THE CHARTERED INSTITUTE OF TAXATION

The Chartered Tax Adviser Examination

November 2008

PAPER IIC

COMPANIES

Suggested Answers (without marks)

Where candidates are required to comment on tax (and in particular CGT) which may apply in 2008/09 and subsequent years they will be given full credit whether they assume that 2007/08 rates (including taper relief) continue to apply or whether they answer using 2008/09 rates (including entrepreneurs relief).

Question 1

EDLOE INVESTMENTS LIMITED

ACCOUNTING PERIOD ENDED 31 MARCH 2008

The dividends will be identified with the distributable income arising in the most recent accounting periods.

The dividend paid by Merwin SA is treated for the purpose of the mixer cap as follows:

	£
Dividend paid	50,000
Underlying tax	50,000
Income for UK purposes	100,000
Tax thereon at UK rate of 30%	30,000

The dividend paid by Colquitt BV is treated as follows:

Dividend paid	170,000
Underlying tax (Colquitt)	25,000
Underlying tax (Merwin)	50,000
Schedule D Case V income	245,000
Tax thereon at 30%	73,500
Double tax relief	55,000
UK tax payable thereon	18,500

The dividend paid by Markham AG is treated as follows:

Dividend paid	200,000
Underlying tax	100,000
Schedule D Case V income	300,000
Tax thereon at 30%	90,000
Double taxation relief restricted to	90,000
UK tax payable thereon	–
EUFT arising	10,000

The EUFT arising cannot be set off against the Colquitt dividend as it is not a qualifying foreign dividend as defined under Section 806C(1)(c) ICTA 1988 because Colquitt has, via the mixer cap, an amount of Case B EUFT.

Question 2

AN Firm
London
UK

Ms Jenifer Child
CFO
Kiddi Inc
New York
USA

X November 2008

Dear Ms Child

I refer to our telephone conversation last week. As agreed I am writing to you to clarify a number of corporation tax self assessment ("CTSA") administrative matters.

Corporation tax deadlines

Once Kiddi Ltd is established, HM Revenue & Customs should be informed that Kiddi Ltd exists and that it is liable for tax, using the CT41G New Companies Details form. Kiddi Ltd will then receive a 'notice to deliver a company tax return form CT600' (form CT603) from HM Revenue & Customs.

If Kiddi Ltd does not receive a form CT603 it must give notice to HM Revenue & Customs that it is chargeable to tax for an accounting period within 12 months from the end of the accounting period.

Kiddi Ltd can send in its company tax return (form CT600) at any time after the end of its accounting period but must do so no later than the 'statutory filing date'. This is the later of:

- 12 months after the end of the company's accounting period;
- Where the company makes up its accounts for a period not exceeding 18 months, 12 months from the end of that period;
- If the company makes up its accounts for a period exceeding 18 months, 30 months from the beginning of that period; or
- 3 months after the company receives a 'notice to deliver a company tax return form CT600' from HM Revenue & Customs.

However, Kiddi Ltd can amend its company tax return at any time within 12 months of the statutory filing date. But if the original return is first sent in more than 12 months after the statutory filing date, the company cannot later amend it.

For most companies, including Kiddi Ltd, payment of corporation tax is due 9 months and 1 day after the last day of the accounting period. There is an exception for 'large' companies but it is assumed that Kiddi Ltd will not be a large company, at least initially.

Accounting periods for tax purposes

An 'accounting period' is the period for which the corporation tax liability must be calculated. It is normally the same period for which the company's accounts are drawn up. However, while a period of account can be longer than 12 months, an accounting period for tax purposes can never be longer than 12 months, although it can be less.

An accounting period starts either when the company first comes within the charge to corporation tax or immediately after the end of the previous accounting period.

An accounting period ends when the earliest of the following takes place:

- The company reaches its accounting date or the reporting year end;
- It is 12 months since the start of the accounting period;
- The company starts or stops trading;

- The company is no longer liable for corporation tax (for example, it winds up its business and sells all income-producing assets);
- The company goes into liquidation, in which case its accounting period will then run for 12 month periods until winding-up is completed);
- The company goes into administration or comes out of administration;
- The company starts or stops being resident in the UK.

HM Revenue & Customs enquiries

If HM Revenue & Customs spots an obvious mistake, it can amend the CT600 to correct it at any time up to 9 months from the day the company delivered it. HM Revenue & Customs will only correct obvious errors, omissions, errors of principle, arithmetical mistakes or otherwise. If Kiddi Ltd disagrees with the correction, it cannot appeal against it but it can amend its tax return to reject the correction. This must be done within the normal time limit for amending a tax return.

Alternatively, HM Revenue & Customs can enquire into a return without giving a reason by giving written notice to the company from the time of receipt of the tax return until the end of a defined period.

The defined period is as follows:

- If the return was delivered on or before the statutory filing date, notice of an enquiry may be given at any time up to 12 months from the statutory filing date.
- If the return was delivered after the filing date, notice of enquiry may be given at any time up to and including the 31 January, 30 April, 31 July or 31 October next following the first anniversary of the day on which the return was delivered.
- If the company amends its return, notice of enquiry may be given at any time up to and including the 31 January, 30 April, 31 July or 31 October next following the first anniversary of the day on which the amendment was made.

Keeping records

Kiddi Ltd is legally obliged to keep 'sufficient' records of outgoings and income to make a complete and correct company tax return. These include details of all receipts and expenses incurred in the course of Kiddi Ltd's activities; details of all sales and purchases made in the course of trade; and other supporting documents.

For tax purposes, HM Revenue & Customs requires a company to keep its records for at least 6 years from the end of the accounting period. This is regardless of whether an enquiry by HM Revenue & Customs could be opened or has been opened.

However, where a HM Revenue & Customs enquiry has been opened, a company may need to keep its records for longer than 6 years. A penalty of up to £3,000 can be charged if a company does not keep records.

Claims for capital allowances

A claim for capital allowances must be included in Kiddi Ltd's company tax return for the accounting period for which the claim is made. It may be included in the return originally made or by amendment.

The claim must specify the amount claimed which must be an amount which is quantified at the time the claim is made. It may be amended or withdrawn by Kiddi Ltd only by amending its company tax return.

The time limit for making a claim is the last of the following dates:

- The first anniversary of the statutory filing date for the company tax return of Kiddi Ltd for the accounting period for which the claim is made;
- If notice of enquiry is given into that return, 30 days after the enquiry is completed;
- If after such an enquiry HM Revenue & Customs amends the return, 30 days after notice of the amendment is issued;
- If an appeal is brought against such an amendment, 30 days after the date on which the appeal is finally determined; or
- Such later time as HM Revenue & Customs may allow.

Error or mistake claim

A company which believes it has been overcharged in a tax assessment by reason of an error or mistake in a return may claim relief in respect of the overcharge no later than 6 years after the end of the accounting period to which the return relates.

Generally speaking, a company should not rely on the possibility of making an error or mistake claim at a later date to get a capital allowances claim right because there are a number of conditions that must be satisfied before a claim under the error or mistake provisions will be accepted by HM Revenue & Customs:

- There must be an excessive assessment;
- Tax charged under it has been paid;
- There has been an error or mistake in a return; and
- There is a causal link (but not necessarily a temporal link) between the error or mistake and the excessive assessment.

The expression 'error or mistake' covers errors of omission such as the non-deduction of an admissible expense, errors of commission, such as computational or arithmetical errors or errors arising from a misunderstanding of the law or erroneous statements of fact.

No relief will be given on the ground of an alleged error in the basis of computation of liability if the return was made on that basis or in accordance with the practice generally prevailing for taxpayers at the time when the return as made.

Where a deliberate choice has been made between two alternatives permitted by the Taxes Acts there can be no error or mistake in the return. For example, if Kiddi Ltd claims less than the full amount of capital allowances, it cannot later say it made an error or mistake. Although the chosen alternative may not, with hindsight, prove to be the best decision, it is not incorrect. And although the assessment may be excessive, it is not excessive 'by reason of some error or mistake in a return.'

Also no relief is given if the return was made on a basis which was wrong in law but had been deliberately adopted by the taxpayer and it gave a result which, having regard to all the relevant circumstances, was 'reasonable and just'.

General time limit for making claims

In general, claims must be made within 6 years from the end of the accounting period to which it relates. However, this is subject to any other provision prescribing a longer or shorter period.

In the case of a carry back loss claim (under s.393A(1)(b) ICTA 1988) there is a two year time limit (s.393A(10) ICTA 1988) that overrides the general time limit. For example, if Kiddi Ltd's accounting period ended on 31 December 2007 and it wanted to set off the losses against the year ended 31 December 2006, Kiddi Ltd would have to make a loss relief claim by 31 December 2009.

If you have further queries, please do not hesitate to contact me.

Yours sincerely

Question 3

As the intellectual property has been developed over a period of ten years, it will be split between that which was created before 1 April 2002 and is, therefore, governed by the old legislation in force up to that date and that which was created after 31 March 2002 and is within the ambit of the new 2002 legislation. This primarily affects the allowances and reliefs given and the treatment of any disposals of the intellectual property assets.

Work has begun on manufacturing using the company's intellectual property. Income from the licences granted will be taxed as the receipt of royalty income regardless of whether the specific property is in the new or old regimes. The licences granted to group companies (including the UK manufacturer) will be subject to UK transfer pricing rules and the company will need to show that these have been calculated on an arm's length basis. As there are also licences to third parties, these should set a benchmark for the arm's length calculations and, if the licences are priced differently, the company will need to explain how the commercial terms, assumptions of risk, etc differ from the third party arrangements to provide justification.

Although there is no withholding tax on the payment of royalties between the companies in the UK, it is commonly the case that withholding tax is due in many countries on royalty and licence payments to non-resident entities. It is, therefore, likely that Glenmont UK Ltd will suffer withholding tax which can be set off against the UK tax payable on the royalty income, calculated by reference to the receipts from that customer less direct costs and an appropriate proportion of overheads.

Relief for revenue expenditure on intangible assets has been given as incurred under both the old and new legislation. However, the treatment of capital expenditure is different. Under the pre-2002 legislation relief was not automatic although some expenditure may have qualified under the capital allowances legislation or under the rules relating to research and development reliefs. Since 2002, however, capital expenditure has qualified for relief on an amortisation basis, i.e. the amount of amortisation debited to the profit and loss account each period qualifies for relief although the company also has the right to elect for the expenditure to be relieved on a straight-line basis over a twenty-five year period.

Additionally, research and development expenditure of a revenue nature may qualify for additional relief under the research and development relief rules. There are different relief regimes for large companies as distinct from small and medium companies and it is clear that Glenmont will fall within the large company regime.

Qualifying expenditure, which is basically that incurred on staff involved in research and development and consumables used in the research and development process, will qualify for an extra deduction of 25% [30% under FA 2008 legislation announced in 2007 – questionable which answer is correct under the exam rules; presumably credit given for either] of the qualifying expenditure incurred.

In addition, capital expenditure related to qualifying research and development is eligible for an initial capital allowance of 100% in the year of expenditure. [ss.437-451 CAA 2001]

The payment to the Australian company will be capital expenditure which will be subject to the capital expenditure relief outlined above. The amortisation period is ten years, so the company would not elect for the twenty-five year write-off but would follow the accounting treatment. Although this was a one-off payment, it is subject to the withholding tax provisions as being in respect of a payment for the use of a patent made to a non-resident, so withholding tax will be required at a 20% rate unless a lower rate is dictated by the double tax convention between Australia and the United Kingdom.

The sale of the patents will firstly require the patents to be split between those which were acquired or created before 1 April 2002 and those acquired or created on or after that date. The more recently acquired patents will be subject to tax under the new intellectual property regime on the credit arising in the profit and loss account; if amortisation for tax purposes has followed the accounting treatment, this will equate to the gain on disposal shown in the accounts. As far as old regime patents are concerned, there will be a balancing charge to the extent that any capital allowances have been given and any excess will be taxed under Case VI of Schedule D. The company has the right to elect that this be spread in equal instalments over a period of six years starting with the period of receipt.

Under the new regime, there is also the possibility of claiming roll-over relief to defer recognition of the gain arising on disposal. This allows the gain to be set off against the cost of newly acquired intangible assets which are capitalised for accounting purposes and acquired during the period running from twelve months before the date of realisation to three years after that date. This applies not merely to qualifying acquisitions by Glenmont UK Ltd itself but to acquisitions by other group members in respect of assets within the charge to UK tax.

The question has also been raised of transferring the existing potentially valuable patent to a group subsidiary in a low-cost jurisdiction. This would be a realisation subject to the rules outlined in the previous paragraph except that roll-over relief cannot be claimed in respect of the disposal of an asset which has been transferred to a related party. Furthermore, the patent right would require to be valued on an arm's length basis under the transfer pricing rules, so there might be considerable uncertainty as to the potential tax liability on the exercise.

Finally, it is very likely that the subsidiary in the low-tax jurisdiction would be a controlled foreign company and, if its main activity were the exploitation of intellectual property, it would not pass the exempt activities test and it would seem very unlikely that it could pass any of the other tests for exclusion from the regime. This would mean that the profits would be apportioned back to the UK shareholder unless an acceptable distribution were made, which would be at least 90% of the apportionable profit within eighteen months of the subsidiary's year-end, ensuring a UK tax rate of at least 25.2% (27% for FY 2007) on the income that the group is seeking to shelter.

Question 4

(1) In the case of *IRC v Duke of Westminster*, the Duke re-arranged his affairs solely for the purposes of obtaining a reduction in his overall tax liability. The House of Lords decided that an annuity was not, for the purposes of tax, to be regarded as wages if it was, in law, an annuity. This decision against the Crown led many into thinking that in construing the tax legislation, the courts would look to form, not substance, and would adopt the literal meaning of the words in preference to the purpose of the provision in question.

This interpretation was limited in the case of artificial avoidance schemes in *W T Ramsay Ltd v IRC*. The Ramsay case concerned a mass-marketed tax avoidance scheme that enabled taxpayers to artificially create an allowable capital loss to be set against gains in order to remove liability for tax. The arrangements were circular and self-cancelling but the documentation was legally correct and the transactions were real, not a sham. The scheme had assumed that the courts would apply a literal construction to the relevant taxing legislation and would look at the legal form of the taxpayer's affairs, and not their substance. The decision, however, was that the Courts could look at the composite transaction as a whole, rather than take a blinkered approach to each transaction separately. So if nothing had really happened, the tax consequences followed that end result, so in Ramsay the transactions were regarded as a nullity for tax purposes.

In *Furniss v Dawson,* there was a linear series of transactions. Here a sale by A to B followed by a sale by B to C was treated for tax purposes as if it were a sale by A to C. In this case, Lord Brightman established the necessary prerequisites for applying the Ramsay principle: first, there must be a preordained series of transactions, or a single composite transaction; second, there must be steps inserted into that series which have no commercial or business purpose apart from the avoidance of a liability to tax. In such a case the inserted steps are disregarded. The transaction is reconstituted to include the starting point before the preordained series of transactions, any steps which were in the series but not inserted for tax avoidance reasons and therefore not disregarded, and the end result. The relevant statutory provisions are then applied to the reconstituted transaction.

Other cases such as *Craven v White* further developed the 'Ramsay principle'. In Craven v White, Lord Oliver said that there were four essential requirements of the Ramsay principle:

(1) the series of transactions was, at the time when the intermediate transaction was entered into, pre-ordained in order to produce a given result;

(2) that transaction had no other purpose than tax mitigation;

(3) there was at that time no practical likelihood that the pre-planned events would not take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life; and

(4) the pre-ordained events did, in fact, take place.

In further cases the judicial interpretation and approach to the application of the Ramsay principle has not been straightforward. None of the cases in which *Ramsay* has been applied has been subsequently overruled but it is arguable that there has been a shift in interpretation over the years with, for instance, pre and post *MacNiven v Westmoreland Investments* eras. For example, the House of Lords in MacNiven considered Furniss v Dawson and said that in that judgment, there was no recharacterisation of the entire transaction but rather the recognition that the taxpayers could not be taxed as if they had made a disposal to B when they had in reality made a disposal to C.

The decisions in *Barclays Mercantile Business Finance Ltd v Mawson* and *CIR v Scottish Provident Institution* provided further authoritative views of *Ramsay*. These judgments are complex but what is clear is that the Ramsay principle is not an anti-avoidance rule. Nor is it a doctrine of economic substance over legal form. The interpretation in *BMBF* of the *Ramsay* case is that it gives the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply. It then decides whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) falls within that statutory description.

This means that when engaging in tax planning, one needs to construe the relevant statute with due regard to its purpose and then apply the statute to the relevant transactions, viewing them realistically.

(2) With effect from 1 August 2006 the disclosure regime applies to the whole of corporation tax. Under this regime, a tax arrangement must be disclosed when:

- It will or might be expected to, enable any person to obtain a tax advantage;
- That tax advantage is, or might be expected to be, the main benefit or one of the main benefits of the arrangement; and
- It is a tax arrangement that falls within any description (known as 'hallmarks') prescribed in the relevant regulations (such as the Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2006 (SI 2006/1543)).

The definition of 'arrangements' is widely defined to include any scheme, transaction or series of transactions.

The definition of 'tax advantage' is widely drawn and follows s.709 ICTA 1988.

The 'main benefit' test is objective and considers the value of the expected tax advantage compared to the value of any other benefits likely to be enjoyed.

Different 'hallmarks' apply to promoted and in-house schemes. The hallmarks for arrangements where there is a promoter are as follows:

- Wishing to keep the arrangements confidential from a competitor or HM Revenue & Customs (regulation 6);
- Arrangements for which a premium fee could reasonably be obtained (regulation 8);
- Arrangements that include off market terms (regulation 9); are standardised tax products (regulations 10 and 11); are loss schemes (regulation 12); or are certain leasing arrangements (regulations 13 to 17).

If a tax arrangement is devised for use in-house it is only considered a hallmarked scheme that needs disclosure to HM Revenue & Customs if the person intended to obtain the tax advantage is a business (a company, partnership or any other person whose profits are charged to income tax as trading or property income) that is not a small or medium enterprise.

The hallmarks for in-house arrangements are:

- Wishing to keep the arrangements confidential from HM Revenue & Customs (regulation 7);
- Arrangements for which a premium fee could reasonably be obtained (regulation 8);
- Arrangements that contain certain leasing arrangements (regulations 13 to 17).

Where a disclosure is required, it must be made by the scheme promoter within 5 days of the earlier of the date on which he makes the scheme available for implementation by another person; or becomes aware that the scheme has been implemented by a transaction taking place that forms part of it.

A 'promoter' is someone who in the course of providing services relating to taxation, designs or makes available for implementation, proposals and arrangements of a hallmarked scheme. However, a person is not a promoter unless any advice he provides is directly connected to the expected tax advantage. [s.307 FA 2004] A person who is involved in the design of a scheme is not a promoter if any of three tests are passed: the benign test, the non-advisor test or the ignorance test. [SI 2004/1865 para 4]

Under certain circumstances, the scheme user may need to make the disclosure. This is where:

- The promoter is based outside the UK;
- The promoter is a lawyer and legal privilege applies; or
- There is no promoter.

Where there is no promoter, including in-house schemes, the user must disclose to HM Revenue & Customs within 30 days of entering into the first transaction forming part of the scheme. [ss.309-310 FA 2004]

Question 5

1 As any tax payable by Inwood Investments Ltd is going to be for the account of Durrette plc under the proposed transaction, it is important to understand the tax position of that company. It is important firstly to check that the investment in Burgoyne Ltd is held as an investment and not as a trading asset. If the company has a lot of investments which it is turning over regularly, it is possible that the realisation of investments could be considered a trading transaction.

Assuming that the investment in Burgoyne is held on capital account, Inwood will not be subject to tax on any gain on the disposal provided that the substantial shareholding exemption applies. The exemption applies to the disposal of a 10% or greater interest in the shares of a company provided that certain conditions are met. This is conditional on that 10% interest having been held for at least twelve months during the two years preceding the date of disposal.

There are certain other conditions which need to be met during that same period and immediately following the disposal. These apply both to the vendor and to the company whose shares are being sold. The vendor must be a trading company or a member of a trading group. It looks likely that Inwood meets the latter requirement as it appears to consist primarily of investments in companies involved in the engineering industry.

However, Burgoyne must also meet this requirement and it will not be met if the members of the Burgoyne group carry on, to a substantial extent, activities other than trading activities. This needs to be investigated further but there would be concern about the accumulation of cash and let properties. To the extent that these arise from the temporary investment of surplus funds and the temporary use of properties which are no longer needed for the business and which it would not be commercially opportune to sell, the position could be defended but, if there has been a conscious decision within Burgoyne to invest funds in these ways rather than use them in trading activity, the qualification for substantial shareholdings exemption may be open to question.

2 To the extent that the individuals receive consideration by way of the issue of shares, the capital gain otherwise chargeable on them will be deferred. The new shares will be deemed to have the same cost as the original shares. However, this case is complicated by the existence of the cash earn-out rights.

Although the cash is not received immediately, the rights require to be valued and capital gains tax will be payable by reference to the value of these rights. This may mean that tax is paid in advance of receiving the cash.

The subsequent realisation of these rights in each of the two instalments will itself be a part disposal of the rights and capital gains tax will be chargeable on the gain over the value of the rights on acquisition. If the company's performance fails to live up to expectation, the individuals may receive less cash than the rights had been valued at. In these circumstances, there are special rules allowing any capital loss on the earn-out to be carried back and relieved against the capital gain at the time of the original disposal.

An alternative structure might be to make these cash payments additional bonus under the employment arrangements of the management. This would involve additional tax (40% as opposed to 18% under the capital gains rules) and national insurance contributions but the bonus would qualify for corporate tax relief and that might overall compensate for the additional bonus needed to make up the effect this difference in tax rates would have on the management members.

3 The shares which will be issued under these arrangements are restricted securities. However, although the restricted securities legislation ordinarily results in the benefit being assessed when the securities are allocated to the employees, the existence of a genuine risk of forfeiture means that the value of the shares will only be assessed as income on the individuals when the risk of forfeiture ceases.

The employees have the right to elect to be taxed at the outset on the unrestricted value of the shares at that time, a risk they may choose to take if they think that there will be a significant future gain in the value of the Durrette shares during the vesting period. However, if the shares were to be forfeited, there would be no relief for the loss and they would have paid tax on income which they had not in practice received.

As far as the cash payment for giving up their rights under the Burgoyne share option scheme is concerned, HMRC is likely to contend that this is taxable as income arising from the employment although a counter could be made that this is received not for performing any of the duties of the employment but as compensation for surrendering existing employment rights and so being exempt from tax at least up to £30,000.

4 The beneficial loan rules within ITEPA do not apply to this loan as it was not made to the employee or to a relative. However, if Burgoyne Ltd were a close company, which it may well have been depending on the ownership of Inwood Investments Ltd, the trust would be an associate of a participator and Burgoyne would have been subject to tax under s.419 ICTA 1988 on an amount equal to 25% of the loan. On the release of the loan, that amount will be repaid.

However, HMRC may be expected to contest the write-off of the debt if it is claimed as a deduction in computing the profit as it does not appear to meet the criteria for being regarded as a bad debt. The trust will be regarded as having received an amount of income which had borne tax at the dividend ordinary rate.

5 Statutory redundancy payments are exempt from tax in the hands of the individuals. Additional voluntary payments made by the employer will also be income tax free up to a threshold of £30,000. Amounts in excess of this threshold will be taxable in full.

Statutory redundancy plus any voluntary payment made by the employer up to a maximum of twice the statutory figure is a deductible expense from Schedule D Case I. [s.90 ICTA 1988] As this is a continuing business, there should be no question as to the deductibility of employee termination payments made by the employer.

6 The issue here is whether the losses can be carried forward. Losses go with the trade so that, if the trade ceases, the losses will not be able to be carried forward. The facts in this case are very similar to those in the case of Robroyston Brickworks Ltd v CIR where the company ceased activity and later resumed under new ownership and in a new location. Possibly surprisingly, the court held that the trade had not ceased and that the losses could be carried forward through such an event.

7 The facts in the case of Burgoyne Mechanical Engineering Ltd give rise to less optimism as to its ability to carry forward the losses. Although the company continues to trade and is arguably continuing to carry on the same basic activity, merely outsourcing the selling function, there are rules which prevent losses being carried forward when there is, within a three year period, both a change in the ownership of the company and a major change in the nature or conduct of the trade. It is considered that the transfer of the distribution of the company to another entity would be likely to constitute a major change in the nature or conduct of the trade, so removing any potential relief for the accumulated losses.

Additionally, the new arrangements give cause for concern on two fronts. Transfer pricing rules will apply so that the sale price from the UK company to the Indian distributor will require to be on an arm's length basis. The Indian subsidiary also requires to be considered in the light of the controlled foreign companies rules whereby the profits of a foreign subsidiary may be apportioned to UK resident shareholders. As India is not a low-tax jurisdiction, that should not apply in this case.

8 The deductibility in this case depends upon whether this is considered to be capital or revenue expenditure. A good parallel is the case of Vodafone Cellular Ltd v Shaw in which the company made a payment to cancel a long-term technical support agreement which was proving onerous to it and its group. Following the precedent of Anglo-Persian Oil Co Ltd v Dale, in which compensation to terminate an agency agreement was held to be allowable, the costs were allowed as deductible revenue expenditure.

Question 6

Memo

To: Finance Director

From: Tax Manager

Date: Y November 2008

Subject: UK tax consequences of outbound sales

You asked me to consider the VAT, PAYE, NICs and UK corporation tax issues concerning Freya Ltd's overseas sales in France, the USA and Denmark.

1 *VAT*

The export of goods via the internet to private individuals in the USA (outside the EU) can be zero-rated.

A distance sale to private individuals in France (within the EU) is chargeable to VAT at UK rates in the normal way on the assumption that these private individuals are not VAT registered. Freya Ltd will need to find out what the 'distance selling threshold' for France is. If the value of its sales to France exceeds that threshold, Freya Ltd must register for VAT in France and charge French VAT on sales to these customers in France.

If the customer in France is VAT registered there, Freya Ltd can zero-rate the supply provided certain conditions are met. These include knowing what the French VAT registration number is and putting it on the sales invoice; and keeping paperwork to show 'evidence of removal' (for example, a customer order). If any VAT is due in France, the French customer should pay it to the tax office in France.

When Freya Ltd transfers its own goods to Denmark (within the EU), whether to another part of its organisation or simply to put in storage, this is treated as if Freya Ltd made an acquisition in Denmark. Freya Ltd will, therefore, have to account for VAT in Denmark and if it is not registered for VAT in Denmark, that means paying VAT. However, if registered in Denmark, based on UK equivalent provisions, this VAT should be recoverable, unless acquired for the equivalent of exempt supplies.

2 (i) *PAYE*

If the employees remain UK resident, all earnings including those from duties performed abroad will remain taxable in the UK. In that case, Freya Ltd should continue to calculate and deduct PAYE tax in the normal way from all payments to its UK employees who are going to work in Denmark.

The Danish authorities may seek to apply their salary withholding mechanisms. However, under the OECD model agreement, the employees may be able to claim exemption from Danish tax on earnings from employment carried on in Denmark if they remain resident in the UK for the purposes of the agreement. This will be if they are not in Denmark for more than 183 days in the period specified in the agreement and their remuneration is paid by (or on behalf of) an employer who is not resident in Denmark, and it must not be borne by a Danish branch of their employer.

However, the employees will be treated as not resident and not ordinarily resident in the UK from the day after they leave the UK to the day before they return to the UK at the end of their time abroad if their absence from the UK and full-time employment abroad both last for at least a whole tax year and during that absence any visits made to the UK total less than 183 days in any tax year and average less than 91 days a tax year. If the employees are not resident in the UK, they will not be taxed on earnings from an employment which is carried on wholly abroad. In this case a no tax code should be issued.

If the Danish income tax rate is significantly different to that of the UK, there may be scope for planning to pay tax in the country with the lower rate.

(ii) *National Insurance*

Since the UK employees will be working in a country within the EEA, the general rule is that their NICs will be paid only in Denmark. This will be the case if at the outset the employees' work abroad is expected to last more than 12 months.

However, if the employees' work abroad is expected to last less than 12 months, Freya Ltd can apply for a certificate E101 for each employee from HM Revenue & Customs, which will enable contributions to be paid in the UK rather than Denmark. If the employees unexpectedly remain in Denmark for a period lasting beyond 12 months, Freya Ltd may be able to extend the period for which UK NICs continue by up to a further 12 months, by applying for a certificate E102 for each employee.

Again there is scope for planning the expected period of secondment on the basis of relative rates in Denmark and the UK.

3 *Branch versus subsidiary*

If losses are anticipated initially and loss relief is important in the UK, which would be the case here since Freya Ltd is profitable, the usual advice is to establish an overseas branch.

Following the Marks & Spencer loss relief case, it is possible for losses of overseas subsidiaries to be used in the UK although in practice, it may be difficult for Freya Ltd to claim that loss relief, since there must be no real possibility of otherwise using the losses overseas in any period. In this case it is likely that any losses could be used in a later period in the Danish subsidiary, assuming that losses may be brought forward under Danish tax rules.

If central management and control of the Danish subsidiary is in the UK, it is arguable that the Danish subsidiary is a dual resident company. In that case, the Danish subsidiary might be able to group relieve its losses in the same way as any UK company, although the rules limiting the surrender of group relief from dual resident companies would require further consideration. However if the Danish subsidiary is effectively managed in Denmark, the tie break clause of the OECD model agreement would deem the Danish subsidiary to be resident only in Denmark.

Assuming that a Danish branch is first set up, once operations in Denmark are profitable, a subsidiary can be established at that stage. This would mean that only profits remitted back to the UK would be taxable in the UK (although the controlled foreign companies' legislation may need to be considered).

On the transfer of the branch to a subsidiary Freya Ltd would need to consider the disposal values for capital allowances purposes and also the transfer values of stock to the Danish subsidiary. The capital gains position would also need to be considered. It may be possible to defer capital gains charges if certain conditions are met, mainly that the consideration for the trade and assets consists wholly or partly of shares, or shares and loan stock, issued by the Danish subsidiary to Freya Ltd. The deferred gain would be assessed on the disposal of shares or loan stock by Freya Ltd, or if the Danish subsidiary disposes of the underlying branch assets within six years of transfer.

Another advantage to setting up a branch initially instead of a company has to do with transfer pricing. The UK transfer pricing legislation would be an issue if a Danish subsidiary were set up. Freya Ltd would have to ensure that transactions with the Danish subsidiary were at arm's length or make computational adjustments in its corporation tax return. Freya Ltd would also have to fulfil various self-assessment obligations to do with record keeping. However, Schedule 28AA would not apply to transactions between Freya Ltd and its Danish branch since transactions would not legally be between separate persons. However, Denmark may require a fair allocation of profits to the branch.

The OECD model agreement has a 'Business Profits Article' under which the taxable profits in Denmark of the Danish branch will be those which it might be expected to make if it were a distinct and separate enterprise dealing with its head office at arm's length. However, this arm's length price will not affect the profits charged to UK corporation tax since all the profits or losses of the Danish branch will be included in Freya Ltd's total profits.

Therefore the profits of the branch as determined in accordance with the Business Profits Article would only be relevant in determining the amount of double taxation relief available in respect of foreign tax on the profits of the branch.

Assuming a Danish branch were established, the UK would be obliged to give credit for Danish tax payable on profits, income or chargeable gains from the Danish branch against any UK tax computed by reference to the same profits, income or chargeable gains by reference to which the Danish tax is computed. Credit relief would be given for the lesser of the foreign tax and the UK tax on the branch profits computed by reference to the UK tax measure of the foreign source income (rather than a notional UK tax based on either the foreign tax measure or the foreign commercial measure).