



Tax Update

November 2012

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Any comments or queries?

Adam Craggs Partner

adam.craggs@rpc.co.uk
D +44 (0)20 3060 6421

Jonathan Levy Partner

jonathan.levy@rpc.co.uk
D +44 (0)20 3060 6472

News

A question of Britishness?

The Government launched a fairly swift consultation on the design of a test to determine whether cultural works such as animation, certain television programmes and video are “culturally British” and hence eligible for tax breaks targeted at the creative sector. The consultation closed on 29 October 2012 and draft legislation is awaited.

See http://www.culture.gov.uk/images/consultations/120927_VG_Condoc.pdf for more details.

Statement of Practice 1/09 – draft legislation published

HMRC has published draft legislation designed to enact provisions of Statement of Practice 1/09, which relates to the tax treatment of employees with UK and overseas duties under the same employment contract. The closing date for comments is 7 December 2012.

More details can be found at: http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_032353

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Cases

R (on the application of Anand) v HMRC: search warrants quashed

The recent decision of the Divisional Court (Pitchford LJ and Foskett J) in the case of *R (on the application of Anand) v HMRC* (unreported) has shed further light on the circumstances in which the courts will quash search warrants granted to HMRC in the course of a criminal investigation into a taxpayer.

The facts

The sole director of the claimant company applied for judicial review of the lawfulness of a search warrant obtained by HMRC. The claimant company was an animation film production company which, in 2009, had made substantial claims for repayment of VAT from HMRC.

In 2010 the production company claimed film tax relief of production costs of £2.2m but no film was ever released.

HMRC commenced a criminal investigation after attempts to make contact with the company's alleged suppliers to verify the VAT claims failed. The investigation found that the sole director was a director of eight other companies which had received approximately £1.7m in VAT and film tax relief repayments over a two year period. HMRC also established that the sole director had not submitted a self-assessment tax return since 2005.

HMRC obtained a search warrant on the London address of the sole director. The warrant provided that all business records, accounts, electronic storage equipment and all items believed to be of evidential value could be searched and seized. The material obtained in the search was subsequently served by the Crown on the defence in the prosecution of the sole director for conspiracy to cheat the Revenue.

The sole director commenced an action for judicial review the day before the three month time limit for doing so under CPR, rule 54.5(1), was due to expire and several weeks after the information that had supported the warrant had been disclosed to him by HMRC.

It was argued on behalf of the sole director that the warrant was unlawful as it was drawn so widely that no-one would have known what items fell within its scope; effectively the warrant gave HMRC carte blanche to seize any items found at the premises without limitation. HMRC, on the other hand, argued that the claim for judicial review should be dismissed as it was not made promptly.

The Administrative Court granted the application. The Court accepted that the action had not been brought promptly, but delay was not an outright bar to the claim being considered by the Court. The Court found that the exercise of its discretion to permit a judicial review should be governed by the merits of the application and whether HMRC would suffer any prejudice. Here, the subject matter of the claim was extremely serious, being the liberty of the sole director and the intrusion into his home. Nor was there prejudice to HMRC as the subsequent prosecution had duly proceeded.

The Court then considered the effect of the Police and Criminal Evidence Act 1984 (PACE). Under section 15(6) PACE it was a requirement that what was sought in the search needed to be specified in the warrant. This safeguard ensured that the person executing the warrant was able to identify which items would or would not fall within the terms of the warrant and prevented the seizure of items that properly were not part of HMRC's investigation. The present warrant did not comply with section 15(6)(b) as it failed to identify, so far as is practicable, the articles to be sought. It would, however, have been a simple matter to specify those articles but the warrant did not and was, therefore, unlawful.

Comment

HMRC have formidable powers under PACE to enter and search premises and seize items such as computers (see PACE, section 8 and Schedule 1) as well as to arrest persons (see PACE, sections 17 and 24(2)). The decision of the Divisional Court in this case is a welcome reminder that the courts are fully cognisant of the need to scrutinise carefully the exercise of the formidable powers available to HMRC and to ensure that the constraints and safeguards provided by Parliament are adhered to. [Back to contents>](#)

McLaren Racing Limited v HMRC: win puts McLaren in pole position

The glamorous world of Formula One does not often collide with the more cerebral realm of the First-tier Tribunal (FTT), but this is precisely what happened in *McLaren Racing Limited v HMRC*¹. The case concerned whether McLaren could deduct a penalty imposed by the governing body of Formula One – the Federation Internationale de L'Automobile (FIA) – from its taxable profits.

Background

In 2006, an employee of Ferrari passed confidential information about Ferrari (including information about Ferrari's cars) to McLaren. The FIA investigated the matter and, in 2007, McLaren was required by the FIA to pay a fine of around £32 million and suffered a points deduction which led to its income being reduced by around £17.6 million.

McLaren, by being in possession of and using proprietary information belonging to its rival Ferrari, had thereby breached the rules of the FIA's International Sporting Code to which it was contractually bound. Accordingly, the penalty was not imposed by any statutory provision but under provisions to which McLaren was contractually bound as a participant in Formula One racing.

HMRC accepted that the reduction in McLaren's gross income reduced its taxable profits, but contended that the £32m penalty was not deductible for corporation tax purposes. McLaren appealed to the FTT.

Arguments

McLaren argued that the penalty was an expense or loss incurred wholly and exclusively for the purposes of its trade and was therefore deductible when computing its taxable profits.

HMRC argued that the penalty was not deductible and fell within either section 74(1)(a) or (e) of the Income and Corporation Taxes Act 1988 (ICTA).

¹ [2012] UKFTT 601 (TC).

Section 74(1) ICTA provided that in computing trading profits no sum shall be deducted in respect of:

“(a) any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade or profession; ...

“(e) any loss not connected with or arising out of the trade or profession.”

The FTT's decision

The presiding member, Judge Hellier, held that the penalty was deductible for corporation tax purposes. He was of the view that, in the non-statutory context, where the actions which gave rise to a penalty could otherwise be said to have been for the purpose of the trade, it is only if the nature of the penalty is to punish a person and if there is a serious public policy which would be diluted by the tax deductibility, that the penalty should not be regarded as an expense of the trade. By analogy, a non-compensatory penalty for late completion imposed in a building contract made under the laws of a jurisdiction which made such a penalty enforceable could be a deductible expense.

In arriving at this conclusion, Mr Hellier had regard to the following:

- the penalty's nature as an alternative to exclusion from trading activity;
- the commercial motivation for the penalty;
- the consideration given to the resources of the McLaren team; and
- the requirement that part of the penalty was a deduction of points.

Accordingly, Mr Hellier concluded that the policy behind the penalty was intended to affect McLaren in its trade rather than as a person. The penalty was set so as to deter others from the same course of action in the pursuit of their trades, but the deterrence of others did not, of itself, point to a policy of personal punishment for McLaren.

The penalty was a commercial penalty designed to affect McLaren in its commercial activity. It was not of a like nature with a statutory penalty designed to be suffered by an individual. The motivating policy was not principally to punish McLaren in its person.

Even if the penalty was personal punishment of McLaren, there was not sufficient public interest in the nature of the conduct of motor racing as to be able to say that it would be preposterous to allow this penalty to be shared with the general body of taxpayers. The safety, health or wellbeing of the public were not at issue. The penalty was not levied for the protection of the public but mainly for the regulation of commercial activity.

Mr Hellier neatly summarised his conclusion as follows:

“This cost was not one imposed on McLaren, but one which it was contractually obliged to pay under contractual obligations undertaken for the purposes of its trade; it did not result from the action of an external regulator, but from a body to whose dictates it had agreed to submit as part of its trade and in order to gain income; it arose from the action of employees in pursuing a course of conduct normally for the benefit of its trade, not from actions unconnected with

its trade; the penalty was motivated by commercial policy and was structured by reference to McLaren's trade; the body imposing the penalty had commercial considerations more than the public interest in view; the protection of fairness in motor sport organised by FIA does not carry the same sort of public interest as that protected by a regulator of a profession based on trust. The penalty was something which arose from its trade, was connected with its trade and was incurred wholly and exclusively for the purposes of its trade."

The other member of the tribunal, Mr Dee, did not agree with Mr Hellier's conclusions. He considered that the nature of the penalty was to punish McLaren, and that this was sufficient to bring the penalty within section 74(1) ICTA. As the tribunal president, Mr Hellier's view prevailed by virtue of the presiding member's casting vote and McLaren's appeal was successful.

Comment

Mr Hellier makes a clear distinction between a statutory penalty and a case like the present, where the incurring of the penalty arises as a result of a contractual obligation entered into by the taxpayer (in this case, the terms of McLaren's participation in Formula One). It is a subtle distinction and one which divided the tribunal. It might seem somewhat "unfair" for McLaren to be able to deduct from its taxable profits a fine imposed as a consequence of its wrongdoing. However, the same could also be said in relation to the reduction in McLaren's income, and subsequent reduction in taxable profit, which HMRC did not take issue with.

This case highlights the difficulty faced by taxpayers and HMRC in determining when expenditure is incurred wholly and exclusively for the purpose of a trade, or is sufficiently connected with that trade to be tax deductible. The fact that the FTT was split in its decision (with the result having to be determined by the presiding member's casting vote) demonstrates that the correct treatment of expenditure of this nature is far from clear and an appeal to the Upper Tribunal by HMRC seems likely.

See <http://www.financeandtaxtribunals.gov.uk/judgmentfiles/j6744/TC02278.pdf> for full details of the case. [Back to contents](#)

UBS AG and DB Group Services v HMRC: tax avoidance scheme succeeds at the Upper Tribunal

The eagerly awaited decision of the Upper Tribunal (UT) in the case of *UBS AG and DB Group Services (UK) Limited v HMRC*² has now been released.

The facts

UBS AG (UBS) and DB Group Services (UK) Limited (DB), each entered into what the UT described as a "carefully planned tax avoidance scheme which was designed to enable the appellants to provide substantial bonuses to employees in the tax year 2003/04 in a way that would escape liability to both income tax and national insurance contributions". The mechanism chosen was the award to employees of shares in an SPV offshore company, the shares being intended to be "restricted securities" within the meaning of the special taxation regime in Chapter 2 of Part 7 of Income Tax (Earnings and Pensions) Act 2003 (ITEPA). If the scheme succeeded, UK domiciled employees would only be subject to capital gains tax at 10% and non-domiciled employees would escape tax entirely unless they chose to remit redemption amounts to the UK.

² [2012] UKUT 320 (TCC).

UBS

UBS created a company ESIP Limited (ESIP) in an offshore jurisdiction. ESIP was not controlled by UBS. The shares in ESIP were held by Mourant & Co Trustees Limited (Mourant), professional trustees of a charitable trust. A special class of restricted shares was created in ESIP. The shares were subject to non-permanent restrictions, being a forced sale provision linked to the occurrence of a trigger event. The trigger event was a specified aggregate rise in the closing level of the FTSE 100 index during a three week vesting period. UBS purchased the restricted shares. UBS, through a nominee, held legal title to the shares and allocated beneficial interests in the restricted shares to employees in value to the amounts that UBS had decided would be payable as bonuses to them.

UBS then claimed that, under section 425 ITEPA, there was no charge to tax on acquisition as the securities were restricted securities within the meaning of section 423 ITEPA.

Shortly thereafter, the restrictions were removed from the restricted shares and UBS claimed an exemption under section 429 ITEPA on the basis that the majority of the company's shares were not held by or for the benefit of the employees of the company or associated companies of the company (section 429(4)(a) and (b)). In order to succeed on this point, it was necessary for UBS to establish that it was not associated with ESIP. Under sections 421H and 432(6) ITEPA, two companies are associated if one controls the other.

DB

DB's scheme was similar to the one used by UBS. There was, however, a key difference between the two schemes. In DB's case the majority shareholder in Dark Blue Investments Limited (Dark Blue), the equivalent of ESIP, was Investec Bank (UK) Limited (Investec) to whom DB paid a fee for its involvement, whereas the majority shareholder in ESIP was Mourant, a professional trustee acting as trustee of a charitable trust.

The FTT's decision

The cases were heard consecutively before the FTT on appeal from determinations made by HMRC that the sums allocated to the employees as bonuses at the start of the scheme were liable to income tax as earnings from employment and to class 1 national insurance contributions (NICs) on the same basis. The FTT decided that:

- the shares acquired under the UBS scheme were not restricted securities but the DB shares were;
- neither UBS nor DB controlled the issuing company;
- the Ramsay principle applied (*WT Ramsay v IRC*³) such that the arrangements did not succeed as for both UBS and DB they fell outside of the restrictive securities provisions contained in Chapter 2 Part 7 ITEPA.

The decision of the UT

The UT allowed the appeal of UBS and dismissed DB's appeal.

³ (1982) 54 TC 101.

Firstly, the UT held that the shares were indeed restricted securities. Here, the key issue was whether or not the employees were entitled to receive less than market value for their shares on a forced sale. The UT decided that the answer to this question was yes, despite a hedging mechanism used under the scheme whereby the amount received by employees on such a forced sale would be equivalent to the cash value of their bonuses.

Secondly, the UT applied the decision of the Court of Appeal in *Steele v EVC International NC*⁴, which decided that control of a company, within the meaning of sections 421H and 432(6) ITEPA, meant control at shareholder level. The UT concluded that there was no evidence of control of ESIP by UBS, or any evidence that UBS together with Mourant exercised control over ESIP.

Thirdly, the UT said that it found the FTT's reasoning (Dr David Williams and Mr David Earle) on the *Ramsay* principle very difficult to follow. The FTT had examined the scheme as a whole and concluded that, in reality, it could not properly be described as one providing restricted securities within the meaning of the legislation. Accordingly, the facts viewed as a whole fell outside Chapter 2 altogether. The FTT stated that the purpose of Chapter 2 was that amounts derived from securities that are within the definition of restricted securities are to be charged to income tax not on acquisition but on a later chargeable event. In the FTT's view, the reality of the scheme was that, had the scheme not been in place, employees would have received a bonus net of tax and NICs. Because of this, the FTT did not consider that "... *in reality, the Scheme can be properly described as one providing restricted securities within the scope of Chapter 2 ...*".

The UT had little difficulty in rejecting the FTT's reasoning. The UT held that it might be possible, on a realistic appraisal of the facts, to conclude that the scheme was not one which provided securities but rather money, which fell outside the definition of securities for the purpose of the legislation. However, the securities in this case had a real and enduring nature and could not be ignored or regarded as a mere vehicle for the transfer of money.

Accordingly, the UT allowed UBS's appeal. However, with regard to DB's scheme, the UT held that DB and Investec together controlled Dark Blue. This was because Investec simply did what DB told it to do, without bringing any independent thought or judgement to bear in the fulfilment of its preordained role. The UT dismissed DB's appeal.

Comment

Two conclusions can be drawn from this decision. Firstly, how an arrangement is structured and implemented is often crucial to whether the intended fiscal result will be achieved. DB's arrangements failed, whereas UBS's succeeded. Secondly, there is a perception amongst many advisers and taxpayers that the FTT has in recent years adopted an over-robust attitude towards all forms of tax planning such that succeeding in an appeal before the FTT is something of a rare event. The decision of the UT is welcome and demonstrates that it is not always sufficient for HMRC to simply cry "the *Ramsay* principle", in order to defeat the taxpayer.

See http://www.tribunals.gov.uk/financeandtax/Documents/decisions/UBS_AG_v_HMRC.pdf for full details of the case. [Back to contents>](#)

⁴. [1996] STC 785.