UK Tax Law Update

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Issue 2

Welcome to the latest issue of the UK Tax Law Update produced by the London Office of Steptoe & Johnson. It covers significant developments that have occurred in the last three months as well as announcements made in the Pre-Budget Report of 2007. This Update is written with a broad spectrum of our clients in mind, therefore if you would like to discuss any particular issue in more detail please contact Kassim Meghjee (kmeghjee@steptoe.com) or your usual Steptoe & Johnson contact. We hope you enjoy reading this and welcome any feedback that you may have.

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International/European Tax Developments

1. EC law freedoms and exemptions from Inheritance Tax

Guerts and Vogten (ECJ Case No. C-464/05)

This case dealt with EC law freedom of establishment and freedom of movement of capital. The reference to the European Court of Justice (the "ECJ") was made in proceedings brought by the heirs of a Mr J Vogten and concerned the refusal by the Belgian tax authorities to grant the heirs an exemption from the Flemish Region's Inheritance Tax (under the Belgian tax code, Inheritance Taxes are regional taxes). The relevant exemption provided, in effect, that a transfer of shares in a family company would not be subject to the Flemish Region's Inheritance Tax if certain conditions were satisfied. One such condition was that the company employed at least five full-time employees in the Flemish Region for a period of three years preceding the death of the deceased. Another condition was that the exemption could only be maintained if at least the same number of employees were retained in the Flemish Region for a period of five years following the death of the deceased. The ECJ held that a condition which grants exemption based on the location of employees within the EC, i.e. an exemption that is available when the employees are employed in one Member State (or part thereof) but not when they are employed in another Member State (or part thereof), is inconsistent with EC law unless it pursues a legitimate objective that is compatible with the EC Treaty or is justified by overriding reasons of public interest, and any such measure was proportionate. The case has been referred back to the national court for final determination.

2. EC VAT and the meaning of "turnover taxes"

KÖGÁS and Others (ECJ Joint Cases Nos. C-283/06 and C-312/06)

In this case the ECJ had to decide whether a local Hungarian business tax (referred to as HIPA) is a turnover tax, similar to VAT, and therefore inconsistent with the EC VAT Directive. The Court held that HIPA was not a turnover tax and therefore Hungary was not precluded from imposing such a tax. The decision was based on, inter alia, that: (i) the tax was not proportionate to the price of goods and services, because HIPA was calculated on the basis of turnover during a particular period; (ii) the amounts paid during preceding stages of the production and distribution process are deducted from the VAT payable to a tax authority - which was not the case for HIPA; and (iii) the burden of the tax was not ultimately passed onto the consumer by operation of the tax laws. As a result, the ECJ decided that HIPA was not similar to VAT and therefore was not precluded by the EC VAT Directive.

3. EC VAT and intra-community trade

Teleos and Others (ECJ Case No. C-409/04)

This case involved the purported removal of mobile phones from the UK to a VAT-registered customer in Spain. No UK VAT is due on such transactions provided the supplier meets certain conditions. The principal conditions are that the supplier must obtain the customer's VAT registration number, and it must also obtain proof that the goods have left the UK. The supplier had obtained the former and delivered the goods to an agent who had then provided the supplier with documentary evidence to show

that the goods had left the UK. This subsequently turned out to be fabricated. The ECJ held that if the supplier acts in good faith, submits evidence establishing a right to a return of VAT, has no involvement in tax evasion and takes every reasonable measure in its power to ensure that the transaction did not lead to tax evasion, then the Member State cannot deny it credit or repayment of VAT it had incurred if the information relied on by the supplier subsequently proves to be false. The practical impact of this decision is that the supplier alone is not burdened with all the due diligence responsibility for its customers and, if it can show that steps had been taken to ensure that the goods it has sold have been delivered as planned, then it should receive credit or a repayment of the VAT it has incurred in making that supply.

4. EC law and tax on commercial value of immovable property in France

Européene et Luxembourgeoise d'investissements SA (ELISA) (ECJ Case No. C-451/05)

By way of background, in the early 1980s, France introduced a tax that was assessed on the fair market value of French real estate owned by non-residents, either directly or through foreign entities. This tax was aimed at discouraging French resident individuals from transferring their properties to foreign entities in order to avoid French wealth tax. Exemptions apply to entities that disclose the names and residences of shareholders, as long as the entities are covered by a French double taxation treaty which provides for administrative assistance or non-discrimination. The entity in question, although based in Luxembourg, could not benefit from the double taxation treaty because it was of a type not caught by the treaty. The French tax authorities considered that the tax was due because it was not able to check the accuracy of information supplied by the company. The tax-paying entity claimed that the EU Mutual Assistance Directive for mutual assistance between Member States for direct taxes (which included the wealth tax) should prevail over the more restrictive double taxation treaty provisions. However, that Directive has a limitation that a Member State cannot be forced to communicate any information beyond that which is required by the provisions of its own domestic legislation and administrative practice. It was in this context that the French Court decided to refer the matter to the ECJ. The ECJ held that, inter alia, EC law relating to the freedom of movement of capital must be read as precluding national legislation that exempts companies established in France from tax on commercial value of immovable property owned in France by legal persons, when, for companies established in another Member State, it makes that exemption subject to the existence of a treaty which has provisions for administrative assistance or non-discrimination.

5. UK remittance rules and non-domiciliaries; certain anomalies relating to remittance rules and an individual's tax residency

Pre-Budget Report 2007 – 9 October 2007 (PBR Notes 18 and 19)

UK residents who, for UK tax purposes are not domiciled in the U.K., can currently use the remittance basis of taxation. This means that income and capital gains arising overseas are only taxed in the UK when funds are remitted to the UK. Changes to the current legislation are proposed which will provide that, after a non-domiciled individual has been resident in the UK for 7 years, he or she will only be able to use the remittance basis of taxation if he or she pays an additional tax charge of £30,000 a year. Where individuals decide not to use the remittance basis (and not pay the additional tax charge), they will be taxed on all their worldwide income and gains whether or not remitted to the UK. The

new rules will come into force on or after 6 April 2008 and all previous periods of residence will count for the purpose of determining whether a person has been resident in the UK for the requisite period. Certain anomalies that currently exist in the rules relating to the remittance bases of taxation are also to be amended. One such example is the arising basis of taxation which applies to Irish investment and employment income; this is to be made consistent with income arising from other parts of the world. In deciding whether individuals are resident in the UK, the Revenue will count the days on which they arrive in and depart from the UK as days of presence in the UK.

6. UK/US double taxation convention – Competent Authority Agreement

The competent authorities of the United States and the United Kingdom have entered into an agreement regarding the definition of "first notification" under the Mutual Agreement Procedure of the Double Taxation Convention entered into by the two states. The relevant paragraph of the Mutual Agreement Procedure provides that *"[w]here a person considers that the actions of one or both of the contracting states result or will result for him in taxation not in accordance with the provisions of the Convention, he may, irrespective of the remedies provided by domestic law of those states, present his case to the competent authority of the contracting state of which he is resident or national. The case must be presented within three years of the first notification of the action resulting in taxation not in accordance with the provisions of the Convention or if later within six years from the end of the taxable year or chargeable period in respect of which that taxation is imposed or proposed."* The competent authorities have agreed that this paragraph shall be interpreted in the way most favourable to the taxpayer, consistent with the approach set out in the OECD commentary on the Model Tax Convention on Income Tax and on Capital. This means that "first notification" shall be treated as the date upon which all domestic remedies have been exhausted.

In the United Kingdom, this will be either the date of issue of a statutory notice required to conclude an assessment and/or any related appeal procedures for the period of assessment in question, or a letter of acceptance by an officer of the Board of HM Revenue and Customs of settlement terms for the period in question.

In the United States, this will be the date of the later of: (i) an assessment pursuant to a notice of proposed adjustment or a statutory notice of deficiency; (ii) when a closing agreement is accepted by the Secretary of the Treasury or his delegate; or (iii) if the taxpayer is a party to an action in a US court regarding a re-determination of tax liability or if the taxpayer is requesting a refund of tax, when such action is finally resolved, including any appeal.

This agreement has retrospective effect from the date upon which the Convention itself came into effect.

7. UK/Saudi Arabia double taxation convention

A double taxation convention between the United Kingdom and the Kingdom of Saudi Arabia was signed in London on 31 October 2007. The treaty generally follows the OECD Model on Double Taxation Convention. Important features include the complete elimination of the withholding of taxes on interest payments by the source country; the taxation at source of dividends up to a maximum rate of 5%; and, the taxation at source of royalties up to a maximum rate of 8%. The Convention will enter into force once

both countries have completed their legislative procedures. In the United Kingdom, the provisions of the Convention will take effect from 1 April (for corporation tax purposes) and from 6 April (for income tax and capital gains tax purposes) in the calendar year following the date of the Convention coming into force. In Saudi Arabia, the provisions will take effect from 1 January in the calendar year after the date the Convention comes into force.

Corporate and Business Tax Developments

8. EIS relief – use of funds and compliance

In order to encourage investments by "business angels" in unquoted companies that are engaged in qualifying trade(s) or research and development, the UK tax code provides for tax relief if certain prescribed conditions are met. The conditions include the issue of shares to raise money for the purposes of qualifying business activity, as well as the issue of a prescribed certificate by the company within a fixed time period. These two conditions have been subject to two recent Special Commissioners cases summarised below.

GC Trading Limited v Revenue & Customs Commissioners (Special Commissioners Case SPC 630)

A company issued shares to its principal director. It then lent some money, raised by the issue of the shares, to another company that was controlled by the principal director's wife – such lending is not a qualifying activity for the purpose of the EIS relief. The company then acquired the trade of a subsidiary company which carried on an advertising business – this is a qualifying activity. The company then applied for an EIS certificate in respect of the shares issued. The Revenue rejected the application on the grounds that the effect of the loan was that the shares had not been "issued in order to raise money for the purposes of qualifying business activity". The company appealed, contending that the loans had been made on a short-term basis, were repayable on demand and were in no way different from the depositing of money in a bank. The Special Commissioner accepted this contention and allowed the appeal, holding that the loans were the equivalent of a bank deposit as the company had raised the funds from the issue of shares and had to hold them until they were needed for the acquisition. Accordingly, the loans were treated as a step in the wider purpose of acquiring the qualifying trade.

Ashley v Revenue & Customs Commissioners (Special Commissioners Case SPC 633)

An individual subscribed for more than 900 shares in a company. He claimed EIS relief in respect of his investment. However, the company failed to issue an EIS certificate in respect of those shares within the prescribed time period. The Revenue rejected the claim on the grounds that the EIS certificate was not issued by the company as required. The individual appealed but the Special Commissioners dismissed the appeal on the basis that a valid claim had not been made.

9. Failure to account for VAT collected because of a misunderstanding of the underlying legislation

Insurancewhy.com Services Limited v Revenue & Customs Commissioners ([2007] Decision 20394)

A company operated a website through which prospective customers were provided with a service that compared the insurance cover provided by various insurers. The company received a commission from

an insurer each time it introduced a prospective customer to the insurer.. It treated its supply as exempt from VAT on the basis that it was an insurance agent. The Commissioners issued a ruling that the company did not fall within the definition of an insurance agent and, as a result, the supplies it made were taxable. The Commissioners required VAT to be accounted to the Revenue; they also imposed a penalty. The company appealed against the ruling. The tribunal reviewed the evidence in detail and rejected the company's contention that it was an insurance agent, holding that, although the company was acting as an intermediary, it failed to qualify as an insurance agent. Accordingly, the company was required to account for VAT on its supplies. It was accepted that the issues raised were extremely technical and therefore the company had a reasonable excuse for having treated its supplies as exempt. Thus, the tribunal allowed the company's appeal against the penalty.

10. Corporate Compliance – Electronic Filing *(SI 2007/2969)*

The Revenue is continuing with its e-filing project, making the online filing of tax forms compulsory over the coming years. From 6 April 2009, employers with 50 or more employees must file online information relating to employee pensions, and start and leave dates. Regardless of employee numbers, from 6 April 2011 all employers must submit this information online. There are statutory penalties for failing to send information online. The announcement has been made at this time to allow those responsible for filing the information to make the necessary changes to their internal procedures.

11. Change to Stamp Duty Rules *(PBR Note 20)*

Transfers that currently attract stamp duty not exceeding £5 (whether fixed or ad valorum) will, beginning on Budget Day 2008, be exempt and not have to be presented for stamping. This will apply to all transfers that attract a fixed duty of £5; for example, transfers of shares otherwise than on sale. It will also apply to transactions where the consideration is £1,000 or less.

12. NIC Exemption and holiday pay *(PBR Note 2)*

With effect from 30 October 2007, the longstanding national insurance contributions ("NICs") exemption in secondary legislation which allows employers to provide holiday pay to employees without paying NICs is withdrawn for all sectors, except for construction. For the construction sector, a five-year transitional period will be implemented before the exemption is withdrawn completely on 30 October 2012.

13. Capital Allowances and Fire Safety Improvements *(PBR Note 4)*

To ensure that businesses do not delay vital safety improvements necessary to comply with fire safety legislation, capital allowances on expenditure incurred to make building alterations after "non-compliance certificates" have been issued will be repealed by legislation that is to be introduced in the Finance Bill 2008. Such relief is not available for similar expenditure incurred prior to the issue of "non-compliance certificates". The relief will not be available for expenditure incurred on or after 1 April 2008 for businesses within charge to corporation tax; the relief will also not be available on or after 6 April 2008 for businesses within charge to income tax. Relief for expenditure on fire safety equipment such as fire alarms and sprinkler systems will continue to be available.

14. Comprehensive code for "forex matching" ***(PBR Note 8)***

Companies holding shares or similar investments in non-sterling businesses frequently hedge the foreign exchange risk that arises by borrowing in the same currency or using currency derivatives. Tax rules allow exchange gains or losses on these loans or derivatives to be disregarded where they hedge (or "match") shares in this way, so that only the net economic position is taxed. The rules that apply at present are currently split between secondary legislation, which applies to companies that have adopted the International Financial Reporting Standards or the UK equivalent, and primary legislation, which deals with companies using the old UK GAAP. From 1 January 2009, the Government intends to introduce legislation which will provide a comprehensive code for all "forex matching" transactions.

15. Tax relief for pension contributions ***(PBR Note 13)***

Legislation is to be introduced in the Finance Bill 2008 to ensure that the rules that spread tax relief for large employer pension contributions cannot be circumvented. The legislation is to come into effect for payments made on or after 10 October 2007, and a binding obligation entered into on or after 9 October 2007. This is an anti-avoidance measure designed to ensure that the spreading of contributions cannot be avoided by, for example, routing them through a new company.

16. Life insurance policies and life annuity contracts to be brought within loan relationship rules ***(PBR Note 10)***

Legislation is to be introduced in the Finance Bill 2008 to bring all life insurance policies and life annuity contracts (other than protection-type policies) to which a company is a party within the loan relationship rules that are used to tax debt and debt-like instruments. The rationale for this change is that where such policies and contracts are used for investment, which is the case in most circumstances, economically they resemble debt-like instruments and therefore ought to be taxed in the same way. This change will apply to the accounting periods of companies beginning on or after 1 April 2008.

17. Life insurance companies and corporation tax deductions ***(PBR Note 12)***

Legislation is to be put in place which will prevent life insurance companies from receiving a corporation tax deduction for expenses relating to reinsured life insurance business where they have not borne the economic cost of those expenses. This measure will be in effect for expenses incurred on or after 9 October 2007, as well as on or after 1 January 2008 for those expenses incurred before that time, which have been spread forward. It will not affect deductions for earlier periods.

Real Estate Tax Developments

18. Construction Industry Scheme and Duty of Care owed by the Revenue

Neil Martin Limited v Revenue & Customs Commissioners ([2007] ALL ER (D) 393(October))

An application was made for a construction industry scheme certificate on behalf of a claimant

construction company. Such a certificate would have entitled the company to receive gross payments from the contractor, for whom the company was carrying out construction services. The certificate was received some three months later. There were several possible reasons for this delay, many of which related to potential errors on behalf of the Revenue. Questions before the Court included whether the Revenue owed the common law duty of care to process the claimant's application for a certificate with reasonable expediency. The High Court ruled that no such duty had been established. The Court of Appeal allowed the appeal in part, holding that, although there was no duty to issue a certificate within a specified period of time, a duty of care was owed to the claimant by an unidentified Revenue employee who had mistakenly chosen to complete papers in support of an application for a registration card that allowed contractors to make a payment to the claimant - but after withholding an amount equal to 18% of the payment due. This was on the basis that the unidentified Revenue employee had processed the application without the claimant's authority – the claimant's application was for a certificate and not a registration card. The Court of Appeal held that the employee of the Revenue had not processed the original application that had been made; rather, he had assumed an authority to process an application that had not been made. There was, therefore, no reason why, in assuming that authority, the employee should not be taken to have assumed a responsibility to the claimant.

19. Land Transactions – notification rules *(PBR Note 21)*

Legislation is to be introduced in the Finance Bill 2008 that will change the rules for notifying the Revenue about land transactions. For transactions in which the chargeable consideration is less than £40,000, the Revenue will no longer need to be notified. Where any chargeable consideration is more than £40,000 and the annual rent is more than £1,000, the Revenue will have to be notified of leases of 7 year terms or more. This measure will come into effect on or after the date of Budget Day 2008. The current threshold for notification of property transactions has effectively been raised from £1,000 to £40,000.

20. Transfer of an interest in property within an investment partnership *(PBR Note 22)*

Legislation is to be introduced in the Finance Bill 2008 to amend the Finance Act 2007, to ensure that, where there is a transfer of an interest in property within an investment partnership, there will be no charge to Stamp Duty Land Tax. This measure is to have retrospective effect and will apply to transactions that occurred on or after 19 July 2007 (the date the Finance Act 2007 received Royal Assent).

21. VAT and renovation and alterations expenditure *(PBR Note 25)*

Secondary legislation is to be introduced to ensure that renovations and alterations to residential properties that have remained vacant for at least 2 years will be eligible for a reduced VAT rate of 5%. Currently, such properties must remain vacant for at least 3 years to qualify for the reduced VAT rate. This measure will come into effect on or after 1 January 2008.

22. Landfill Tax – extension of exemption *(PBR Note 26)*

Legislation is to be put before Parliament to extend the scope of the exemption from landfill tax to waste arising from dredging activities. The exemption will now cover any materials that may be added to

ensure compliance with waste acceptance criteria. This extension will have effect for relevant disposals made on or after 30 October 2007.

Personal Taxation Developments

23. Capital Gains Tax – increase in rates and consequential amendments *(PBR Note 17)*

Legislation is to be introduced in the Finance Bill 2008 to change the taxation of chargeable gains. A new, single 18% rate of charge is to apply. Consequential changes will include the withdrawal of taper relief, the withdrawal of indexation allowance, the abolition of halving relief and the simplification of share identification rules. The annual exemption amount will remain, the current level of which is £9,200 for individuals and £4,600 for some trustees. This measure will have effect for disposals made on or after 6 April 2008. The current capital gains tax rules will apply for disposals made up to and including 5 April 2008.

24. Transfer of unused inheritance nil-rate band *(PBR Note 16)*

Legislation is to be introduced in the Finance Bill 2008 which will allow a claim to be made to transfer any unused inheritance tax nil rate band on a person's death to the estate of the surviving spouse or civil partner who dies on or after 9 October 2007. This means that unions recognised by law will have a cumulative inheritance tax nil rate band of £600,000 in the current tax year, rising gradually over the next three years to £700,000 in the tax year 2010/11.

25. Pre-owned Assets Rules and prescribed Form IHT500 *(SI 2007/3000)*

Generally, if a donor gives an asset to another but retains some benefit, he or she is subject to an income tax charge to the extent of the use he or she enjoys – the rules which impose this charge are commonly referred to as pre-owned asset rules. Primary legislation which enacted these rules in 2004 provided for the taxpayer to be able to elect for this charge to be subject to inheritance tax and not income tax. The prescribed form of the election was to be set out in regulations. In the absence of the regulations the Revenue were accepting elections made by a letter. The regulations have now been published and come into effect on 14 November 2007. This means that from that date such an election has to made in the prescribed form otherwise it will not be effective.

26. Payments made under a Deed as compensation for a shortfall in widow's pension held taxable as income

Ford v Revenue & Customs Commissioners ([2007] SpC 634)

A managing director of a family company agreed to leave the company and work as a consultant from home two years before his retirement. That agreement was confirmed in company minutes in which the company directors promised that if he left, his remuneration would remain the same until his retirement date. Following that, and as a result of a pension deficit, the company announced that its spouse death in service pension benefit was to cease. The husband, who had been diagnosed with cancer, received a reserved benefits statement showing that if he died before his retirement, his widow's pension would be

some £12,000.00 per annum. If he died after his retirement, the pension would be £40,000 per annum. In the light of his diagnosis, the husband wrote to the company directors about the implications for his wife should he die before retirement. They replied that the company would comply with its obligations. The husband died before his retirement and the wife requested that the company make up its pension shortfall. Through a deed entered into by the company, it agreed to pay her an additional monthly sum. The wife did not treat that payment as taxable income and the Revenue required the payment made under the deed to be treated as such. The wife appealed contending: (i) in consideration of her husband's agreeing to leave the company, the company directors promised, through personal liability, to meet the shortfall in her pension; (ii) had she, in her capacity as the husband's executor, sued them for breach of that promise she would have obtained damages of £1million; and (iii) therefore the payment made under the deed were instalments of capital. The Special Commissioner found that there was no personal liability of the company directors to pay the husband's salary and pension. What was promised was that the husband would effectively leave service but continue to be paid the same salary until his 60th birthday, and, as part of that arrangement, the company had told him that his remuneration and benefits and pensions would remain the same. The Special Commissioner considered that it was doubtful that the wife could have successfully sued the company. Whether or not the obligation could have been enforced against the company was irrelevant because the company duly met its moral obligation by entering into the deed. The Special Commissioner therefore considered that the payments under the deed were taxable.

Other General Measures and Anti-Avoidance

27. The Investment Manager Exemption *(PBR Note 7)*

The investment manager exemption which enables non-residents (funds and individuals) to appoint UK-based investment managers without the risk of exposing themselves to UK taxation is to be amended to provide a more proportionate tax effect for non-qualifying transactions or arrangements through the removal of a rule which may cause the entirety of the non-resident's UK profits to be brought into the UK tax net. This would be the case if the investment manager carries out a transaction in the capacity of a permanent establishment. This measure will have effect on or after the date on which the Finance Bill 2008 receives Royal Assent.

28. Interest deductions and acceleration of tax relief – Anti-Avoidance *(PBR Note 3)*

Legislation is to be introduced in the Finance Bill 2008 to block an avoidance scheme in which all interest on a loan is paid in advance, with the aim of accelerating tax relief. Under the current rules, the amount of interest paid which is eligible for relief is the amount of interest paid in the tax year, regardless of the period to which the interest relates. This has been abused by individuals who borrow money that has been invested in partnerships or certain types of small companies. This measure will deny relief for interest paid that relates to a later tax year than the year in which the interest is paid. The measure will come into effect in relation to interest that is paid on or after 9 October 2007.

29. Sale and Leaseback – Anti-Avoidance *(PBR Note 6)*

Legislation is to be introduced to counter avoidance involving the sale and finance lease-back of existing plant and machinery by removing a rule that allows businesses to dispose of plant and machinery free of tax and by bringing the finance lease-back within the scope of the rules for tax and long-funding leases. The measure will have effect for transactions entered into on or after 9 October 2007.

30. Conversion of interest into non-taxable income – Anti-Avoidance *(PBR Note 9)*

Legislation is to be introduced in the Finance Bill 2008 to block a scheme that aims to convert what is, in essence, interest into non-taxable income. The current anti-avoidance legislation provides that certain shares which mimic debt be treated as loans and thus what would otherwise be exempt distributions are treated as chargeable to corporation tax. Prior to the announced change, only income that would otherwise be subject to corporation tax would have been subject to these anti-avoidance rules. The new anti-avoidance measure will bring into charge to tax other types of distributions that are not chargeable to corporation tax. This measure will have effect on distributions paid on or after 9 October 2007.

If you would like further information please contact Kassim Meghjee (kmeghjee@steptoe.com) in London or your usual Steptoe & Johnson contact.

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