HAARMANN HEMMELRATH

UK TAX BULLETIN

November 2005

Main Points this Month

A summary of UK tax developments during November 2005

Pre Budget Report : 5 December 2005 1

Distributions : the definition of "asset" 1

Stamp Duty Land Tax : extension of leases 2

Industrial Buildings Allowance : the problems with storage facilities . . 2

Production of Documents : the powers are becoming confused 3

Jointly Owned Chattels : the valuation principles 4

Exempt Gilts : an unexpected opportunity 5

Recovery of Tax Debts : the net tightens for non residents 6

Pre Owned Assets : a breach of the Human Rights Act? 6

Pre Budget Report

The Chancellor will be announcing his Pre Budget Report next week - on 5 December. it is increasingly difficult to distinguish between the Pre Budget Report and the Budget these days, at least in terms of tax changes. I suppose that in the Budget we know there will always be significant tax changes but we can live in hope that maybe there will not be any in the Pre Budget Report. Some hope - but we shall see.

If anything significant arises, I may issue a supplement later in the week.

Disributions

Section 209 Taxes Act 1988 defines what is meant by distribution from a company for tax purposes. It goes on a bit – in fact it goes on for pages.

One of the circumstances in which a distribution can arise is where there is a transfer of assets between a company and its shareholders. This arises from section 209(4) TA 1988 which reads broadly as follows:

"Where on a transfer of assets or liabilities by a company to its members or to a company by its members the amount or value of the benefit received by a member ... exceeds the amount or value of any new consideration given by him, the company shall ... be treated as making a distribution to him of an amount equal to the difference".

The most obvious circumstance where this provision applies is on the transfer of an asset by a company to a shareholder at an undervalue.

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Current Rates

Indexation

Retail Price Index: October 2005	193.3
Inflation Rate:	2.5%

Indexation factor from March 1982:

: to April 1998	1.047
: to October 2005	1.431

Interest on overdue tax

Income tax/CGT/NIC	6.5%	from	06.09.05
Inheritance tax	3%	from	06.09.05
VAT	6.5%	from	06.09.05
Corporation tax	6.5%	from	06.09.05
CTSA instalments	5.5%	from	15.08.05

Repayment Supplement

Income tax/CGT/NIC	2.25%	from	06.09.05
Inheritance tax	3%	from	06.09.05
VAT	3%	from	06.09.05
Corporation Tax	3%	from	06.09.05
CTSA instalments	4.25%	from	15.08.05

Official Rate of Interest

From	06.01.02	5%

Bank Base Rate

From	04.08.05	4.5%

HMRC have consistently taken the view that the asset referred to in section 209 can include cash (although this is certainly not a view shared by many other people). However, they have recently reconsidered the position and now accept that section 209 (4) does not include cash after all.

This is obviously welcome, not least to companies who make charitable donations in cash because hitherto they have been denied relief for their donations on the grounds that section 339(1) TA 1998 excludes from the definition of qualifying donation, the payment of a sum of money which is regarded as a distribution under section 209(4). Such a cash donation is no longer disqualified and can qualify for relief – although it remains to be seen what is going to happen about earlier years. Having regard to the acceptance by HMRC that their view was not generally accepted, they can hardly claim that it represents a prevailing view and deny error or mistake claims on those grounds.

Stamp Duty Land Tax

HMRC have recently issued a guidance note concerning the SDLT treatment of lease extensions. They explain that where a business lease comes to an end but the occupation continues, this period of holding over is treated as an extension of the original lease by one year. Where the original lease was chargeable to SDLT, the extended lease is also taxable and SDLT will arise as the net present value of the rent will be increased by the additional year's rent. Where the period of holding over extends into a second or subsequent year, you have to do this calculation every year and pay tax each time.

Thankfully, if the original lease was granted before 1 December 2003 the period of holding over as an extension of the original lease does not give rise to any SDLT.

Industrial Buildings

The recent case of Maco Door and Window Hardware (UK) Limited SPC508 was concerned with a claim for industrial building allowances in respect of a building used to store goods.

This used to be a interesting and controversial area but a series of cases some years ago seemed to resolve the main problem areas. However, HMRC have clearly started a new offensive in this area which is shown by the somewhat extraordinary challenge to the taxpayer's

claim in this case.

The company's business was importing products manufactured by its Austrian parent and selling them in the UK. They had a great big warehouse with storage on fifteen levels. It was extremely high-tech including a automatic railed crane. The company's customers were mainly wholesalers who sold the products in smaller quantities to window and door fabricators. There were eight employees who dealt with receiving, breaking down bulk deliveries, storing, retrieving, packaging and dispatching products.

One might think that however you define an industrial building, this would be one. But of course it is not as simple as that. The important question was whether the building was in use for the purposes of a trade which consisted in the storage of goods : section 18 Capital Allowances Act 1990.

HMRC claimed that the company's trade was not that of storage but of buying and selling products wholesale. The storage was not part of a trade but something inherent in wholesaling. The Special Commissioner observed that the HMRC argument lead to the conclusion that no wholesaler could ever qualify for industrial buildings allowance – at least not unless goods are kept in a separate building by a separate subsidiary whose business is that of a warehouse and probably not even then, because of the need to retrieve the goods in store, pack them up and despatch them, none of which they claim is part of the trade of storage.

This did not find favour with the Special Commissioners who concluded that the building was in use for that part of the company's trade which consisted in the storage of goods and therefore qualified as an industrial building.

I do not know whose interest it can possibly serve for HMRC to pursue an argument to the Courts (with admitted difficulty) which has the effect of vitiating an entire relief. This was not a question of the facts being unsuitable; the HMRC argument was that no wholesaler, no matter how big his storage facility, can qualify for industrial buildings allowance.

Production Of Documents

Mr Paul Low in SpC 510 caused some interesting issues to arise before the Special Commissioners. He did not turn up (for no good reason) so the appeal carried on without him. He claimed that the Inland Revenue's request for information under section 19ATMA 1970 was an invasion of his privacy under Article 8 of the Human Rights Act 1988 which provides that everyone has the right to respect for his private and family life, his home and his correspondence. He was particularly concerned that it required him to explain the amounts of money spent on food and details of his children's education. Doomed I am afraid – but his argument was not improved by the fact that HMRC had not requested any information about his expenditure on food or the education of his children.

The reason for mentioning this case is the unusual approach to the production of documents. Various items of information were requested all of which were broadly relevant to deductions he had claimed in his self-employed accounts. However, although HMRC requested an analysis of drawings, they said that they would not insist upon it if there was no such analysis in existence. Similarly, they asked for a business profit and loss account, explaining of the good reasons why this was necessary but said they would not insist upon it if there was not one in existence.

This seems to be extraordinarily generous – particularly in light of the earlier case of An Accountant SpC 195 when the taxpayer was required by a notice under section 19A to provide a balance sheet. He claimed that the notice could not include documents which did not exist. However, the Special

Commissioner did not agree and decided that section 19A authorised the Inland Revenue to ask for such accounts to be brought into existence.

Nevertheless the judgment would seem to follow the case of Guest House Proprietor v Kendall SpC 454 in which HMRC required the taxpayer to produce the asset register. He did not maintain an asset register and the Special Commissioners decided it was not necessary for one to be produced:

"Documents can only be demanded if they are in the taxpayer's possession or power. If there was no register it is plainly outside the provision to ask for one".

The value of this latest case is uncertain because I am not sure how reasonable it is for a self-employed individual to calculate his profits chargeable to tax without some kind of profit and loss account. Anyway, it does perhaps indicate a softening of the approach towards the production of documents.

Jointly Owned Chattels

HMRC Share Valuation have published the minutes of their fiscal forum in October, a substantial meeting at which 30 people attended and another 37 sent their apologies. Among the matters discussed was the extremely interesting area of how you value the interest of a joint owner in a chattel. They concentrated on the level of discount which might be appropriate to reflect the problems of joint ownership and referred to a previous statement issued by the SVD on the subject:

"Many of the valuations that we see relate to 50:50 ownership cases where there are no particularly unusual circumstances and no reason to believe that a new co owner could not reasonably expect to contentedly enjoy the fair benefits of joint ownership. In these situations we would expect to see a discount slightly higher than the 10% which has historically been accepted as appropriate in 50:50 land cases - the higher discount being because section 188(1) Law of Property Act 1925 is untested and prima facie does not give 50% plus owners of chattels as much legal protection as enjoyed by joint owners of land".

HMRC did not expect the position to be any different in Northern Ireland despite the fact that there is no legal protection for co owners in Northern Ireland because section 188 LPA 1925 does not apply there. On the grounds that no-one has ever applied to the court for a division under section 188 in respect of a jointly owned chattel, HMRC concluded that the protection offered by section 188 looks to have no practical use and they see no reason for there to be any material difference between the discounts used in England and in Northern Ireland.

This cannot possibly be right as a matter of common sense, let alone as a matter of law. Just because nobody has broken into my great big vault to steal all my diamonds does not mean that I do not need one. Anyway, my difficulties go rather further than this.

Imagine a situation where a chattel is owned 95% by one person and 5% by another – perhaps by a parent and child or a husband and wife. This may be a painting or possibly a large piece of furniture. How do you value a 95% interest in the asset. You could take a straight pro rata value; you might argue that the partial interest requires the value to be discounted; alternatively you might say that this has no material effect on the position and that a premium above pro rata value is appropriate.

HMRC take the view that it is necessary to discount the pro rata value but I do not feel this is appropriate at all. For both capital gains tax and inheritance tax it is necessary to consider the price at which a 95% interest in the asset might reasonably be expected to fetch on a sale in the open market on the various hypothetical assumptions to which such valuations have to be made - that is to say a hypothetical sale between

hypothetical parties on a particular day in the open market. However, it is important to recognise that the hypotheses go no further. The identity of the other co-owner is not hypothetical and neither is the asset itself. Nor do we have to abandon common sense.

One might well say that the 95% interest in the asset was worth more than pro rata value because the nature of the asset means that the 5% holder has practically nothing. The 95% holder has physical possession and enjoyment of the whole of the asset. A purchaser would similarly have physical possession of 100% of the asset but would not have to pay 100% for it. Of course if the asset were to be sold he would only get 95% of the proceeds but he would never get less than 95% of the proceeds and he would still have the enjoyment of the whole of the asset rather than just his pro rata share. It may be said that the premium would not be very much - there is not much space between 95% and 100% - but the point is not how much, but the fact that these circumstances can give rise to a premium in principle.

HMRC suggest that a discount is appropriate because the existence of the 5% joint owner imposes a clog on the enjoyment and freedom of disposition of the asset. Whilst acknowledging the principle, no such clog would really exist - and certainly not one to merit any discount, it would almost certainly be outweighed by the 95% holder having effective unfettered enjoyment of the whole of the asset at only a proportion of the cost.

In reality, the 5% holder only has a financial interest in the asset; he has no opportunity to benefit from it in any other way. Of course, each joint owner is entitled to possession of the chattel by virtue of his interest, but one still has to look at the practical reality of that principle in these circumstances. If the 5% holder were to insist on taking physical possession of the asset, it would be necessary for him to arrange for it to be transported to his own premises and to insure it for the journey and at that different location. Accordingly, the 5% holder is never really going to exercise his right to physical possession and enjoyment of the asset and in truth he will only have a financial interest in the asset. The only aspect capable of devaluing the interest of the 95% holder is if the 5% holder could frustrate a sale by the other.

It is not clear whether section 188 LPA 1925 would allow the 95% holder to enforce a sale of the asset and for the proceeds to be dividend rateably. Views differ whether an order under section 188 is likely to be successful. However, in circumstances where one person owns a 95% interest in an asset and the other only 5%, such difficulties are unlikely to arise. The 95% holder wishing to sell the asset will not need to seek an order from the court because the 5% holder will hardly want to frustrate a sale, which is the very act which will provide him with the realisation of his interest.

For all these reasons it seems to me that a discount from a pro rata value of the 95% holder is unlikely to be tenable in most circumstances and a premium would seem to have rather more merit. But having regard to the latest statement by HMRC on this matter I doubt whether this issue is going to get any clearer in the short term.

Exempt Gilts

HMRC have recently updated their guide to inheritance tax which includes a helpful passage concerning exempt government securities.

It is well known that some government securities are exempt from inheritance tax in the hands of foreign domiciled individuals (although it is extraordinarily difficult to identify which ones qualify for the exemption). There was a change in 1996 which extended the exemption to individuals who are not ordinarily resident in the UK, even if they are UK domiciled.

The latest guide does helpfully confirm that

some British Government securities (unfortunately not specified) which were first issued before 30 April 1996 are exempt from inheritance tax if the holder is neither domiciled nor ordinarily resident in the UK. Furthermore, if the securities are settled property, they would be excluded property if the life tenant is not UK domiciled nor ordinarily resident and in the case of discretionary trusts, if all past present and future potential beneficiaries are neither domiciled nor ordinarily resident in the UK. (That will usually be impossible to satisfy given the conventional width of a discretionary settlement; after all, a discretionary beneficiary might at some time have an illegitimate child who would take the domicile of his mother who could be UK domiciled).

For British Government securities first issued after 29 April 1996 there are different conditions which means that the domicile of the holder is no longer relevant; he needs only to be not ordinarily resident to benefit from the exemption, and this also applies to securities that are settled property.

From 6 April 1998 these later conditions apply to all British Government securities (except 3.5% War Loan). This sounds comprehensive but the Inland Revenue Manuals do not set out the position quite so clearly and suggest that there are some securities which remain subject to the domicile test. However, one can perhaps conclude that as a general rule, British Government securities held by persons who are not ordinarily resident in the UK will be free of inheritance tax.

This is an extremely generous exemption which may not be widely appreciated by those who have taken up residence abroad, but perhaps without the commitment necessary to have established a foreign domicile.

Tax Debts Of Non-Residents

Some years ago I made reference to the case of QRS1 APS v Frandsen [1999] STC 616 which challenged the principle established in Government of India v Taylor HL 1955, that one country will not enforce the revenue laws of another. They claimed that the principle was overridden by the EC Treaty. They failed but things have moved on because in June 2001 EC Council Directive 2001/44/EC gave member states power to enforce outstanding taxes on income and capital (and interest and penalties) in other member states.

HMRC has now established a Non-Resident Recovery Unit which describes itself as “a proactive team with a firm commitment to providing a professional quality service to all our customers”. How quaint. Who could possibly interpret this as meaning "we are going after you in a big way".

A recent press release from this unit explains that they have “various options regarding enforcement including as a last resort referring the debt the tax authorities of the country of residence”. Whilst their present powers only extend to other member states in the EU, HMRC are apparently negotiating with other countries to set up reciprocal arrangements for the collection of tax on a similar basis.

They add that tax debts of persons resident overseas are kept on file, so that even if the taxpayer concerned is not resident within the EU, recovery procedures will be commenced as soon as he or she turns up in a country which by that time has entered into a reciprocal arrangement.

Anybody expecting to escape the attention of HMRC by remaining outside the UK might like to think again.

Pre Owned Assets

The idea that the tax on pre owned assets is somehow unlawful as being in breach of the European Convention on Human Rights because of its retrospective nature is a delightful thought - although I fear a tad

unrealistic. HMRC have their disingenuous line that it is not retrospective because it deals with future events – i.e. it is a charge in respect of future use of the relevant assets. The fact that the consequences of your earlier arrangements are not quite as you anticipated just bad luck.

There is of course no question of the Revenue moving the goalposts after the game has finished. They move them during the game, after the ball has been kicked and it is on the way to the goal. By the time the ball crosses the line, the goal is somewhere else. That of course is an event taking place after the ball was kicked. I think that if the State is going to deprive their citizens of their property, their intellectual justification ought to be rather better than this.

In any event, I do not think that a tax provision being in breach of the European Convention Human Rights makes much difference; that does not make it void any more than being in breach of the Human Rights Act 1998. As I understand the position all that a breach of the Human Rights Act does is to enable the Court to make a Declaration of Incompatibility. A few blushes perhaps, but no refunds.

It must also be acknowledged that retrospective legislation has always been permitted - although frowned upon - except where the need is clearly shown. The convenience of HMRC hardly falls within that category, nor does the mutant technique of backdating legislation to the date of an announcement.

Members of Parliament seem to be very anxious to protect our liberty so that we cannot be held by the State for more than 28 days; I wish some of them would pay some attention to the protection of our property.

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