Tax update

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Any comments or queries?

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About this Update

The Tax update is published on the first Thursday of every month, and is written by members of RPC's Tax Disputes team.

We also publish a general VAT update on the final Thursday of every month, and a weekly blog, RPC Tax Take.

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News

Types of financial institutions and automatic exchange of information

HMRC has published guidance on its views on the automatic exchange of information relating to holding companies and treasury companies for the purposes of the UK's agreements with the USA, Crown Dependencies, Gibraltar and EU member states (the latter under Council Directive 2011/16/EU).

There are four categories of financial institution common to each of the agreements:

- custodial Institution
- depository Institution
- investment Entity
- specified Insurance Company.

The International Tax Compliance Regulations (SI2015/878) implemented Council Directive 2011/16/EU in the UK, and incorporated regulations arising from the UK/US agreement. This change means that UK financial institutions are no longer required to file nil returns it also removed "relevant holding company" and a "treasury company" as categories of financial institution.

This change aligns the UK position with that of most other countries and clarifies the position of holding companies and finance companies for non-financial groups and should lead to a reduced compliance burden for some businesses. There may be instances where some holding company members have registered with the IRS as the lead financial institution of an Expanded Affiliated Group under the previous regulations. As changing this status is likely to prove onerous, HMRC has indicated that in circumstances where an entity registered as a lead financial institution also comes within the definition of a financial institution under one of the remaining four categories they will continue to be defined and treated as a financial institution in the UK.

Where this is not the case, HMRC has indicated that it is content for an entity to choose to use the extended definition of financial institution found in the US Treasury regulations (which include "relevant holding companies" and "treasury centres of financial groups"), should they wish.

Company groups may need to review the status of their holding companies and treasury centres in the light of HMRC's guidance, in particular, whether the activities they undertake mean that they are financial institutions as now defined.

The guidance can be found here.

Government procurement and tax compliance

The Cabinet Office has issued updated guidance on the policy of using the procurement process to promote tax compliance.

Since 1 April 2013, all companies bidding for government contracts with a value over £5m have been required to self-certify "tax compliance". The guidance indicates that all Pre-Qualification Questionnaires for such contracts are required to ask whether, in respect of returns filed on or after 1 October 2012, the supplier has been convicted of criminal offences relating to taxation, or received civil penalties for fraud or evasion. Additionally, prospective suppliers have to

indicate if any of their returns have been successfully challenged under the GAAR, on the basis of the *Halifax* abuse principle, or in relation to a scheme subject to the DOTAS regime (or equivalent legislation in other jurisdictions).

Where a disclosure of "an Occasion Of Non Compliance" is made the relevant department has the discretion to exclude that supplier from the procurement process. Companies may offer mitigation and the guidance provides more detail on the acceptability of various factors, such as changes in senior management or that the company's policy towards tax planning has "become more in line with government objectives regarding tax avoidance".

You can read more here.

The Queen's speech

The state opening of parliament took place on 27 May 2015. The Queen set out the new Government's plans for the coming year which included various measures relevant to taxation.

A new *National Insurance Contributions Bill* and a *Finance Bill* is to be introduced which will bar any increases in income tax, VAT and national insurance.

The speech repeated the Government's plan to raise the tax-free proportion of earnings from £10,600 to £12,500.

The Scotland Bill follows the recommendations of the Smith Commission and will provide new tax and welfare powers to the Scottish Parliament.

More changes will become apparent in the 8 July 2015 budget statement, however, it is expected that there will be amendments to tax relief on pensions contributions for additional rate taxpayers, transferable IHT allowances on main residences passed to children, possible further anti-avoidance measures and changes to the annual charge for non-doms.

You can read (or watch) the Queen's speech here.

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Cases

Court of Appeal issues guidance on the meaning of "sham" in pension scheme case

The Court of Appeal has provided some helpful guidance on the requirements of "sham" in R v Quillan and others[1].

Background

The underlying case involved a criminal prosecution of Mr Quillan and five other defendants (the Defendants). The Crown alleged that the Defendants had set up two schemes with the dishonest intention of obtaining income tax relief at source from HMRC by repeatedly paying the same sum of money into pension schemes. The offences ranged from conspiracy to defraud, common law cheat, and false accounting.

In very broad terms, the first scheme worked as follows. In order to set up a self-invested personal pension (SIPP), an investor borrowed money from an off-shore loan company. That money was then paid into the SIPP and income tax relief was claimed from HMRC, which was also paid into the SIPP. The funds in the SIPP were then invested in unquoted UK companies which used the funds to lend to the off-shore loan company and so the cycle went on.

The Defendants were involved in the promotion of the scheme with the associated loan and unquoted companies being controlled by their associates. The administrators of the SIPP, though originally subject to prosecution, had the case against them dropped on the basis that there was no evidence to suggest they had knowingly participated in any criminal activity.

The purpose of a SIPP is to provide the investor with a pension on retirement. In this case, however, the contributions were funded by debt which contained a rate of interest higher than the rate obtained by the unquoted companies when they provided finance at the end of the chain. The answer to this apparent paradox, so the Defendants maintained, was that the tax relief would generate sufficient return through other investments to repay the loans and interest over time and make up any shortfall.

Superficially, investors in the scheme appeared to be running some risk: the loans were unsecured at each end of the transaction and it appeared that many members were investing their entire annual incomes for two or three consecutive years. The apparent risk was, however, mitigated somewhat by an unusual feature: the members were not required to pay any money to join and would not be required to pay anything in the future. In fact, in many instances, prospective members were paid between a few hundred and a few thousand pounds to join.

Subsequently, one of the Defendants set up his own scheme, using the same model as outlined above, save that in his case, the share sale proceeds were only used for the purposes of re-lending (rather than other investments). In all cases the members of the schemes indicated (and the Crown accepted) that they believed the schemes to be legitimate.

Following an investigation by the Financial Services Authority, the Defendants' offices and homes were raided and they were arrested. The Crown's case was that the Defendants knew that the schemes would not generate sufficient funds to pay off the loans and interest and

1. [2015] EWCA Crim 538.

generate an income for retirement. Rather, the purpose of the schemes was to generate large amounts of tax relief by recycling the same capital. Much of the relief was, it was alleged, syphoned off to pay administrative fees and expenses.

The Crown argued that the client contributions were in fact a sham and accordingly there was no entitlement to tax relief. Further, the Crown argued that in order to qualify for relief the member had to be an "active member" of a pension scheme (section 151, Finance Act 2004). If there was no pension scheme, by virtue of the initial contributions being a sham, or otherwise not compliant with the relevant legislation (section 188, Finance Act 2004), then no relief was due.

The judge at first instance found that nothing in the Finance Act 2004 precluded the use of borrowed funds with which to make a "contribution". In the judge's view, the word "contribution", in this context, merely meant "payment" and could include money or money's worth. The judge was of the opinion that a person would be an "active member" if there was an agreement in place between the SIPP holder and the scheme for the accrual of benefits. He concluded that such agreements were in place.

Judgment of the Court of Appeal
The Court of Appeal agreed with the judge's analysis. The scheme satisfied the relevant statutory test and the tax relief became properly due and payable. As to the allegation of sham by the Crown, the Court found that the Crown's arguments had been put at "a very high level of generality, without any attempt being made to analyse the precise respects in which it was alleged that the arrangements were sham".

Citing the well-known cases of *Snook v London and West Riding Investments Ltd*, the Court found that if the Crown was to establish sham it would be necessary for it to show that "the contributions lacked any true legal substance". The Court found that it would have been impossible to make out such an argument unless the Crown could show that the members were themselves conscious participations in the sham, since the authorities all require that for there to be sham there must be a common intention of the parties to a particular transaction. Since the Crown accepted the members considered the schemes to be legitimate, the Court of Appeal was of the view that its arguments on sham were "hopeless".

Comment
The concept of "sham" is often hinted at by HMRC in tax disputes, in particular, in relation to disputes relating to tax planning, but rarely, when pressed, does HMRC seek to formally plead and argue it before the tax tribunals and courts. It is, as Diplock LJ said in *Snook* "a popular and pejorative word", however, within the law it is a term with specific meaning. Although many may view the particular structure at issue in this case objectionable; at a time when the use and conflation of terminology for the purposes of political expediency and popular opinion are common-place, it is gratifying to see the courts attaching the proper meaning to words of importance and requiring those who seek to allege sham to do so properly, in accordance with established law, in order to make good their contentions.

The decision can be found here.

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Tribunal orders HMRC to pay taxpayers' costs in avoidance case

Having successfully overturned penalties issued against them in *R, A and M Gardiner v HMRC*[2] the taxpayers have successfully applied for their costs against HMRC, pursuant to Rule 10(1)(b) of the Tribunal Rules, on the basis that HMRC had acted "unreasonably in bringing, defending or conducting" those proceedings.[3]

Background

The three appellants were husband, wife and son. They participated in tax planning arrangements and following the hearing of a test case[4], they accepted that the planning did not achieve the intended fiscal consequences and paid the additional tax claimed by HMRC. This was not sufficient for HMRC, who alleged that the appellants had negligently delivered incorrect returns and issued penalties against the appellants accordingly. The appellants' appeals against the penalties were allowed by the First-tier Tribunal (FTT).

By way of summary, the FTT concluded in the substantive appeal that:

- HMRC had failed to fully particularise its allegations of negligence in support of the penalties it had imposed
- the negligence which HMRC did particularise was that the appellants ought to have realised that the tax avoidance scheme they had participated in had not been properly implemented.
- HMRC had failed to adduce evidence in support of that allegation of negligence and had failed to establish a prima facie case of negligence.

Decision of the FTT

In granting the application for costs, the FTT said that HMRC had failed to produce evidence of its assertion that the appellants had been negligent in relation to the tax planning arrangements they had participated in. It was clear from the appellants' notice of appeal that they had put HMRC to strict proof of negligence and HMRC therefore had to adduce evidence if it wished to establish negligence on the part of the appellants. Without adducing such evidence, there was no prospect that HMRC would succeed at the original appeal hearing. In the opinion of the FTT, it was unreasonable conduct on the part of HMRC to defend the appellants' appeals without producing evidence to establish negligence on the part of the appellants. Accordingly, the FTT concluded that HMRC should pay the appellants' costs.

Comment

HMRC is often very quick to allege that taxpayers have negligently delivered an incorrect return and impose penalties, especially where taxpayers have participated in tax planning arrangements. The FTT has made it very clear that in such circumstances, HMRC must not only particularise its allegations of negligence - it is not sufficient to simply make a general assertion – it must also adduce sufficient evidence in support of that allegation. Failure to do so will not only lead to the taxpayer's appeal against the imposition of penalties succeeding, it is also likely to lead to an adverse costs order against HMRC.

The decision can be found here.

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2. [2014] UKFTT 421 (TC).
3. [2015] UKFTT 0115 (TC).
4. *Drummond v HMRC* [2009] EWCA CIV 608.

Expert witnesses required to disclose professional relationship

In the recent case of *EXP v Dr Charles Simon Barker*[5], the High Court has emphasised the importance of the independence of expert witnesses and of disclosing any conflicts of interests at the earliest opportunity. Although the case involved a claim for clinical negligence, the judgment is of relevance to tax appeals before the FTT, where the parties often seek to rely upon evidence from expert witnesses.

Background

The claimant brought a successful claim for clinical negligence against Dr Barker in relation to his failure to identify the presence of an aneurysm in her brain. Both parties instructed their own medical experts. During the course of the trial, it emerged that Dr Barker and his expert witness had failed to disclose a long standing professional relationship. This raised an issue regarding the expert's credibility and the claimant argued that the expert evidence relied upon by Dr Barker should be declared inadmissible.

Decision of the High Court

Having considered the relevant authorities, Mr Justice Parker, reluctantly, allowed the expert's evidence. However, he confirmed that confidence in the independence and impartiality of experts plays an important role when courts and tribunals are evaluating the competing and often finely balanced judgements of rival experts. The judge said that he "came very close" to ruling the evidence inadmissible, as his confidence in the expert's independence and impartiality had been seriously undermined. The judge also made it clear that when deciding what weight to attach to the expert's evidence, he would take into account the reservations he had in relation to the expert.

Comment

Both the taxpayer and HMRC often wish to call expert witnesses when litigating before the FTT, in particular, in relation to the correct accounting treatment of entries in the taxpayer's accounts. In order to ensure that any such evidence is objective and impartial, the parties should of course call experts who are completely independent of either party. Although such a statement is self-evident, it is surprising how often HMRC seeks to call an employee of the department to provide expert accounting evidence. Such an expert is certainly not independent of HMRC, and it is questionable whether an expert who is connected to the party calling him (by way of employment) can provide an objective opinion.

A tax appeal can turn on whose expert evidence the FTT prefers, and the *Barker* case is a timely reminder of the importance of independent and impartial expert evidence and of the duty experts owe to the tribunal.

The decision can be found here.

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5. [2015] EWHC 1289 (QB).

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- **Highly commended – Law firm of the Year at the Lawyer Awards 2013**
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