Insight and analysis for the business tax community

TAX JOURNAL

www.taxjournal.com Issue 1151 • 18 December 2012

Reflections on 2012

Views on tax that matter

David Gauke MP • Exchequer Secretary to the Treasury
Graham Aaronson QC • Barrister • Pump Court Tax Chambers
Alexi Mostrous • Special Correspondent • The Times
John Whiting • Tax Director • The Office of Tax Simplification
Paul Johnson • Director • The Institute for Fiscal Studies
Paul Aplin • Chairman • ICAEW Tax Faculty Technical Committee
Sara Luder • Partner • Slaughter and May
Andrew Gotch • Chairman • CIOT's OMB taxes subcommittee

ECONOMICS FOCUS

Osborne buys time – but how much?

David Smith • Economics editor • The Sunday Times

ANALYSIS ON DRAFT FINANCE BILL 2013 MEASURES

A review of the draft Finance Bill

Chris Sanger & Mike Gibson • Ernst & Young

The GAAR

Ashley Greenbank & Nigel Doran • Macfarlanes

The statutory residence test

Simon McKie & Sharon McKie • McKie & Co

Residential property aspects

Robert Langston • Senior manager • Saffery Champness

VAT FOCUS

The CA decision in *Secret Hotels2*

Michael Camburn & Gavin McLoughlin • KPMG

INTERNATIONAL

This year's key developments overseas

Francesca Lagerberg • Head of tax • Grant Thornton

COMMENT

- Unitary taxation: the case for and against
- Using the procurement process to deter avoidance
- Starbucks and tax: 'I wouldn't start from here...'

Double edition

Build a strong foundation for global tax risk management.

For many multinational corporations, ERP systems' native tax functionality doesn't provide the necessary level of indirect tax assurance. With Vertex, you not only get automated tax calculation and reporting, but constantly updated VAT rates and rules for more than 200 countries around the world including Brazil, China, and India.

Over 700 of the world's largest companies already rely on Vertex® Indirect Tax *O Series*® for improved global tax risk management. Contact Vertex today to learn more.

To learn how tax automation can provide a strong foundation, visit vertexinc.com/solutions/indirect.

ACCREDITED SOFTWARE

*The Institute of Chartered Accountants in England and Wales has accredited Vertex Inc. under the terms of the ICAEW Accreditation Scheme. Purchasers should ensure that the software, its security features and related support meet their own specific requirements, as the Institute will not be liable for any damage whatsoever, incurred by any person, occasioned by the use of the software, or any related products or services howsoever caused.

Contents

From the editor

It is interesting to see how the focus on tax in the national media has evolved over the last 12 months. At the start of 2012, the attention was firmly on HMRC, with allegations of 'sweetheart deals' for some large corporates. HMRC remains under scrutiny but the focus has now widened to cover tax avoidance in general and the rules on the taxation of multinationals in particular. Starbuck's recent announcement that it will pay more tax than legally due is an astonishing development, which shows just how far things have moved.

This week's edition reviews some of the key changes in 2012. Graham Aaronson QC reflects on the progress of the GAAR, probably *the* development of the year. Alexi Mostrous, special correspondent for *The Times*, looks back on his series of reports in that newspaper and outlines the issues he'll be considering in 2013. Paul Johnson, Director of the IFS, observes that 2012 was not a great year for tax policy. On a more optimistic note, Paul Aplin suggests that this year might be the turning point for HMRC in improving its customer service delivery.

Editor Paul Stainforth
paul.stainforth@lexisnexis.co.uk

This is the final edition of Tax Journal for 2012. The next edition will be published on Friday 11 January.

Editorial Board

Philip Baker QC, Gray's Inn Tax Chambers
Ian Brimicombe, AstraZeneca
James Bullock, Pinsent Masons
Michael Conlon QC, Hogan Lovells
David Cruickshank, Deloitte
Peter Cussons, PwC
Bill Dodwell, Deloitte
Stephen Edge, Slaughter and May
Judith Freedman, University of Oxford
Malcolm Gammie CBE QC, 1 Essex Court
Melanie Hall QC, Monckton Chambers
Dave Hartnett CB, formerly HMRC
John Hayward, Pension Consultant
Francesca Lagerberg, Grant Thornton
Pete Miller, The Miller Partnership
David Milne QC, Pump Court Tax Chambers
Chris Morgan, KPMG
Paul Morton, Reed Elsevier
Lakshmi Narain, Baker Tilly
Clive R Othen, Studio Indirect
Jennie Rimmer, Aspen
Chris Sanger, Ernst & Young
Adrian Shipwright, MLaw
John Whiting OBE, Chartered Institute of Taxation

2 **News**

4 **Cases**

6 **In brief**

8 **This week**
Tax lawyers condemn 'attack on the rule of law'.

9 **The debate: unitary taxation**
The case for and against by **Sol Picciotto** and **Miles Dean** respectively.

10 **Reflections on 2012**
Views from **David Gauke MP**, Exchequer Secretary to the Treasury (the government's digital agenda); **Graham Aaronson QC** (the GAAR); **Paul Johnson** (tax policy); **Alexi Mostrous** (*The Times*' coverage on tax); **Paul Aplin** (HMRC customer service); **John Whiting** (the work of the OTS); **Sara Luder** (multinational tax planning); and **Andrew Gotch** (business record checks).

15 **Comment**
Chris Morgan on Starbucks' recent announcement on tax; and **Jason Collins** on potential changes to the procurement process.

Analysis

16 **Osborne buys time – but how much?**
George Osborne came through his Autumn Statement in better shape than most people expected. But the tough times are not over, **David Smith** writes.

17 **Examining the draft Finance Bill 2013**
The draft legislation has four key themes. **Chris Sanger** and **Mike Gibson** examine the detail.

20 **FB 2013: The GAAR**
Ashley Greenbank and **Nigel Doran** contend that the GAAR, as set out in the draft provisions, is an anti-avoidance rule in all but name.

23 **FB 2013: The statutory residence test**
The SRT is an improvement on the current situatiobn but is far from fulfilling the aims of reform, according to **Simon** and **Sharon McKie**.

26 **FB 2013: The residential property proposals**
Robert Langston considers the three new taxes.

VAT focus

28 ***Secret Hotels2*: agent or principal?**
Michael Camburn and **Gavin McLoughlin** consider the CA decision in a case on the VAT tour operators' margin scheme.

30 **2012 international review**
Key developments from around the globe, by **Francesca Lagerberg**.

36 **Ask an expert**
Martin Mann answers a query on legal fees for fines.

37 **What's ahead & One minute with ...**
Key dates for your tax diary, and one minute with **Ian Brimicombe**.

News

Covering the key developments in tax

People and firms

Timothy Lyons QC, barrister, now practises at **39 Essex Court**. Lyons practises in both direct and indirect taxes, and was formerly at 4-5 Gray's Inn Square.

Business taxes

Unitary taxation

Unitary taxation of multinationals' profits would increase tax revenues and make it easier for governments to lower corporate tax rates, according to a new paper published by the Tax Justice Network. Read more at lexisurl.com/KhO2Y. See also p 9.

Google

Google's chairman Eric Schmidt defended the group's structure and said its tax planning was based on incentives offered by governments after Bloomberg reported that, according to an analysis of recent filings, Google 'avoided about $2bn in worldwide income taxes in 2011 by shifting $9.8bn in revenues into a Bermuda shell company, almost double the total from three years before'.

Bloomberg reported on Wednesday that Schmidt said the company's efforts around taxes were legal: 'We pay lots of taxes; we pay them in the legally prescribed ways. I am very proud of the structure that we set up. We did it based on the incentives that the governments offered us to operate … The company isn't about to turn down big savings in taxes,' he said.

The report continued: 'It's called capitalism,' he said. 'We are proudly capitalistic. I'm not confused about this.' Responding to Schmidt's comments, UK business secretary Vince Cable told journalists that governments had been 'very much behind the curve'. He called for more international co-operation 'to clamp down on multinationals shifting profits to low-tax countries', *The Guardian* reported. See lexisurl.com/LJuZb.

Telegraph apologises

The *Daily Telegraph* apologised to Margaret Hodge, chairman of the Commons Public Accounts Committee (PAC), for a news story regarding Stemcor, a privately owned steel trading company in which Hodge has a shareholding. See lexisurl.com/yEGM1.

'Attack on the rule of law'

MPs are wrong to suggest that HMRC is not adequately tackling tax avoidance, and their recent criticism of multinationals is an 'unprincipled attack on the rule of law', a leading tax lawyer has said. See page 7.

Johnson defends Starbucks

Paying tax is not a voluntary choice, Danny Alexander told the BBC's Andrew Marr after Starbucks stores around the UK were disrupted by protests despite the company's commitment to pay UK corporation tax 'above what is currently required by tax law' for the next two years. The chief secretary to the Treasury said he could not comment on individual companies, but 'thinking of the tax system as if it's like the church plate going around on a Sunday morning is completely the wrong way to think about it'. Boris Johnson defended Starbucks, pointing out that it has a duty to its shareholders (lexisurl.com/eZHvY).

John Lewis

Tax is a moral issue for businesses, and a recent intervention in the tax avoidance debate has provided 'good background publicity' for John Lewis, the company's managing director Andy Street said (lexisurl.com/n3vpF).

Starbucks' pledge

Starbucks' decision to pay more corporation tax in the UK than required by law could lead to the group paying less tax overall, experts at Tolley Tax said. The 'most likely losers', the *Daily Telegraph* noted, were the Netherlands, Switzerland or the US. But the *Telegraph* quoted a Starbucks spokesman as saying: 'The action we announced in the UK is isolated to our UK business and is not expected to have an impact on any of our affiliated businesses in other countries' (lexisurl.com/swSpK).

Starbucks had not consulted HMRC on its proposal but would consider extending the 'terms' of its commitment beyond 2014, said Kris Engskov, the UK company's managing director. Tax professionals and anti-avoidance campaigners alike criticised the company's pledge to pay £20m over the next two years regardless of profitability. HMRC, citing taxpayer confidentiality, was unable to tell *Tax Journal* how it would deal with a voluntary payment that was clearly not due under corporation tax law (see lexisurl.com/454PH).

Starbucks' commitment failed to persuade UK Uncut to call off 40 planned 'actions' at Starbucks stores. 'While Starbucks has complied with all UK tax laws, today we are announcing changes that will result in the company paying higher corporation tax in the UK,' Kris Engskov, managing director at Starbucks UK, wrote in an 'open letter' on the company's website. 'Specifically, Starbucks will not claim tax deductions for royalties and standard intercompany charges. Furthermore, Starbucks will commit to paying a significant amount of tax during 2013 and 2014 regardless of whether the company is profitable during these years.' The company will about £10m in UK corporate tax in each of the next two years regardless of profitability, the *Financial Times* reported (lexisurl.com/2wNuz).

CFCs: regulations

The Controlled Foreign Companies (Excluded Territories) Regulations, SI 2012/3024, provide a list of excluded territories for the purposes of the excluded territories exemption (ETE), set out a further requirement for the ETE to apply, and provide a modified ETE exemption to apply in specified cases. The Controlled Foreign Companies (Excluded Banking Business Profits) Regulations, SI 2012/3041, provide an exclusion from a CFC charge in relation to finance trading companies including banks, based on the level of capital held by those companies. 'The general condition within the primary legislation refers to how much capital it would be reasonable for an independent company to hold. These regulations offer an alternative "safe harbour" for banks, based on a comparison between the capital held by the CFC and the capital held by the banking group of which the CFC is a member,' HMRC said. The Insurance Companies and CFCs (Avoidance of Double Charge) Regulations, SI 2012/3044, are intended to mitigate administrative compliance burdens for life insurance companies and prevent double taxation of life insurance companies under the CFC rules and TCGA 1992 s 212 in relation to investments in CFCs. The Taxation (International and Other Provisions) Act 2010 (Part 7) (Amendment) Regulations, SI 2012/3045, ensure 'the correct interaction' of the debt cap rules in TIOPA 2010 Part 7 and the CFC rules in Part 9A.

Life insurance companies

The Insurance Companies (Transitional Provisions) Regulations, SI 2012/3009, contains further detailed transitional rules in relation to the new corporate tax regime for life insurance companies and friendly societies. The Friendly Societies (Modifications of the Tax Acts) Regulations, SI 2012/3008, make modifications to the life insurance rules as

they apply to friendly societies in order to accommodate certain tax exempt business carried on by friendly societies.

Authorised investment funds
The Authorised Investment Funds (Tax) (Amendment No. 3) Regulations, SI 2012/3043, correct an 'inadvertent effect' of a change to SI 2006/964 following the tax law rewrite process. They restore the previously intended tax treatment of dividend distributions made by AIFs and received by life insurance companies as part of certain long term insurance business where returns are normally taxed (if applicable) only in the hands of the policyholder.

Personal taxes

Allowances
The Income Tax (Indexation) Order, SI 2012/3047, provides for the indexation of allowances and rate limits for 2013/14. However, the autumn statement announced that legislation in Finance Bill 2013 will increase the basic personal allowance to £9,440 and reduce the basic rate limit to £32,010.

Professional fees
The Income Tax (Professional Fees) Order, SI 2012/3004, adds to the table in ITEPA 2003 s 343 fees payable under the Gambling Act 2005 on application for or variation of a personal licence, and any fee payable under s 132 of that Act. ITEPA 2003 s 343 provides for a deduction from employment earnings for professional fees.

Car and van fuel
The Car and Van Fuel Benefit Order, SI 2012/3037, increases the figure in ITEPA 2003 s 150(1) – used to calculate the cash equivalent of the benefit of car fuel received by an employee – to £21,100, and increases the van fuel benefit figure in s 161(b) to £564, with effect from 6 April 2013.

Universal credit
The draft Universal Credit Regulations 2013 provide for the determination of entitlement to, and the calculation of, an award of universal credit, and the draft Universal Credit (Transitional Provisions) Regulations 2013 provide for the introduction of universal credit on a 'pathfinder' basis from 29 April 2013 (lexisurl.com/JA8vl).

Indirect taxes

Motor vehicles
Revenue & Customs Brief 34/12 confirms that VAT Notice 701/59 (motor vehicles for disabled people) has been cancelled and replaced by two help sheets, VAT 1615 and VAT 1616, and states that the material 'remains largely unchanged'. *Revenue & Customs Brief 35/12* provides details of a new voluntary scheme to help HMRC gather information from traders about zero-rated sales of adapted motor vehicles and boats to disabled people.

Small consignments
The Value Added Tax (Small Non-Commercial Consignments) Relief (Amendment) Order, SI 2012/3060, amends SI 1986/939 to reduce the value limit for goods imported outside the EU from £40 to £36 in order to comply with Council Directive 2006/79/EC. The directive sets the limit at €45 and the Euro was revalorised on 1 October 2012.

Climate change levy
The Climate Change Levy (General) (Amendment) (No. 2) Regulations, SI 2012/3049, amend SI 2001/838 to reflect removal of a CCL exemption for electricity that is generated in a combined heat and power station and is supplied to an energy consumer by an electricity utility.

Air passenger duty
The Finance Act 1994, section 30A (Appointed Day) Order, SI 2012/3015, appoints 1 January 2013 as the relevant day for the purposes of section FA 1994 s 30A, which was inserted by FA 2012 to provide for the Northern Ireland Assembly to set rates of air passenger duty (APD) on direct long-haul flights departing from Northern Ireland. The Air Passenger Duty (Amendment) Regulations, SI 2012/3017, amend SI 1994/1738 to reflect the FA 2012 provisions changing the definition of 'passenger' and devolving APD rate setting powers to Northern Ireland.

International

Isle of Man
A tax information sharing agreement with the Isle of Man will provide HMRC with a range of 'additional information' about potentially taxable income in Manx bank accounts, HM Treasury announced: 'This is part of a package of measures being developed by the UK and the Isle of Man as part of a shared commitment to combat tax evasion' (lexisurl.com/67WXz).

EU powers
HM Treasury has invited comments on the EU's impact on taxation in the UK, as part of the government's review of the 'balance of competences' between the UK and the EU (lexisurl.com/aNAze).

A common GAAR
Action to step up pressure on tax havens, and the development of a common general anti-abuse rule, are among EC proposals to be presented to EU finance ministers and the European Parliament. Details are set out in a new website titled 'Fight against tax fraud and tax evasion', which declares that 'up to €1 trillion per year are missing in EU countries budgets'. As *Tax Journal* reported in March, that estimate was based on a study written by Richard Murphy, director of Tax Research UK. Read more at lexisurl.com/fxaES.

Co-operation
The European Administrative Co-Operation (Taxation) Regulations, SI 2012/3062, includes provisions implementing Council Directive 2011/16/EU (the ACD) on administrative cooperation in the field of taxation. They 'protect confidential information provided by HMRC to other public authorities for the purposes of the ACD by imposing a restriction, supported by a criminal sanction, on further disclosure'.

Administration & appeals

Finance Bill & Budget date
The government published draft legislation for Finance Bill 2013 and has invited comments on the draft clauses by 6 February 2013. The next Budget will be delivered on Wednesday, 20 March 2013. David Gauke said in a written ministerial statement that measures would take effect from 11 December 2012 in relation to 'debt cap – group treasury company election; corporation tax – deferral of payment of exit charges; and VAT forestalling – road fuel'. Measures taking effect from 1 January 2013 relate to 'annual investment allowance; bank levy; UK-Swiss agreement – remittance basis; and controlled foreign companies'. A pdf containing all of the draft clauses and explanatory notes has more than 1,000 pages.

General anti-abuse rule
Changes to the proposed general anti-abuse rule (GAAR) were welcomed as an indication that the government is 'listening' to professional bodies and tax advisers (lexisurl.com/dTF5w).

More news on the web ...
Visit www.taxjournal.com

Cases

Reporting the tax cases that matter

Business tax

Money withdrawn from company account by director/shareholder

In ***Mirror Image Contracting Ltd v HMRC*** (TC02350 – 20 November), an unmarried couple (S and J) had incorporated a company (M) in 2004 to carry out construction work. J owned 51% of the shares, while S owned 49% of the shares and controlled M's finances. In 2008 S and J separated. S withdrew more than £110,000 from M's bank accounts. He also sold M's van and used the proceeds to buy a car which he registered in his own name. HMRC issued an amendment to M's self-assessment for the year ended March 2009, charging tax under what is now CTA 2010 s 455 on the amounts which S had withdrawn from M. The First-tier Tribunal (FTT) dismissed M's appeal against this amendment. Judge Aleksander also observed that the effect of the decision in *Bamford v ATA Advertising Ltd*, Ch D (1972) 48 TC 359, was that M was not entitled to a deduction for the amounts which S had withdrawn.

Why it matters: **When a shareholder unilaterally withdraws money from the company, this is an advance to him which gave rise to a charge to tax under what is now CTA 2010 s 455.**

Personal tax

IHT: beneficial ownership

In ***J Matthews v HMRC*** (TC02329 – 7 November), an elderly widow, who had inherited some money from her father, transferred £94,000 from a bank account in her name to a new account in the joint names of her and her son (M). She died eight years later. HMRC issued a notice of determination charging IHT on the whole amount held in the account. The FTT upheld the determination and dismissed M's appeal, applying the principles laid down in *Sillars & Another v CIR*, Sp C [2004] STC (SCD) 180.

Why it matters: **The FTT upheld HMRC's contention that IHT was chargeable on the whole of the amount held in the relevant bank account at the time of the widow's death. The decision here is in line with the previous cases of *Sillars & Another v CIR* and *Boland's Executrix v HMRC*.**

NIC: failure to claim small earnings' exception

In ***J Pugsley v HMRC*** (TC02366 – 20 November), an individual (P) registered as self-employed and paid Class 2 national insurance contributions between 2005 and 2010, although he qualified for small earnings' exception under SSCBA 1992 s 11(4). In 2011 he claimed a refund of the contributions he had paid. HMRC agreed to repay the contributions which P had paid for 2009/10, but rejected his repayment claim for earlier years. The FTT dismissed P's appeal against this decision.

Why it matters: **The lesson here is that all claims for small earnings' exception, and all repayment claims, should be lodged within the statutory time limits.**

IHT: money lent by shareholder

In ***Mrs G Silber (MMM Lerner's Personal Representative) v HMRC*** (TC02369 – 20 November), an individual (L) died in 1999. He was a shareholder in a company (T), and T's records showed that L had lent T £107,210. HMRC issued a notice of determination including this £107,210 as part of L's estate. L's personal representative appealed, contending that the £107,210 should have been treated as a gift to T rather than a loan. The FTT rejected this contention and dismissed the appeal.

Why it matters: **The FTT upheld HMRC's contention that the amount which the deceased had lent to the company formed part of his estate for IHT purposes.**

VAT

Supplies of hotel accommodation

In ***HMRC v Secret Hotels2 Ltd*** (CA – 3 December), a company (S) operated a website through which it marketed hotel accommodation outside the UK. About 94% of its sales were to travel agents and about 6% to holidaymakers. It failed to account for VAT on its supplies. HMRC issued assessments charging output tax of more than £7,000,000. S appealed, contending that it was acting as an agent for the owners of the hotels, and should not be required to account for UK VAT. The FTT rejected this contention and dismissed the appeal, holding that S was acting as an independent principal and 'was not simply supplying agency services to the hotels, but was itself supplying the holiday'. Accordingly S was required to account for VAT under the tour operators' margin scheme. The Upper Tribunal reversed this decision but the CA unanimously restored it. Sir John Chadwick observed that S had 'treated deposits and other monies which it received from holidaymakers and their agents as its own monies. It did not account to the hotel operators for those monies. It did not enter those monies in a suspense account so as to take advantage of article 11A(3)(c); and so cannot rely on the exclusion from the scope of article 26 of the Sixth Directive which is contained in the second sentence of that Article.'

Why it matters: **This is an important case concerning the application of the tour operators' margin scheme. The CA unanimously upheld HMRC's contention that the UK company was making the relevant supplies of hotel accommodation, and rejected the company's contention that it was acting as an agent for the owners of the hotels and was only required to account for VAT on its commission.**

Demolition of buildings

In the ***Romanian case of SC Gran Via Moinești SRL v Agenția Națională de Administrare Fiscală (ANAF)*** (CJEU Case C-257/11), the CJEU held that article 185 of Directive 2006/112/EC 'must be interpreted as meaning that, in circumstances such as those in the main proceedings, the demolition of buildings, acquired together with the plot of land on which they were constructed, which is carried out with a view to developing a residential complex in place of those buildings does not result in an obligation to adjust the initial deduction of the value added tax relating to the acquisition of those buildings'.

Why it matters: **The Romanian tax authority was not entitled to claw back the input tax which it had initially claimed on the purchase of the buildings which it subsequently demolished.**

Input tax: MTIC fraud

The principles laid down in *Kittel v Belgian State*, CJEU Case C-439/04, [2008] STC 1537, were applied in the Bulgarian case of ***Bonik EOOD v Direktor na Direktsia 'Obzhalvane I upravlenie na izpalnenieto' – Varna pri Tsentralno upravlenie na Natsionalnata agentsia za prihodite*** (CJEU Case C-285/11), where the CJEU held that 'a taxable person may not be refused the right to deduct VAT in relation to a supply of goods on the ground that, in view of fraud or irregularities committed upstream or downstream of that supply, the supply is considered not to have actually taken place, where it has not been established on the basis of objective evidence that the taxable person knew, or should have known, that the transaction relied on as a basis for the right of deduction was connected with VAT fraud committed upstream or downstream in the chain of supply – a matter which it is for the referring court to determine'.

Why it matters: **Some commentators had speculated that the CJEU decision in this case might modify the effect of its previous decision in the *Kittel* case. However the CJEU appears to have emphatically reaffirmed its previous**

decision, upholding the principle that the key test is whether the taxable person 'knew or should have known' that the relevant transactions were connected with VAT fraud. Where a taxable person knew or should have known that the transactions were connected with VAT fraud, he does not have the right to deduct the relevant input tax. Where it is not shown that the taxable person should have known that the transactions were connected with VAT fraud, he retains the right of deduction.**

VAT grouping

In ***European Commission v Kingdom of Sweden*** (CJEU Case C-480/10), the European Commission applied to the CJEU for a ruling that, by restricting the availability of VAT grouping to the financial and insurance sectors, Sweden had failed to comply with its obligations under article 11 of Directive 2006/112/EC. Advocate General Jääskinen delivered an opinion in favour of the Commission.

Why it matters: **Advocate General Jääskinen upheld the Commission's contention that the Swedish restrictions on VAT grouping contravened Directive 2006/112/EC. It seems likely that the CJEU will uphold this opinion.**

Services to investment fund

In the German case of ***GfBk Gesellschaft für Börsenkommunikation mbH v Finanzamt Bayreuth*** (CJEU Case C-275/11), Advocate General Cruz Villalón expressed the opinion that article 13B(d)(6) of the EC Sixth Directive 'must be interpreted as meaning that an advisory and information service provided by a third party, relating to the management of a special investment fund and the purchase and sale of assets, constitutes an activity of "management" specific and distinct in nature, provided that the service is found to be autonomous and continuous in respect of the activities actually performed by the recipient of the service, a matter which it is for the national court to verify'.

Why it matters: **Article 13B(d)(6) of the Sixth Directive provided that 'management of special investment funds as defined by Member States' qualified for exemption from VAT. Advocate General Cruz Villalón's opinion appears to suggest that the services supplied by the appellant company qualify for exemption under this provision.**

Administration & appeals

Penalty imposed at 15%

In ***S McHale v HMRC*** (TC02329 – 7 November), an employee (M) changed jobs at the end of September 2009. On his 2009/10 tax return, he only declared his income from the second employer, and only declared his benefits from his first employer. When HMRC discovered this, it imposed a penalty under FA 2007 Sch 24, at the rate of 15% of the potential lost revenue. The FTT upheld the penalty and dismissed M's appeal.

Why it matters: **The First-tier Tribunal held that there was no reasonable excuse for the errors in the appellant's return, and upheld the penalty which HMRC had imposed under FA 2007 Sch 24.**

Penalties imposed on solicitor for failure to comply with notice

In ***MJ Rayner v HMRC*** (TC02363 – 22 November), a solicitor failed to comply with a notice under TMA 1970 s 19A. HMRC imposed penalties under TMA 1970 s 97AA. The FTT upheld the penalties and dismissed the solicitor's appeal.

Why it matters: **TMA 1970 s 97AA provides statutory penalties for failure to comply with a notice under TMA 1970 s 19A. The FTT upheld the penalties which HMRC had imposed in this case, and also upheld discovery assessments issued on the basis that the solicitor appeared to have overstated his expenditure. Judge Coverdale's decision is worth reading in full, as an illustration of the difficulties which HMRC sometimes encounter in attempting to administer the tax system.**

Time limit for assessment

In ***K Gobie v HMRC*** (TC02364 – 22 November), an individual (G) submitted two returns in which he overclaimed foreign tax credits. When HMRC discovered this, they issued assessments to recover the tax due. G appealed, contending that the assessments had been issued outside the statutory time limit. The FTT rejected this contention and dismissed the appeals. Judge Coverdale held that the conditions of TMA 1970 s 29(5) were satisfied.

Why it matters: **TMA 1970 s 29(5) provides that HMRC may issue an assessment outside the normal time limits where 'the officer could not have been reasonably expected, on the basis of the information made available to him before that time, to be aware of the situation …'. The FTT upheld HMRC's contention that this condition was satisfied here, as HMRC had not previously been aware that the appellant's return overstated his entitlement to foreign tax credits.**

Editorial & production

Editor: Paul Stainforth (020 3364 4448; paul.stainforth@lexisnexis.co.uk)

News editor: Andrew Goodall (andrew.goodall@lexisnexis.co.uk)

Cases editor: Alan Dolton

Design: Jack Witherden

Production manager: Angela Waterman

Marketing manager: Rakhee Patel

Director of news and insight: Tristan Hilderley

To contribute

Please email a synopsis of the topic you would like to cover (what it is & why it matters) to the editor. Unsolicited articles are rarely published.

To advertise

For display advertising & sponsorship opportunities: Nick Lee (020 8662 2065; nick.lee@lexisnexis.co.uk)
For recruitment advertising: Stuart Cousins (020 8212 1997)

To subscribe

Contact Customer Services (0845 370 1234; customer.services@lexisnexis.co.uk)
Annual subscriptions cost £366 post-free (UK); £646.85 2 year (UK); £801.90 3 year (UK); £514.50 overseas 1 year.

Missing copy?

Contact Derek Waters (020 7400 2898)

About Tax Journal

This publication is intended to be a general guide and cannot be a substitute for professional advice. Neither the authors nor the publisher accept any responsibility for loss occasioned to any person acting or refraining from acting as a result of material contained in this publication. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical or otherwise, without the prior written consent of the publisher and editor.

Printed by Headley Brothers Ltd, Ashford, Kent.

Published by LexisNexis, Quadrant House, The Quadrant, Sutton, Surrey SM2 5AS. Tel: 020 8686 9141. www.lexisnexis.co.uk

© Reed Elsevier (UK) Limited 2012

ISSN 0954 7274

Follow us on Twitter **@tax_journal**

Join the **Tax Journal** group on LinkedIn

In brief

Our pick of recent tax commentaries & client briefings

There's always unexpected details in a Finance Bill

Patrick Stevens
CIOT

In amongst the 90+ measures in the draft Finance Bill are some points that many have missed. This is perhaps inevitable when there are over 1000 pages of draft legislation and explanatory notes. Tax experts at the CIOT pointed to one potential catch and one potential helpful measure that may slip below people's radar screens.

No exemption for pension contributions made for an employee's family member: An employee might ask their employer to make pension contributions – perhaps via a salary sacrifice – on their behalf in respect of some family members. The aim might be to sidestep the £50,000 (soon to be £40,000) annual limit for contributions to approved pension schemes. The new measure stops employees gaining an advantage.

Treating a spouse as UK domiciled: Although most focus on UK residents who are non-domiciled is on how they might escape income tax, there are disadvantages for inheritance tax purposes where one party to a marriage (or civil partnership) is UK domiciled and the other is not. In such cases, the traditional IHT exemption for transfers between spouses is severely restricted, with the UK spouse only having exemption up to £55,000, for transfers to their non-domiciled spouse. That exemption lever is being increased to £325,000 but there is a provision that allows the non-domiciled spouse/civil partner to go a step further and elect to be UK-domiciled for IHT purposes. That may be very helpful for those wishing to organise their estates though it is something to use with care: it cannot be revoked it seems. But it does not affect the general non-domiciled status.

Commenting, CIOT President Patrick Stevens said: 'It just shows how important it is to look at all the measures in a Finance Bill. With that in mind it is worrying how much material we have here that needs to be digested before April. But at least we have time to do that and the government is to be congratulated in honouring its commitment to expose the legislation in draft. At least no tax adviser will be short of something to read over the festive season!'

'Huge boost for the tax attractiveness of EMI'

David Cohen
Norton Rose

At the March 2012 Budget it was announced that an employee who exercised an enterprise management incentive (EMI) option and then sold his shares would be eligible for entrepreneurs' relief on the sale even if he did not previously own at least 5% of the shares of the company. Qualification for entrepreneurs' relief means a reduction in the rate of capital gains tax from 28% (for a higher rate taxpayer) to 10%.

However, there was disappointment that employees exercising EMI options would still have to comply with the requirement of having held their shares for at least 12 months. EMI options are most often used by private companies and very frequently can only be exercised on the sale of their company. In such a situation, the proposed abolition of the 5% requirement would be of no benefit to the employees because as part of the corporate transaction they would be forced to exercise their options and sell the shares immediately and thereby fail to meet the 12 month holding requirement.

HMRC has announced that 'the normal 12 month minimum holding period requirement will include the period the option is held'. This is a huge boost for the tax attractiveness of EMI. It will mean that an employee can be granted an EMI option today, hold the option for a minimum of 12 months and then exercise the option and sell the shares immediately and still benefit from the 10% tax rate. Coupled with the increase in the individual limit from £120,000 to £250,000 which took effect in June, EMI options are now by for the most tax-effective arrangements for rewarding UK executives.

De-enveloping: 'the race is on'

Sean Randall
Deloitte

The fact that the government has decided to press ahead with [the annual residential property tax, a new tax on ownership of residential property worth more than £2m by companies and other 'non-natural persons'] is no surprise. They were committed to the concept from the beginning. It is designed to deter high-value residential properties being 'enveloped' within a company so as to prevent an opportunity for SDLT avoidance on future sales. It is also designed to encourage individuals to 'de-envelope' such property from existing companies.

What's certain is that trust companies, lawyers and tax advisers operating in this space will all be very busy in the run up to April advising their clients which structure is the most appropriate for them taking into account all taxes: SDLT, inheritance tax, capital gains tax and ARPT.

The government has listened to industry representations on ARPT and its cousin, the super rate of 15%, which acts as a further disincentive to enveloping, by ensuring they only apply, as intended, to individual owner-occupiers. A large number of exclusions from the super rate will be introduced for various businesses, aligning it to the scope of ARPT. Controversially, however, there is no indication, as yet, that the exclusions will apply before the summer of next year. Consequently, property companies, pension funds, landed estates and new developers appear likely to continue to have to pay SDLT at the super rate despite no tax avoidance. This appears unfair and I hope the government recognise this by back-dating the exclusions from March this year.

Draft GAAR legislation 'shows government is listening'

Lisa Macpherson
PKF

The draft legislation [on the general anti-abuse rule] is significantly different in many instances to the Treasury's original proposals and a welcome sign that the government is listening to professional bodies and advisers ... Putting back the start date to mid-July – to the date of Royal Assent – will allow time for the GAAR panel, HMRC and advisers to properly understand the legislation and guidance, and ensure the rules are applied consistently and fairly. It is also encouraging to see that the draft legislation includes additional protection for taxpayers. There was concern that the new rules could create uncertainty by potentially changing tax policy retrospectively, but today's announcement should help alleviate some of the concerns. In particular, it will reassure many to see that the Treasury is likely to look more favourably on schemes that 'accord with established practice, where HMRC had, at the time the arrangements were entered into, indicated its acceptance of that practice'.

This is an important piece of new legislation and it is essential that the government gets it right first time so as not to undermine confidence in the tax system. The draft legislation strongly suggests that the Treasury has made a good job of it.

The cap on income tax relief and professional partnerships

Bill Dodwell & Alison Bond
Deloitte

Bill Dodwell, Deloitte's head of tax policy said: 'Our view is that the cap should be targeted at "investment" reliefs and that losses from the individual's main business or businesses should be offset without restriction. The government has listened to some of the representations on the cap on income tax reliefs. Overlap relief (a relief for profits taxed twice when an individual starts up in business) won't be capped and the use of trade losses will be made easier. However, interest expense incurred by an individual on investing in a partnership or qualifying trading company will potentially be restricted. Some partnerships will need to look again at how they are financed, as full relief is given for interest incurred by a partnership; the potential restriction applies only to interest paid by the individual partner.'

Alison Bond, head of professional partnerships tax at Deloitte adds: 'It is good to see that HMRC have responded to the concerns regarding overlap relief but we are disappointed that the cap will adversely affect the tax position of professional partnerships operating internationally through separate vehicles (for regulatory or risk reasons) by restricting relief for losses incurred there. We regret that these rules are unsupportive of international business expansion into emerging markets.'

Tax books from Spiramus Press

***NEW* VAT & Financial Services** *Mark Chesham*

December 2012 ISBN: 978 1907444 42 5 £49.95

VAT & Financial Services takes the reader through the relevant legislation and case law, and key legal concepts; examines the consequences of outsourcing; looks at the key issues facing financial services and insurance; and discusses the VAT cost sharing exemption.

VAT and the NHS *Martin Kaney* **August 2012 ISBN: 978 1907444 68 5 £49.95**

VAT & the NHS is intended to be both a reference manual and a practical guide to managing VAT in the NHS. Covers important changes as a result of the Finance Act 2012 and recent cases including Reed Employment.

"This book should help Taxation readers who act for clients affected by the continuing organisational change within the NHS. It is certainly a welcome addition to my own library." Taxation, 18 October 2012

***NEW* European Tax Law: Direct Taxation (3rd edition)**

Editors: Michael Lang , Pasquale Pistone, Josef Schuch and Claus Staringer

January 2013 ISBN: 9781907444 68 5 Price: £29.95

A useful introduction to European direct taxation for both students and practitioners. Designed for students, useful also for experienced international tax specialists with little knowledge of European law, and non-Europeans dealing with Europe who need to understand the foundations of European tax law.

The LITRG Tax Credits Handbook 2012/13

Victoria Todd and Robin Williamson **July 2012 ISBN: 978 1907444 03 6 £29.95**

Covers working tax credit and child tax credit. Provides detailed commentary and practical guidance on who can claim and how a claim should be made.

Books and ebooks available from www.spiramus.com

This week

Tax lawyers condemn 'attack on the rule of law

> 'Increasing public pressure on companies seems to be throwing taxes in to disarray'
>
> *Richard Jordan*

MPs are wrong to suggest that HMRC is not adequately tackling tax avoidance, and their criticism of multinationals is an 'unprincipled attack on the rule of law', a leading tax lawyer has said.

David Goldberg QC argued in a letter to *The Times* that the Commons public accounts committee (PAC) had set up its own standard for HMRC and criticised the department for not achieving that standard. 'But the standard set up has no basis in fact or in law,' he said in response to an article written by PAC chairman Margaret Hodge.

HMRC 'must pursue aggressive tax avoiders more vigorously', Hodge wrote. 'It's not just a matter of resources; it's also about culture and attitudes.'

Last week's PAC report was highly critical of tax arrangements at Amazon, Google and Starbucks. 'We were not convinced that their actions, in using the letter of tax laws both nationally and internationally to immorally minimise their tax obligations, are defensible,' the PAC said.

All three companies defended their tax arrangements but Starbucks made a public commitment to pay more corporation tax than required by law. 'Specifically, Starbucks will not claim tax deductions for royalties and standard intercompany charges. Furthermore, Starbucks will commit to paying a significant amount of tax during 2013 and 2014 regardless of whether the company is profitable during these years,' Kris Engskov, managing director in the UK, said in an open letter.

The *Financial Times* reported that Starbucks had said 'it would not claim tax deductions for royalties, coffee purchases, interest on intercompany loans, or capital allowances, and would not carry forward tax losses'.

'Principle, not demotics'

However, Goldberg suggested that the PAC had exceeded its remit: 'It is beyond the competence of the committee to determine whether a particular taxpayer has paid the "right" amount of tax; the proper job of the committee is to examine, against the standards of good administration, whether HMRC is doing its job.'

Hodge had adopted 'far too broad a conception of tax avoidance', Goldberg added. 'A company which pays tax on its profits, computed by deducting from its receipts the expenses incurred to earn them, cannot be said to have avoided tax.' A stand needs to be made 'for principle, not demotics', he warned.

Increasing public pressure on companies such as Starbucks 'seems to be throwing taxes in to disarray', said Richard Jordan, a partner at the law firm Thomas Eggar. He warned that Starbucks' commitment 'does not represent a reasonable way to pay taxes and sets a dangerous precedent.'

As *Tax Journal* reported last week, Hodge told the BBC's Today programme that accountancy firms 'supporting anybody in trying to avoid tax in an aggressive way' should be denied access to government contracts.

In her *Times* article Hodge said she questioned 'whether the public will continue to tolerate the current practices of the big accountancy firms, banks and tax lawyers'.

She added: 'Helping people to avoid tax may make you lots of money, but it is increasingly regarded as unethical and unacceptable.'

Professional bodies have backed the government's efforts to tackle aggressive avoidance. Practising tax experts have been engaged in consultation on the proposed general anti-abuse rule, and gave a broad welcome to the revised draft GAAR published this week.

Responding to criticism aired on the Today programme, the big four firms of accountants stressed 'their global role and their requirement to respond to the needs of their clients'. Ernst & Young told *Tax Journal* that the firm's clients sought advice on 'a wide range of issues, including the most appropriate tax planning that is in compliance with the applicable laws and rules'.

Tax academics have stressed the difference between the aggressive schemes that the GAAR is designed to deter and the use of tax havens and low-tax jurisdictions to manage a multinational's effective tax rate within the law.

'Unjustified scrutiny'

Richard Jordan said: 'Margaret Hodge continues to be gaining traction in her comments on tax professionals and I strongly believe we will be next on the agenda for unjustified scrutiny. Rather than alienating tax professionals, HMRC could be working with us to help weed out those companies that aggressively avoid tax. Government engagement and discussion with sector representatives of the professional advisers – for example at the Society of Trust and Estate Practitioners (STEP) and the Chartered Institute of Taxation – would be far more fruitful than professional bashing in the press.'

Jordan is a member of the UK technical committee at STEP. He told *Tax Journal* that he did not regard the tax planning under scrutiny at Amazon, Google and Starbucks as aggressive avoidance. 'If you want to change that, you have to change the law,' he said.

But Jordan welcomed the fact that the issue of what is morally acceptable tax behaviour was now 'centre stage', and called for a sensible discussion about 'how to change behaviours'.

If HMRC asked tax professionals to go on record and denounce certain types of activity, many of the leading firms would do so, he said: 'Pre-ordained, packaged tax schemes are wrong.'

Andrew Goodall, news editor, Tax Journal
andrew.goodall@lexisnexis.co.uk

The debate

Should we move to a system of unitary taxation?

The case in favour

Sol Picciotto
Emeritus Professor, Lancaster University

The current system of international taxation is badly in need of reform. Unitary taxation is the equitable and practicable solution. Currently, transnational corporations (TNCs) are taxed under an international system whose basic structures were devised a century ago. Under unitary taxation, they would be taxed not according to the legal forms that their tax advisers create for them, but according to the genuine economic substance of what they do and where they do it. This would be far more legitimate and simpler to implement than the current system.

The present international tax system treats TNCs as if they were loose collections of separate entities operating in different countries, which gives TNCs tremendous scope to shift profits around the globe to suit their tax affairs. This mainly involves two related methods. First, TNCs create subsidiary companies or entities in convenient countries, either to carry out activities (e.g. financial transactions, transport, providing advice or other services) or to act as holding companies for assets such as intellectual property rights, bonds, or shares. By channelling profits through or to them, the group's overall taxes can be reduced, even though they often exist only on paper. Secondly, a TNC can adjust the prices of transfers between members of the TNC group, to shift profits from high-tax to low-tax countries, known as 'transfer pricing'.

Unitary taxation deals with *both* problems, by treating a TNC engaged in a unified business as a single entity. It would be required to submit a set of worldwide consolidated accounts in each country where it has a business presence, then the overall global profit is apportioned to the various countries according to a weighted formula reflecting its genuine economic presence in each country. Based on experience, e.g. among US states, and a current proposal for the EU, there should be a three-factor formula: physical assets, employees, and sales revenue.

Unitary taxation would cut the costs of compliance for firms and greatly simplify tax administration, benefiting poor developing countries especially. TNCs are major users of tax havens, providing them powerful political cover: curbing this would make it easier to tackle tax havens on financial secrecy and many other issues. Aligning tax rules more closely to economic reality would improve the fairness and transparency of international tax and help create a level playing field for business. With increased globalisation in recent years there has been a trend towards a more 'territorial' basis for taxation of TNCs, as states which are their 'home' countries have accepted that it is no longer possible for them to claim to tax TNCs' foreign profits, e.g. under rules governing 'controlled foreign corporations'. Unitary taxation would place this on a sounder foundation, by allocating the tax base of TNCs according to their actual presence within the territories of the countries where they operate. This would ensure that they make a fair contribution as corporate citizens towards the costs of the public services provided by the states where they do business.

A discussion paper by the author, 'Towards Unitary Taxation', is published by the Tax Justice Network and is available at taxjustice.net and via lexisurl.com/UnitaryTaxation. The paper provides a fuller discussion and suggests a roadmap for a transition.

Vs.

The case against

Miles Dean
Founder, Milestone International Tax Partners

Practical difficulties make implementing unitary taxation a pipe dream. The economic effects for the UK are far from clear. Unitary taxation has been touted as a panacea to the current issue of multinational tax avoidance. Advocates say that such a system produces a more equitable result on the basis one can fairly allocate global profits according to an agreed formula which takes account of where the economic activity occurs. This is a fallacy for two main reasons. First, and most significantly, is that the practical difficulties in implementing such a system make the concept of unitary taxation little more than a pipe dream. There are three critical elements to any unitary taxation system that would need to be adopted consistently on a global basis:

- the taxable unit would need to be defined (i.e. defining which entities form part of the group or 'unit');
- the profits would need to be measured; and
- perhaps, most controversially, a formula would need to be agreed (whether by reference to sales, payroll, headcount, expenses or a combination of these factors) by which the taxing rights over the global profits would be allocated between each jurisdiction.

The first two elements might conceivably be agreed on a global basis (for example, based on a modified version of international accounting standards). However, it is inconceivable that a global consensus could emerge as to how global profits should be allocated between jurisdictions. For example, a highly developed knowledge based economy might favour a formula that gives preference to payroll costs. On the other hand, a developing economy might give preference to an allocation factor that favours headcount. The point is that each jurisdiction will develop their own formula that maximises their share of the global profit. The result (absent an entirely new framework of tax treaties) will be double taxation which in turn will diminish economic growth and magnify unemployment.

Secondly, the economic effects of the UK moving to a system of unitary taxation system are far from clear. Margaret Hodge and the 'kangaroo court' that is the PAC appear to advocate a unitary system of taxation with an allocation factor based on sales because, in their simplistic view, this would increase the corporation tax take from multinationals such as Amazon. However, a sales based allocation factor is likely to significantly reduce the UK's corporation tax take from UK based multinationals, such as Rolls Royce and the pharmaceutical companies, which generate significant overseas sales based on UK knowledge based activities. Until the economic impact of a unitary system has been properly evaluated the case for unitary taxation is far from clear.

And finally, one might observe that the EU has for many years been attempting to impose unitary taxation in the form of a Trojan horse that is the common consolidated tax base. The fact that this project has not gone further than the drawing board despite years of consultation highlights the practical difficulties of designing and implementing a unitary system. The growing instability in the eurozone highlights the potentially dangerous implications of ceding further sovereignty over the UK's tax system.

Reflections on 2012

Views from across the profession

Making the tax system simpler, fairer and more efficient

David Gauke MP
Exchequer Secretary to the Treasury

Since taking office in 2010, the government has made it a priority to have a tax system that is simpler, fairer and more efficient. In tax as in other public services, we want to make tax easier for people, by taking advantage of the digital revolution. Part of the government's digital strategy is for HMRC to become digital by default, something on which we've made significant progress.

Our work this year began at Budget 2012, when HMRC published *Making tax easier, quicker and simpler for small business*. This set out changes to the rules to make the tax system easier for small to medium-sized enterprises (SMEs) to understand and outlined how HMRC is going to improve the experience of SMEs when dealing with the tax system. We also announced that 20 million taxpayers will get an online personal tax statement from 2014/15, helping them to better understand their tax affairs.

As a leader in government digital services, HMRC has already embraced many of the opportunities provided by new technology but they believe they can go further. Each year, HMRC have 60 million hits to the website and over 270 million online transactions; they are constantly looking for ways to improve their relationship with businesses and individuals and this year has seen HMRC make further progress, both at Budget and Autumn Statement.

In May we launched the personal tax calculator, an online tool and smartphone app that allows people to work out how much tax they pay and how the government spends it. With more than 250,000 downloads, the tax calculator helps to demystify the tax system, making it more transparent.

And we are going further. This month the chancellor announced that the government will forge ahead with its digital strategy by significantly expanding HMRC's online service aimed at taxpayers. For the first time:

- the UK's 4.6 million SMEs will be able to access everything they need online and from a personalised homepage with secure digital messaging;
- 39 million individual taxpayers in PAYE will be able to let HMRC know of changes to certain information that affects their tax; and
- the 10 million self-assessment tax payers will be able to carry out all their transaction online.

These changes to HMRC's online services will save businesses time and money and give individual taxpayers greater understanding of their tax affairs. Under PAYE Online, taxpayers will be able to update certain information which affects their tax, helping HMRC to accurately calculate their tax code. HMRC's self-assessment online service is already used by 80% of self-assessment tax payers. The Autumn Statement announcement by the government will mean a totally digital experience, completely eliminating 22 million pieces of paper from the system.

Finally, the new service for SMEs, 'tax for my business', will give them access to everything they need to know and do online from their own personalised homepage – they'll be able to register, file and pay online as well as get tailored advice. This follows on from HMRC's 'one click programme' which delivered a tax dashboard for businesses and an online registration service in April 2012. These services will be up and running from the 2014/15 tax year.

HMRC will soon publish a digital strategy providing more information on this work. The digital strategy will contain details of the cross-government initiative, 'assisted digital', which will support users to access digital services and encourage further take up.

The ambitious digital advancements made this year signal a significant change in how taxpayers can interact with their tax affairs. Government is committed to providing individuals and businesses with straightforward, streamlined access to online information and services at times and in ways which are convenient to them – on a scale that has never been done before – and we will continue to forge ahead, making the best use of the advantages technology can offer us.

The GAAR

Graham Aaronson QC
Barrister, Pump Court Tax Chambers

What a difference a year makes.

Just over a year ago the GAAR study report was published. It received a pretty warm welcome by the TUC and, dare I believe it, Richard Murphy of the Tax Justice Network. The CBI was also cautiously happy with it. The doubters were tax professionals who worried about creating uncertainty for tax planners and driving investors abroad.

Well, I took on the GAAR study job because I thought it likely that the combination of coalition politics and years of austerity would move tax avoidance closer to centre stage; and it would be far better to develop a sensible GAAR through a rigorous and non-partisan study than to have one produced hurriedly by HMRC as a response to public anger at tax avoiders. This was the message I gave in the many consultations I held with various professional bodies during the study.

I know it can be very irritating to listen to 'I told you so'. But I did tell you so. So what do we have now, a year later? Thanks to Jimmy Carr, Starbucks and Amazon, tax avoidance is in the very centre of the stage, Joe Public is baying for tax avoiders' blood, Richard Murphy is saying that the GAAR does not go nearly far enough, and tax professionals are praying that the GAAR legislation and the all important guidance notes will hold the sensible line which the study group drew.

To their great credit Treasury ministers and HMRC have not caved in to public pressure, there has been no 'mission creep', and the draft GAAR to be introduced in FB 2013 does hold that line. All the major safeguards are in, the GAAR will target abusive schemes and the centre ground of tax planning remains unaffected.

As for the guidance notes, my job in chairing the interim advisory panel will be to ensure that it too will not cave in to public pressure and that the notes which it must approve will make the GAAR an effective weapon to deter and counteract abusive schemes, while not materially affecting reasonable tax planning.

If I have a message for the coming year, then it is – please wait and see. If I am invited to write an equivalent piece next December, then I hope that I will be able to say again 'I told you so'.

What is wrong with tax policy making?

Paul Johnson
Director, The Institute for Fiscal Studies

2012 has not been a great year for tax policy. For one thing the debate over tax avoidance has created a great deal of heat without a commensurate amount of light. But the actual making of new policy has certainly not climbed the heights of clarity and coherence.

The March Budget led to the popularising of the marvellous term 'omnishambles', and much of that was about tax policy. The problem wasn't so much that the particular measures proposed were daft. Or rather the daft ones weren't on the whole the ones that led to the omnishambles tag.

Take getting rid of the additional income tax personal allowance for pensioners. It is a perfectly rational and defensible policy. Had the government announced, when it introduced the policy of moving all personal allowances up to £10,000, that it would then get rid of the very small additional advantage that pensioners would have I doubt there would have been that much fuss. Instead it sprang the idea on an unsuspecting world and described it as a 'simplification'.

Or what about the 'pasty tax'? Since our system of VAT requires a line to be drawn somewhere it is not obvious that there is anything wrong with moving hot pasties from one side of the line to the other. If the government had a coherent strategy for extending the VAT base then one could have understood where the pasty tax came from and what its purpose in tax strategy was. Even if this was a genuine attempt at simplification the announcement in fact looked like no more than an opportunistic grab for a bit more revenue.

That is not to say that we haven't also seen some tax policy making which it would be hard to fit into any economically coherent tax strategy.

Economists may be famous for not agreeing on much, but you'd be hard pressed to find many who think that stamp duty land tax is a good idea. It is a tax on transactions which reduces welfare pretty directly by discouraging mutually beneficial trades in the housing market. Yet it was increased to a hefty 7% on properties over £2m. This may not be a group of house purchasers who will gain much public sympathy, but the tax is nevertheless a bad one. A much better reform to housing taxation would be to update the values used in council tax assessments and make payments proportional to house value – as opposed to capped and regressively related to value as at present. But such a change has been ruled out.

Then in the Autumn we got the 'shares for rights' scheme proposing exemption from capital gains tax for employees who give up certain employment rights. Even as issues of tax avoidance were in the headlines the government's fiscal watchdog warned that this could create a new multi million pound avoidance industry.

The list goes on.

So far as tax policy is concerned this has been a year littered with evidence of a lack of any coherent long term strategy for most parts of the tax system. We are left with little idea of the government's long term direction. What does the government expect to go next with pension taxation? I have no idea. What role does it think taxes should play in adjusting behaviour? I don't know. How does it think housing should be taxed in the long run? Not a clue. And as for the taxation of petrol! The continued succession of on, delay, delay, off announcements for indexing fuel duty has descended from soap opera into farce.

This lack of clarity is costly economically. It reduces people's welfare. And it makes planning much more difficult than need be.

Oddly, perhaps one of the better processes – whatever you think of the outcome – was associated with the reduction of the 50p rate of income tax to 45p. For once this was a policy which came with some serious and high quality analysis. There remains a lot of uncertainty over the precise effect of the 50p rate, but nobody could look at the data and ever again believe that taxes don't sometimes have a very big effect on behaviour.

The evidence of massive forestalling might also have led you to believe that no chancellor would ever again announce changes to tax rates for those on over £150,000 with a year's warning to allow maximum tax planning. You would of course have been wrong. By giving a year's warning before reducing the 50p rate Mr Osborne has ensured that the timing of many billions of pounds worth of transactions will again be determined more by changes in the tax regime than by any economic fundamentals.

Tax and *The Times*

Alexi Mostrous
Special correspondent, *The Times*

This year tax has risen to the top of the political agenda. I confess. This time last year I was not fascinated by tax. Beyond a vague awareness that it was deducted from my *Times* payslip, I knew nothing about it. Little could I have imagined that ten months later I would be conversant in the finer points of employer funded retirement benefit schemes, general anti-abuse rules and unregulated collective investment strategies. I'm still unsure whether this is a good thing.

After writing a series of stories exposing how the wealthy dodge tax, my eyes have been opened. Tax avoidance by individuals is a major problem. In Britain the practice costs the economy, on the most conservative of revenue estimates, £4.5bn a year. Add into the mix corporate tax avoidance and tax at risk rises to more than £30bn. These are staggering figures.

This year has seen tax avoidance rise to the top of the political agenda, partly as a result of stories published by our newspaper.

The Times' undercover investigation exposed providers who shelter billions of pounds for their clients. Hundreds more tax avoidance firms are in business, generating more than 300 new DOTAS schemes a year. As one told us, accurately: 'Between us and the Revenue, it's a game of cat and mouse.'

In June, David Cameron took the unprecedented step of condemning Jimmy Carr, the comedian, after we revealed he was a member of the K2 tax scheme. Interestingly, Mr Cameron refused to condemn Gary Barlow, the Take That singer and Tory supporter, who had also invested millions of pounds in two suspected avoidance schemes.

The Carr story was followed by front-page splashes exposing abuses of film tax relief, Britons claiming tax breaks in Monaco, and a £1bn avoidance scheme called Liberty which attracted

2,000 investors, including BBC presenter Anne Robinson. Responding to the growing political disquiet, the government toughened the rules around disclosure, signed a FATCA-esque agreement with Guernsey, and moved closer towards introducing a GAAR.

Articles on tax provoked a 'marmite' response from our readers. Many commentators on *The Times*' website pointed out, correctly, that avoiding tax is perfectly legal. They said it was up to HMRC, rather than the taxpayer, to change the rules. This argument has strong logical force. But it arguably ignores a societal shift in attitudes towards tax, and in particular towards the relationship between the state and the individual.

From talking to industry professionals and members of the public, my impression is that tax is now viewed by many as an essential component in a civilised society. Perhaps in a time of austerity, the hackneyed old quotation used on every tax avoidance provider's website, that 'every man is entitled if he can to order his affairs so that the tax … is less', holds less authority than it once did. No longer is the taxman regarded as a thief slipping his hand into your pocket.

To earn more than £100,000 a year and opt out of it, however legal your methods, is considered by increasing numbers of people as morally unacceptable. The same can be said for multinationals who charge £5 for a coffee and funnel the profits offshore.

In 2013 it will be fascinating to see how the landscape develops further. Will the GAAR shut down aggressive tax schemes? Or will it prove a toothless tiger, with no real penalties and no possibility of catching anything but the most obviously aggressive 'abuse'?

Will HMRC still cleave to the principle of taxpayer confidentiality? Could the government introduce a limited exception to the rule, allowing some exposure of those entering legal tax avoidance schemes? And what of tax havens such as Jersey and Guernsey?

And are the big banks and the big four accountancy firms really out of the business of aggressive tax avoidance? All these questions will preoccupy me in the New Year.

HMRC customer service

Paul Aplin
Chairman, ICAEW Tax Faculty Technical Committee

I hope that we may look back on 2012 as a year in which something fundamental happened within HMRC, something that changed the department's view on service delivery.
The trigger for the change was the Treasury Select Committee's report in 2011. That report recommended, inter alia, that HMRC should try to see things through the eyes of stakeholders. The professional bodies wrote to HMRC's then chairman, Mike Clasper to suggest that we should meet to take the TSC's ideas forward. Mike agreed. Over the next few months several dozen people from HMRC visited tax practitioners' offices and a number of tax practitioners visited HMRC post processing and call centres. In 2012 HMRC started to act on the information those visits had yielded.

Top of the list of issues was the P35 process. In 2011 it had the feel of something deliberately aimed at catching out employers and at maximising penalties by only telling employers they had failed to file on time after several months' penalties had already accrued. In 2012, because of the visits and the conversations that followed, things were very different. There was better guidance, better timing of the notice to file, an additional reminder letter and a first penalty letter issued after one month rather than four, allowing those who had missed the deadline to cap their penalty at a much lower figure. As a result, far fewer employers faced penalties or multiple penalties.

Another major issue was call centre response times. Detailed discussions took place over the summer and HMRC's new leadership took decisive action. Lin Homer agreed to reallocate £34m of HMRC's budget to call centres, and to redeploy 1,000 staff. She also agreed to publish call waiting times so that the effect of the action could be monitored.

In addition HMRC put in place a better process for dealing with bereavement cases, launched an email pilot and took action to improve post handling.

Central to success was Mike Clasper's willingness to engage and the professional bodies and tax charities willingness to work with HMRC. The dialogue required trust on both sides and as it developed, the degree of openness and candour was – in my experience – unprecedented. The initiative soon began to influence thinking at Board and EXCOM level and attracted some very powerful advocates within HMRC. It quickly gained the total support of HMRC's new top team.

So, in the immortal words of Bart Simpson, are we there yet? No we are not, but we are at last heading in the right direction. We need to ensure that the initiative retains momentum through 2013.

The simple idea at the heart of it was giving people the opportunity to see things through each other's eyes. To keep the momentum we have to do more of that. Personally I think that every member of HMRC's board, of EXCOM and all at director/deputy director level should spend a day with a tax practice, a tax charity or a small business to see service delivery through their eyes.

We must also continue to tackle head on the major problems as well as more routine issues. In 2012 we tackled P35s and call centres. In 2013 the initiative will tackle – amongst other things – debt management and CIS refunds. Another major challenge in 2013 will be RTI and I would urge HMRC to ensure that those who are working on RTI spend time outside Whitehall, with employers (especially small employers), to gain a real and practical understanding of the impact RTI will have.

HMRC's leadership has embraced this taxpayer focused approach and now it needs to embed the culture across the entire department.

Ministers and politicians (of all parties) have a role to play too. HMRC must be properly funded. The Chancellor's remit letter to Lin Homer earlier this year made my heart sink: 'do more with less' is, in my view, a factor at the heart of the problems we have seen since the merger back in 2005. Efficiency savings are one thing, but the department has been asked to do too much with too little for too long. The announcement in the Autumn Statement of extra funding for HMRC was, therefore, very welcome: but funding is needed for better service delivery as well as for tackling evasion and aggressive avoidance. Taxpayers who think they are being listened to and treated fairly are far more likely to be compliant.

So did the joint initiative really achieve anything in 2012? In

my view yes, it most certainly did. Many thousands of employers saw a very real change, but the new commitment to the simple idea of seeing things 'from the outside in' is even more important: it has the potential to be transformational. We have to make sure that this potential is fully realised.

Getting simpler ... slowly

John Whiting
Tax Director, The Office of Tax Simplification

A look back at what was achieved in 2012, and a look ahead at what's in store in 2013.

A recent letter to *The Daily Telegraph* enquired, in the wake of the Autumn Statement, 'What are the bureaucrats in the Office of Tax Simplification doing?'. My response, apart from stressing that my (very small) team is very un-bureaucratic, was in terms of what we had achieved, which I suggested was pretty good.

Not that we've produced a simple tax system. Nor will we ever achieve that – we live in complex times, in a complex business environment. All the more reason why we should work towards a simpler tax system and that is what the OTS does: research areas of the tax system and come up with recommendations for improvements. It's then up to Ministers, with advice from HMRC and the Treasury, to decide how to take forward our recommendations.

The OTS has been going for over two years now and 2012 has seen us get into our stride. We have established a sound methodology for our projects: plenty of research and fact-finding among as wide a group (practitioners, businesses, individuals and HMRC staff) as possible; working up and testing ideas by a small staff of civil servants and (mostly volunteer) private sector secondees; lots of support and challenge from our very active consultative committees; reports that identify changes in legislation and administration that will reduce complexity and burdens.

A good deal of our focus has been on small business taxation. The reports we produced in the Spring have all been taken forward:

- HMRC administration: a programme of improvements is in hand, with the Administrative Burdens Advisory Board monitoring progress;
- disincorporation: consultation over a potential new relief, with draft Finance Bill legislation just published; and
- cash basis: our recommendation for cash basis for the smallest businesses is going ahead at a higher level of turnover, together with more use of flat rate allowances.

Our recommendations for improvements to the four tax-advantaged share schemes are moving forward well, again following a constructive consultation. We also had a lot of favourable reaction to our interim pensioners' report, analysing the areas of difficulty older taxpayers face with the tax system. Plus work on moving income tax and NICs closer together continues, stemming from a 2011 OTS report.

So what does 2013 hold? First up will be our final reports on pensioner taxation and unapproved share schemes. Both are coming together well and will have a range of constructive recommendations, large and small, that should make a difference. Publishing in January should mean the Chancellor can give a considered response in the March Budget, although changes are most likely to be from April 2014, after consultation.

Then we will be starting on a new project, on employee expenses and benefits. The terms of reference (ToRs) for this large project are published on our website at www.hm-treasury.gov.uk/ots . Like all of our projects it has revenue-neutral simplification as its aim, though even before the ToRs were published some commentators were saying authoritatively that we were going to abolish this and cut that with a view to raising £x bn for the chancellor. Sorry, but that is neither our remit nor our aim: we are on the lookout for simplifications and I want to test whether the whole system is fit for 21st century working patterns. We'll be seeking input for our project (and indeed people to help us with it) and I will say more about it in a future *Tax Journal* article.

Finally, do keep an eye on our work on complexity. We did some analysis work on the length of the UK's tax code during 2012 and have recently published a paper on a complexity index. A paper on tax thresholds is about to be published. All are available on our website and we really would welcome comments on them. If we can establish the causes of complexity, that should be a significant step towards simplification. Now there's a theme for a New Year's resolution ...

Multinational tax planning

Sara Luder
Partner, Slaughter and May

The issues behind the recent outcry on unacceptable tax planning are far more complicated than have been portrayed in the mainstream media.

The coverage of multinational tax planning this year has been unprecedented, and often frustrating. Common misconceptions include that tax is paid on revenues (rather than profits), corporation tax is paid by reference to where customers are located (rather than where the business is carried on) and transfer pricing is 'tax avoidance'.

Was it right that Starbucks felt the need to offer to pay additional 'voluntary' tax? The Starbucks brand and operating systems distinguishes its business from a local coffee shop. A third party franchisee would have been prepared to pay significant amounts for the use of those assets, and so international tax principles quite properly envisage that the UK subsidiary would pay an arm length's fee for the use of the Starbucks brand. This is a fair allocation of profit to where the value is generated. The most notable fact is that the royalties are not being paid to the US, but that is US, not UK, tax planning.

Earlier in the year the demand was that UK multinationals should pay more UK tax on their worldwide profits, but the territorial principle of tax is that non-UK profits should primarily be taxed in the regime where those profits are generated. A UK headed group will therefore not pay UK tax on its worldwide profits, but transfer pricing should mean that the UK parent will pay UK tax to the extent it can justify

charging foreign affiliates for value that it provides (brands or management services, for example) to the worldwide business. The tax rules for in-bound and out-bound investment need to be consistent.

The allocation of profits amongst taxing jurisdictions can never be wholly within the control of the UK. Transfer pricing is based on international tax principles, backed up by the OECD and a network of bilateral tax treaties signed by the UK with its major trading partners. These tax treaties also preserve the right of businesses to trade *with* the UK (rather than *in* the UK) without being subject to UK tax. In the last decade these rules have been under almost continuous review to ensure they remain relevant for the e-economy, but perhaps the time has come for a more radical reassessment.

The EU angle also makes it very difficult for the UK to take unilateral steps to change the rules. The EU treaties preserve the right of multinationals to set up their European operations in whichever member state they want to, and to sell to customers throughout the EU single market from that location. Should the EU be asking itself whether it is appropriate for member states to seek to attract businesses with attractive tax policies? Would an EU common consolidated tax base help, or simply add another unwelcome layer of complexity, given that the underlying issue would still be one of profit allocation?

It is also the EU that controls how VAT revenues are divided between member states. Is it a correct allocation of tax revenues that currently much of the VAT attributable to supplies of e-books made by Amazon to UK retail customers should benefit Luxembourg, not the UK? Should we be criticising Amazon for taking tax into account when choosing where to locate its operations, or looking more generally at EU VAT policy?

These issues are complicated, and need careful consideration. The current knee-jerk reactions are doing little to provoke an informed debate on international tax policy.

Business record checks

Andrew Gotch
Chairman, CIOT's owner-managed business taxes subcommittee

The new regime on business records checks imposes an impossibly high compliance burden for many businesses.

Business record checks (BRCs) went live at the beginning of November. There was a whimper rather than a bang when it did so, which suggests a lack of understanding in the professional world of what BRCs are and what they are meant to do, despite the late Dame Leslie Strathie citing BRC to the Treasury Select Committee in March 2011 as her sole example of how HMRC would achieve its £7bn CSR anti-evasion target. In reality, there are good grounds for saying that there is plenty for advisers and taxpayers to worry about and that the BRC initiative heralds a renewed attack on the soft target of the small business sector that has been the traditional cannon-fodder of HMRC investigation for many years.

BRCs are not benign and are not educational in inspiration, albeit that taxpayers with 'inadequate' records will certainly be taught a lesson. BRCs are the thin end of HMRC's compliance wedge. There is no random selection, and any taxpayer chosen for a BRC has been selected because they have been identified as a positive compliance risk by HMRC's increasingly sophisticated risk analysis function. So simply receiving notification should ring alarm bells – the taxpayer concerned is on the compliance conveyor belt already, and advisers must act promptly to identify and address potential risk, and to make appropriate disclosure should any be required.

So which taxpayers should be feeling nervous? The telephone questionnaire makes it plain that those in the front line are businesses that deal wholly or partly in cash, and that those particularly at risk are unrepresented cash businesses. The questions (a statistical risk assessment exercise) seek initially to identify whether taxpayers are unfamiliar with all their tax compliance obligations and/or uncomfortable with form-filling. More specific questions then follow, the point of which is to identify how many sales and purchases are in cash, how often records are written up and whether private use is indentified, all questions familiar in an investigative context. The message for all advisers is that clients who deal in cash need to be told that they are under the microscope.

BRCs seek their statutory backing from the intrusive and unappealable compliance checking powers in FA 2008 Sch 36 Pt 2. However, the legislation does not compel the presence of taxpayers, nor does it require records to be at a particular location. Thus, as HMRC agrees, it is perfectly in order for records to be examined at a remote location (an adviser's offices, for example) without the taxpayer being there. It is also agreed by HMRC that it is perfectly in order for an adviser to deal with the initial telephone questionnaire on the behalf of a client, which, given the propensity of clients to give imprecise or inaccurate answers to such questions, is a sensible precaution. HMRC has given an assurance that a taxpayer whose BRC is dealt with in this way will not be automatically selected for a visit.

If a visit takes place, what can advisers and taxpayers expect? What HMRC is seeking to establish is whether the records are 'adequate' – not a word used in the statute and not really descriptive of HMRC's expectations. HMRC does not accept that incomplete records are acceptable in any way at all. HMRC's view is that, following s 12B(3), records of *all* receipts and expenses must be kept. So the hurdle is set, in practice, impossibly high, and particularly so for the small and medium-sized cash businesses that are the focus of the BRC initiative. HMRC seems to be seeking to replace a test of a balance of probabilities with a test of beyond reasonable doubt.

If HMRC decides that records are inadequate, a period of grace will be given to allow a taxpayer to put in place records that may meet HMRC's standards. There will then be a follow-up visit, and if the purported inadequacies have not been addressed by then to HMRC's satisfaction, a penalty will be levied. There is a sliding scale and penalties can run into thousands.

So what should be done if a penalty is levied? The better view is that HMRC's interpretation of s 12B is wrong and that the legislation does not allow for the imposition of in-year penalties for record inadequacies unless records have been deliberately destroyed. It follows that in any case where a penalty is imposed, an appeal should be made and the case progressed to the tribunal without delay.

There is no doubt that every one of the 2.4m small UK businesses with turnover of under £20,000 and which transacts in cash is now seen as a potential compliance risk and suitable for a BRC. Taxpayers in that group, and those who advise them, need to consider the implications of that now.

Starbucks and tax

Chris Morgan
Head of Tax Policy, KPMG

I wouldn't start from here …

Starbucks' announcement on Thursday 6 December that they are going to pay more tax than is legally due regardless of whether they make a profit was extraordinary. It shows the power of consumer sentiment and the dramatic extent to which the landscape has shifted on tax. It also raises some complex questions.

First, is this just an admission that the transfer pricing was wrong? I think the answer is no as, apparently, the royalty rates had been agreed with HMRC applying internationally accepted transfer pricing principles. HMRC is tough but fair in policing these rules.

Secondly, does this indicate that the rules are wrong and need changing? There is an ongoing debate about how the effectiveness of traditional tax rules to modern businesses and the knowledge economy, in particular to intellectual property. The OECD will issue a report next year on base erosion and profit shifting and it may be some changes need to be made. But fundamentally the system is not broken.

Thirdly, is the payment not in fact tax, as it is voluntary? If so, should HMRC accept the payment? Tax is levied according to law. Starbucks is undertaking to pay an amount even if it has losses.

The conclusion must be this is a voluntary payment. The only other similar incident I can think of is when some MPs volunteered to pay 'capital gains tax' after 'flipping' their second homes. I believe these voluntary payments went into a fund to reduce the public debt but were not actually accounted for as tax.

Finally has the Starbucks' announcement helped or hindered the debate? Above all, I think it has shown that the terms of the debate need to change. No one seems to be happy with the situation where a company makes a voluntary payment.

On the one hand, we cannot have a situation where a tax liability is decided according to public opinion and not according to law.

But on the other, tax is complicated and often there is no one answer, but rather a range, especially in applying transfer pricing rules. I think companies will need to take more account of the views of all their stakeholders in setting their tax strategies.

Equally I think companies are going to have to be more proactive and transparent in explaining their tax charge so as to inform the debate. Companies already pay around 30% of all taxes collected in the UK in the form of corporation tax, employers NIC, business rates and other levies. They also generate and collect much of the remaining tax in the form of PAYE and VAT. There is mounting evidence that the UK tax regime is becoming increasingly attractive. And this is very welcome because we need inward investment and for companies to be successful.

We must not let the heat in the current debate damage our position. Now companies need to fully engage to ensure we continue to have a competitive regime but one that carries the trust of all stakeholders.

How will a government blacklist work?

Jason Collins
Head of tax, Pinsent Masons

The government hopes to use purchasing power to change business culture on tax.

One of the announcements buried in the Autumn Statement was that the Cabinet Office and HMRC will 'consult on the use of the procurement process to deter tax avoidance and evasion'. To put it in more common parlance, Danny Alexander said at the Liberal Democrats' Autumn conference that 'If you want to work for us, you should play by our rules. Taxpayers' money should not be funding tax dodgers'.

It is not difficult to see why the government has taken this tack. It may not be able to defeat every form of tax avoidance through counteraction, so it hopes to use its purchasing power to change business culture around tax – in the same way it uses that power to try to change, say, diversity in the workplace. But will an effective blacklist actually work in practice?

There are issues which will need to be navigated deftly – for example, how to define 'tax dodging'. Ever since the *Ramsay* judgment more than 30 years ago, the courts have grappled with setting the boundaries of legitimate tax avoidance – and it is rarely as easy to define as politicians and policy-makers might hope.

One approach might be to define the measure by reference to arrangements which are reportable under DOTAS. The government might for example give a higher score to a bidder who has not engaged in such arrangements or has wound them up. Given the measure is intended to deter avoidance, the measure may also extend to professional services firms which help their clients to avoid tax – which would be warmly welcomed by team Margaret Hodge. The Public Accounts Committee was reportedly told recently that 10% of disclosable schemes are still emanating from the big four accounting and magic circle law firms, who also unsurprisingly do a lot of work for government.

This measure will have to comply ultimately with EU law which requires procurement rules to be objective, fair and transparent. Domestic rules already contain provisions dealing with convictions for tax evasion and non-payment of tax where the liability is not disputed. These are clearly delineated concepts – could the same be said for tax avoidance?

Because of these legal problems, the measure may never see the light of day. However, the government may feel that, while there may be legal skirmishes in individual cases, this would not be enough to prevent HMRC from pressing ahead. The measure is an extension of HMRC's 'tax on the boardroom' agenda initiative – which itself has no legal standing. The policy objective would be achieved even if the mere existence of the measure is enough to put some bidders off having a higher risk tax strategy.

The government procures a very wide range of services – including construction, IT, outsourcing and consultancy services, to name a few. The boards of companies in these sectors will need to take note. If they haven't been overly concerned thus far with HMRC's view of their attitude to tax risk, this measure may mean that will soon change. The consultation begins soon and the measure is timetabled to come into effect on 1 April 2013.

Economics focus
Osborne buys time – but how much?

SPEED READ George Osborne pulled off several surprises in his Autumn Statement. A drop in borrowing this year was unexpected, as were some of the individual tax measures he announced. The underlying fiscal position deteriorated, however, and the chancellor will face some tough choices in future budgets and spending reviews.

David Smith has been economics editor of *The Sunday Times* since 1989, where he writes a weekly column. He is also chief leader-writer, an assistant editor and policy adviser. He is the author of several books, including *The Age of Instability: The Global Financial Crisis and What Comes Next*. Email: david@economicsuk.com.

Before his Autumn Statement on 5 December, the consensus was that George Osborne was up against it and due for the biggest humiliation in his relatively short period as chancellor. Instead, he emerged more or less intact and, thanks to a cack-handed response by Ed Balls, any humiliation was on the other side.

How did he get away with it and has he merely postponed the day of reckoning? The chancellor was forced to abandon one of his fiscal rules; public sector net debt will no longer be falling as a percentage of gross domestic product by the end of the parliament. Instead it will be rising from 79% of GDP in 2014/15 to 79.9% in 2015/16, before falling slightly the following year. That, however, was widely expected, and sanctioned beforehand by the likes of Sir Mervyn King, the Bank of England governor, and the International Monetary Fund. Better to let that rule slip, they said, than impose a further fiscal tightening on a weak economy.

The real surprise, and it was this that wrong-footed Balls, was that this year's borrowing figures were not worse. Against the odds, Osborne was able to announce a small reduction in underlying public sector borrowing from 2011/12's level of £121.4bn.

There are so many adjustments in the numbers for the public finances that only experts should delve into the figures. So this year's borrowing has benefited from the £28bn transfer of the Royal Mail pension fund's assets, and by the Treasury's decision to move across the accumulated gilt coupons (the interest paid), that the Bank of England has received on the gilts it has purchased through its quantitative easing programme. Stripping all these out, it boils down to a simple fact. Underlying borrowing is falling this year because the Office for Budget Responsibility has booked the £3.5bn the government expects to get from the sale of the 4G mobile phone spectrum in January.

Was there anything wrong with doing that? At first I thought so and that the proceeds should be spread over time, but the OBR insists it is playing it by the rules. Including the £3.5bn is legitimate.

There is still scope for egg on face for both Osborne and the OBR, if tax receipts prove disappointing over the winter or the mobile phone auction proves disappointing. The margins are thin: the underlying figure for this year is £120.3bn, only £1.1bn below last year. But Osborne has bought himself time.

The other surprise was that, within a fiscal position that has undoubtedly deteriorated, notwithstanding this year's borrowing coup, Osborne found room for some modest tax giveaways. Some of this is simply those 4G proceeds being handed back (a lot rests on them), while he has also given himself something to play with by limiting the increase in most non-pension benefits to 1% annually for the next three years.

Even so, this was not an Autumn Statement from a chancellor with his back against the fiscal wall. One unexpected announcement was the additional £235 increase in the personal allowance from April, which will now rise sharply from £8,105 to £9,440, the biggest ever jump in cash terms. That extra £235 will cost £1bn, while the total bill for over-indexing the allowance is £5bn. There was more. The chancellor had been expected to yield to pressure to postpone January's 3p a litre rise in fuel duty. Instead he cancelled it, at a cost of £890m this year, £1.64bn in 2013/14.

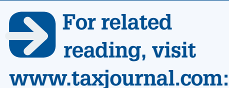
Businesses got something too, including an additional cut in the main rate of corporation tax, to 21%, from 2014, which will eventually cost £875m a year and bring it in sight of the 20% target. The two-year rise in the annual investment allowance to £250,000, which will benefit SMEs, will have a maximum annual cost of £910m.

What is going on? Has Osborne, having been told he will break one of his rules, given up on austerity? No, but with the measures for business he is trying to show that he doing his bit for growth, and to enhance Britain's attractiveness to international firms. Cutting the corporation tax rate when there is a row raging about the tax contributions of multinational companies was bold. Shifting £5bn from current to capital spending over the next three years was a direct response to pressure to spend more on the infrastructure and ease some of the problems of the construction industry. As for the personal allowance, the view seems to be that even if other targets are proving difficult, the coalition will deliver on its pledge to increase it to £10,000 by the election. That, barring accidents, looks assured.

As always, much depends on the economy. Given the continued disappointments on growth and the necessity of extending the austerity into the next parliament, Osborne was imaginative and did better than expected. But after a year in which the economy shrank marginally, according to the OBR, he desperately needs something stronger in 2013 and beyond.

Osborne desperately needs something stronger in 2013 and beyond

So far there is not much evidence of that, and the numbers so far point to a disappointing fourth quarter. Even growth of a little over 1%, which is the official forecast, is far from assured. Maybe one day growth will surprise on the upside. Stranger things have happened. That, in turn, would set off a virtuous circle in which the deficit would fall more rapidly and, perhaps, some of the future austerity could be cancelled. Nice though that would be, for the moment it has to be something of a pipe-dream. ■



For related reading, visit www.taxjournal.com:

Is this when the real recovery begins? (David Smith, 1.11.12)

Business gets impatient for growth (David Smith, 13.9.12)

Why cutting public borrowing is hard slog (David Smith, 2.8.12)

Analysis
Examining the draft Finance Bill 2013

SPEED READ The draft Finance Bill clauses, published earlier this month, are open to consultation until 6 February 2013. The Finance Bill focuses on four key themes: growth and incentives; countering tax avoidance; clarification measures; and EU law responses. The 2013 Budget has been announced for 20 March 2013; this date would be consistent with a Finance Bill timetable similar to 2012.

Chris Sanger is head of tax policy at Ernst & Young, chairman of the Tax Policy Committee of the ICAEW and the Management of Taxes Committee at the CIOT, a member of the exchequer secretary's Tax Professionals Forum and a former adviser to HM Treasury. Email: csanger@uk.ey.com; tel: 020 7951 0150.

Mike Gibson is a director in Ernst & Young's tax technical knowledge team, and monitors legislative and case-law developments with a view to keeping the tax practice and its clients up to date. Email: mgibson1@uk.ey.com; tel: 020 7951 0568.

On 11 December, so called 'legislation day', the government published the draft tax legislation for inclusion in Finance Bill 2013, as well as responses to consultations that have taken place over the summer. This is the third year that, under the process outlined in HM Treasury's document, *Tax Policy Making: A New Approach*, the draft Finance Bill clauses have been published before Christmas, seeking to increase the competitiveness of the UK by making the policy making process more transparent.

Technically, this stage of consultation, which is open until 6 February 2013, is focused on the efficacy of the technical drafting of the clauses, rather than the underlying tax policy issues, which have previously been the subject of consultation. However, given that the draft legislation itself provides more detail as to how the policies apply, we can expect that further discussion on many of the items included will continue.

The Finance Bill clauses have the following key themes:

- growth and incentives;
- countering tax avoidance;
- clarification measures; and
- EU law responses.

There are also tax administration changes, including details of the interest and penalty regime for real time information reporting.

Growth and incentives

The draft Finance Bill clauses include a number of measures to support growth. These include a number of measures which were announced by the chancellor in the Autumn Statement in the previous week, such as the reduction in the main rate of corporation tax to 21% in 2014 and the increase in the annual investment allowance for plant and machinery to £250,000 for two years from 1 January 2013. The legislation will also take forward the promised reliefs for the creative sector, subject to compliance with EU State aid rules, and the capital gains tax relief on qualifying shares for 'employee shareholders'.

There is confirmation of the introduction of an 'above the line' tax credit for research and development activities for large companies. This credit will be taxable and will be available at the headline rate of 9.1% (49% for companies in the oil and gas ring-fence) to enable no less than the current effective rate of relief to be obtained. Following concerns from some sectors, the ATL credit will initially be introduced alongside the existing super-deduction in April 2013 but fully replace the super-deduction in April 2016. Companies will be able to elect to claim R&D relief via the ATL credit at the end of their accounting period, for expenditure incurred on or after 1 April 2013. Once a company has elected to claim the ATL credit it will not be able to claim via the super-deduction scheme in subsequent accounting periods.

The payable credit will be limited to the amount of a company's total PAYE and NIC liabilities in relation to staff engaged in qualifying R&D activities in the accounting period. This cap will apply to the credit after the offset of the claimant's current year corporation tax liability. The amount up to the cap can be utilised in a variety of ways, including being group relieved or offset against other tax liabilities of the company. However, the order of offset is prescribed by legislation. The excess over the cap will be treated as an ATL credit in the following accounting period, and we have confirmed with HMRC that this excess can be carried forward indefinitely.

The PAYE and NIC cap, which will have come as a surprise to many, may significantly reduce the ability for companies to obtain the refundable payment in situations where, for instance, claims are made with a large proportion of expenditure on consumables and/or externally-provided workers.

Tax avoidance

The draft legislation implements several actions against tax avoidance, including the general anti-abuse rule (GAAR) and amendments to the controlled foreign companies (CFC) rules to close avoidance and planning opportunities. Specific anti-avoidance measures, along with accompanying draft legislation, were announced at the time of the Autumn Statement and these will also be included in Finance Bill 2013.

The GAAR

The draft legislation covering the introduction of the GAAR has been amended from that contained in the 12 June 2012 consultation document to reflect feedback received. The first draft of the

> In a welcome change of policy, it has been confirmed that the GAAR will not apply to arrangements which began prior to Royal Assent of Finance Bill 2013

guidance has also been released for comment. The guidance is particularly important as it needs to be taken into account by a court or tribunal in considering the application of the GAAR.

In a welcome change of policy, it has been confirmed that the GAAR will not apply to arrangements which began prior to Royal Assent of Finance Bill 2013. Where the arrangements form part of broader arrangements that began before Royal Assent, the taxpayer (but not HMRC) may refer back to the broader arrangements where to do so would show that the post-commencement arrangements are not abusive.

The core 'double reasonableness test' now explicitly states that, in determining whether the test is met, consideration should be given to whether the means of achieving the overall result involves one or more 'contrived or abnormal steps'.

The draft legislation has also been amended so that non-commercial terms of transactions or agreements are no longer highlighted as indicators that the arrangements are abusive, not least to address concerns that this indicator is always present when considering inheritance tax. In addition, the indicators set out in the draft legislation of abusive arrangements are only to be

The 2013 Budget has been announced for 20 March 2013. This date would be consistent with a Finance Bill timetable similar to 2012

taken as such if it is reasonable to assume that such a result was not the intended result of the provisions.

The provisions dealing with counteraction and consequential adjustments have been expanded, and the legislation will make it clear that the consequential adjustments can only reduce a person's liability to tax. The updated draft legislation sets out the procedural requirements relevant to the application of the GAAR. This includes details of the role in this process of the GAAR advisory panel including the appointment by the chair of a sub-panel of three with relevant expertise. This panel will consider written representations by both HMRC and the taxpayer and will provide a joint opinion or separate opinions on the application of the GAAR on a particular case. It has previously been announced that HMRC will not be represented on the panel and that an independent chair will appoint the members.

The panel is also responsible for approving the guidance, the first draft of which has now been issued, though further work is required before it becomes final. This draft guidance includes a series of examples of arrangements to which HMRC would, and would not, seek to apply the GAAR.

CFCs

The draft clauses include legislation to prevent a potential loss of tax by amending the new CFC rules and limiting double taxation relief in order to close avoidance and planning opportunities. In line with the new CFC rules, the legislation will affect CFCs with accounting periods beginning on or after 1 January 2013.

The legislation will:

- clarify the definition of 'relevant finance lease' to include arrangements of a similar substantive character so the definition applies to any asset. This will prevent arrangements structured, for example, as hire purchase business, from falling outside the CFC rules dealing with finance leases;
- limit the UK double tax relief available in circumstances where loans made by one CFC to another CFC are routed through one or more UK companies. Relief for withholding tax will no longer be claimable for an amount in excess of the corporation tax liability on the relevant loan relationship;
- ensure that, throughout the new CFC rules, questions of accounting treatment where accounts have not been prepared under either UK generally accepted accounting practice or international accounting standards are considered by reference to international accounting standards; and
- introduce a minor consequential provision to ensure the arbitrage rules do not apply merely as a result of the application of another territory's CFC rules that are similar to the UK CFC rules.

These changes are corrections to the new CFC rules targeted at specific situations and do not represent fundamental changes to the regime.

Other measures

There are proposed changes to the worldwide debt cap exemption for group treasury companies. These amend the conditions that companies have to satisfy in order to make an election under TIOPA 2010 s 316 to be treated as outside the worldwide debt cap and how the election applies to financing expenses and financing income. The draft clauses are intended to ensure that only the financing expenses and financing income related to treasury activities are included in the election.

The draft legislation will also enact the proposals announced in Budget 2012 to counter avoidance of stamp duty land tax, including the introduction of the annual residential property charge and the proposed extension of the capital gains rules. Full details of this latter measure will become clearer in January 2013 but the government has announced that the new charge is only intended to apply to gains which accrue from 6 April 2013. There are also measures to restrict tax relief in certain circumstances, most notably the promised cap on income tax reliefs to the greater of £50,000 or 25% of income, and the restriction

of pension tax relief announced in the Autumn Statement.

Clarification measures

In addition to a focus on growth and tax avoidance, the draft clauses contain provisions which clarify and simplify the operation of tax law in a number of areas. Examples include:

- the introduction of a statutory residence test with the draft clauses containing revised legislation from that proposed;
- the abolition of the concept of 'ordinary residence' for most tax purposes, with effect from 6 April 2013;
- provisions that where a company uses a non-sterling functional or designated currency, it must calculate chargeable gains on a disposal of shares in that currency. It is disappointing that the new rules do not apply to all assets;
- the confirmation that tier two capital issued by a bank is treated as normal debt for corporate tax deductibility and group relief purposes;
- the new contractual mechanism for providing certainty to companies in the UK Continental Shelf over tax relief for decommissioning costs; and
- changes recommended by the Office of Tax Simplification to the rules governing the four tax-advantaged employee share schemes.

European law obligations

There are also changes aimed at bringing certain existing tax provisions into line with European law obligations. The changes to rules on transfers of assets abroad and gains on assets held by foreign companies, in response to infringement proceeding brought by the European Commission have been consulted upon previously. The draft legislation includes two further measures which are introduced to respond to judgments of the Court of Justice of the European Union (CJEU).

Firstly, legislation will be introduced to allow the deferral of the payment of exit charges when a UK company transfers its place of management to another EU Member State. In the case of *National Grid Indus BV* (CJEU Case C-371/10), the CJEU ruled that where a company transfers its place of effective management to another Member State, then, to ensure its rules do not infringe the right of the freedom of establishment, a Member State should offer a choice between immediate payment or the option of deferral of exit charges, subject to certain conditions.

Legislation is now to be introduced in response to this judgment. Where a company incorporated in the UK or another EEA territory becomes a resident of, and established in, another Member State of the EU (or EEA), it will be able to manage the corporation tax charges that arise in respect of specified unrealised chargeable gains or income profits under an exit charge payment plan. For these purposes, an exit charge is one that arises under the following tax provisions: TCGA 1992 ss 185 and 187 (chargeable assets), CTA 2009 ss 859–860 (intangible fixed assets) and CTA 2009 s 609 along with CTA 2009 s 333 (loan relationships and derivative contracts).

There are two options for deferral. The first spreads the total tax over six equal annual instalments. The second allocates the tax due on an asset by asset basis. For intangible assets, derivative contracts and loan relationship profits, tax is spread in equal annual instalments over the useful life of the asset. Tax related to exit charges on any other assets may be deferred for up to a maximum of ten years, or until the disposal of the asset, if sooner.

The amounts deferred under either of the above options will be subject to interest. Security may be demanded by HMRC. This measure will allow companies to opt for deferred payment arrangements from the publication of the draft legislation.

Secondly, following the 6 September 2012 ruling of the CJEU in the *Philips Electronics* case (CJEU Case C-18/11), legislation will be introduced to amend the restrictions on the surrender of losses as group relief by UK branches of companies resident in the European Economic Area. In the *Philips Electronics* case, the CJEU held that UK group relief rules constitute an unlawful restriction on the freedom of establishment principle. This is insofar as they preclude the transfer of losses by a UK permanent establishment of a non-UK resident company to a UK resident company within the same group relief group.

In particular, CTA 2010 s 107 will be amended so that companies resident in the European Economic Area will be able to surrender as group relief losses arising in their UK branches on or after 1 April 2013. This will be subject to restrictions where the losses are actually used against non-UK profits. Where a loss that has been surrendered is later used against non-UK profits, then the benefit of the UK group relief will be withdrawn to the extent that the loss has been used elsewhere. Section 107 will not be amended for non-UK resident companies resident outside the EEA.

It remains to be seen whether, given the reasoning adopted by the CJEU in *Philips Electronics*, the new proposals will be acceptable to the CJEU.

Next steps

The 2013 Budget has been announced for 20 March 2013. This date would be consistent with a Finance Bill timetable similar to 2012 with substantive enactment in late June or, more likely, early July and Royal Assent in July. For UK GAAP and IFRS purposes, whilst the tax accrual will only need to be amended for changes if the proposals have been substantively enacted, there may be a need for disclosure of the impact of the changes, where the impact is expected to be significant. ■

For related reading, visit www.taxjournal.com:

The draft GAAR: the 'double reasonableness test' (Frixos Hatjantonas, 29.8.12)

FA 2012: CFCs, the new regime (Andrew Boucher, 7.9.12)

Comment: Group relief and the *Philips Electronics* case (Roopa Aitken, 19.7.12)

Analysis
Finance Bill 2013: The GAAR

SPEED READ The GAAR recommended by the Aaronson study group was restricted to highly artificial and abusive avoidance schemes. The actual GAAR in the draft Finance Bill is capable of being read as a wider general anti-avoidance rule because its crucial filter is based on reasonableness, not artificiality. As a result, it risks introducing considerable uncertainty into normal tax planning and adversely affecting the attractiveness of the UK as a destination for inward investment. The guidance is a valiant attempt to reduce that uncertainty but, because reasonableness is treated by HMRC as inherently unreasonable, it ultimately fails in that objective.

Ashley Greenbank is head of the tax and structuring group at Macfarlanes LLP. He advises on the full range of corporate tax issues, but particular specialisations include the corporate tax aspects of UK and cross-border corporate finance transactions, including M&A, flotations, and private equity-backed transactions. Email: ashley.greenbank@macfarlanes.com; tel: 020 7849 2512.

Nigel Doran is a consultant at Macfarlanes. He provides technical support to the tax and structuring group as well as advising on corporate and international taxation and dispute resolution. From 2009 to 2012, he was an anti-avoidance adviser at HMRC, where he was involved in a wide range of dispute resolution and policy work. Email: nigel.doran@macfarlanes.com; tel: 020 7849 2382.

Barring any last minute changes to the Finance Bill clauses, we now know the precise shape and nature of the UK's first ever GAAR and, in the draft guidance, we now have our first valuable insight into how HMRC sees the GAAR operating in practice.

Taxes covered

There has been no change since the June 2012 consultation document in the scope of the taxes covered by the GAAR. Furthermore, despite representations, it will apply to tax advantages arising from, but conflicting with the purpose of, a double tax treaty.

The first filter: 'tax arrangements'

The GAAR will apply to arrangements which pass through two filters. The first takes the form of a definition of 'tax arrangements' but is effectively a general anti-avoidance rule. Arrangements will pass through this filter if their main purpose, or one of their main purposes, is obtaining a tax advantage. 'Tax advantage' includes a tax relief and, crucially, tax avoidance (and, indeed, deferral). Whether the parties to an arrangement have a main purpose of tax avoidance is to be tested objectively, rather than (as is more usual in TAARs) subjectively.

There are two strands to the approach taken by the courts in defining what amounts to 'tax avoidance'. The first can be found in the cases concerning transactions in securities, in which transactions have been characterised as involving tax avoidance if they 'improve the taxpayer's position vis-à-vis the Revenue' (*IRC v Trustees of the Sema Group Pension Scheme* [2003] STC 95). It is irrelevant that the actual transaction carried out by the taxpayer (which is more tax advantageous than the hypothetical comparator transaction) may itself be wholly commercial and fully accord with the evident purpose of the legislation. All that matters is that the improvement in the taxpayer's position vis-à-vis the Revenue is a main purpose of the transaction, rather than mere 'icing on the cake'. There was no suggestion in *Sema* that the carrying out by the pension scheme of a transaction giving rise to repayable tax credits conflicted with or defeated the evident intention of parliament or that parliament would have restricted the availability of repayable tax credits to pension schemes and charities if it had thought about it.

The second strand to the approach taken by the courts to 'tax avoidance' is one which distinguishes between tax planning and tax avoidance (a distinction not properly addressed in *Sema*). According to Lord Templeman in *CIR v Challenge Corpn Ltd* [1986] STC 548 and Lord Nolan in *IRC v Willoughby* [1997] STC 995, tax planning involves the taxpayer taking a course of action to improve his tax position (generally by reducing his taxable income or increasing his allowable expenditure) which accords with the evident purpose and the spirit of the legislation. This may be in response to a fiscally attractive option expressly made available by the legislation (e.g. taking out an ISA) or it may involve a course of action implicitly envisaged by the legislation (e.g. two spouses taking advantage of the principle of independent taxation by equalising their savings). By contrast, tax avoidance involves the taxpayer taking a course of action 'designed to conflict with or defeat the evident intention of parliament'. The scheme in *Ramsay* was clearly designed to conflict with the statutory intention (namely, that CGT losses should have a commercial reality) and, therefore, involved tax avoidance.

A course of action designed to defeat the will of parliament must include one which, though it does not conflict with the evident intention of the legislation, does conflict with its spirit. For instance, the transactions in *Mayes v HMRC* [2011] STC 1269 clearly involved tax avoidance but did not conflict with the strict letter of the legislation. (The legislation was highly mechanistic and evinced no purpose of taxing life assurance policies on a commercial or economic basis.) However, the transactions in that case did contravene the spirit of the life assurance legislation, because Parliament would clearly have negated the scheme if, at the time of enactment, it had been made aware of the shortcomings in the legislation exploited by the scheme. Testing whether a course of action is inconsistent with the spirit of the legislation will generally involve consideration of the policy underlying it. Despite the policy anchor, it is the

uncertainty generated by the concept of 'what parliament would have done' that in the past has caused business such fear of a general anti-avoidance rule.

The second filter: the 'reasonableness' test

So, only arrangements which are designed to conflict with the evident purpose of the legislation or its spirit (or both) pass through the first 'avoidance purpose' filter. They then move to the second filter which, it is claimed, will confine the GAAR to artificial and abusive schemes. The GAAR will only apply to arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action, having regard (in particular) to the consistency of the substantive results of the arrangements with the principles and policy underlying the relevant tax provisions, the use of contrived and abnormal steps to achieve those results and whether the arrangements exploit any shortcomings in those provisions. One indication that an arrangement might not be reasonable is that it results in profits or losses which diverge from economic reality and that result cannot reasonably have been intended when the tax provisions were enacted.

In our view, it will be very difficult to persuade the advisory panel or the tribunal on an appeal that an arrangement which is designed to defeat the will of parliament is nevertheless a reasonable course of action. One example might be a piece of bad law which HMRC (whether lawfully or not) has consistently refrained from enforcing over several years but has not taken steps to repeal or reform. Indeed, this is now recognised in the GAAR by a provision that the fact that tax arrangements accord with established practice which has been accepted by HMRC might indicate that the arrangement is reasonable. But, in such a case, the reasonableness filter does not add much to the taxpayer's existing right to enforce by judicial review his legitimate expectation that HMRC's practice will be applied equally to him.

The central weakness in the reasonableness filter is that the main considerations to be taken into account are the legislation, its policy and its shortcomings. These are all decisive considerations already taken into account at the first filter. The reasonableness test does not add anything, unless it is reasonable to design arrangements to defeat the will of Parliament. What would really make the second filter a genuine safe harbour for responsible tax planning and confine the GAAR to artificial and abusive schemes would be an express requirement that the arrangement must comprise elements which are artificial or contrived. Representations to that effect were made in response to the June 2012 consultation document but all that has been conceded is a provision that the presence of contrived steps in the arrangement is a relevant consideration. However, a *requirement* of artificiality features in GAARs in other countries and is a key requirement of the GAAR which the European Commission has recently recommended be adopted by all EU member states.

Counteraction of tax advantages

Tax advantages caught by the GAAR will be counteracted on a just and reasonable basis.

In practice, this is likely to mean that:

- an arrangement which is wholly self-cancelling will be taxed as if it had not been entered into, generally with the result that a loss will be disallowed;
- a party to a commercial transaction on to which an avoidance scheme has been grafted will be taxed as if he had carried out the transaction that he was most likely to have carried out but for his tax avoidance purpose; and
- in any other case (including where it is not possible to determine what the corresponding transaction would have been), a bespoke just and reasonable approach will be required.

Although the concept of counteraction implies an action initiated by HMRC, the GAAR will in fact operate under self-assessment. Representations on this point went unheeded. This is counter-intuitive. No taxpayer will self-assess the operation of the GAAR. Indeed, it is debatable whether the GAAR requires him to do this. The GAAR does not seem to make the tax arrangement ineffective from the outset (which *would* require self-assessment) but merely provides for an apparently effective tax advantage to be counteracted by adjustment. We expect to see renewed representations on this point.

Commencement

The decision to apply the GAAR only to arrangements entered into after Royal Assent is welcome. It seems representations that it would be unsatisfactory if the GAAR applied to arrangements at a time when the advisory panel and the guidance which it approves had no statutory mandate have been heeded. Parties to pre-commencement tax arrangements which they wish to vary will need to consider whether the variation gives rise to a new post-commencement arrangement.

The advisory panel

The key function of the advisory panel will be to provide opinions on the potential application of the GAAR as a kind of reality check. In particular, it will provide evidence of the reasonableness of the taxpayer's actions in the relevant commercial context. Quite how this will differ from the judicial function of giving a first-tier decision remains to be seen.

The procedure for making representations to the panel and providing responses imposes strict time limits on taxpayers but none on HMRC. This seems unfair and not necessarily conducive to

What is in truth a general anti-avoidance rule is being missold as a general anti-abuse rule

The examples in Part B ... tell us nothing about what forms of responsible tax planning are excluded from the GAAR

producing the 'quick and cost effective' means of establishing the limits of the GAAR promised by the consultation document.

It is most disappointing that representations that the panel should publish its opinions in full (if necessary, in an anonymised form) fell on deaf ears. It is grossly unfair that HMRC, being a party to every dispute, will have access to every opinion of the panel, whilst taxpayers generally will be denied such access. An annual digest of key principles is no substitute for the detailed reasoning in individual cases.

Following strong representations on the potential for unfairness and conflicts of interest if HMRC was represented on the panel, HMRC recently announced that it was relinquishing such a role. Furthermore, the chair of the panel will be independent of HMRC and have sole control of the membership of the panel.

The guidance

Representations that the guidance should be totally independent went unheeded. The drafting and revising of the guidance will be initiated by HMRC, though it has to be approved by the panel. This gives the panel an important, but nevertheless passive, role.

The draft guidance just published confirms our worst fears that the GAAR will be a general anti-*avoidance* rule in all but name.

Part A contains a fair explanation of tax arrangements and the double reasonableness test. However, it does not add much to the draft clauses. Interestingly, HMRC recognises that taxpayers are legally entitled to minimise their taxes (quoting from Lord Tomlin in the *Duke of Westminster* case) but points out that that does not make all tax avoidance reasonable. It also points out that the view that tax is legalised theft, such that all avoidance is reasonable, is an extreme view and not, therefore, one which can reasonably be held!

Our fears derive from Part B. This Part founds on the assumption that the question whether an arrangement is reasonable depends wholly on whether it is consistent with the principles and policy underlying the relevant tax provisions or whether it is designed to defeat those principles and that policy, for instance by exploiting loopholes. But, in the draft clauses, these are merely circumstances to be taken into account. They are not decisive. More importantly, as we have pointed out above, these questions are an integral part of the test in the first filter. If an arrangement is consistent with the principles and policy underlying the relevant tax provisions, it does not involve avoidance, as properly defined, and does not pass through the first filter. Conversely, if every arrangement which conflicts with the principles and policy underlying the legislation, and therefore passes through the first filter, is *necessarily* an unreasonable course of action, then the second filter achieves nothing and the GAAR is a general anti-*avoidance* rule.

All of the examples in Part B to which the GAAR is said to apply are highly egregious schemes which either have no commercial purpose or involve bolting a highly artificial avoidance scheme on to a commercial transaction. They produce results which defy economic reality and many involve transactions other than at arm's length. With one possible exception, they clearly break both the evident purpose and the spirit of the legislation. The one exception is the IHT reservation of benefit example. It cannot be said with complete confidence that parliament would have blocked this scheme if it had been aware of it, given that it is precisely the sort of scheme taken into account when the law was changed after Lady Ingram's case. Most of these egregious schemes would be defeated by technical arguments or by the *Ramsay* principle. They tell us nothing about what forms of responsible tax planning are excluded from the GAAR.

In our view, none of the examples in Part B to which the GAAR is said not to apply would pass through the first filter, because they are innocuous transactions which do not involve avoidance, as properly defined. Each one is said to be consistent with the principles and policy underlying the legislation and is, therefore, *necessarily* reasonable. But that is irrelevant. Because they do not pass through the first filter, their reasonableness is never tested. These examples tell us nothing about what forms of tax planning pass through the first filter but nevertheless fall outside the scope of the GAAR because they are reasonable.

It is interesting that HMRC regard the late paid interest example as consistent with the principles and policy underlying the legislation. On balance, we feel that this example does not pass through the first filter on the grounds that taking steps to avoid a tax relief becoming stranded (a tax result which is worse than the economic result) is not avoidance, as properly defined.

One final point on the guidance. It is clear that, at least in borderline cases, taxpayers and HMRC are likely to differ on what constitutes a contrived step. For instance, in the agricultural property example, we suspect few taxpayers would regard buying a farm with an IHT saving in mind, letting it for seven years and then transferring it into trust as being contrived steps. They are the genuine purchase and subsequent gift of a tax efficient asset (like an ISA).

Conclusion

Neither the revised GAAR legislation nor the guidance provide any comfort that the GAAR will not operate as a general anti-*avoidance* rule or that it will reduce the uncertainty surrounding the scope and application of any such rule. It will not, therefore, give taxpayers confidence that, without an informal clearance from their CRM (if they have one), they can safely proceed with commercial transactions which they structure tax efficiently. What is in truth a general anti-avoidance rule is being missold as a general anti-abuse rule. ■

For related reading, visit www.taxjournal.com:

News: Tax experts welcome changes to general anti-abuse rule (Andrew Goodall, 11.12.12)

The GAAR: Where do we go from here? (Steve Edge, 9.8.12)

Special focus: The proposed GAAR (multi-author, 29.6.12)

Analysis
FB 2013: the statutory residence test

SPEED READ **The draft Finance Bill contains a new draft of the proposed statutory residence test which is to be enacted with effect for 2013/14 onwards. The government has ignored the fundamental criticisms made by the professional bodies of the structure of the test and of the definitions it provides, choosing instead to make many small changes and to enact some unnecessary anti-avoidance legislation. Significant anomalies are found, for example, in key concepts such as 'home', 'available accommodation', the 'exceptional circumstances exemption' and the phrase 'living together as husband and wife or … as if they were civil partners'. The new test is an improvement on the current situation but is far from fulfilling the aims of the reform.**

Simon McKie is a partner in McKie & Co (Advisory Services) LLP, a leading consultancy specialising in providing advice on the taxation of private clients. He is currently writing, jointly with Sharon McKie, *McKie on Statutory Residence* which will be published by CCH next year. Email: enquiries@mckieandco.com; tel: 01373 830956.

Sharon McKie is a partner of McKie & Co (Advisory Services) LLP. She has practised taxation since 1994 and has specialised in the taxation of private clients since 1997. She has a particular expertise in the management of complex tax litigation. Email: enquiries@mckieandco.com; tel: 01373 830956.

The draft Finance Bill which was published on 11 December contains updated draft legislation (the 'new draft') to implement the statutory residence test (the 'SRT'). It supersedes the last draft which was published last June (the 'June draft') together with a consultation document (the 'June condoc'). The draft legislation has swollen from 39 to 55 pages but the changes are primarily of detail rather than of structure and principle. Indeed, what is most important is what has not been changed rather than what has.

In this article we concentrate on the first two parts of the draft Schedule which implements the SRT and which contains the fundamental principles of the new test with Part 1 (all references in this article are to the new draft unless otherwise stated) being headed 'The rules' and Part 2 'key concepts'.

A disappointing outcome

Although it has been recognised for many years that the lack of an exhaustive statutory definition of residence for tax purposes is highly unsatisfactory it was only in November 2007 that the pressure for reform began to build. At that time the taxation profession hoped that the test would be a simple, objective test based on days of presence in the UK probably following the US model (see the CIOT's letter to HMRC, dated 14 November 2007). That hope has been disappointed. The draft legislation is complex and in parts highly uncertain in its scope. The reason for that is that the government has chosen to use concepts which are incapable of precise definition instead of finding arithmetical tests which can stand as reasonable proxies for them.

A home

The most important of these is the use of the concept of a 'home' in the second automatic UK test (para 8), the accommodation tie (para 32) and the split year provisions (Part 3). Home is a word of broad and imprecise meaning. The professional bodies have strongly criticised its use in the SRT as undermining the aim of the new legislation to provide a 'clear, objective and unambiguous' test of residence (see the foreword to June condoc). At the very least, they said that the legislation should combine an exhaustive definition of what is a home. In spite of this, the new draft legislation does not contain one. A new para 24 slightly expands para 14 of the June draft but does not change its approach of avoiding definition. So, for example, sub-s (1) now says:

'A person's home can be a building or part of a building or, for example, a vehicle, vessel or structure of any kind.'

That says no more than that it is possible for the items enumerated to be a home but not how one determines whether they are a home or not. A new sub-s (2) provides that:

'Whether, for a given building, vehicle, vessel, structure or the like, there is a sufficient degree of permanence or stability about P's arrangements there for the place to count as P's home (or one of P's homes) will depend on all the circumstances of the case.'

This assumes that to be a home P's arrangements must have a 'sufficient degree of permanence or stability'. It does not even say that the arrangements which must have permanence or stability are arrangements in relation to the building etc which may or may not be P's home but only that the arrangements must be 'there'. It is as if the draftsman has had the elements of a definition in the back of his mind but could not bring himself to set it down expressly.

The June condoc which accompanied the June draft said that: '… the government does not consider a holiday home, weekend home or temporary retreat should count as a "home"' (June condoc, para 3.89).

The new draft has now included this in a

The taxation profession hoped that the test would be a simple, objective test based on days of presence in the UK … That hope has been disappointed

The [exclusion for a 'temporary retreat'] raises more uncertainties than it settles

modified form in a new sub-s (3) which provides:

'But somewhere that P uses periodically as nothing more than a holiday home or temporary retreat (or something similar) does not count as a home of P's.'

That raises more uncertainties than it settles. For it implies that without this specific provision a 'temporary retreat' might be a home which suggests that 'home' in the SRT should be interpreted widely rather than narrowly. What is more, it requires the taxpayer to be able to determine what is a 'holiday home or temporary retreat (or something similar)'.

The second automatic UK test

The second automatic UK test, which utilises the concept of a home, has been substantially recast (para 8). It is now a condition of the test that P must be present at the home (whilst it is his home) for at least 30 separate days in the year (para 8(1)(b)). This does not mean that a place cannot be one's home for the purposes of the legislation if one never enters it at all during the fiscal year. It merely means that in those circumstances one would not satisfy the second automatic residence test.

Another change to the second automatic UK test makes it easier for one to be resident here. In the June draft one could only satisfy the automatic residence test by reference to a period or periods of at least 91 days in which one's only home was in the UK. Under the new draft, it will be possible to pass the test in respect of a period of more than 90 days in which one has a home in the UK and also overseas if one is present in the overseas home on fewer than 30 separate days in the year (para 8(3)).

The accommodation tie

As we have seen, the concept of home is also relevant to the accommodation tie. The draft of the accommodation tie contained in the June draft had also been severely criticised for its imprecision. Only one minor change has been made to it. It still contains a host of concepts of uncertain meaning for which no statutory definition has been provided. Most importantly it preserves the concept of available accommodation (para 32(3)(c)) which has always caused immense problems in respect of the existing concept of residence.

Other areas of difficulty

Days spent

The exceptional circumstances exception: Another area of difficulty which has not been addressed is the exceptional circumstances exception in determining the days spent in the UK. Paragraphs 21(4)–(5) have been taken over unchanged, but renumbered, from the June draft. They provide that a day does not count as a day spent in the UK where:

'… (a) [the individual] would not be present in the UK at the end of that day but for exceptional circumstances beyond [this individual's] control that prevent [him] from leaving the UK, and

(b) [he] intends to leave the UK as soon as those circumstances permit.

'(5) Examples of circumstances that may be "exceptional" are:

(a) national or local emergencies such as war, civil unrest or natural disasters, and

(b) a sudden or life-threatening illness or injury.'

One of the difficulties of this provision is that exceptional circumstances must 'prevent [the individual] from leaving the UK' rather than prevent him from going to his intended destination. If an individual is in London and had intended to return to a Near Eastern country suddenly engulfed in civil war he would not be prevented from leaving the UK and travelling to a peaceful country such as France. Of course, the courts might repair the legislation's deficiency through a radical purposive construction but the whole point of the SRT is that the taxpayer should be able to determine his residence status with certainty without having to guess how the courts will repair the inadequacies of the government's legislation.

Another anomaly which survives from the June draft is the provision that the maximum number of days which will be treated as days which are not spent in the UK because of the exceptional circumstances exception is sixty (para 21(6)). It is not clear why it is necessary to place a maximum here. The most likely circumstance in which a person will be prevented from leaving the UK for more than two months is where they are either seriously ill themselves or are caring for somebody who is seriously ill.

Unlikely avoidance: In the June condoc the government suggested that a special rule would be required for those who regularly move in and out of the UK on the same day in order to manipulate the residence rules (June condoc, para 3.153). This would either seem to require a taxpayer to fly in and out of the country on a large number of days or else to be based in Northern Ireland and to regularly walk across the border with the Irish Republic and back shortly before and after midnight. It is difficult to believe that the population of people sufficiently rich to make that worthwhile and sufficiently indifferent to their own comfort to be willing to do so will be large enough to justify the complication caused by specific provisions to frustrate such behaviour. Nonetheless such provisions have been introduced in para 22 modifying the general rule, stated in para 22(1), that if a person is not present in the UK at the end of the day, that day does not count as a day spent by the individual in the UK. The new rule will apply if:

- the individual has at least three UK ties for a tax year;
- the number of days in that tax year when the individual is present in the UK at some point in the day but not at the end of the day is more than 30; and
- the individual was resident in the UK for at least one of the three tax years preceding the tax year concerned.

Where these conditions are satisfied and the number of such qualifying days in the tax year reaches 30, each subsequent qualifying day in the tax year is to be treated as a day spent by the individual in the UK.

'Living together as husband and wife or, if they are the same sex, as if they were civil partners'

The new draft utilises, in the family tie (para 30(2)(b)) and in the split year provisions (para 42(9)), the phrase 'living together as husband and wife or, if they are the same sex, as if they were civil partners'.

The phrase 'living together as husband and wife' is found elsewhere in tax and other legislation and has been considered judicially on a number of occasions. A civil partnership is a creation of statute and the Civil Partnership Act 2004 does not limit civil partnerships to any particular form of relationship between two persons entering into such a partnership. It is difficult to see, therefore, how two people can live together as civil partners who are not civil partners. The phrase is used in a number of other statutory contexts, but in those contexts it is invariably used subject to a statutory definition usually providing that two people of the same sex are to be treated as living together as if they were civil partners if, and only if, they would be treated as living together as husband and wife were they of the opposite sex. There is no such deeming provision in the new draft legislation and no indication why the draftsman has not followed the normal statutory form.

Both an improvement and a wasted opportunity

An improvement: It is clear that the SRT has now almost reached the form in which it will be enacted. The government has made only minor changes to the most important provisions of the test and has largely ignored the fundamental criticisms of structure and of definition which were made by the professional bodies. The new test, when it is enacted, will be an improvement on the current situation but it will be very far from fulfilling the aims for the draft legislation set out in the June 2012 condoc that it should: 'Be transparent, objective and simple to use'.

A wasted opportunity: Once enacted the SRT is unlikely to be recast significantly for many years. It will no doubt provide, in the future, considerable occupation for the courts and the Revenue Bar but the government has wasted an opportunity for significant and cost free simplification of a key element of the tax code. ■

For related reading, visit www.taxjournal.com:

Comment: The statutory residence test: is this the way to make new law? (Jonathan Schwarz, 13.9.12)

The proposed statutory residence test (Steve Wade, 5.7.12)

News: CIOT lists 'initial points' on statutory definition of tax residence (Andrew Goodall, 8.9.12)

6 CPD HOURS

TAX PLANNING FOR LANDED ESTATES

Tolley® Conferences

Ensuring the protection of your clients' landed estates and maximising the potential tax planning opportunities available

Wednesday 13 March 2013, Central London

Book your place today!

Tax Journal readers receive a £150 discount.

Email conferences@tolley.co.uk quoting code TJ.

www.conferencesandtraining.com/landed-estates

Tolley® Tax intelligence from LexisNexis®

Analysis
FB 2013: The residential property proposals

SPEED READ **Finance Act 2012 introduced an increased rate of SDLT on acquisition of residential property over £2m. The draft Finance Bill 2013 confirms the annual charge on the value of residential property over £2m, and capital gains tax on the disposal of residential property over £2m. However, reliefs should mean that the only structures affected are those which hold residential property which is occupied by a shareholder or beneficiary.**

Robert Langston is a senior tax manager at Saffery Champness. He advises companies and their shareholders on cross-border tax issues, including UK companies expanding outside the UK; non-UK companies establishing in the UK; cross-border transactions and group restructuring, including cross-border migrations. Email: robert.langston@saffery.com; tel: 020 7841 4129.

On the same day as the chancellor delivered his Autumn Statement, his Irish counterpart outlined an annual tax on the value of all Irish residential properties, including those held by individuals. The draft Finance Bill 2013 published on 11 December 2012 outlines the more limited new taxes on UK residential property held by companies and other 'non-natural persons'.

Certain proposals are not yet included in the draft legislation, but are outlined in the HM Treasury response to the consultation titled *Ensuring the fair taxation of residential property transactions*. In addition, some proposals are subject to further consultation, but the main principles now appear to be established.

This article outlines the three new taxes which have been introduced:

- increased rate of SDLT on acquisition of residential property over £2m;
- annual charge on residential property worth over £2m; and
- capital gains tax on the disposal of residential property over £2m.

Despite responses to the previous consultation, the government remain committed to all three measures.

However, the latest proposals significantly extend the reliefs which will be available from these taxes. As a consequence, the only structures which should be affected are those which hold residential property which is occupied by a shareholder or beneficiary.

Reliefs

The reliefs will exclude most structures from the new rules. Relief from all of these new taxes (the 15% rate of SDLT on acquisition, the annual charge and capital gains tax) will be available for:

- property developers and property dealers (no minimum period of trading is now required);
- residential property owned for rental to third parties on a commercial basis;
- residential property open to the general public with access to the interior for at least 28 days per year on a commercial basis, for example historic houses which are open to visitors;
- employee accommodation, other than accommodation which is provided to (or which 'is likely to' be provided to) an employee who holds a 5% or greater interest in the partnership. Care will be required to ensure that the 'likelihood' condition is not breached;
- farmhouses connected with farmland and occupied by the farmer; and
- residential property held for charitable purposes of a charity.

These reliefs are not available if the property is occupied by connected parties (as defined in CTA 2010 s 1122).

Relief from the 15% SDLT charge on acquisition will be withdrawn if no relief applies in the three years following the date of acquisition. A developer who is unable to sell a property should still qualify for relief if it is held for rental purposes. However, relief could be withdrawn if the property were let to shareholders, or if it were simply held with no intention of sale or rental.

Reliefs: transitional rule for increased rate of SDLT

Relief from the 15% rate of SDLT on acquisition will only be available under the new rules from the date Finance Act 2013 receives Royal Assent. Until then, relief is only available to property developers who have been trading for at least two years. Where the company making the acquisition is a member of a group, the two year condition may be satisfied by any member of the group.

This does present problems (as HM Treasury acknowledges in the response to the consultation) because a property developer will typically establish separate special purpose vehicles (SPVs) to undertake different developments.

As I have outlined in a previous article, a potential solution to the two year requirement is for a developer to acquire an existing property development company (from a third party or controlling shareholder). Due diligence would need to be undertaken and an appropriate price negotiated.

Increased rate of SDLT

Finance Act 2012 has already introduced two changes to the taxation of residential property:

- 7% SDLT on residential properties worth more than £2m; and
- 15% SDLT on residential properties worth more than £2m where acquired by a 'non-natural person'.

A non-natural person is defined as a company, a partnership which has a corporate partner or member or a collective investment scheme.

Annual residential property tax

An annual residential property tax (ARPT) will apply from 1 April 2013 where UK residential property valued at over £2m is owned by a 'non-

natural person'. The definition of a 'non-natural person' will be the same as for the 15% SDLT charge (see above).

The tax will be an annual charge based on the market value of the interest in the property that the 'non-natural person' owns on the relevant valuation date. There will be an anti-avoidance rule to prevent the splitting of an interest between connected parties – for example, a company cannot grant a lease to a connected party in order to reduce the value of its freehold.

An initial valuation will be required on 1 April 2012 (if the property was held at that date), and revaluations are required on certain events including acquisition, cessation of a subordinate interest, or conversion of the property. Properties will in any case need to be revalued every five years, so a further valuation will be required on 1 April 2017.

The charge will be based on a banding structure and the initial bands will be as set out in the table below.

The proposed amount of the charge

Value of property	Annual charge
Greater than £2m but not greater than £5m	£15,000
Greater than £5m but not greater than £10m	£35,000
Greater than £10m but not greater than £20m	£70,000
Greater than £20m	£140,000

Property owners liable to the charge will be required to self-assess by filing an annual charge tax return, providing the address, the Land Registry title, the interest held, the beneficial owners and their addresses, the self-valuation, the band applicable and the amount due.

The due date for filing the return and payment will be 15 days after the commencement of the period of account, i.e. by 15 April each year.

The property owner may also be required to provide a professional valuation report and HMRC will offer a pre-return valuation checking service where the value is close to £2m.

As the first period of account will begin before Royal Assent is given to Finance Bill 2013, the first return and payment will be due by 1 October 2013.

The charge will be pro-rated where it is not applicable for the whole year. As the payment is made at the start of the year, a repayment will be made if the property ceases to be owned by the non-natural person part way through the year.

Capital gains tax

From 6 April 2013 CGT will be charged on gains realised on the disposal of UK residential property owned by non-UK resident 'non-natural persons', where the amount or value of the consideration exceeds £2m. The definition of a 'non-natural person' will be the same as for the 15% SDLT charge – in a change from the previous proposals, it will not include trusts.

The CGT charge will apply to a disposal, part disposal or a grant of an option over such property. It will not apply to indirect interests in UK residential property such as shares in property owning companies – again a change from the previous proposals.

The charge will only apply to the gain which accrues after 5 April 2013, providing a rebasing of the asset. This is similar to the rebasing election which offshore trusts could make in 2008, and experience of this demonstrates the importance of having formal valuations undertaken.

Any losses arising will be ring-fenced so that they are only available for offset against gains arising on the disposal of other residential properties.

Gains will be taxed at the current CGT higher rate of 28%. A marginal relief will apply where disposal proceeds are only slightly above £2m to prevent a 'cliff edge'. No indexation will be available, and there will be no private residence relief.

Companies which are already subject to corporation tax will continue to pay corporation tax on the gain. HM Treasury are considering whether they should instead pay CGT so that all disposals of residential property are taxed at the same rate.

Partnerships will be transparent for the purposes of CGT. If a partnership sells residential property for more than £2m, corporate partners will be subject to capital gains tax even if the corporate partner's share of the proceeds may be less than £2m. As individuals and trustees will not be subject to CGT, some families may wish to hold residential property in a family limited partnership – the inheritance tax consequences of this structure would also need to be considered.

Existing structures

It may be difficult to unwind existing structures, and the costs of doing so will need to be weighed against the ongoing costs of maintaining the structure. Costs of unwinding may include:

- capital gains tax or income tax on shareholders or beneficiaries if property is distributed;
- SDLT if the property is subject to a loan, as the novation of a loan will be treated as consideration; and
- insurance against future inheritance tax liabilities if property is to be held personally.

There is no relief in the new rules for unwinding existing structures.

If existing structures are retained, there may be other tax consequences. Many residential properties are held in 'dry' structures which hold no funds to pay the annual charge. If funds are provided by a shareholder or beneficiary of a trust, this may trigger other anti-avoidance rules as the individual may become a settlor or a transferor in relation to the structure. ■

For related reading, visit www.taxjournal.com:

Ask an expert: The new annual charge for high-value residential property (Richard Woolich, 20.6.12)

Private client briefing for June 2012 (Wendy Walton, 20.6.12)

News: Thousands of high value homes are in corporate ownership, says Exaro (Andrew Goodall, 11.6.12)

VAT focus
Secret Hotels2: agent or principal?

SPEED READ **What are the indicative factors that determine whether for VAT purposes a taxpayer is acting as an agent or principal? In the travel sector it is crucial to get this right as this has a fundamental bearing on who needs to account for VAT under the tour operators' margin (TOMS) scheme. Relying upon the legal form of an arrangement to support an agency position is unlikely to be sufficient. The substance of the arrangements, including the VAT accounting outcome of the proposed position must also be considered.**

Michael Camburn is an indirect tax partner at KPMG. He works with a number of multinational corporations, specialising in online travel and internet retailers. Email: mike.camburn@KPMG.co.uk; tel: 0207 694 8686.

Gavin McLoughlin is an indirect tax senior manager at KPMG working in the large corporates team. Email: gavin.mcloughlin@kpmg.co.uk; tel: 0207 311 1634.

HMRC has won a significant decision against the taxpayer in *Secret Hotels2 Ltd (formerly Medhotels)* [2012] EWCA Civ 157. The Court of Appeal has upheld HMRC's appeal, restoring the decision of the First-tier Tribunal (FTT) which concluded that the taxpayer was acting as principal in relation to the provision of hotel accommodation.

Background

Medhotels operated a website through which it marketed accommodation. Customers (travel agents or holidaymakers) would book and directly pay Medhotels for the accommodation. The price paid by the customers was set by Medhotels. Medhotels had agreed to purchase the accommodation at a lower 'net rate' from the hotels and would pay against invoices received from the hotels plus local VAT, where applicable. The difference between these amounts represented the main income stream for Medhotels. The holidaymaker did not know the rate the hotel charged to Medhotels and the hotel did not formally know how much the holidaymaker had paid. Crucially, local VAT was therefore only charged on the net amount received by the hotel and not on the full price paid by the customer. Therefore, the impact from a VAT perspective was that although Medhotels made a 'variable commission' on the subsequent sale to the customer, this commission was rarely, if ever, liable to VAT (even under the reverse-charge procedure) as no VAT invoices were issued by Medhotels to the accommodation suppliers. (It should be noted that at the time, this form of VAT accounting practice was by no means unusual in this sector).

From a VAT perspective, the main dispute concerned the legal capacity in which Medhotels was acting. The taxpayer had argued that for the period in dispute they were acting as a disclosed agent in arranging the sale of hotel rooms (i.e. the hotel operator was acting as the principal and was responsible for VAT in the country where the hotel was located). The difference between the price paid by the customer and that passed to the hotel represented commission earned by Medhotels who argued this was supported by the terms and conditions on the website. Helpful of this position, as the Upper Tribunal (UT) had found, was the fact that the written agreements between the parties were instructive as to the nature of the relationship between them.

The UT accepted it as common ground between the parties that the agreements were not 'shams or were superseded by later agreements on different terms' and therefore, preferred, what can probably be best described as a '[legal] form over substance' approach in terms of how Medhotels operated.

In other words, notwithstanding the underlying dysfunctional VAT accounting outcome, the manner in which the contracts had been concluded overrode the substantive aspects of the commercial relationship between the parties. Medhotels may have failed in the fiduciary duties of an agent to its principal in a number of respects, but this was not found to disturb the underlying agency relationship.

Under the special scheme for travel agents (articles 306–310 of the VAT Directive), Member States are required to lay down rules for taxable persons who buy in goods and services and provide travel services to end customers. Crucially this only applies where the taxable person acts in their own name, i.e. as principal or undisclosed agent.

Therefore if, as HMRC contended, Medhotels was acting as principal, VAT should have been accounted for under TOMS where Medhotels was established (i.e. the UK) rather than by reference to the business to business 'commission' that was collected but never formally invoiced (and on which Medhotels was not accounting for VAT in the UK or in Member States where accommodation was situated).

HMRC argued that when the entirety of the commercial arrangements and the accounting procedures were considered, the taxpayer was acting as a principal. HMRC cited *Reed Personnel Services* [1995] STC 588, which found that 'the concept of making a supply for the purposes of VAT is not identical with the performance of an obligation for the purposes of the law of contract', and confirmed it may be necessary to look beyond the contract to determine the 'nature' of a supply for VAT purposes.

The decision

The Court of Appeal first considered whether the FTT had erred in law and had been remiss

in considering whether it should have regard to not only the contractual documents, but also needed to more widely consider 'the behaviour of Medhotels'.

The UT considered that on the basis the agreements were not shams, the proper weight had not been given to their construction and that the FTT's approach was more akin to scenarios where no written contracts existed. The Court of Appeal, however, agreed that the FTT was correct and there was a need to have regard to 'the whole facts of the case'. This, the court concluded, was what the FTT had in mind when it said it would look 'not only at the various contractual documents but the behaviour of the appellant'.

The court also decided that the FTT was entitled to conclude Medhotels was not an agent of the hotels. The court placed particular weight on the fact that Medhotels dealt with holidaymakers in its own name in respect of the use of its website and in certain situations (such as when the holidaymaker complained). The court also noted for VAT accounting purposes, it did not act in a way consistent with it being the agent of the hotels – in particular it did not inform the hotels the amount of its 'commission' that it deducted from the payment by the customer. This made it impossible for the hotels to account for the correct amount of VAT on the accommodation that would be due if the hotels themselves were acting as principal.

Where does this leave us?

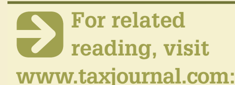
Lord Justice Sedley remarked in the *Royal & Sun Alliance* case [2001] STC 1476 that 'Beyond the everyday world ... lies the world of VAT, a kind of fiscal theme park in which factual and legal realities are suspended or inverted'.

The *Medhotels* case is an apposite reminder that the factual reality of VAT can often be at odds with the legal proposition; this case is illustrative, not only in the immediate impact upon the travel sector, but it also points to a wider notion that the role of an agent or intermediary needs to be critically analysed in order to determine whether they act as such. This is not only apparent in the UK. The European Commission has recently published guidelines (document C taxud.c.1(2012) 1410604 – 709) concerning article 28 of the Principal VAT Directive where it is stated that 'the VAT Committee is of the almost unanimous view that in providing the electronic service to the final consumer the intermediary ... shall be presumed to have acted in their own name'. This is a fundamental proposition which will have, if implemented, deep ramifications for a number of internet operators. Although the legal vires behind this is clearly different to what would be UK law as it relates to agency, the sentiment shows a general shift to minimising ambiguity and uncertainty where possible around the tax base.

In the immediate case, those who hold themselves out to act as travel agents will need to look very carefully at their arrangements with both their suppliers and also their customers to consider who, for VAT purposes, acts as the principal.

However, this is easier said than done. In the *Medhotels* case, the reality of the arrangements was that 94% of the hotel accommodation was sold to travel agents, some of whom would have sold directly on to final customers and some who may have sold on to other travel agents … and so on. Identifying at what stage in the chain the 'true principal' acts can be difficult and there still remains the threat of VAT leakage, particularly when considering cross-border transactions. This becomes increasingly more complicated when one starts to take into account 'dynamic packaging' or the bundling of various travel products by an 'agent' seemingly as a single supply to a customer – again, travel suppliers will need to ensure that at a very granular level, the legal form is closely matched by the practical substance of the commercial position. Simplistic though it may appear, and perhaps offensive to the legal purist, one of the key factors that would appear to have carried 'particular weight' for the Court of Appeal was around how the commission earned by Medhotels was treated from a VAT perspective; it was clearly at odds with VAT law that this amount was not subject to the tax and therefore, 'following the money' was an effective way of identifying the principal.

It would be somewhat extreme to suggest that this case heralds the end of the disclosed agency model in the travel sector. What it does signal, and we have to be thankful to the FTT and Court of Appeal in this regard, is that there is a clear template around how a disclosed agency model needs to operate in order that the desired VAT effects are achieved. ■


For related reading, visit www.taxjournal.com:

Cases: ***HMRC v Secret Hotels2*** (Alan Dolton, 14.12.12)

Agent versus principal (Julie Park, 7.9.11)

Applying TOMS in the EU (Damon Wright, 9.6.11)

The Indirect Tax Specialists

BLT are long-established as the market leaders in Indirect Tax recruitment and the recruiter of choice for the Indirect Tax fraternity. Our vastly experienced team Liz Watt, Guy Barrand and Emma Wade have specialised exclusively in this field for more years than we care to remember, so our knowledge of the market and experience of recruiting Indirect Tax specialists is second to none. Please visit our website **www.blt.co.uk** for more information.

Phone 020 7405 3404 or email vat@blt.co.uk
Quality House, 5/9 Quality Court, Chancery Lane, London WC2A 1HP **www.blt.co.uk**

International review: key developments in 2012

Francesca Lagerberg is the head of tax at Grant Thornton UK LLP and is set to become global tax leader of Grant Thornton International in July 2013. In this feature, she focuses in on some key international tax developments in 2012.
Email: francesca.lagerberg@gtuk.com; tel: 020 7728 3454.

Europe

Ireland

Ireland recently introduced two provisions concerning the mobility of workers:

- special assignee relief program (SARP); and
- foreign earnings deduction (FED).

The SARP is available where the assignment commences in 2012, 2013 or 2014 and replaces the limited remittance basis available to non-Irish domiciled individuals on employment income. The SARP operates by granting an exemption from income tax on 30% of employment income between €75,000 and €500,000, equating to a maximum annual deduction of €127,500. For a marginal rate (41%) taxpayer, the net value of the relief would be €52,275. The relief can be claimed for the duration of the assignment up to a maximum of five years. The SARP does not reduce liability for the universal social charge or PRSI (social insurance contributions).

The FED is an incentive for companies assigning Irish based employees into emerging markets in Brazil, Russia, India, China, and South Africa (the BRICS countries). The relief operates by way of a deduction against employment income for employees who spend at least 60 qualifying days in a year in a BRICS country and will operate for three tax years commencing 1 January 2012 and ending on 31 December 2014.

France

As the austerity package begins to bite there are multiple tax changes on the table. A new income tax rate of 45% will be applied broadly on household income exceeding €150,000 and an exceptional rate of 75% in 2013 (with respect to 2012 income) on income exceeding €1m per person. Increased rates are also being applied to non-residents with French property, e.g. a holiday home.

France has just introduced a new rule that disallows the deduction of interest and other financing expenses incurred for acquisitions if the decisions relating to the shareholdings are not made in France or the control or influence over the acquired company is not exercised in France. This new rule therefore affects the tax treatment of French and non-French acquisitions by French companies held by international corporate groups or private equity funds that do not have an autonomous decision-making centre in France.

The rule concerns participation shareholdings, eligible for the French participation exemption regime, which provides for a 90% exemption of capital gains realised on the sale of shares. The rule does not apply to shareholdings in companies with assets that consist primarily of real estate assets or shares in real estate companies.

Spain

Spain has introduced several changes to its corporate income tax regime to deal with the financial crisis. These include:

- a further restriction on the carry forward of losses;
- replacing the thin capitalisation rules with a limitation on net financial expenses;
- reducing the deprecation rate of intangible assets with an indeterminate useful life from 10% to 2%; and
- introducing an optional 10% tax rate for dividends and gains derived from abroad.

Belgium

Until 2011, Belgium only applied its thin capitalisation rule to the payment of interest to a beneficial owner established in a tax haven. In 2012, Belgium strengthened its rule (5:1 debt:equity ratio) and extended it to interest paid to group companies. Companies are deemed to belong to the same group if one company has decisive influence over another company or if both companies belong to a consortium. If a loan is guaranteed or financed by a third party, that party will be deemed to be the beneficial owner if the main purpose of that guarantee or financing is tax avoidance. The deduction of interest paid on debt will be disallowed if, and to the extent of the excess, the total amount of the debt exceeds five times the company's equity.

Denmark

A law has been enacted that allows new machinery and equipment to be depreciated in an amount equal to 115% of the purchase price. The 'super-depreciation' will apply only to newly manufactured (unused) machinery and equipment acquired on or after 30 May 2012, and up to 31 December 2013. It will not apply to cars, ships, and certain leasing equipment or to machinery and equipment with a very long useful life, such as aircraft, oil rigs, power stations, and railway facilities. Qualifying equipment is added to the depreciation base with an increased value (i.e. 115% of the purchase price) and depreciated by an annual rate of 25%.

Italy

The Italian government approved a surcharge to be applied on income earned by all Italian residents for the period 2011–2013. This is intended to ease the European Central Bank and market concerns about Italy's economy. The surcharge will amount to:

- 5% on any income exceeding €90,000, up to €150,000;
- 10% over €150,000,

and would be deductible from the gross income as of 2012. In addition, if its application results in a marginal tax rate of more than 48%, taxpayers could opt to apply the 48% tax rate instead of the solidarity tax.

This charge will impact executives working in Italy who are subject to Italian personal income tax. Foreign companies with executives on an Italian assignment should factor this additional cost into their executives' compensation package.

Malta

Prior to recent amendments, Malta exempted royalties and similar income including any amounts paid for the grant of a license to exercise rights derived from registered patents for qualifying inventions, whether registered in Malta or elsewhere. The Maltese Parliament has approved amendments to the income tax law that extend the scope of the royalty exemption to cover income from some copyrights, thereby enhancing Malta's position as a European domicile of choice for intellectual property planning. The amendments apply retroactively from 1 January 2012.

The Americas

Canada

Canadian corporations that owe debt to certain non-residents should review the modifications to Canada's thin capitalisation in the 2012 federal budget.

These modifications include a reduction in the debt-to-equity ratio, an extension of the regime to partnership debt, and the introduction of a new deemed dividend rule for excess interest expense.

Although the reduction of the debt-to equity level to 1:5 (from 2:1) will generally not apply until 2013, other important changes are already in effect.

Mexico

The Mexican tax authorities have issued rules that will prevent tax deductions for Mexican residents unless certain details are contained on an invoice. The rules apply from 1 January 2012 to supplies from residents abroad (without a permanent establishment in Mexico) that undertake transactions with Mexican residents.

US

Very few tax changes were made during this election year, and the floodgates are expected to open wide for congressional action on changes scheduled for 2013. The election did not change the current balance of power in Washington and any resolution on the unfinished tax items before the end of the year (the 'fiscal cliff') will depend on both parties' willingness to strike a deal. The important tax issues for consideration include:

- expired provisions like tax 'extenders' and the alternative minimum tax (AMT);
- new Medicare taxes scheduled to take effect in 2013;
- the Bush-era tax cuts scheduled to expire at the end of 2012; and
- current estate and gift rules scheduled to expire at the end of 2012.

Without legislation, the expiration of the 2001 and 2003 tax cuts would result in:

- income tax rate increases across all tax brackets, with a top rate of 39.6%;
- an increase in the capital gains rate from 15% to 20%;
- the reinstatement of the personal exemption phase-out (PEP) and the phase-out of some itemised deductions; and
- the end of marriage penalty relief, the $1,000 refundable child tax credit and several other benefits, including increased dependent care and adoption credits, and enhanced education incentives.

New Medicare taxes enacted in the health care legislation are also scheduled to take effect in 2013. First, the rate of the individual share of Medicare tax will increase from 1.45% to 2.35% on earned income above $200,000 for single filers and $250,000 for joint filers. The 1.45% employer share will not change, creating a top rate of 3.8% on self-employment income. Second, investment income such as capital gains, dividends and interest will be subject for the first time to a 3.8% Medicare tax to the extent adjusted gross income exceeds $200,000 (single) or $250,000 (joint). This tax will not apply to active trade or business income that is not otherwise considered to be self-employment income, or to distributions from qualified retirement plans.

Brazil

A recent ruling created a new filing obligation for information concerning transactions involving non-resident persons regarding services, intangibles and any other operation with an impact on the equity of resident persons. The parties responsible for providing this information are those individuals and/or legal entities resident in Brazil who:

- render or contract services;
- dispose or acquire intangibles, including intellectual property rights, by any legal means;
- represent unincorporated bodies that carry out transactions which may change their equity value.

Africa

South Africa

On the 5 July 2012, the South African treasury published the Taxation Laws Amendment Bill to further help the government's goal of making South Africa the gateway to Africa for international investment. The bill seeks to address double taxation and offset aspects of the country's strong anti-avoidance legislation. A key provision of the bill offers relief from South Africa's effective management regime, which has served as a disincentive for firms wanting to use South Africa as their launching board.

Because much of Africa lacks economic infrastructure, overseas firms are forced to set up a significant portion of their overall African operation in the relatively more developed South Africa. In some cases, political instability and the lack of qualified personnel add to the difficulty, requiring companies to carry out most of their management in South Africa.

However, under South African tax laws, extensive guidance issued from South Africa to a related party in another African country crosses the effective management threshold. The company is deemed to be South African and is then treated as a resident for tax purposes. With taxes also due in the target African country, double taxation arises.

In order to promote South Africa as an ideal destination for international capital dedicated to African regional investment, an exception from the effective management test for foreign investment funds has been created. The purpose of the exception is to remove the potential to subject the fund to South African worldwide taxation if the fund is managed by a South African manager.

Mauritius

The Mauritian government has recently enacted the Limited Partnership Act which came into force on 5 December 2011. The Limited Partnership (LP) structure was introduced in Mauritius to add to the country's wide range of offshore products that already comprises companies, trusts and sociétés. The LP structure is of particular interest to managers in the private equity/venture capital business who may use it to create an investment fund under the control of a general partner, who alone has unlimited liability for the partnership's obligations. The limited partner is only liable to the extent of his contributions, provided he does not take part in the management of the partnership business. The LP vehicle provides investors with benefits of a separate legal personality and limited liability protection while preserving the fiscal transparency and 'look-through' component associated with partnerships generally.In terms of taxation, only the share of profit allocated to the partners is subject to tax at the rate of 15%. An LP holding a category 1 global business license can choose not to have the partners taxed and opt for the LP to be treated as a company which in turn will be taxed at an effective tax rate of 3%.

Another key element introduced by the legislation is the registration of foreign limited partnerships in Mauritius – which might increase the tax planning options for those foreign limited partnerships subject to a tax rate higher than 15%. Those foreign limited partnerships that are eligible for a category 1 global business license would only be subject to tax at an effective rate of 3%.

Russia

Key tax policy trends adopted by the Russian government for 2013–15 have been published. These measures represent the basis for drafting amendments to the tax legislation. Significant proposals are:

- to introduce controlled foreign companies rules;
- to develop special tax regimes for small enterprises;
- to define the tax residence for companies based on criteria used in tax treaties concluded by Russia;
- to develop the mutual agreement procedures;
- to amend individual income taxation;
- to improve taxation of depositary notes and eurobonds of Russian issuers; and
- to increase the mineral resources extraction tax on extraction of natural gas.

The Russian government approved criteria for the establishment of four special economic zones. The four types of zones are: industrial and production; technological and innovative; tourist-recreational; and port operations.

India

The Finance Bill 2012 in India included a number of measures with international significance. These included:

- taxing indirect transfers of capital assets in India (with retrospective effect from 1 April 1962);
- the proposed introduction of a general anti-avoidance rule (GAAR), although this is now being deferred for further consideration;
- limiting benefits that can be claimed under a tax treaty by requiring a certificate of tax residence to prevent residents of third party countries claiming treaty benefits;
- denying treaty provisions where the GAAR applies;
- changes to the transfer pricing rules to: enable an advance pricing agreement to be obtained, valid for five years; expand the remit of the rules to include specified domestic transactions and intangibles; reduce the permitted variation from the arm's length price from 5% to 3%; change the appeals process; and change the powers and penalties.

India also had the controversial *Vodafone* decision around retrospective legislation. A high-level expert panel set up by the government has said retrospective amendments in tax laws targeting overseas mergers and acquisitions of companies with assets in India, should be scrapped. Retrospection should only apply in the 'rarest of rare cases'.

Malaysia

The Inland Revenue Board of Malaysia has recently issued a Public Ruling (PR) dealing with foreign nationals working in Malaysia to provide clarification as to the claiming of tax treaty relief for foreign nationals working seconded to Malaysia for a short period of time by non-resident employers. To be eligible for tax exemption in the country of source the following three conditions must be met:

- The foreign national is present in Malaysia for a period or periods not exceeding 183 days in aggregate in the fiscal/calendar year concerned; or the foreign national is present in Malaysia for a period or periods not exceeding 183 days in aggregate in any 12 month period commencing or ending in the fiscal year concerned
- The employer paying the remuneration must not be a resident of the country where the employment is exercised
- Remuneration is not borne by a resident or permanent establishment in Malaysia

The PR looks at the three conditions and how they are applied in Malaysia.

Australia

On 22 November 2012, the Australian Treasury released the Exposure Draft of the Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2013: Modernisation of transfer pricing rules (Stage 2) which proposes to update Australia's domestic transfer pricing regime. The key impacts of Stage 2 are expected to be the following: the application of significant penalties to transfer pricing adjustments where the company does not maintain specific transfer pricing documentation; the intention of the Australian Taxation Office (ATO) to apply the new transfer pricing rules to all cross-border transactions, including transactions between third parties; shifting transfer pricing to a self-assessment basis, placing on the company's public officer the responsibility of determining the company's overall tax position arising from all cross-border dealings; the introduction of time limits of eight years on when the ATO can make transfer pricing amendments; and the introduction of specific rules allowing the ATO to reconstruct transactions and arrangements. Stage 1 of this process received Royal Assent on 8 September 2012 and focused on the retrospective application of transfer pricing rules for companies dealing with foreign associated entities located in countries that have a double tax treaty with Australia. Stage 2 focuses on how Australia's transfer pricing regime will operate prospectively for all taxpayers, including the application of significant penalties to transfer pricing adjustments where the company does not maintain specific transfer pricing documentation. The proposed changes align the existing transfer pricing regime to the self-assessment taxation system operative in Australia, placing on the company's public officer the responsibility of determining the company's overall tax position arising from all cross-border dealings.

Australia is also considering whether to update its own GAAR, which has now been in place for many years.

Japan

The Japanese government released tax reform proposals, which include a restriction on the deductibility of interest paid to some foreign affiliates (earnings stripping). Interest would be limited to 50% of adjusted taxable income, and the deductibility restriction would be in addition to the existing thin capitalisation rules. If enacted, the measure could have a detrimental impact on the Japanese operations of foreign companies that receive financing from offshore group companies. The regime would apply for fiscal years beginning on or after 1 April 2013.

China

The State Administration of Taxation (SAT) issued an announcement providing rules on determination of beneficial owner under tax treaties.

Whether or not a resident of a contracting state is the 'beneficial owner' may not be decided merely on certain adverse factors or the absence of the intention of tax evasion or reduction and shifting or accumulation of profits. It must be determined on the basis of an analysis of the following: the article of association; financial statements; statement of cash-flow; minutes of the board of directors; allocation of human resources and assets; related expenditures; function and risk analysis; loan contracts; agreements on use or transfer of intellectual properties; certificate of the patent registration; certificate of the ownership of author's right; and contract on agency or designated nominee.

If the requesting taxpayer of the tax treaty benefit for the dividends derived from China is a listed company of the contracting state, the applicant automatically meets the definition of the beneficial owner. The same applies to 100% subsidiaries directly or indirectly owned by the listed company of the contracting state (the intermediate indirect shareholding in a third country is excluded) provided that the dividends stemmed from the shareholding of the listed company.

Oceania

New Zealand

An issues paper for public comment *Taxation of foreign superannuation*, deals with the rules for taxing foreign retirement savings of New Zealand residents. Foreign retirement savings may have been accumulated by people migrating to New Zealand, or by New Zealanders who have previously worked overseas. The current law for taxing foreign retirement savings is complex and can produce inconsistent outcomes. The issues paper proposes a single set of rules, which are designed to achieve fairness and simplicity from a compliance perspective. The issues paper proposes the following: pensions would be taxed at an individual's marginal tax rate when received; lump-sum payments would be partially taxed depending on the length of time between when the individual arrives in New Zealand and the date that they transfer or withdraw their superannuation funds. At the time the funds are withdrawn or transferred from the foreign superannuation scheme, the individual would apply an 'inclusion rate'. The individual's marginal tax rate would be applied to the result calculated by multiplying the amount of superannuation funds withdrawn by the inclusion rate; and transitional residents would continue to be temporarily exempt from most New Zealand tax, including tax on foreign superannuation. Lump sums arising from a retirement benefit scheme in Australia are not taxable in New Zealand under the Australia/New Zealand income tax treaty (2009). Also, superannuation falling under the new arrangement with Australia regarding the portability of retirement savings would not be affected.

Ask an expert

Legal fees in relation to fines

Q My client's trading company is a member of a regulatory body which impose statutory trading conditions under which my clients are contractually bound. Due to perceived gross misconduct, my client has been charged a penalty for breaching regulations and as the case is likely to be generally reported this could be detrimental to the business and the client's reputation. Legal fees have been incurred in defending the position. Can you let me know whether a corporation tax deduction can be claimed for the legal fees and, assuming the case is lost, the fine and what points will be considered when making a claim.

Martin Mann
Director, Gabelle
Email: martin.mann@gabelletax.com
Tel: 020 7182 4745

A It goes without saying that it is essential that you gather all the facts that applied at the time the expenditure was incurred before any decision is made on their deductibility. In the absence of specific statutory provisions, the two main principles that need to be satisfied in relation to the expenditure are:

- the expenditure must be incurred wholly and exclusively for the purposes of the trade; and
- the expenditure must be of a revenue rather than a capital nature.

With minimal definition of these in statute you will need to examine the wide range of relevant case law.

Capital versus revenue

In calculating the profits of a trade, no deduction is allowed for items of a capital nature (CTA 2009 s 53). Expenditure is capital where it is for the enduring benefit of the trade, for example the acquisition of goodwill, premises or equipment. This is to be contrasted with revenue expenditure sometimes referred to as circulating capital which covers most day to day running costs of a business.

The expenditure in question displays the characteristics of revenue expenditure and therefore the next step is to consider whether this has been incurred wholly and exclusively for the purposes of the trade.

Wholly and exclusively

CTA 2009 s 54 states that no deduction is allowed for expenses not incurred wholly and exclusively for the purposes of the trade however, s 54(2) does not prohibit a deduction for any identifiable part or proportion of the expense incurred for such wholly and exclusive purpose. In practice difficulties arise where expenditure includes a business and non-business purpose where duality cannot be distinguished.

Legal costs

There appear to be similarities in this case with the case of *McKnight v Sheppard* [1999] 71 TC419, a stockbroker who faced suspension which was later reduced to fines. He claimed a deduction for both the fine and legal costs incurred in connection with the disciplinary proceedings. Suspension would have had a serious impact on the viability of the business and the costs had been incurred solely to avoid this arising. HMRC argued that part of the costs were incurred to defend personal reputation and thus were dual purpose.

The Court of Appeal found in favour of Mr Sheppard and while it found that a successful defence would have been advantageous to Mr Sheppard's reputation this was an unavoidable consequence and was not the purpose for which the money had been spent.

In the contrasting decision of *M A Raynor (deceased) and Mrs B C Raynor* TC01649 the deductibility of legal costs incurred in defending criminal prosecution (which could lead to a custodial sentence) in connection with polluting a river with insecticide was considered.

The Tribunal decided that there was a significant personal motivation in seeking to avoid a custodial sentence and because there was a personal purpose deduction must be denied. Reference was made to the fact that the expenditure was not broken down into separate elements on the invoices from the solicitors, but that if that had been done there may have been scope to claim a deduction for parts of the expenditure. This may be a key point to consider in the case in hand.

Fines

A fine incurred as a result of a trader's infraction of the law is not allowable as it is not incurred wholly and exclusively for the purposes of the trade. This follows *CIR v Alexander von Glehn Ltd* [1920] 12 TC232. This was supported by Lord Hoffman in the *McKnight v Sheppard* case who took the view that a fine or penalty was not deductible because its purpose is to punish the person concerned and it would not be right for that burden to be shared with the public by allowing a tax deduction.

The recent surprising decision in the *McLaren Racing Ltd* case (TC02278) has cast some doubt on this. In that case while McLaren were fined for effectively cheating as the fine derived from a contractual obligation the penalty was seen as commercial rather than 'personal punishment' and being closely associated with the trade met the wholly and exclusively conditions. As the Tribunal were split on the decision it is likely to go to appeal. Nevertheless, as things stand the decision could mean that fines raised by other regulatory bodies may be tax deductible.

Summary

As expressed in *Mallalieu v Drummond* (1983) 57 TC 330, 'The object of the taxpayer in making the expenditure must be distinguished from the effect of the expenditure'. What you will need to examine is the detrimental impact the fine and more importantly, the 'naming and shaming' would have on the business and whether it can be argued that the legal costs (or at least an identifiable proportion) were incurred solely to defend the business rather than an incidental reputational concerns. The fines are unlikely to be allowable but if there is a commercial argument the *McLaren* decision, if not overturned on appeal, may help extend the relief available. ■

'Ask an expert' provides expert answers to your tax queries. **If you would like a second opinion on a tax issue, please contact the editor** at paul.stainforth@lexisnexis.co.uk and we will endeavour to commission an answer for you. All questions will be anonymised.

What's ahead

Dates for your diary

December

15 **Regulations:** The Bank Levy: International Tax Enforcement Arrangements (Federal Republic of Germany) Order, SI 2012/2933, comes into force.

18 **Upper Tribunal hearing:** *HMRC v Pawson's Personal Representatives* TC01748: IHT, college let as holiday accommodation.

19 **CJEU judgments:** *3D I srl v Agenzia delle Entrate - Ufficio di Cremona* C-207/11: whether calculation of a capital gain on disposal of shares is compatible with the merger directive. *Grattan plc v HMRC* C-310/11: VAT, agents' commission. *Direktor na Direktsia 'Obzhalvane i upravlenie na izpalnenieto' - grad Burgas pri Tsentralno Upravlenie na Natsionalnata Agentsia za Prihodite v Orfey Balgaria EOOD* C-549/11: VAT, construction work.
Parliament: House of Lords rises for Christmas recess, returning on 8 January.

20 **Regulations:** The VAT (Place of Supply of Services) (Transport of Goods) Order SI 2012/2787 comes into force.
Parliament: House of Commons rises for Christmas recess, returning on 7 January.

21 **Regulations:** The Income Tax (Purchased Life Annuities) (Amendment) Regulations, SI 2012/2902, and the Registered Pension Schemes (Relevant Annuities) (Amendment) Regulations, SI 2012/2940, come into force.

30 **Self-assessment:** Deadline for online submission of 2011/12 return for HMRC to collect tax through PAYE code where tax owed is less than £3,000.

31 **Regulations:** The Inheritance Tax (Market Makers and Discount Houses) Regulations, SI 2012/2903, and the Insurance Companies and CFCs (Avoidance of Double Charge) Regulations, SI 2012/3044, come into force. The Car and Van Fuel Benefit Order, SI 2012/3037, comes into force and will have effect from 6 April 2013.

January

1 **Regulations:** The AIF (Tax) (Amendment No. 3) Regs, SI 2012/3043; the Climate Change Agreements (Eligible Facilities) Regs, SI 2012/2999; the APD (Amendment) Regs, SI 2012/3017; the Aircraft Operators (Accounts and Records) (Amendment) Regs, SI 2012/3020; the CFC (Excluded Territories) Regs, SI 2012/3024; the FA 1994 s 30A (Appointed Day) Order, SI 2012/3015; the Regulated Covered Bonds (Amendment) Regs, SI 2012/2977; the VAT (Amendment) (No. 3) Regulations, SI 2012/2951; the VAT (Removal of Goods) (Amendment) Order, SI 2012/2953; and the VAT (Relief for ERIC) Order, SI 2012/2907 come into force.

One minute with ...

Ian Brimicombe
Head of Group Tax and Treasury, AstraZeneca

Who in tax do you most admire?
I have been very fortunate to work with some exceptional people in tax over the years. I have always admired Graham Aaronson for sheer technical ability and his articulation of complex matters in simple terms.

Is there a common problem in tax you come across time and again?
Our key concern is resolving transfer pricing matters usually bilaterally and with relevant governments. It's a constant challenge to reconcile a global operating model of a highly integrated multinational company like AstraZeneca to local tax bases. The process requires deep functional understanding and clear communication.

Name a memorable moment in your career.
There have been so many in AstraZeneca including deals done, settlements achieved, APAs etc but if I had to pick one it was the opening of the Oxford Centre for Business Taxation led by Mike Devereux. There was a lot or preparation work by a small group of us and it was great to witness the opening and continuing success of the Centre in making a significant contribution to the development of UK tax policy.

What's your view of HMRC?
HMRC is a key asset in the overall competitiveness of the UK economy. Getting the right tax regime is one thing, administering it effectively and fairly is equally important. It's right that the Chancellor has spared HMRC from further cuts as their role to collect, monitor and enforce is ever increasing not only in the UK but in dealing with overseas taxpayers and governments to ensure effective administration of cross-border trade. HMRC represents the UK around the world in setting high standards for tax administration and it should continue to invest in this activity to enhance prospects for British business.

HMRC needs to address its approach to medium-sized and smaller businesses to ensure the service is accessible, consistent and efficient. I understand HMRC is focused on this aspect.

Where do you stand on the GAAR?
I am in favour. It was clear to business that the nature of some planning particularly in the HNWI sector was well beyond the intention of the law and could not necessarily be countered by small step changes to the law. DOTAS does not seem to have prevented the proliferation of schemes and a GAAR is a natural step to take to deal with the gap at the extreme end of abusive planning. We will of course have to see how the panel operates the new measure.

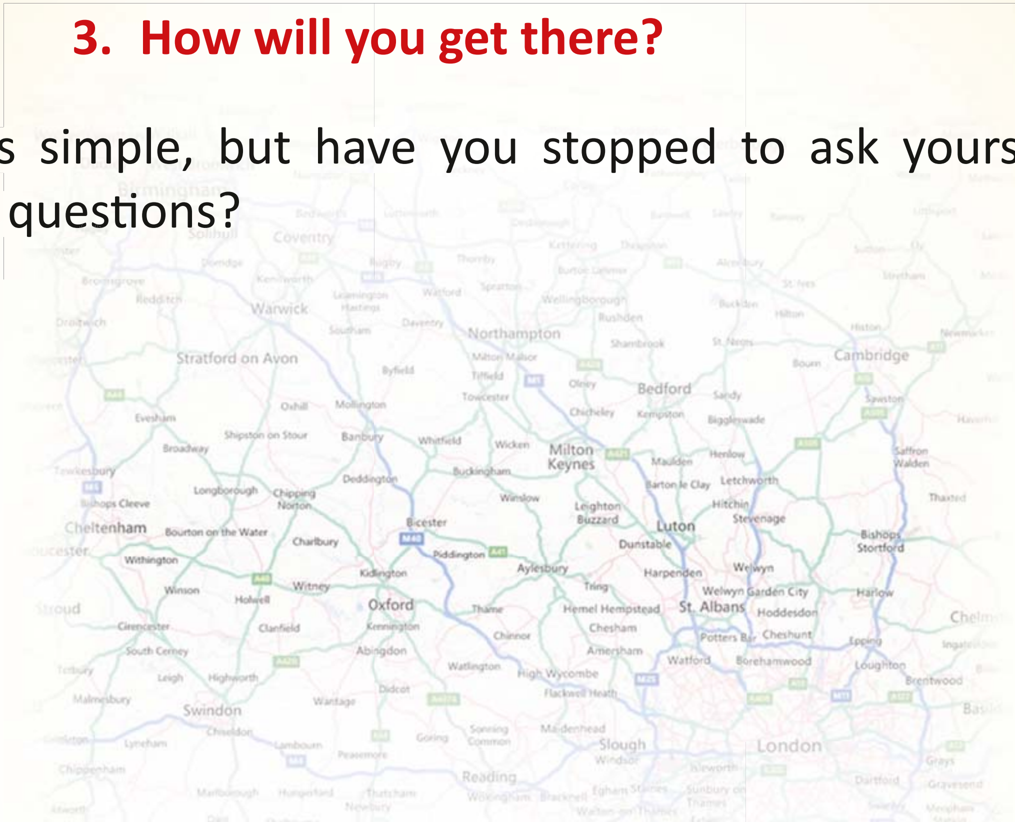
How do you see the rules on corporate taxes evolving?
I see less emphasis on corporate tax in the future and more on indirect taxes as governments aim to improve efficiency and predictability of tax collection. This will require a mindset shift in the electorate but the fact is that global companies do have choices for location of investment in funding and substance. In the meantime corporate tax remains an important source of funds and the battleground is set for an alternative tax base for corporates – away from profits and toward sales and substance. Governments should be very wary of allowing this choice to be promoted without serious debate and business must play its part in explaining the basis of its contribution.

A longer version of this interview appears on www.taxjournal.com.

Career Methodology

1. **Currently, where is your career at?**
2. **Where do you want your career to go?**
3. **How will you get there?**

Seems simple, but have you stopped to ask yourselves these questions?



Your first step to making something happen in your career is to call the experts in your market. When you speak to Pro-Tax we don't just find you your next job, we give you the road map too.

Call: Alison Humphries 020 7269 6312
Jim Halstead 020 7269 6318

Visit us at: www.pro-tax.co.uk

20 – 23 Greville Street, London EC1N 8SS w: www.pro-recruitment.co.uk e: info@pro-recruitment.co.uk t: +44 (0)20 7269 6333