forward and set off against the profits of the same trade in the following years. The question which frequently arises is whether the profits in future arise from the same trade as that which incurred the losses in earlier years. This was the issue in the recent case of Netlogic Consulting Limited v HMRC SpC 477. There are some additional provisions dealing with the situation where in a period of 3 years there is both a change in the ownership of a company and a major change in the nature or conduct of the trade. In these circumstances section 768 Taxes Act 1988 provides for a disallowance of losses to avoid the buying and selling of tax loss companies. However, this is not in issue here.

In Netlogic, the company manufactured designed and traded in computers and significant losses arose. In due course, the company carried on the business of computer consultancy and the provision of management services which made significant profits against which they sought to use the losses from earlier years.

A delicate balance arises here. The Inland Revenue claimed that the company's losses had arisen from the manufacturing and trading of goods whereas the profits had arisen from a subsequent activity being the provision of IT consultancy services.

The company claimed that the Inland Revenue's view was much too narrow and that IT consultancy includes the provision of everything in the nature of services and goods to fulfil the customer's requirements for IT systems. Sometimes they want goods, sometimes they want services and although the activities might have been different in nature at different times, it was all a single trade. He classified the trade as "IT Consultancy" but that was only a description and it was necessary to identify whether the loss

making activities were the same trade as the profit making activities, however they may be described.

The Special Commissioners referred to an organic unity about a trade and found that the two activities were not part of a single whole; there was a trade in dealing in computers and which gave rise to losses but this ceased and new trade of providing IT consultancy services commenced. Accordingly, the losses were not available for relief.

Whilst the logic of this decision is clear and easily understood, whether or not a number of different activities can be lumped together under a single description may be nothing more than the skill of the advocate. I cannot help thinking that if the company had been involved in providing both goods and services throughout its existence, the organic unity of the trade would have encompassed both activities, rather than being dissected into two or more separate trades.

Seperate Trades

By coincidence, a further examination of this issue arose in the case of Electronics Limited SpC 476. This case is noteworthy as it demonstrates the interesting musical chairs which can take place with the Special Commissioners. One of the advocates in this case was Malcolm Gammie QC who comparatively recently sat as a Special Commissioner with Dr Avery Jones in the celebrated Marks & Spencers appeal. In this case however Mr Gammie appears as advocate before Dr Avery Jones.

Although some may take the view that sitting as a judge one day and pleading a case as advocate the next is somehow all wrong, I prefer to think of it as a typically English arrangement relying on the unquestionable integrity of the gentleman involved rather than being concerned about the possibility for impropriety. It is surely a great compliment to our system and those who operate it, that this can occur with the confidence of both the public and the parties.

Anyway back to the tax issue. This related to a terminal loss relief claim and whether an international business operating in the UK through several divisions was carrying on a single trade or a number of different trades. The company was rather keen for each division to be regarded as a separate trade because it could then argue that some of those trades had ceased and terminal loss relief could be carried back against the profits for earlier years. The Inland Revenue took the view that there was a single trade carried on by all six divisions and this clearly eliminated any possibility of a terminal loss relief claim as the single trade did not cease.

Again it was suggested that whether there was one trade or six trades depended upon how they were described. The Special Commissioners regarded all the products of the UK divisions as being related under a "general electronics" heading with most of them being concerned with communication. Although each division operated entirely separately with their own operational management, separate supply chains, premises, budgets, sales and accounting departments, the Special Commissioners regarded these as matters of how the parent company chose to operate, dictated largely by the different customer based on each division (interestingly this was the very point raised by the Inland Revenue in Netlogic referred to above on the basis of Seaman v Tucketts 41 TC 422 that differences in the customer base indicated a separate trade).

The Special Commissioners looked at the global position where all divisions were ultimately managed by the Chief Executive under the same brand and concluded that globally there was one trade; they took the view that the same position existed in the UK and as only one trade existed, no terminal loss relief could be available.

Double Taxation Relief

The Special Commissioners expressed themselves with uncharacteristic boldness in the recent case of UBS AG v HMRC SpC 480 which related to a claim by UBS for relief under section 243 Taxes Act 1988. In broad terms, where dividends are received by a company they are within what used to be known as schedule F and are not chargeable to corporation tax. Where a company has surplus

franked investment income, that is to say more dividend income received than dividends paid to its shareholders, it could claim that the surplus be treated as taxable and eligible for loss relief so that it could receive a repayment of the tax credits attaching to the dividends. Although the rules have changed and this relief is no longer available, it will be apparent that the principles involved here are of extremely wide significance.

UBS AG is a Swiss company with a UK permanent establishment and it claimed that the denial by the Inland Revenue of the relief under section 243 was discriminatory, contrary to the UK/Switzerland double taxable agreement and in particular article 23(2) which states:

"The taxation of a permanent establishment which an enterprise of a contracting estate has in the other contracting state shall not be less favourably levied in that other state than a taxation levied on enterprises of that other state carrying on the same activities".

As the relief was denied by the Inland Revenue on the grounds that the taxpayer was not resident in the UK it is no great surprise that the Special Commissioners concluded that the relief should be allowed; it would clearly be discriminatory for the relief to be denied.

However, that is only half the story. It was then necessary to consider the internal law question of whether the treaty had been incorporated into UK law. Unfortunately, it had not. Section 788 Taxes Act 1988 specifically restricts the scope of the non discrimination article and accordingly the right under the treaty to receive a payment in respect of the tax credit under section 243 was not part of UK law and the company could not therefore succeed in its claim.

The Special Commissioners expressed their dissatisfaction with the position. The treaty gave the company an entitlement to claim repayment on the tax credits but because that entitlement has not been incorporated into UK law the appeal must fail. This means that the UK has made a treaty but has not given effect it in domestic law and is therefore in breach of the treaty under international law. The failure to do so may or may not have been deliberate but the result was clear and the Special Commissioners suggested that Parliament should reconsider section 788.

Pre-owned Assets

We have recently been looking at a number of situations where the pre owned asset legislation in schedule 15 to the Finance Act 2004 is in point. There are a number of strategies which can be adopted to deal with the income tax charges under this legislation, and perhaps one of the most effective is a revertor to settlor trust set up by the person who received the asset, or an interest in the asset, which was given away by a tax payer as part of a tax planning exercise in past years. For example, in the case of Ingram schemes or reversionary lease schemes in respect of property, an interest in the taxpayer's home may well have been passed down to the children, and they could now put the asset back into trust for their parents on terms that it reverts to them on the parents death.

Under the current legislation, this type of trust can be structured to provide full inheritance tax and capital gains tax reliefs, and as a result they are very popular with tax planners. One drawback is that that is no way of avoiding any charge to a capital gain which arises on setting up the trust, as by its very nature it will be a settlor interested trust and there is no longer any holdover in this situation.

Perhaps the main worry with these arrangements is that the Government seems determined to stamp out all but the most benign forms of tax planning, and Ministers seem to have no qualms about attacking schemes which have already been set up by imposing some newly invented tax charge on them. After all, in the Ingram case itself, the House of Lords thought that the scheme carried out by Lady Ingram was perfectly acceptable under the gift with reservation of benefit provisions and it was by no means the case that Lady Ingram should be branded as a tax avoider. Despite this, in the standing committee debates on the Finance Act 2004 Ms Dawn Primarolo said that "we are concerned specifically with the range of schemes that allow wealthy taxpayers to give their assets away, or achieve the appearance of doing so, and so benefit from the

inheritance tax exemption for lifetime gifts, while in reality retaining continuing enjoyment of an access to those assets, much as before". She later continued "the Government wanted to send a clear message that artificial avoidance of that kind is not acceptable".

Although it seems impossible to reconcile these ministerial remarks with what was said in the House of Lords in the Ingram case, one still has to recognise that the Government has not simply moved the goalposts with regard to tax planning; it has transported the whole pitch into a completely different realm. It is no longer necessarily the case that arrangements which can be validly set up today will remain unscathed under new legislation introduced in the future.

Of course, there will be some who readily accept the capital gains tax charge on setting up a revertor to settlor trust as the price to be paid for the future tax reliefs which the trust will provide, as well as escape from the pre owned asset legislation. One can only hope that this will be sufficient to persuade Ministers that existing revertor to settlor trusts should keep their tax benefits, but I would not like to bet too much money on it. There must be some danger that schedule 15 will be amended to target these trusts. Even so, they carry other tax benefits and I doubt whether the Government would find it necessary to make general changes to the statutory regime for them.

Malcolm Gunn

Societas Europa

A Societas Europaea is the new European company which was created by council regulation (EC) 2157/2001.

The Finance Bill presently before Parliament now includes a provision to prevent any balancing charges under the Capital Allowances Act as a result of the merger of two or more companies where not all the merging companies are resident in the same member state.

Tax is not explicitly covered by the regulations so the tax law of each member state applies to these new entities. The changes introduced by the Finance Bill are intended to give certainty regarding the tax treatment of transactions involving European companies, particularly mergers and will enable UK businesses to take advantage of the new corporate vehicle without tax penalties. No balancing charges will arise as a result of a merger to the extent that the assets involved remain within the scope of UK tax.

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