Inland Revenue

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ISSUE 60

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Review of links with Business - International tax issues

The Review of links with business, published in November 2001, recommended (R35) that the Revenue should publish guidance that would:

- Better focus transfer pricing enquiries by giving more advice on the nature of the risk assessment to be carried out before the decision to embark on an enquiry is made;
- Facilitate the timetabling of the course of an enquiry, by setting out what could reasonably be expected of each side in terms of the time to provide information and to examine what is provided.

This article is concerned with transfer pricing enquiries into an enterprise's fundamental pricing structure for cross-border transactions with associated enterprises. These include enquiries into such areas as royalty rates, distributor margins, manufacturer margins, pricing methodologies (for example cost plus versus profit split). This article is not concerned with enquiries into such areas as thin capitalisation, imputation of interest on outward loans; guarantee fees, or management fees where such an area is the only cross border transaction. Such enquiries do not generally require the level of analysis of other transfer-pricing enquiries and do not normally take as long.

Representations received by the Revenue clearly favoured a collaborative approach to timetabling rather than a prescriptive or inflexible approach. This article sets out a collaborative approach. It is hoped that this will meet the best interests of both companies and the Revenue. Where it is not possible to pursue a collaborative approach enquiries will need to be based on what is specifically provided for in UK legislation supplemented by exchange of information powers in tax treaties. Such an approach is likely to be longer and less flexible than collaboration.

This article addresses Recommendation 35. It does not address Recommendation 34 (Transfer Pricing documentation requirements). However, the Revenue recognises that some taxpayers are anxious to know the level of documentation to be submitted with a CTSA return. In that context, we can reaffirm that, although there is a requirement that appropriate documentation needs to exist at the time the return is made, there is no requirement to provide such documentation as a routine matter along with a CTSA return.

Risk Assessment Process

- Transfer pricing enquiries can be enormously resource intensive for both companies and the Revenue, so a transfer pricing enquiry should not be contemplated without first undertaking a detailed risk assessment.

- In view of the potential resource cost of a full enquiry, transfer pricing risk assessments should be conducted to a greater level of detail than risk assessments in many other potential enquiry areas.

- It is recommended that risk assessment should ideally include:

  - A review of any previous transfer pricing papers

  - A detailed examination of six years' consolidated group accounts and of accounts of individual UK and appropriate non-UK entities;

  - Consideration of the group structure and identification of haven/shelter countries;

  - A review of industry trends, details of the company's place in its sector, and recent developments within the group (new acquisitions, new locations, etc);

  - A review of databases for multiple year data and potential comparables;

  - A review of company returns in other jurisdictions;

  - Liaison with PAYE office for details of highly-paid UK staff;

  - Possibly liaison with Customs & Excise;

  If such pre-enquiry work seems excessive in a particular case this may be an indication either that the case is not suitable for a transfer-pricing enquiry, or that any enquiry should have limited scope.

- The mere presence of cross-border transactions between associated entities is not in itself sufficient reason to initiate a transfer-pricing enquiry, even if the amounts involved in the transactions are substantial. For example, a car distributor may purchase £1bn of cars from its foreign parent company, but if a net profit in line with commercial experience in car distribution is achieved on UK activities, there may be no substantial transfer pricing risk.

Obtaining Information for Risk Assessment

- There may be difficulties obtaining some of the information outlined above; particularly with foreign owned small or medium sized groups. Such cases sometimes are not (even on a world-wide basis) large enough to feature on data bases, websites, sector commentaries, etc.

- If the group as a whole does not feature in the above sources, this may be an indication that the UK operation is small: the potential tax at risk may not justify the resource cost of a transfer pricing enquiry for either the Revenue or the business.

- In a large multi-national enterprise (MNE) the high value-adding activities can be located in any part of the group. There is a risk that UK companies within the group might be rewarded as if they were performing routine functions with low added value that understate the economic reality. With smaller firms, the high value-adding parts of the enterprise are more likely to be found in the home territory and this should be borne in mind when conducting risk assessments. Of course if the evidence of the accounts (e.g. large bonuses to staff) or other sources suggests otherwise then a different view of the risk may need to be taken.

- Depending on the functions and role of the UK business, it may not always be necessary to know a lot about the rest of the group. For example if the UK business is a distributor, it may be appropriate to establish the arm's length price by examination of comparable uncontrolled transactions of independent UK distributors which would not necessarily involve analysing the results of the world-wide group.

Exchange of Information

- Information powers under domestic UK law are not suitable for dealing with information not in a UK resident's power and possession.

- UK subsidiaries can often legitimately say that some of the information requested in transfer pricing enquiries is in the power and possession only of a foreign associate. Where a double tax treaty with the UK exists and contains an Exchange of Information article, the UK Competent Authority can request the information about associated entities via his/her opposite number in the associate company's territory.

- In the light of this alternative power, businesses may want to volunteer the information, in the knowledge that the Revenue can obtain it eventually anyway, and that failure to do so would hold up the enquiry. Many Multi National Enterprises already volunteer the information where they are persuaded that it is relevant.

- There are no de minimis limits for an Exchange of Information request. However the Revenue will not generally burden other tax administrations with routine requests where the amount of tax at stake is either small or speculative.

Particular Risk Areas

- Existence of tax haven entities outside the CFC rules that are profitable despite the absence of significant activities carried out in their bases;

- Instances of mismatches between the likely scale of tax haven operations and the level of profits allocated to them; (Although the existence of transactions with affiliates in low tax areas may act as an important indicator, potential transfer pricing issues should not be ignored simply because the other party is in a normal or even high tax rate jurisdiction).
- Profit margins in the UK are lower than in the group generally AND there are reasons to believe that this should not be the case;
- UK company possesses the resources to generate high margin profits yet produces only a routine low margin profit. The Revenue will look for presence of e.g.
    - Heavy investment
    - highly skilled and remunerated technical or R&D workforce
    - intangibles e.g. trade names, know-how, patents etc.
- Royalty or management fee payments that don't appear to make commercial sense AND which substantially impact on UK bottom line e.g.:
    - for a brand name unknown in the UK;
    - for technology to which significant value has been added by complex processes carried out in the UK;
    - for nebulous bundles of intangibles.
- Poor performance over a number of years when there is no obvious prospect of super profits in later years to justify the risk of continuing losses
- Any period in which changes in intra group contractual arrangements purport to adjust the risk profile, and hence the reward, of the UK group; e.g.:
    - distributor becomes commissionaire (AND net profits fall away);
    - full manufacturer becomes contract manufacturer;
    - R&D activities that once generated royalties move to contract basis.
    - Cost sharing arrangements introduced.

There are no de minimis limits or safe harbours in UK transfer pricing legislation, but regard should be given to both the potential tax at risk and the level of difficulty in establishing the arm's length price.

Where, for example, the cost base is agreed to be £5m, in a case where exceptionally an arm's length cost plus percentage is agreed to be the appropriate method, each 1% increase in the mark up adds only £50,000 to profits. Given the difficulties that can sometimes arise in establishing an arm's length mark up, an enquiry into whether the cost plus percentage should be, for example, 11% rather than 10% may well not be appropriate.

Where on the other hand a company makes an interest free loan of £1m to a well capitalised affiliate, the potential adjustment may still only be in the order of £50-£100,000, but such a case could well merit enquiry because of the relative ease of identifying an arm's length price.

Timetabling

A timetabling framework already exists for transfer pricing cases where applications are accepted for Advance Pricing Agreements (APAs). Further details are set out in Tax Bulletin 43E(part 3) (page 697) and Statement of Practice 3/99. There, the Inland Revenue aims to complete the APA process in 18 months. An important feature of an APA is that the process is initiated by the company and the timetable does not start until the company has submitted a comprehensive formal proposal. APA formal proposals often contain information that may not be in the power and possession of a UK resident, and hence possibly go beyond the requirements of CTSA. As business operations become more globally integrated a functional analysis of the counterparty to a transaction or details of how the business is structured globally may be relevant in establishing the arms length price. In such circumstances a company may have complied with its obligations under CTSA but still not be in a position to produce readily all the information requested by the Revenue.

A transfer pricing enquiry, unlike an APA, is initiated by the Revenue and the timetable may well need to be longer than 18 months to enable the company to collate the information prepared for CTSA purposes and to obtain any further information requested by the Revenue.

Transfer pricing enquiries can be broken down into four stages

Stage 1	Initial enquiry following risk assessment by the Revenue
Stage 2	Provision by the company of response to Revenue initial enquiries
Stage 3	Revenue's consideration of company's response
Stage 4	Negotiation and agreement

As a result of the risk assessment the Revenue may decide not to make enquiries. Similarly the conclusion of the Revenue's consideration may be that the company's transfer pricing need not be challenged and the enquiry will be closed. A typical analysis of the full enquiry process is illustrated at the end of this article.

Whilst the structure afforded by an APA style timetable can have benefits both for companies and the Revenue, other transfer pricing enquiries may need to be more flexible. In particular, it may not be in the interests of anyone for the timetable for the whole enquiry to be set in stone at the outset. There are advantages in ongoing discussion to agree a timetable for the next stage of the enquiry. So, for example, when the initial enquiry is made there will be an agreement as to how long the company would have to make a response. When the company responds the Revenue will agree with the company a reasonable time for the Revenue response, and so on. Where the agreed timeframe for a particular stage exceeds 3 months it may be appropriate to agree an interim meeting to discuss progress.

Initial Enquiry (following risk assessment)

- The initial enquiry should be both focused and comprehensive.
- The risk assessment may show that it is not appropriate or feasible to review all cross border transactions in a single enquiry, particularly for large complex groups.
- In a pharmaceutical company for example, it may be appropriate to focus on the transfer pricing issues arising from a single drug. In a financial concern it may be appropriate to focus on a single business stream, say fund management, but not capital markets. In an industrial conglomerate there may be little overlap between different businesses so it may be appropriate to deal with them separately.

If there is an existing agreed procedure for reviewing risks with a company this may be particularly helpful in questions of transfer pricing. But once having identified an area of concern, the initial enquiry should be comprehensive, the objective being to procure from the company a justification for its transfer pricing in the relevant area comparable to that of an APA formal proposal. So, for example, where the risk assessment identifies a royalty rate as a concern, the opening enquiry will generally extend to include other cross border transactions such as management fees or purchases of goods.

Requests by the Revenue for information should avoid placing an unnecessary or disproportionate burden upon the company. Sometimes putting the company to considerable trouble is unavoidable but an early meeting to discuss the practicalities of producing and presenting the information could be beneficial. For example:

- A request for information in a particular format that was particularly difficult or incompatible with the way that the company keeps its records could be avoided.
- The Revenue and the company would have an opportunity to ensure that the Revenue's concerns were clear and that the company understood what information was required to address those concerns.

Company's Response to Initial Enquiry

When a company makes a return under CTSA there is a statutory requirement to prepare and retain documentation that demonstrates that its transfer pricing satisfies the arm's length standard. This documentation needs to exist at the time the return is made. This is discussed further in Tax Bulletin 37A (Part 2) (page 580) published in October 1998.

In response to an initial enquiry, a company will need to make use of the documentation that existed at the time the return was made. Such documentation ought to be capable of being produced quickly. The company might, however, want to provide material going beyond what is contained in the required documentation or going into that material issues in greater detail. Such material might or might not exist at the time the initial enquiry is made. Where it does exist, it can be produced quickly. Where it does not exist, the time necessary to produce it will vary with the nature of the material. Depending on the circumstances and complexity of the issues, it would be reasonable for the company and the Revenue to agree a period of anything up to 6 months to produce the material.

In the event that the company is able to respond within a month, because all the requested documentation exists at the time the return is made, the Revenue does not then have an extra 5 months to complete its own consideration. Nor has the company gained 5 months grace for some later stage in the process. The response times for each stage of the process – whatever they are agreed to be- are determined independently of response times in other stages of the process.

Depending on the nature of the transactions under enquiry some of the information requested might not be in the power and possession of UK subsidiaries. The Revenue may be able to obtain such information under the Exchange of Information article of the relevant Double Taxation Treaty, but this will inevitably introduce delay. If the process is to be speeded up the company will need to volunteer such information.

Revenue's Consideration of Company's Response

The Revenue will aim to conclude its initial review of the company's position within a timeframe agreed with the company. In the APA model this initial review phase can take up to 6 months, with a further 6 months for obtaining and reviewing additional information. This phase of the transfer pricing enquiry needs to be carefully handled and the time needed will vary greatly from case to case. It is not sensible to be prescriptive but the following is indicative of the steps and timeframes that may be achievable.

- Within 6 months the Revenue aims to conclude its initial review and to share its preliminary conclusions with the company. The Revenue may decide at this stage to close the enquiry. If not the Revenue will say what the concerns are and explain what further information is required and why.

- The company and the Revenue may agree to schedule an interim meeting, for example after 3 months, to discuss the Revenue's preliminary findings and report on progress.

- The Revenue's request for supplementary information will often include arrangements for site visits and the opportunity to meet key employees of the company. The purpose of such visits and meetings would be to obtain information required by the Revenue to complete its consideration of the company's position.

- In the next 6 months the company produces the requested information, arranges any site visits and makes further representations in support of the appropriateness of its transfer pricing. Representations and information may be presented at meetings, in writing or through any other convenient and secure media. Again interim meetings to discuss progress can be agreed.

- Following receipt of the supplementary information the Revenue will present its position, either in writing or at a meeting. The enquiry may be closed at this stage. The Revenue may request further information if appropriate (again giving reasons) but ideally the enquiry should be narrowing by now.

In practice there may be more or fewer steps in this phase, and depending on the facts and circumstances of the particular case, one step may take longer than another. The important point is that the Revenue will explain its reasons for any supplementary information requests and for its decision to continue with the enquiry.

Negotiation and settlement

The Revenue and companies have a mutual interest in settling transfer pricing enquiries by negotiation rather than through litigation. The combination of well directed risk assessment and an agreed timetable for enquiries should mean that the negotiating stage is reached after a reasonable period with the disputed areas clearly identified.

Mutual Agreement Procedures

In the event that an adjustment to UK profits results from the enquiry, then the company may be exposed to double taxation. Where Mutual Agreement Procedures are invoked the respective tax administrations will endeavour to eliminate that double taxation. At present the Revenue has an agreed timetable framework for dealing with Mutual Agreement Procedure cases involving the USA and is seeking to extend that framework to other treaty partners. More details about Mutual Agreement Procedures will be published in due course.

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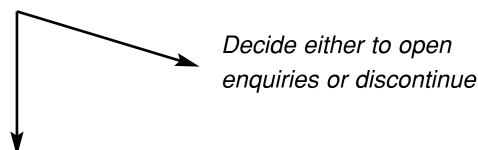
Transfer Pricing Enquiries – Process Map

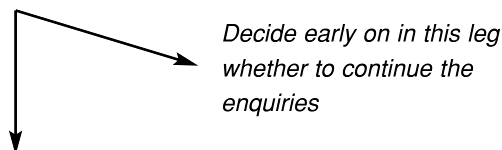
1. Pre-enquiry risk asssessment



Decide either to open enquiries or discontinue

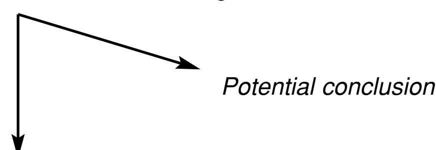
2. Taxpayer's case / establishing facts

3. Revenue's response / testing taxpayer's case



Decide early on in this leg whether to continue the enquiries

4. Negotiation and unilateral agreement



Potential conclusion

5. Post-audit (MAP / competent authority)

Authorised Unit Trusts (AUTs) and Open-Ended Investment Companies (OEICs)

New Loan Relationships and Derivative Contract regimes

This statement has been agreed between the Investment Management Association (IMA) and the Inland Revenue to confirm the tax treatment of AUTs and OEICs which invest in Loan Relationships and Derivative Contracts following the introduction of the Finance Act 2002.

The new provisions extend the previous exemption for profits arising from derivative contracts. This statement is intended to remove any possible uncertainty arising from the new provisions and to explain the rules under which tax exemption will continue, thereby enabling funds to invest in these instruments with certainty as to their tax treatment.

Background

1) AUTs and OEICs are included in the revised loan relationships and derivative contract regimes that will come into force for all accounting periods beginning on or after 1 October 2002. The revised loan relationships regime also broadly assimilates provision for taxing foreign exchange gains.

2) These are important changes for the sector. Previously AUTs and OEICs were only within loan relationships in respect of their debtor relationships (liabilities). And they were not "qualifying companies" for the purposes of the old financial instruments or foreign exchange rules.

3) Reform will ease the compliance burden for managers of AUTs and OEICs when preparing their tax computations, because the tax treatment of the funds will now be more closely aligned with fund accounting. Much of the complexity associated with the old rules, including the application of the accrued income scheme, will be removed. The new arrangements are also expected to be complementary, and more responsive, to commercial and regulatory change.

4) In general, the new rules make no distinction for most companies between the taxation of capital and revenue profits from loan relationships or derivative contracts. But authorised funds are to be treated differently.

5) This is because AUTs and OEICs are exempt from corporation tax on their capital gains. The underlying policy is that the capital profits of AUTs and OEICs should not be taxed (or their capital losses relieved), either under the new Schedule or under any other provision.

6) Bringing AUTs and OEICs into the new regime has also meant that some existing special provisions that applied to them can be repealed, in particular, section 468AA and Paragraph 1(2)(c) Schedule 5AA ICTA 1988, which prevented the taxation as income of certain profits from futures and options contracts.

7) The following "Q&A" explain how the new rules work in relation to AUTs and OEICs and cover the main practical implications of reform.

"Capital Profits"

How do the new rules define those profits that are not taxable?

8) The legislation provides that "capital profits and losses" from the creditor (asset) loan relationships of AUTs and OEICs and their derivative contracts must not be taxed or relieved as credits or debits respectively. The treatment of AUT and OEIC debtor (liability) loan relationships remains the same.

9) If, in accordance with a relevant Statement of Recommended Practice (SORP), an AUT or OEIC properly accounts for creditor loan relationship and derivative contract profits or losses under either of the two headings,

- "net gains/losses on investments" or
- "other gains/losses",

those profits or losses will be treated as "capital profits and losses". As such the appropriate accounting treatment will govern whether or not a profit is taxable.

What is a relevant SORP in this context?

10) The current SORP is, for AUTs, the SORP issued by Investment Management Regulatory Organisation (IMRO) in January 1997 and, for OEICs, the SORP issued by the Financial Services Authority (FSA) in November 2000. Responsibility as SORP making body for collective investment schemes is expected to pass to IMA, which intends to combine and update the existing SORPs.

11) Where an AUT or OEIC is either required or permitted to use a different SORP in the future, the new rules provide for the tax treatment to link to that SORP as well.

The new rules include regulating powers for the Treasury to change the definition of "capital profits and losses". Why are they needed?

12) As the legislation is linked to the language and definitions of the relevant SORPs, it might be necessary to respond quickly to changes in those SORPs. It would most likely be impracticable to make the necessary changes by primary legislation so provision for secondary legislation is needed. The rules are clear that the regulation powers can only be

used when changes are made to a SORP which an authorised fund is required or permitted to follow.

Repeal of section 468AA ICTA 1988

Section 468AA ICTA 1988 provided that profits of an AUT or OEIC from futures and options could not be taxed as trading income. Does its repeal signal an intention to argue that certain authorised funds are trading in respect of their derivative contracts; and, in particular, will the Revenue seek to tax capital returns?

13) No. The repeal of section 468AA has no impact on this in practice.

14) Further, while it is impossible to say, in advance of a transaction taking place, that it is not going to be a trading transaction, the general and prevailing assumption is that authorised funds will not be conducting a trade. They are investment vehicles and are regulated as such.

15) Section 468AA has been repealed because it is no longer necessary and because its retention might in fact create distortions in tax treatment. Where a fund returns a profit from a derivative contract that is to be dealt with under the new Schedule, that profit can only be taxed under the rules of the Schedule. So if the profit is a "capital profit", it cannot be taken into account as a taxable credit. There is no question of it being taxable under any other provisions, including Case I of Schedule D. This follows from the provisions of paragraph 1 and 32(1) (AUTs) and 33(1)(OEICs) Finance Act 2002.

16) This treatment will cover the majority of derivative contracts held by an authorised fund. In fact, because the new rules for derivative contracts are drawn more widely than the financial instruments legislation, funds should have greater certainty about their tax treatment. Section 468AA only gave Case I exemption for futures and options, but that exemption now goes further. A number of capital returns that were previously not exempt from tax are now exempted, including those on certain derivative contracts which did not previously enjoy exemption under section 468AA.

17) Even if a derivative contract is otherwise excluded because of the nature of its underlying subject matter, and the relevant contract is entered into for trading purposes, any resultant profit or loss will normally be subject to the rules of the Schedule.

18) If, in such cases, profits are returned as income and are therefore taxable credits under the Schedule, the retention of section 468AA is contradictory. It makes no sense to exempt something under one rule yet tax it under another.

19) The overall effect therefore is that where profits are properly accounted for as "capital profits", they will not be taxable. The exemption applies to all contracts within the new regime and it is not open to the Revenue to tax (under Schedule D Case 1 as trading profits or under any other provision apart from Schedule 26) capital profits which arise from them and are properly accounted for as such.

What will happen to profits from those derivative contracts that are not dealt with by the new Schedule?

20) In terms of relevance to section 468AA repeal, the derivative contracts affected would only be those over land, tangible movable property (other than commodities which are tangible assets) and intangible fixed assets. Where profits from such contracts are properly accounted for as "capital profits", which would be the expected accounting treatment, the existing protection provided by section 100(1) TCGA 1992 ("gains accruing to an AUT [and OEIC] shall not be chargeable gains") is sufficient. There is no need for the further protection that section 468AA might provide.

21) But in the unlikely event that profits from contracts outside the scope of the charging provisions in the new schedule were ever accounted for as income, the expectation is that treatment would follow for tax. It is not justified to afford funds the blanket protection they have previously had from section 468AA in such circumstances. It would be inconsistent with the treatment of profits that are subject to the new Derivative Contracts Schedule.

Transitional Arrangements

What arrangements are there to provide for transition from the old rules to the new?

22) Transitional rules for derivative contracts are not necessary because AUTs and OEICs were not "qualifying companies" for the purposes of the financial instruments legislation.

23) But for loan relationships, a number of transitional rules relating to interest in general, the accrued income scheme and relevant discounted securities have been made to ensure that no amount is either taxed twice or relieved twice.

Offshore Fund Consequentials

Currently the UK Equivalent profits (UKEP) of a "distributing" offshore fund are calculated on the basis that the income tax rules relating to unauthorised unit trusts (UUTs) apply to the offshore fund's creditor loan relationships. This was in line with the previous treatment of AUTs and OEICs, so has there been any change?

24) No. UKEP will still be calculated on the existing UUT basis. The offshore funds regime is however under review. So, subject to the outcome of that review, there may be further change.

And is the position the same for an offshore fund's derivative contracts?

25) Yes. The UUT income tax rules will apply to the calculation of UKEP in respect of an offshore fund's derivative contracts as they will for its creditor loan relationships.

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interpretation

Private Finance Initiative (PFI) Projects: Scope of trade

We have been asked to clarify the approach we take to establishing the scope of trades carried on by private sector entities involved in PFI projects. This article follows consultation with the PFI working group referred to on page 642 of Tax Bulletin 40 (April 1999).

Summary

The scope of a particular trade is essentially a question of fact. In some PFI cases we have accepted that the scope of the trade includes design and construction services as well as other support services.

Background

In a typical PFI transaction a private sector entity (the 'operator') contracts to provide services to a public sector body (the 'purchaser') for a period, in return for annual service charges (the unitary charges). This will often involve the operator in the design and construction of a facility, for example a prison, hospital, or road.

Previous Tax Bulletin articles on PFI (TB40, April 1999 and TB43, October 1999 page 694) were specifically concerned with projects where, on the facts, it was clear that the operator's design and construction costs were capital expenditure for tax purposes. That is, the facility was a fixed capital asset of the operator's business, irrespective of whether the accounting treatment showed it as "off balance sheet to the operator". For a brief review of the relevant accounting treatment anticipated when dealing with PFI contracts see TB40 April 1999, at page 642.

PFI projects can be structured in a variety of ways and the trade of a PFI operator can cover a wide range of activities. At one end of the spectrum is the operator who builds a facility as the setting in which to carry on the trade. An example is the operator whose trade is running a prison and who constructs a prison on land acquired for that purpose. There is the operator who builds a facility in order to rent it out, with related support services. For example an operator acquires land to build a hospital, leases it to an NHS Trust and also provides non clinical support services to the lessee by way of trade. In both of these examples the construction costs are capital expenditure for tax purposes and relief is only available against Schedule A or Case I income to the extent that it qualifies for capital allowances.

At the other end of the spectrum is the PFI operator who does not acquire a major interest in land, such as a freehold or leasehold, and whose trade is the provision of design, construction and maintenance services. An example is the operator who contracts to build and maintain a road or hospital on land that belongs to the purchaser. In such circumstances the design and construction costs, together with the costs of any other services provided, are revenue expenditure for tax purposes. None of this expenditure will qualify for capital allowances.

Scope of trade

The question of whether or not a PFI operator is carrying on a trade of providing services is, generally, not in dispute. The scope of such a trade is a separate question.

As noted above, this is essentially a question of fact. Each case will depend upon its own particular facts and it is not, therefore, possible to provide a definitive checklist of all the factors to consider. However, the intention of the operator, the terms of the PFI agreement, as well as what the operator actually does, are all relevant factors.

The operator's stated intention does not, by itself, resolve the question of the scope of the trade. As Lord Justice Atkin noted, in Collins v The Firth-Brearley Stainless Steel Syndicate Ltd (9 TC 520) at p. 573, *"in order to examine the facts you must look at what the company purported to do, and also at what it in fact did"*. Where the facts point to a different conclusion, as for example in the case of The Alianza Company Ltd v Bell (5 TC 60), the stated intention cannot prevail over what it is that the operator in fact does. The question is what trade is actually carried on, not what trade the operator claims to carry on. However, where the facts are equivocal, the intention of the operator may well be a relevant factor in reaching a conclusion.

Shares & Share options: Internationally Mobile Employees & other international issues: Follow-up to TB46, 55 and 56

The articles in Tax Bulletin 55 (Oct 2001) page 883 and TB56 (December 2001) page 896 generated considerable interest. This further article is in response. It clarifies certain aspects and also deals with other questions on international issues that have been raised on taxation and National Insurance Contributions (NIC) with regard to shares and share options.

Q1 Is relief by allocation of taxing rights ONLY available if the five factors detailed in TB55 are present?

TB55 stated:

To avoid double taxation, where an employee:

- *was granted a share option in the UK during the course of an employment,*
- *exercised that employment in the other country during the period between the grant and exercise of the option,*
- *remains in that employment at the date of the exercise and,*
- *would be taxed by both of them in respect of the option gain; and*
- *is not resident in the UK at the date of exercise;*

then the UK will give relief in calculating the tax charge for the proportion of the option gain which relates to the period or periods between the grant and exercise of the option during which the employee exercised the employment in the other country.

The article was written to give certainty in the most common situation where double taxation arises, which is when all five factors are present. But this section has been interpreted as meaning that relief by time apportioning the gain will be due ONLY when all of the factors are present. This is incorrect. There are other situations in which some relief by allocation of taxing rights may be appropriate, for example if the employment ceased shortly before the options were exercised. However there are many permutations possible and it would not have been constructive to try and deal with all of these in that article. Cases that do not fall within the circumstances described in TB55 will continue to be considered on their own facts.

Q2 Does an employment "continue" if the employee changes contractual employer on being relocated?

If the employers were in the same group of companies and the change did not affect the employee's stock option rights, then the UK would normally regard it as one employment for the purposes of apportioning the option gain attributable to the UK.

Q3 TB55 says that alternative methods of apportionment may only be used "very occasionally". Is this a change from previous policy?

No. The Inland Revenue has always maintained that time-apportionment should be the expectation and in practice few cases have been seen claiming another basis. We are continuing to look at such claims on their merits, if necessary consulting with the other country concerned. However, this is one area in which an international consensus is evolving.

Q4 Is it necessary for the country of residence to actually tax the gain?

The normal expectation would be that tax would actually be levied. TB55 was worded so that absolute certainty could be given to people in the most common situation. Relief may be due in some other cases, but this depends on the country and particular circumstances involved.

Q5 If the employee is resident and ordinarily resident in the UK both when the option is granted and when it is exercised, can the gain ever be time-apportioned in the UK? Example 4 of TB55 implies that it can.

The statement that "a claim may be relevant under the employment income Article…." does not mean that relief would be due by leaving out of account a part of the gain that related to overseas employment. It was meant to reflect that relief by means of credit might be available if the UK recognised that another country had a valid claim to tax part of the gain because it could be said to be derived from employment performed there.

Q6 Does it matter whether the option is over shares in an overseas or a UK company?

In general, no. The source for double taxation treaty purposes will be the employment, and where it is carried on.

Q7 Is any relief due on an option gain if an employee were resident in the UK at the date of grant but resident in a non-treaty country at the date of exercise?

The whole gain is taxable in the UK under Section 135 of the Income and Corporation Taxes Act 1988. If there were overseas tax payable on any part of the share option gain, the UK would consider unilateral relief on a claim. However,

unilateral relief may only be given by means of giving credit, not by time-apportioning a gain. The amount of unilateral relief may never exceed what would be available if a double taxation treaty with the country existed.

Q8 Why have some important issues, such as periods of residence in a third country, short-term business visitors, or what happens when an option vests before it is exercised, not been covered in TB55?

TB55 said that the UK is actively involved in work at the Organisation for Economic Co-operation and Development (OECD) to reach a common international consensus on the treatment of share option gains. The OECD has now published a discussion paper on their OECD website at **www.oecd.org/pdf/M00026000/M00026818.pdf**.

This paper covers many of these topics. In practice many have only been seen infrequently in the UK. They have been dealt with on an individual basis, sometimes when international dialogue was in the early stages. As common international practices develop the UK is likely to harmonise its own rules in line with these. It would therefore be premature for the UK to publish guidelines based on past practice if some realignment becomes necessary. In the meantime specific cases arising in practice should continue to be referred to Susan New at the address below.

Q9 Why are NICs payable on the full gain rather than the amount taxable under PAYE?

The NICs legislation is clearly underpinned to the amount of tax chargeable under Section 135 ICTA 1988 on any gain, not what is eventually taxed after relief. There are no contribution relief provisions under Social Security legislation, European Union (EU) legislation, Reciprocal Agreements (RA) or Double Contribution Conventions (DCC).

Q10 Are UK NICs payable on any gain on exercise of a share option where the gain has already been subject to the legislation of another European Economic Area (EEA), RA or DCC country?

No. There can never be a dual liability on the same payment of earnings. We will usually seek to apply UK legislation on the amount of gain chargeable to tax under Section135 ICTA 1988 arising from exercise of a share option granted in the UK where that gain was not subject to legislation of the host country. This practice follows the 1997 European Commission Agreement referred to in Example 2 of TB56 page 897, but this may depend on the country and particular circumstances involved.

Q11 Can share options fall within the 1997 European Commission Agreement?

The agreement referred to payments of social security contributions on income. Generally, share option gains can fall within this category.

Q12 From what date does the European Commission Agreement take effect for share options?

On any gain chargeable to tax under Section 135 ICTA 1988 arising from the exercise, assignment or release of a share option granted on or after 6 April 1999.

Q13 Is an individual, granted an option whilst in a Case II/III employment, still liable under S162(1) ICTA 1988 if he has left that employment before the time that option is exercised?

No, for the following reasons:

(a) Section 162(1) taxes Case II/III employees who are “employed or about to be in employment”. It makes no mention of those who used to be employed.

(b) If S162(1) did apply, then S160(1) would be applied and that section deems such a benefit to be an emolument.

(c) If it were an emolument, then S19(1)(4A)(b) could be used to treat it as an emolument of last year of employment.

(d) However, the fatal flaw in this argument is that S160(1) cannot be reached without complying with the condition in S162(1)(a)+(b), and those conditions are not satisfied.

(e) Thus, when a Case II/III employee is granted an option whilst employed in UK, but exercises that option after ceasing employment there is no Schedule E liability, under S162(1).

(f) It would still be possible for a NR/NOR individual to be within the charge to UK tax; the crucial test is one of employment.

(g) Similarly, where there is no S162(1) liability there can be no subsequent liability under S162(5) when the shares are sold.

(h) However, there will still be a potential liability under S162(5) when the employment ceases between the time of exercise of the option and when the shares are sold, because of the provisions of Section 160(3).

(i) There also continues to be a potential liability under the “stop loss” provisions of S162(6) after employment ceases, because the employment is deemed to continue under S162(7).

Q14 Can an interest in the shares of a foreign company gain exemption from the conditional shares legislation under S140A ICTA 1988, by virtue of the shares being only forfeitable through that company's 'articles of association' under Section 140C(3)?

Yes, we have changed our view of this section and what follows describes the reasons for that change and what we propose to do.

14.1 Background
Some share schemes use conditional shares, a common feature of which is shares being subject to forfeiture if certain conditions are not met. When such a condition is lifted the value of the share increases. Finance Act 1998 introduced Sections 140A - C ICTA 1988 to determine the tax treatment of such shares.

S140A exempts any direct charge under S19 ICTA 1988 (Schedule E emoluments) and charges tax under Schedule E on the excess of the market value of the shares over any consideration given by the employee.

Section 140C describes the types of shares to be treated as conditional for the purposes of Section 140A. Section 140C(1A) exempts shares or securities that are conditional only for the reasons set out in subsections (2) to (4).

Subsection (3) exempts shares that are conditional only by virtue of a clause in the articles of association. It does so in the following terms:

> *"This subsection applies in relation to a person if the articles of association of the company require him to offer the shares for sale or transfer them if he ceases to be an officer or employee of the company or of one or more group companies or of any group company."*

14.2 Previous Tax Bulletin Article 46
In April 2000 we published an article in Tax Bulletin 46 page 731, Employee Share Plans: Conditional Shares, which sought to explain the interpretation of Sections 140A - H ICTA 1988. Part of that article explained how we strictly construed the term "articles of association" in S140C(3) and said that it did not extend to foreign company equivalents of UK "articles of association".

Since we wrote that article we have received further legal advice that has cast doubt on our strict line.

14.3 Articles of Association
Black's Legal Dictionary defines "articles of association" in a multi-jurisdictional context as:

> *"the document that sets forth the basic terms of a corporation's existence, including the number and classes of shares and the purposes and duration of the corporation."*

Black's also notes that in most states the articles of association are filed with the Secretary of State as part of the process of forming the corporation.

We have seen cases where foreign companies have documents called "articles of association", and other cases where there is a document that performs a similar function under a different (foreign) name. Failure to recognise the function that such a document serves rather than relying simply on its descriptive name could raise issues of discrimination.

14.4 Change of Revenue View
We have looked critically at S140C(3) and now accept that our previous interpretation of the term *articles of association* was too narrow. Consequently we consider the exemption in S140C(3) should also be available to non-UK companies:

- if the condition referred to in S140C(3) is set out in a document broadly equivalent to UK articles of association and in line with the Black's definition above.

- It will be a question of fact whether the foreign document is of equivalent status and performs an equivalent function to UK articles of association.

14.5 Transitional Issues
A number of issues arise where taxpayers followed our previous advice and accepted that there was no exemption under S140C(3).

- Under the previous practice they would be charged to tax (and National Insurance) for the year in which forfeiture was lifted rather than the year in which the shares were awarded.

- Under the revised practice tax (and National Insurance) will be charged for the year in which the shares were awarded rather than the year in which forfeiture was lifted.

Adopting the previous practice could have led to either a higher or a lower tax/NIC charge at a later date. Taxpayers following our previous practice will not have been charged tax/NIC for the year in which the shares were awarded and would be expecting to pay (or have already returned and paid) tax/NIC when the risk of forfeiture was lifted.

As a consequence of following our previously stated practice the acquisition cost of such shares for capital gains tax purposes would be the amount on which Schedule E was charged when the risk of forfeiture was lifted. Our revised practice will give rise to a different acquisition cost for capital gains tax purposes based on the amount on which Schedule E is charged when the time the shares are awarded.

14.6 What We Propose To Do

We believe the number of people affected by this change is likely to be relatively small.

(a) Where return already submitted on basis of previous advice

We will take no action. Exceptionally, where the time limit has not yet expired for amending the return, the taxpayer will be able, should he/she so wish, to amend the return.

(b) Where return not yet submitted

The return, for whichever year, should be submitted in accordance with the new advice.

(c) Error or mistake claims

Employees who believe that they may have been overcharged to tax in an assessment, and which they have paid, because of the Revenue's previous advice may make a claim for error or mistake relief under Section 33 TMA 1970. The usual conditions of that section will need to be satisfied for a claim to be accepted, including a reduction of the claim for any tax that would have been due under the new practice but which will now not be assessed (see (a) above). Claims should be made initially to the local inspector.

(d) Capital gains tax

Where a capital gain/loss on shares subject to this change of practice is or has been made, similar rules will apply to it as to the income tax gain described above.

The base cost for CGT purposes will be the value of the shares self-assessed for Income Tax purposes.

(e) PAYE

Where PAYE has been operated by the employer, it will not affect the operation of the self assessment rules described above, including time limits for amendment of returns. But see below regarding NIC.

(f) National Insurance Contributions

Employees and employers who believe that they may have overpaid Class 1 National Insurance, because of the Revenue's previous advice, may make a claim for a refund. Please see instructions at NIM37000 *et seq*. An offset for NIC that should have been paid at another time, but was not, should be made in the claim. Claims should be submitted to:

National Insurance Contributions Office
Refund Group
Room BP1001
Benton Park View
Longbenton
Newcastle upon Tyne
NE98 1ZZ

14.7 Tax Law Rewrite

In view of this Tax Bulletin article, the recently published draft Income Tax (Earnings and Pensions) Bill includes at Clause 419(5):

In subsection (2)(b) "articles of association" includes, in the case of a company incorporated under the law of a country outside the United Kingdom, any equivalent document relating to the company.

Further information

Further information on international aspects of share options may be obtained from

Susan New
Revenue Policy International
Victory House
30-34 Kingsway
London
WC2B 6ES

Telephone: 020 7438 7250
E-mail: Susan.New@ir.gsi.gov.uk

Further information on the interpretation of United Kingdom legislation on share options may be obtained from

Michael Staples
Share Schemes
New Wing
Somerset House
London WC2 1LB

Telephone: 020 7438 6778
E-mail: Michael.Staples@ir.gsi.gov.uk

Further information on liability to pay NICs on share options may be obtained from

Steve Hickson
Revenue Policy
Personal Tax
Room 75E
Benton Park Road
Newcastle Upon Tyne
NE98 1ZZ

Telephone: 0191 22 56029
E-mail: Steve.Hickson@ir.gsi.gov.uk

miscellaneous

Employees coming from abroad to work in the UK

Guidance available on tax and National Insurance

The UK hosts many ex-patriates from overseas who come to work in the UK either for an overseas or a UK employer. Our website contains a great deal of guidance on tax and National Insurance matters but at present this is scattered around various publications. This is because in the past the Inland Revenue's approach was to produce separate guidance for employers, employees, Revenue staff and tax practitioners. However in recent years, for example with the introduction of self assessment, the approach has been to produce common guidance for our direct customers, their advisers and Revenue staff.

We recognise that in the area of employees coming from abroad it would be particularly helpful to have common guidance. So we are working to bring together all the available guidance electronically and to update it where necessary. In the meantime this article lists the main guidance currently available that may be relevant in this area, including Inland Revenue Manuals which are available on the Internet under Open Government. We would be grateful for any suggestions or additions to the list below which we will need to consider when preparing the electronic version. These should be sent to the people listed at the end of this article.

Abbreviations used in this article are:

TB: Tax Bulletin
DT: Double Taxation manual
SE: Schedule E manual
SSM: Share Schemes Manual
EP: Employment procedures manual
NIM: National Insurance Manual
CA: Contributions Agency
CWG: Employer's Further Guide to PAYE and NICs

Manual pages and booklets are available on our website. Booklets are also available from Inland Revenue Enquiry Centres

General guidance on liability to UK tax, and PAYE and NICs

Booklet IR20 - Residents and non-residents - liability to tax in the UK
Residence Guide - Chapter 5: Liability to UK tax
SE40001-40603 - The scope of Schedule E
NIM 33000-33019
CWG2 Employer's Further Guide to PAYE and NICs (Chapter 4)
Booklet 490 - Employee Travel, A Tax and NICs Guide for Employers (Chapter 7)
Employment Procedures Manual (Chapter 8)

Whether a UK employer exists
TB17C: Determining the true employer

The "60-day" exemption
TB25: "Employees and double taxation agreements"

Dual contracts for overseas and UK employments
SE40103 and 40104: Dual contract arrangements

National Insurance Contributions
CA76: A guide to NIC for people coming to the UK
CWG2 (Chapter 4)
NI38 - "Social Security Abroad"
SA29 - for workers moving within the EU

Deferred remuneration or bonuses
SE 42200: introduction to basis of assessment

Supplying services through a company ('IR 35')
IR175: Supplying services through a limited company

UK tax on overseas income
IR139: Income from abroad - a guide to UK tax on overseas income

Residence in the UK
IR20 - Residents and non-residents: Liability to tax in the United Kingdom Residence Guide
SE41000-41050 - Residence and domicile - brief description
SE42800-42950 - Residence - taxpayers coming to or leaving UK
NI38
NIM 33031-33032

Teachers coming to the UK for less than two years
DT1935 -1945: Teachers coming to the UK

Foreign Emoluments
SE32660-32681 - Relief for corresponding payments

Modified PAYE for people working in two countries
EP 8127 and EP App4 - Criteria for short term business visitors

Tax Equalisation
EP 8257 and EP App6 - Modified PAYE in tax equalisation cases
TB59 - Tax equalisation
SA Helpsheet IR 212 - Tax Equalisation for tax agents and employers

How days are counted
SE42840: What counts as a day for residence purposes
DT1921: What counts as a day for relief under a double taxation agreement
DT19860: What counts as a day for US residence rules

Share options
SSM11.1: Shares and share options, non-residents, Case II and III issues
DT1925-1925B: Taxation of share options
TB55: Taxation of share options for internationally mobile employees
TB56: NIC on share options

Travelling Expenses
SE34000-34200 - Special rules for employees travelling to work outside the UK
SE35000-35140 - Travelling expenses for employees working but not domiciled in UK
TB56 - Travel expenses of employees not domiciled in UK

Other expenses
TB50: Employees sent here on secondment for less than 24 months
SE31750-31770 - Expenses deductible under Case II/III Schedule E
SE03100-03140 - Removal or transfer costs

Accommodation provided by an employer
SE11300 onwards : Living accommodation

Further help

Applying double taxation treaties:

Susan New
Revenue Policy International
Victory House
30-34 Kingsway
London
WC2B 6ES

Tel: 020 7438 7250
(from abroad): +44 20 7438 7250
E-mail: Susan.New@ir.gsi.gov.uk

Assessable income and deductions

Martin Delnon
Revenue Policy Personal Tax
Sapphire House
550 Streetsbrook Road
Solihull
B91 1QU

Tel: 0121 71 34634
(from abroad): +44 121 71 34634
E-mail: Martin.Delnon@ir.gsi.gov.uk

National insurance Contributions

Steve Hickson
PT Technical
Room 75E
Benton Park Rd
Newcastle Upon Tyne
NE98 1ZZ

Tel: 091 22 56029
(from abroad): +44 191 22 56029
Email: Steve.Hickson@ir.gsi.gov.uk

Residence and domicile

Doug Devine / Stuart Keenay
Centre for Non-Residents
St John's House
Merton Road
Bootle
Merseyside
L69 9BB

Tel: (from UK):0151 472 / 6201 / 6227
(from abroad): +44 151 472 / 6201 / 6227
E-mail: non-residents@inlandrevenue.gov.uk

Composite Service Companies and the 'Service Company' legislation ('IR35')

Composite service companies exist in a number of different areas of business. These include, for example, construction, IT, teaching, medicine, accountancy etc. Composite service companies usually employ workers and then supply them to clients for whom they work. Sometimes the clients will be found via employment or recruitment agencies rather than directly via the composite service company.

The employees of a typical composite service company are normally paid a small wage or salary for the work they do - usually at or slightly above the level of the national minimum wage. However, the employees are also usually shareholders of the composite service company, and each employee will usually hold a different class of shares in that company. So, for example, Employee A will hold class 'A' shares, Employee B will hold class 'B' shares, and so on. The employee's shareholding will then usually entitle him/her to receive dividends based on the amounts received by the composite service company for the services the employee performs for the client's business. These dividends will supplement, often substantially, the small amount the employee is already receiving from the composite service company in wage or salary payments. Dividends may be paid on monthly or even weekly basis in some cases.

The people actually running and managing the composite service company will usually prepare all the necessary legal paperwork on behalf of the company and its employee/shareholders, including any returns to the Inland Revenue, and will charge the composite service company a weekly fee to cover administration costs.

The working arrangements as described above are fairly typical arrangements for composite service companies. However, they can obviously be organised in other ways as well. Regardless of how the composite service company is organised, it will need to consider the 'service company' legislation[1] in exactly the same way that any other service company has to.

The 'service company' legislation says that:

- where an individual ("the worker") personally performs services for the purposes of a business carried on by another person ("the client"); but
- does so via a service company rather than directly; and
- works for the client in such a way that they would be regarded as an employee of the client, had they worked for them directly rather than via the service company; then

the service company will have to deduct and account for tax under PAYE and Class 1 National Insurance contributions in respect of that worker on (broadly) all of the money the service company receives from the client in respect of work done for the client by that worker.

This legislation applies equally whether the service company employs only one or two workers or whether, as a composite service company, it employs many workers.

In some cases, the number of employees/shareholders in a composite service company exceeds 20. This makes no difference to the applicability or otherwise of the 'service company' legislation. The service company legislation will apply in any situation where the relevant conditions are met and the worker **either** holds 5% of the shares in the service company[2] **or** receives payments which 'could reasonably be taken to represent remuneration for services provided by the worker to the client'.[3]

We are monitoring compliance with the 'service company' legislation as part of our general programme for supporting voluntary compliance and for tackling non-compliance.

[1] Schedule 12 FA2000 and the Social Security Contributions (Intermediaries) Regulations 2000

[2] paragraph 3(1)(a) and (4) of Schedule 12 FA 2000 and regulation 5(2)(b)(i) and (4) of the Social Security Contributions (Intermediaries) Regulations 2000

[3] paragraph 3(1)(b) of Schedule 12 FA 2000 and regulation 5(2)(b)(ii) of the Social Security Contributions (Intermediaries) Regulations 2000

Simpler rules for dealing with Instruments of Variation for IHT and CGT purposes

This article explains the new procedures introduced in Finance Act 2002 for dealing with the IHT and CGT treatment of instruments of variation ["IoVs"]. In particular these changes will mean that it is no longer appropriate to send IoVs to the Inland Revenue in most cases.

Instruments of Variation

It is not unusual for an instrument of variation ["IoV"] to be executed which changes the way in which property passes following someone's death. There are many reasons why a variation may be desirable, for example, to take account of the differences in the personal finances of the beneficiaries, or to pass the inheritance on to the next generation. Normally, a variation takes effect from the date of the document varying the inheritance. But provided those making the variation comply with certain requirements, the variation can be treated for inheritance tax (IHT) and most capital gains tax (CGT) purposes as if it had been made by the deceased. This means that for those purposes the variation is backdated to the date of death. IHT is worked out taking account of the variation being made, and for CGT computational purposes the new beneficiaries are treated as if they acquired the assets from the deceased at the date of death and at the value agreed on death.

The old rules

The old rules contained in section 142 Inheritance Tax Act 1984 [IHTA] and section 62 (6) to (9) Taxation of Chargeable Gains Act 1992 [TCGA] allowed an IoV to have retrospective effect for all IHT purposes, and most CGT purposes. But to achieve this it was necessary to make an election under section 142(2) IHTA and/or section 62(7) TCGA, and send it to the Board of Inland Revenue within 6 months of the date of the IoV, or within such longer time as the Board permitted.

New rules

The elections are abolished by Sections 120 and 52 Finance Act 2002; instead the IoV will automatically have effect for IHT and/or CGT purposes, if

(a) it contains a statement of intent, that the provisions of s.142(1) and/or s.62(6) should apply,

(b) it is executed within two years of the relevant death,

(c) it meets the other statutory requirements, and

(d) it is legally valid.

The change only applies to IoVs executed after 1 August 2002; the existing requirements of s.142(2) and s.62(7) continue to apply to all IoVs executed before that date.

New procedures

If the IoV results in a change to the IHT payable on death, you should send a copy to the office dealing with the IHT liability (see the end of this article) Otherwise the signatories should retain the IoV or a copy until it is needed.

Thereafter, a copy of the IoV will only need to be sent to us if we ask for it during an Enquiry. For example

- for inheritance tax, if a beneficiary who made a variation dies within 7 years and we ask about any gifts he or she made, the variation will be evidence that the assets it redirected should not be added to the beneficiary's estate,
- for CGT, we may exceptionally ask to see the IoV for the purposes of determining a particular issue, in particular the identity of the settlor if a trust is created or varied by the IoV,
- for Income Tax, the IoV might alter the income entitlement of the beneficiaries during or at the end of the administration period, so the office dealing with the administration of the estate may wish to see a copy of the IoV as evidence of that change. However, IoVs do not retrospectively alter a beneficiary's entitlement for Income Tax Purposes.

Any IoVs executed after 1 August 2002 that are sent to us which have no immediate tax consequences will be returned without comment.

Stamp Duty

The existing rules for Stamp Duty are unchanged. Therefore an IoV must either be stamped or contain a certificate using this wording:

> "I/We certify that this instrument falls within category M in the Schedule to the Stamp Duty (Exempt Instruments) Regulations 1987.

The conditions for an IoV to fall within category M are the same as for S142 IHTA and S62(6) to (9) TCGA.

Possible Questions

Does the statement have to cover both IHT and CGT?
No. The elections under s.142(2) and s.62(7) have always been separate elections. The right under the new provisions, to apply both sections or one section and not the other to the IoV, is preserved in the new system.

Can I get help in drafting an IoV?
We propose to issue a checklist (form IoV2) which will help you to see whether your proposed IoV meets the requirements of IHTA and TCGA. This is available from the addresses at the end of this article and is also included in the revised version of booklet IHT8, available from the same addresses or on our website **www.inlandrevenue.gov.uk** . We regret that we cannot assist you by looking at IoVs in draft.

When do I have to decide whether to include the statements or not?
What these changes will mean in practice is that you can draft an IoV in the usual way, but to have retrospective effect for IHT and/or CGT purposes it must contain a statement of the parties' intent, rather than a formal election, although if an IoV follows old drafting precedents and refers to an election, this would be regarded as a statement of the parties' intent. As the statement must be part of the IoV, the parties will need to consider both the IHT and CGT consequences at the time the IoV is being drafted and decide at that time whether or not they wish provisions of s.142 and/or s.62 to apply.

In practice most elections under the old rules were included in the IoV itself. So apart from minor changes from the standard wording which you may wish to adopt to reflect better the change from elections, the difference is that under the old rules it was possible, although an election had been made in the IoV, to prevent it having any retrospective effect for IHT and CGT by choosing not to send it to the Board within the six month period. This option is no longer available.

What if the IoV is executed more than 2 years after the death
The IoV cannot have retrospective effect for IHT and CGT. It is a statutory condition for the application of s.142(1) and s.62(6) that the IoV is executed within the specified period.

What about disclaimers?
The election procedure did not apply to disclaimers. The position is unchanged.

Addresses

Nottingham
Inland Revenue Capital Taxes
Ferrers House
PO Box 38
Castle Meadow Road
Nottingham
NG2 1BB

Helpline: 0115 974 2400

Belfast
Inland Revenue Capital Taxes
Level 3
Dorchester House
52-58 Great Victoria Street
Belfast
BT2 7QL

Helpline: 028 9050 5353

Edinburgh
Inland Revenue Capital Taxes
Meldrum House
15 Drumsheugh Gardens
Edinburgh
EH3 7UG

Helpline: 0131 777 4050

An Update On Double Taxation Conventions (DTCs)

Annual Review

In order to set its treaty priorities each year, the Inland Revenue consults the main representative bodies and other Government departments and also invites representations from other interested parties.

The comments received provide useful information on problems with existing treaties and possible gaps in the UK's treaty network.

The Paymaster General, Dawn Primarolo, MP, has recently agreed the negotiating programme for double taxation conventions for the year to 31st March 2003. Full details are given in the Inland Revenue News Release issued on 19 July 2002 and a summary is given below.

DTC Negotiating Programme

- We hope to complete work on new treaties with Botswana, France, Georgia and South Africa.
- We plan to finalise Protocols to the existing treaties with Canada and the Netherlands.
- We intend to continue negotiations with Australia, Chile, Croatia, Germany, Namibia and Slovenia.

New /Exploratory Talks

We consider the scope for new or updated treaties, as and when circumstances allow. There has been a particular interest in new treaties with Croatia, Iran, Libya, Poland and the Federal Republic of Yugoslavia. We also hope to update certain provisions of the treaty with Italy. The timing of any negotiations with these countries will depend, among other things, on the extent of our other commitments. Representations on these and other negotiations are welcome - see the section below for details. In line with our existing practice we will generally invite country-specific representations through an Inland Revenue News Release before we begin any new negotiations.

Tax Information Exchange Agreements (TIEAs)

Following the recent publication by the Organisation for Economic Co-operation and Development (OECD) of a model TIEA, we will be commencing a programme of negotiating TIEAs with jurisdictions that have made commitments to the OECD to introduce transparency and effective exchange of information in tax matters. These will provide for exchange of information between the UK and jurisdictions with which we do not have a DTC.

Recent Developments

Australia
The second round of negotiations on a new comprehensive DTC was held in Canberra in March 2002.

Botswana
Talks were held in London in December 2001 and the text of a new DTC has been initialled by officials.

Canada
A further round of negotiations on a Protocol took place in Ottawa in June 2002.

France
A further round of talks on a DTC was held in London in November 2001.

Georgia
A second round of negotiations on a comprehensive DTC took place in London in May 2002.

Jordan
A comprehensive DTC was signed between the UK and The Hashemite Kingdom of Jordan on 22 July 2001 and entered into force on 24 March 2002. The provisions of the Convention will apply: in the UK from 1 April 2003 for corporation tax and from 6 April 2003 for income tax and capital gains tax and from 1 January 2003 in Jordan.

Saudi Arabia
An initial round of talks was held in Riyadh in May 2002.

South Africa
A new comprehensive DTC between the UK and South Africa was signed on 4 July 2002 in London by Chancellor of the Exchequer Gordon Brown and South Africa’s Finance Minister Mr Trevor Manuel.

It will enter into force once the relevant legal procedures have been completed in both countries.

Slovenia
We held an initial round of talks in London in February 2002.

Taiwan
A comprehensive double taxation agreement between the British Trade and Cultural Office, Taipei and the Taipei Representative Office in the United Kingdom was signed in London on 8 April 2002 by David Coates, Director General of the British Trade and Cultural Office, Taipei and Louis Tzen, Representative, Taipei Representative Office, London.

Representations

General representations concerning new DTCs, or suggestions about changes to existing conventions, are welcomed and should be addressed to:

Mrs Jas Sahni
Revenue Policy International
Inland Revenue
Victory House
30-34 Kingsway
London
WC2B 6ES

Email: Jas.Sahni@ir.gsi.gov.uk

Queries regarding the effects of a double taxation convention on a particular taxpayer's tax liability should always be referred to the Inland Revenue office responsible for dealing with their tax affairs.

Further Information

Further information on double taxation and related issues can be obtained via the Internet on the Inland Revenue website at **www.inlandrevenue.gov.uk**

Copies of double taxation conventions published from 1997 onwards can be found on the Stationery Office's website at **www.hmso.gov.uk** or purchased via **www.tso.co.uk**

Copies of older conventions can be obtained from the Stationery Office -

Telephone 0870 600 5522. The Statutory Instrument number should be quoted (see TB 59 page 939).

Further information on double contribution conventions can be obtained from

Inland Revenue
National Insurance Contributions Office
International Services
Longbenton
Newcastle Upon Tyne
NE98 1ZZ

General double taxation issues arising in connection with estates, inheritances and gifts should be addressed to:

Angela Cole
Revenue Policy Capital and Savings
Inland Revenue
Room 121
3rd Floor
New Wing
Somerset House
London
WC2R 1LB

Email: Angela.Cole@ir.gsi.gov.uk

Quarterly Payments of Corporation Tax for large companies - Further Guidance Issued

We have recently published further practical guidance on estimating quarterly payments of Corporation Tax and on the use of penalty powers under the quarterly instalment regulations.

This guidance was drafted in discussion with business and is aimed at providing companies with examples of what is good practice when calculating their instalment payments. It focuses on acceptable methods of estimating quarterly instalments, which the Revenue regards as sufficient to ensure the company doesn't risk incurring a penalty under the quarterly instalment regulations.

The guidance covers the following:

- general issues such as commercial practice and governance
- the roles of interest and penalties in the Quarterly Payments system
- estimating the tax liability
- record keeping

It also provides further detail on specific areas including:

- group relief and losses

- ‘one off’ transactions such as chargeable gains
- market movements
- changes in law or practice including, developments in case and statute law, accounting practice, regulatory requirements, international developments
- open enquiries on previous years, which may have an impact on the current year (for example Capital Allowances, Revenue/Capital expenditure).

The guidance also includes a series of Question and Answers highlighting acceptable methods of estimating quarterly payments. The guidance is available at **www.inlandrevenue.gov.uk**.

Group Relief - accounting periods prior to 1 April 2000 - UK branches of companies resident in the European Economic Area (EEA)

We have recently considered a case involving group relief and UK branches of companies resident in another EU Member State.

The accounting periods concerned pre-date the introduction of the new group relief rules in Finance Act 2000. Claims had been made to surrender branch losses to a UK resident subsidiary of the EU resident parent and to set losses of UK resident subsidiaries against UK branch profits, and appeals had been made against decisions to refuse group relief. The basis of the appeals was that to deny group relief would be contrary to EC law.

We have decided not to contest those appeals, so the claims will now be accepted. We are advising Inspectors to settle any other similar cases, raising issues of group relief and UK branches of EEA resident companies prior to Finance Act 2000, on the same basis.

Finance Act 2000 introduced new rules governing group relief for branches. Those rules are in Section 403D and section 403E ICTA 1988 and apply in relation to accounting periods ending on or after 1 April 2000. There is an article about the new rules in Tax Bulletin 49 page 788 October 2000.

Look out for your subscription form in the next issue of Tax Bulletin

Inland Revenue Statements of Practice and Extra-Statutory Concessions issued between 1 June 2002 and 31 July 2002.

Extra Statutory Concessions

There have been no Extra Statutory Concessions for this period

Statements of Practice

There have been no Statements of Practice for this period

You can get copies of SPs and ESCs by telephoning 020 7438 4266.

CONTENT

The content of Tax Bulletin gives the views of our technical specialists on particular issues. The information published is reported because it may be of interest to tax practitioners. Publication will be six times a year, and include a cumulative index issued on an annual basis.

- You can expect that interpretations of the law contained in the Bulletin will normally be applied in relevant cases, but this is subject to a number of qualifications.
- Particular cases may turn on their own facts, or context, and because every possible situation cannot be covered, there may be circumstances in which the interpretation given here will not apply.
- There may also be circumstances in which the Board would find it necessary to argue for a different interpretation in appeal proceedings.
- The Bulletin does not replace formal Statements of Practice.
- The Board's view of the law may change in the future. Readers will be notified of any changes in future editions.

Nothing in this Bulletin affects a taxpayer's right of appeal on any point.

Letters on any article appearing in Tax Bulletin should be sent to the Editor, Aidan Close, Room G7, New Wing, Somerset House, Strand, London, WC2R 1LB or e-mail Aidan.Close@ir.gsi.gov.uk. We are sorry though that neither he nor our contributors will normally be able to enter into correspondence about Tax Bulletin or its contents.

SUBSCRIPTION

The subscription for 2002 is £22. If you would like to subscribe to Tax Bulletin please send your name and address together with your cheque to Inland Revenue, Finance Division, Barrington Road, Worthing, West Sussex BN12 4XH. Cheques should be crossed and made payable to "Inland Revenue".

If you would like information regarding Tax Bulletin subscription or distribution please contact Mr Bryan Kearney, Room G7, New Wing, Somerset House, Strand, London, WC2R 1LB. Telephone: 020 7438 6373. For more general information regarding Tax Bulletin, please contact Mrs Jayne Harler, Assistant Editor, on 020 7438 7842 or at the address provided above..

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