



Main Points this Month

A summary of UK tax developments during July 2005

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Employee Benefit Trusts

The case of *MacDonald v Dextra Accessories Limited* [2005] UK HL 47 has now reached the House of Lords who have found conclusively in favour of the Revenue. The issue was whether payments to an employee benefit trust and properly shown as a deduction in the accounts of the company were allowable for corporation tax purposes. This follows the general, and now statutory rule contained in section 25 Income Tax (Trading and Other Income) Act 2005, that profits for tax purposes are found from the application of generally accepted accounting principles - subject to any adjustments required or authorised by law in calculating profits for income tax purposes. One of those adjustment required by law was section 43 Finance Act 1989 (which now in reworded fashion can be found in section 36 ITTOIA 2005) which denies a deduction for remuneration in an

accounting period if the remuneration is paid more than 9 months after the end of the accounting period. This restriction also applies to "potential emoluments" which are "amounts or benefits reserved in the accounts of an employer, or held by an intermediary, with a view to their becoming relevant emoluments".

The essential question in the *Dextra* appeal was whether the monies held by the employee benefit trust (clearly an intermediary for this purpose) were held "with a view to their becoming relevant emoluments". There was no certainty that the funds would be used to pay emoluments and the terms on which the money was held indicated that the company had other purposes in making the payments.

However, the House of Lords unanimously concluded that the funds in the employee benefit trusts were held with a view to becoming

Current Rates

Indexation

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

Indexation factor from March 1982:

: to April 1998	1.047
: to June 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%
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Bank Base Rate

From	05.08.04	4.75%
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emoluments because there was at least a realistic possibility that they would be so paid. Accordingly, it is only when the payments were made from the employee benefit trust to the employees (whereupon the amounts become chargeable to tax in their hands) that a tax deduction would be allowed.

Whilst things have moved on in the area of employee benefit trusts it was still perhaps optimistic to expect that substantial (ad fully tax deductible) amounts could be paid to an offshore trust by the company with the amounts being rolled up tax free offshore for an indefinite period.

The House of Lords acknowledged that unless the funds are eventually paid out as emoluments, a corporation tax deduction will never be obtained and there may be a number of reasons why they will not be paid out as emoluments. However, they suggested that this aspect had not troubled Parliament at the time and anyway it was a consequence of an arrangement into which the taxpayers had chosen to enter.

The decision has a serious sting in its tail for close companies which have entered into such arrangements. Normally payments to an employee trust will not represent a transfer of value for inheritance tax purposes because of section 12 IHTA 1984. This provides that a disposition is not a transfer of value if it is tax deductible. Accordingly where a payment to an EBT is not tax deductible (as

in this case) it becomes a transfer of the value which (by section 94 IHTA 1984) is apportioned among the participators by reference to their interests in the company. The apportioned amount cannot by definition be a potentially exempt transfer (section 3A(6) IHTA 1984) and it is therefore a chargeable transfer on which inheritance tax is payable at the lifetime rate of 20%.

With the opportunity to obtain two lots of tax on the payments to an EBT it is no surprise that the Revenue have set up a special team to ensure that the taxes are collected "systematically and consistently".

Domicile

The House of Lords have broken fresh ground on the law of domicile in the recent case of *Mark v Mark* [2005] UKHL 42. This was a matrimonial case in which the jurisdiction depended upon the domicile of the claimant.

The case begins with an outline of the circumstances of the claimant and her husband both of whom are Nigerian nationals. It is explained that the claimant's husband was a professional soldier and occupied a variety of government posts after the military coup in 1983 amassing a very considerable fortune during this period. Um.

The issue was whether a person can be domiciled in

England and Wales if their presence in this country is unlawful - in this case being a criminal offence under the Immigration Act 1971.

A domicile of choice is acquired by the combination of residence in the chosen territory and the intention to reside there permanently or indefinitely. The traditional view is that lawful presence is necessary to establish a domicile of choice. Indeed the proposition that a person must be lawfully present in the country with the intention of remaining there permanently can be traced back to the Roman jurists. In his judgment, Lord Hope drew attention to a statement attributed to Marcellus which (helpfully translated) said that "There is no restriction on a place where a person may have his domicile as long as it is not prohibited for him". There is a significant line of authority which says that unlawful residence prevents the acquisition of a domicile of choice and indeed Dicey and Morris have consistently stated that a domicile of choice cannot be acquired by illegal residence. "The reason for this rule is that the court cannot allow a person to acquire a domicile in defiance of the law which that court itself administers".

Baroness Hale explained that it is necessary to consider the matter in principle. The object of the rule for determining domicile is to discover the system of law with which the individual is most closely connected. Sometimes that connection will be to his advantage but not always. Accordingly, recognising that connection despite the irregularity of his presence here it does not offend against the general principle that a person cannot be permitted to acquire a benefit from his own criminal conduct.

The connection is established by the coincidence of residence and intention. Her Ladyship observed that both these are issues of fact and a person could be resident in the place where he has no right to be. He can also form an intention to reside in a place despite considerable uncertainty as to whether this would be possible. English law requires only that the intention be bona fide in the sense of being genuine and not pretended. In her view there was no reason why a person whose presence in the UK is unlawful cannot acquire a domicile of choice in this country. That is not to say that the legality of a person's presence here is completely irrelevant. As in the cases of precarious residence, the illegality of the presence may be relevant to the question whether

the required intention had genuinely been formed. But this is a question of fact and not (as it was held to be in *Smith v Smith*, a Rhodesian case) a question of law.

For these reasons Baroness Hale differed from the proposition of law stated by Dicey and Morris and declined to follow the authorities cited in support. Accordingly, it may now be stated with certainty that unlawful presence is no bar to the establishment of a domicile of choice.

Disclosure of Tax Schemes

New rules come into force on 1 August 2005 for the disclosure of stamp duty land tax schemes to the Revenue. The rules are absolutely amazing. We expected the existing rules for the disclosure of tax schemes to be the thin end of a wedge, but the thick end is upon us with immediate effect for stamp duty land tax. It will be recalled that the rules introduced last year for tax schemes contained tests in connection with premium fees and confidentiality agreements with the broad intention that only aggressively marketed artificial tax schemes would be caught. Does the same apply to the stamp duty land tax disclosure rules? Not a bit of it. Basically the Revenue want to know about every stamp duty land tax scheme which is devised within five days of it being put to the client. Where the "promoter" is covered by legal professional privilege, the client has to notify the Revenue within 30 days of the first transaction forming part of the arrangements.

There are some filters in the disclosure rules, but they are confusing and ill defined. It will often be difficult to place any reliance on them. Disclosure is required where a stamp duty land tax scheme is to be used wholly or partly for a non-residential property and where the total market value of the chargeable interests in the property are at least £5 million. There is also a list of "steps" which the Revenue say are already known to them as common stamp duty land tax mitigation devices, for example, special purpose vehicles and it is not necessary to notify schemes which involve one of these steps, but if certain combinations of the steps are employed, notification is required.

The guidance notes on the rules mention that many

have already asked: “How do I know whether my scheme will be used for a non-residential property?” The answer apparently is that if you are not sure, disclosure should be made. You will only be safe if the particular scheme has been devised specifically for residential property.

Another difference with the existing disclosure rules is that notification to the Revenue has to be made on a prescribed form. One cannot simply write a letter.

I think it is no exaggeration to say that these rules are quite draconian, and unnecessarily harsh, given that stamp duty land tax is not subject to annual returns like income tax and capital gains tax; notification of transactions takes place as and when they arise. The rules indicate the importance to the Government of the revenue from stamp duty land tax. The announcement in the pre-budget report of retrospective legislation to block schemes relating to employee securities seems to have put paid to tax planning in that area, and I would not be surprised if these disclosure rules mark the end of innovative stamp duty land tax schemes. [Malcolm Gunn](#)

Disclosure of Tax Schemes Generally

The Inland Revenue guidance on disclosure of direct tax avoidance schemes has been substantially re-written. I have not found anything of great moment in the new text, as it seems to say broadly the same as the original text, but is written rather more skilfully. The law has not changed of course. The definition in the regulations of “premium fee” remains the same, and the Revenue’s guidance gives an interpretation of the test which bears little in relation to it; it amounts to the Revenue saying “this is what we really mean in the Regulations, but it was difficult to phrase it in statutory language”. There is still the nonsense about obtaining a premium fee “from a person experienced in receiving services of the type being provided”. I wrote to the Revenue and said such a person doesn’t exist so how do I apply the test? The reply offered no guidance. [Malcolm Gunn](#)

Residence

The recent case of *Shepherd v HMRC SpC 484* concerned an airline pilot who claimed to have left the UK and become resident in Cyprus.

In any case concerning residence the outcome will always depend on the precise facts but this case does provide an interesting review of the issues involved. The Special Commissioner, Dr Brice, set out the following principles from which residence and ordinary residence should be determined:

- a) The terms should be given their natural and ordinary meanings.
- b) Residence and to reside mean “to dwell permanently or for a considerable time, to have one settled or usual abode, to live in or at a particular place”.
- c) Ordinary residence requires more than mere residence; it connotes residence in a place with some degree of continuity; ordinary means normal and part of everyday life, or a regular habitual mode of life in a particular place which has persisted despite temporary absences and which is voluntary and has the degree of settled purpose.
- d) Residence is a question of fact.
- e) No duration is prescribed by statute; it is necessary to take into account all relevant facts such as the duration of presence in the UK the regularity and frequency of visits, and the connections with the country.
- f) A reduced presence in the UK of a person whose absence is caused by his employment does not necessary mean that the person is not residing in the UK.
- g) The availability of accommodation in the UK is a fact to be borne in mind in deciding if the person is resident here.
- h) The fact that an individual has a home elsewhere is of no consequence; a person may reside in two places.
- i) There is a difference between a person establishing a residence in the UK and then being absent from it, and a person who has never had a residence in the UK at all.
- j) It can be relevant if there is evidence that a move abroad is a distinct break.
- k) A person can become non-resident even if his intention was to mitigate tax.

Applying these principles to the facts of the case (which are a bit boring and do not need to be dwelt on particularly) Dr Brice concluded that the appellant’s past and present habits of life, the regularity and length and visits to the UK, his ties with this country and the temporary nature of his

attachments abroad meant that he remained resident in the UK. She came to the conclusion that he dwelt permanently here and this is where he had his settled or usual abode. He resided here continuously as part of his everyday life, his residence here was part of the regular and habitual pattern of his mode of life and it persisted despite temporary voluntary absences to fly in the course of his employment or to go to Cyprus or to go sailing or to go visit Europe.

Having regard to these findings of fact, the result seems to be inevitable.

An important part of the Inland Revenue's case was that the taxpayer continued to reside in his UK house when he was present in the UK and this was indicative of a continuity of residence here. It may be remembered that prior to 1993, where a person had accommodation available for their use, they would be regarded as UK resident if they spent only a single day in the UK. In 1993 this rule was abolished, and the question of whether a person is in the UK for some temporary purpose only and not with the intention of establishing his residence here now being decided without regard to any accommodation available in the UK for his use.

However, this only applies to eliminate consideration of living accommodation for somebody who is in the UK for some temporary purpose only. If, as the Inland Revenue claimed in this case, the taxpayer was in the UK for a settled purpose, and not only temporarily, they could take into account the existence of accommodation in the UK. It is no doubt for this reason that the Inland Revenue directed considerable attention to establishing that Mr Shepherd had a continuity of residence here.

I think this case deserves some careful study and it may be that the Inland Revenue will not in the end be particularly happy with the judgment - to the extent that the Inland Revenue's arguments (or the Special Commissioners conclusions) are inconsistent with the terms of IR20.

Trust Appointments

Another case has hit the courts with the trustees claiming to have an appointment set aside on the

grounds that it was void because they failed to take into account relevant matters – i.e. that it would have had an unsatisfactory tax consequence.

This whole subject is getting rather confused and it is extremely unclear where the line is to be drawn i.e. the circumstances in which an appointment with undesirable consequences can or cannot be set aside. Some thought that *Gibbon v Mitchell* [1990] 1 WLR 1304 created a distinction between the effect and the consequence of an appointment; a mistake as to the effect of a transaction may enable the transaction to be set aside, but not where the mistake was of its consequences or the advantages to be gained by entering into it.

This is not an easy distinction to grasp; the effect seems to me to be remarkably similar to the consequence and this may be one reason why the concept seems not to have caught on. It certainly has not represented an obstacle in any of the subsequent cases – not least in the latest case of *Sieff and others v Fox and others* [2005] EWHC 1312.

The trustees exercised their discretionary power to make an appointment which was followed by an assignment of the subject matter by the beneficiary. It was overlooked that this appointment had unfortunate capital gains tax and inheritance tax consequences (or effects perhaps) and the trustees rather wished they had not done it. They had received wrong legal advice and had they received correct advice they would not have made the appointment. The effect of their appointment was different from that which they had intended and it was therefore set aside. The principle established in *re Hastings-Bass* (1975) Ch 25 is alive and well and came to the rescue.

Transfers of Goodwill

In the case of *Colley v Clements* SPC 483, the Special Commissioners recently had occasion to consider the terms of section 162 TCGA 1992 which provides an exemption from capital gains tax where an unincorporated business is transferred to a company as a going concern in exchange for shares. The particular issue concerned the transfer of goodwill and it is coincidental that the Inland Revenue have recently issued a detailed statement about the valuation of goodwill and the

consequences of such a transfer. However, this case was less concerned with the valuation but with the question whether the goodwill had been transferred to the company (along with the other assets of the business) for a consideration consisting of the issue of shares or whether there was some other consideration.

The facts are incredibly confused not least because the taxpayer made various conflicting representations of fact. He started by explaining that he had sold his share of the goodwill to the company for an amount which was credited to his directors loan account. His accounts had been professionally prepared on this basis.

Clearly this explanation precludes any possibility of relief under section 162 because the transfer of the goodwill was made for a consideration other than the issue of shares in the company. The taxpayer subsequently decided that actually this was all wrong and he had not sold the goodwill at all; he had given the goodwill to the company and he claimed holdover relief under section 165. If those facts were correct, relief under section 165 (the general holdover relief provision) would have been available, but the Special Commissioner did not accept that the earlier statements and earlier accounts could be overturned so easily. The whole basis of the taxpayers arguments collapsed.

It is interesting that throughout the judgment various references are made to a claim under section 162 but the section does not require a claim. Section 162 is mandatory in that its provisions apply if the relevant conditions are satisfied. It was therefore not a question of the taxpayer making a claim or an election under section 162. It was a question of the Special Commissioners determining whether the facts making the mandatory application section 162 existed. Clearly they did not.

Fixed and Floating Charges

The House of Lords' recent decision in *Nat West Bank plc v Spectrum Plus Limited* confirmed that the charge over book debts cannot be classified as a fixed charge but has to be treated as a floating charge. This was not a tax case, but the Inland Revenue were particularly interested in the outcome because there were insufficient assets to pay

Spectrum's secured and preferential creditors in full. *Nat West Bank* claimed that it had a fixed charge ranking ahead of the Inland Revenue's preferential claim but the Inland Revenue argued that it had the superior claim because the bank only had a floating charge over the book debts.

The House of Lords agreed with the Inland Revenue, confirming the 2001 decision in *Agnew v IRC* [2001] All ER (D)21 and validating the Inland Revenue's statement of 13 February 2002 on the matter. In that statement, the Inland Revenue made it clear that where an insolvency practitioner causes a company to make a distribution of book debt proceeds subject to a purported fixed charge, the Crown Departments will challenge the distribution if they believe the charge was actually a floating charge.

I cannot claim any expertise on fixed and floating charges but it seems the House of Lords were not saying that it is impossible to have a fixed charge over book debts. They were merely noting that there was not a fixed charge in this case not least because the bank had no control over the use of the account into which the proceeds were paid and this freedom was inconsistent with the concept of a fixed charge. This certainly seems to be the position of the Revenue.

In addition, VAT repayments will be made to companies subject to insolvency procedures in preference to other Crown creditors only when the Customs & Excise are satisfied that the charge is actually a fixed charge.

I think I have an infinite amount of information available on this subject.

VAT: Card Handling

The long running debate over the VAT implications of card handling agreements undertaken by Debenhams and others continues with the decision of the Court of Appeal.

It may be remembered that Debenhams introduced a system whereby a separate company processed all payments made by credit cards for a fee of 2.5%. This amount was deducted from the price of the merchandise to the customer. The card handling fee

was exempt from VAT so that the VAT supplies were reduced in value by 2.5%. The saving in VAT was obviously substantial.

Customs and Excise took the view that VAT was still payable on the full amount on the grounds that there was only one contract - a contract for the sale of the goods at 100% of the ticket price. The High Court held that there were two contracts; one for the merchandise and one for the card handling services and VAT was only chargeable on 97.5% of the ticket price.

The Court of Appeal have come to the opposite view. They say that there was only one contract with the customer. Debenhams made a single supply consisting of the full amount payable by the customer on the transaction.

It seems to me that a detailed examination of the Court of Appeal's judgment may be unnecessary for the moment as the matter is certain to proceed to the House of Lords.

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July 2005

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Pre-Owned Assets

In his article in Taxation of 28 July 2005, Malcolm Gunn discusses three popular tax planning schemes under each of the three headings in Schedule 15 to the Finance Act 2004: occupation of property, chattels and settlements of intangibles. It illustrates that those hardest hit by the pre-owned asset legislation will be individuals who have entered into schemes in relation to their home and in many cases it can be quite difficult to see what should be done. Revertor to settlor trusts are the ideal way out, but the capital gains tax cost on setting up the trust may be prohibitive. On the other hand, it is unlikely that any past schemes relating to chattels will be caught, and it can be quite a simple matter to reorganise trusts with intangibles to escape the legislation.

Schedule 15 has so many anomalies both for and against the taxpayer, that one can only hope that the Government decides to have a rethink about it before too long.

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Published by:
Haarmann Hemmelrath LLP
Tower 42, 28th Floor
25 Old Broad Street
GB-London EC2N 1HQ
Internet: www.haarmannhemmelrath.com
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Printed by Williams Lea