Inland Revenue

Tax Bulletin

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CONTENTS

TRANSFER PRICING AND THE ARBITRATION CONVENTION

Introduction

The Arbitration Convention may be used as an alternative procedure to the mutual agreement procedure under the UK's Double Taxation Agreements in certain cases of double taxation arising from transfer pricing adjustments. The Tax Bulletin article "The Mutual Agreement Procedure in UK Double Taxation Conventions" (Issue 25 October 1996) indicated that further guidance would be provided, and this article provides that guidance. Although the article necessarily expresses the UK's interpretation of the Arbitration Convention, the Inland Revenue has discussed the implementation of the Arbitration Convention with other contracting states and believes that the interpretations expressed are shared by other states. The Inland Revenue expects that such discussion will continue in the light of greater practical experience in implementing the Arbitration Convention.

The UK, along with the other member states of the European Union, is a signatory to the Arbitration Convention ("Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises" 90/463/EEC) - referred to in the rest of this article as "the Convention". The Convention came into force on 1 January 1995 for an initial period of five years. (The process of extending the provision of the Convention to the new member states - Austria, Finland, and Sweden - is currently under way but ratification is not yet complete).

Period and Scope of Convention

Cases can be considered under the provisions of the Convention only if they are validly presented while it is in force. If a case is so presented, it can be considered under the provisions of the Convention even though the action which results or is likely to result in double taxation (see below) took place before 1 January 1995. Similarly, even if the Convention terminates after its initial five-year life-span, as long as a case is validly presented while the Convention is in force, the case can be considered under the provisions of the Convention notwithstanding its termination.

The Convention provides for independent arbitration to ensure the elimination of the double taxation which could result from a transfer pricing adjustment in one of the contracting states. The transfer pricing adjustment must relate to the profits of an enterprise of one contracting state in respect of transactions with an enterprise of another contracting state. For this purpose, permanent establishments of such enterprises are included, provided the permanent establishment is itself situated in a contracting state (Article 1 (2)).

Mutual agreement stage

Unless the enterprises and contracting states involved have already agreed to the transfer pricing adjustment under Article 5 of the Convention, the first stage of action under the Convention is a mutual agreement procedure. If an enterprise of a contracting state considers that it faces double taxation as a result of a transfer pricing adjustment in a contracting state, it can present its case to its competent authority (Article 6 (1)). If the competent authority considers the complaint to be well-founded and cannot itself arrive at a satisfactory solution (Article 6(2)), then it will enter into a mutual agreement procedure with the other competent authority concerned.

At this stage the procedure is no different in practice to that followed under the mutual agreement procedure of the relevant Double Taxation Agreement, and an enterprise may present its case under either of the conventions or under both. However, there is an important consequence of any agreement reached under the Arbitration Convention which differs from agreement reached under the relevant Double Taxation Agreement. Where agreement is reached under the Arbitration Convention, then it will be implemented irrespective of any time limits prescribed by the domestic laws of the contracting states (Article 6 (4) and effected for the UK by Section 815B Income and Corporation Taxes Act (ICTA) 1988). As the earlier Tax Bulletin article explained, claims under the mutual agreement procedure of the relevant Double Taxation Agreement are constrained by the six-year domestic time limit. In view of this difference, enterprises are required to state clearly, when presenting cases to the competent authority, whether the Arbitration Convention is being invoked.

Time limits

An enterprise must present its case "within three years of the first notification of the action which results or is likely to result in double taxation" (Article 6 (1)). There is no provision for extending this time limit. The wording is similar to that used in Article 25 of the Organisation for Economic Co-operation Development (OECD) Model Tax Convention and, while it is not possible to specify what in every case and in every state will be regarded as the first notification of the action, there is a general view among contracting states that the phrase should be interpreted in the way most favourable to the taxpayer in accordance with paragraph 18 of the OECD Model Commentary on Article 25. That paragraph goes on to indicate that the action giving rise to double taxation is considered to be "the act of taxation itself, as evidenced by a notice of assessment or an official demand or other instrument for the collection or levy of tax." The approach in the OECD Model Commentary of identifying a late, substantive action is relevant to the Arbitration Convention, since the OECD Model Tax Convention assumes the overriding of domestic time limits as implemented by the Arbitration Convention. In its own Double Taxation Agreements, however, the UK does not extend domestic time limits with the result that, as mentioned in the earlier Tax Bulletin article, taxpayers are advised to consider making early claims under the mutual agreement article of the relevant Double Taxation Agreement in order to reduce the risk of any conflict with domestic time limits.

Thus, where cases are presented under the Convention in respect of transfer pricing adjustments made by the Inland Revenue, the first notification of the action will be interpreted by the Inland Revenue as the finalising of a transfer pricing enquiry which gives rise to double taxation. This stage will be marked by the determination of the quantum of the additional profits arising from the transfer pricing adjustment to be taken into account in a tax assessment, loss determination, or other official demand for tax. The raising of an estimated assessment or the making of a Direction Notice under Section 770(2)(d) ICTA 1988 in conjunction with an estimated assessment will not be regarded by the Inland Revenue as the first notification of the action if at that time enquiries to determine the quantum of the transfer pricing adjustment have not been completed. Where it is considered that a case is being presented prematurely in respect of UK initiated transfer pricing adjustments, the Inland Revenue will nevertheless contact the other contracting state or states involved to explain why presentation is considered to be premature and to seek the agreement of the other state(s) as to what the first notification of the action would be in that particular case.

Where cases are presented to the Inland Revenue in respect of transfer pricing adjustments made in another contracting state, the Inland Revenue will check with the tax administration of that other state to determine whether the case has been presented within three years of the first notification of the action taken by that other tax administration. If the enterprise is uncertain what might be regarded as the first notification of the action in the other contracting state, it is recommended that the enterprise seeks clarification from the other tax administration. Additionally, the enterprise may wish to secure its position under the mutual agreement article of the relevant Double Taxation Agreement by making a protective claim as recommended in the previous Tax Bulletin article, and to express an interest in invoking the Arbitration Convention. In dealing with the claim under the mutual agreement article of the Double Taxation Agreement, the

UK will then also seek to establish what the other tax administration regards as the triggering action in the particular case under Article 6 (1) of the Arbitration Convention.

Arbitration stage

If the competent authorities cannot eliminate the double taxation by mutual agreement within two years of the date on which the enterprise presented its case, then the Arbitration Convention provides for a second stage, in which the case goes to an advisory commission (Article 7(1)). The two-year time limit is extended where the case is still under appeal through domestic procedures in one of the contracting states, but this does not apply in the UK, as explained below, and can also be extended under Article 7(4) by mutual agreement between the competent authorities and the enterprises.

In the UK, however, before the second stage can commence the time provided for appeal must have expired without an appeal having been made, or the taxpayer must have withdrawn the appeal or settled it by agreement. This approach is provided for in Article 7(3) which the UK (and France) have declared will apply. UK taxpayers need, therefore, to be aware, in the event of mutual agreement not being reached, that arbitration will only commence if the domestic appeals process has been concluded in this manner. There may effectively be a choice for UK taxpayers between pursuit under the domestic appeals process and arbitration. In this respect, it should be borne in mind that arbitration can eliminate double taxation, whereas pursuit under the domestic appeals process can determine only the UK tax position (which would not be varied in any mutual agreement procedure of the relevant Double Taxation Agreement, as explained in the previous Tax Bulletin article). Where matters other than transfer pricing are, or may become, the subject of an appeal, a taxpayer will not be denied access to arbitration under the Convention purely because of the outstanding appeal or appeal rights, provided appropriate undertakings are given by the taxpayer acknowledging that the appeals process will not extend to the transfer pricing issue which is the subject of arbitration.

The advisory commission, constituted in accordance with Article 9 and before which the enterprise may appear (Article 10 (2)), must deliver within six months a decision which will eliminate the double taxation (Article 11). The competent authorities must then act within six months in accordance with the decision, unless they agree to eliminate the double taxation by some other means (Article 12).

Under Article 8 of the Convention neither of the two stages, mutual agreement and advisory commission, will be initiated where one of the enterprises is liable to a serious penalty. The UK has declared that this would be interpreted for UK taxpayers as comprising criminal sanctions and administrative sanctions in respect of the fraudulent or negligent delivery of incorrect accounts, claims, or returns for tax purposes. Other contracting states have supplied their interpretations of this Article in the light of their own procedures.

Presenting a case

To date, experience of implementing the provisions of the Convention has been negligible. Enquiries about the provisions, or about presenting a case, should be addressed to the people named at the end of this article. The Inland Revenue envisages that the information required in the initial presentation of a case will be the same as that required to initiate the mutual agreement procedure provided for in Double Taxation Agreements. As previously stated, taxpayers should indicate when presenting their case whether they wish to follow the procedure set out in the Arbitration Convention rather than the mutual agreement procedure of the relevant Double Taxation Agreement.

Further Information

Requests for further information should be addressed to:

Daniel O'Mahony
Telephone 0171 438 6838
Fax 0171 438 7518

Andrew Hickman
Telephone 0171 438 6916
Fax 0171 438 7629

at

International Division
Melbourne House
Aldwych
London WC2B 4LL

Requests for further information about the application of the Convention to cases involving oil taxation should be addressed to:

Jane Whittles
Telephone 0171 438 7579
Fax 0171 438 6910

at

Oil Taxation Office
Melbourne House
Aldwych
London WC2B 4LL

SELF ASSESSMENT TAX RETURN: EMPLOYMENT PAGES AND TAX EQUALISATION

Advisers to foreign national employees working in the UK can face particular difficulties with the SA Employment Pages. These can become still more complex where their clients are tax equalised. In consultation with tax practitioners the Inland Revenue has agreed some practical measures to make the completion of SA Returns for tax equalised individuals more straightforward. Special instructions for the Employment Pages have been written to take account of the taxpayers' circumstances.

This article gives details of those instructions and agreements in advance of publication of a fully revised print of Help Sheet IR212.

Tax Equalisation - a definition

Tax equalisation can take various forms and is therefore difficult to define precisely. The term is used in this article to describe an arrangement between an employer and a foreign national employee working in the UK under which :

- the employee is entitled to a net amount of cash. Non-cash benefits may also be provided **and**
- the employer undertakes to meet some or all of the UK income tax arising from the emoluments **and**
- the employer provides the services of a professional adviser to deal with the individual's UK tax affairs.

Help Sheet IR212 "Tax Equalisation"

Help Sheet IR212 has been rewritten for 1997-98 as a guide for practitioners. It assumes a working knowledge of the Schedule E rules as they apply to foreign nationals and sets out the instructions and agreements described below. The new leaflet will be available for April 1998.

The Employment Pages - amended instructions for a tax equalised individual

Boxes 1.1 - 1.5 Individuals assigned to work in the UK by an overseas employer should:

- enter details of the UK company which is benefiting from their services in 1.1 - 1.5, **and**
- enter details of the off-shore principal employer in Additional Information.

Box 1.8 Ignore the descriptor for this box on page E1. Enter:

- the aggregate of cash emoluments, **plus**
- grossed up tax on cash and non-cash benefits.

For tax equalised employees the figure reported is unlikely to be the same as the P60 pay figure.

Box 1.9 Ignore the descriptor for this box on page E1. Enter chargeable amounts of emoluments received in 1997-98 though earned in an earlier or later year. See Agreement (4) below. If an agreement is reached with the local Inspector this income may be included in box 1.8.

Box 1.10 Ignore the descriptor for this box on page E1. Enter in box 1.10 any emoluments paid in an earlier year which are liable to income tax only under Case III of Schedule E if they are "received in" the UK and in 1997-98 there were remittances to the UK.

Boxes 1.12 - 1.23 should be completed in accordance with the guidance "Notes on Employment" pages EN3 - EN6.

Box 1.31 Amounts entered in box 1.31 may be an aggregate of:

- emoluments outside the scope of Schedule E,
- emoluments potentially chargeable under Case III of Schedule E which were not remitted to the UK in 1997-98,
- amounts not charged to UK income tax as they are subject to a claim under a Double Taxation Treaty. Treaty exemption claims should be made using Help Sheets IR 302 or IR 304. However, in certain circumstances the treaty exempt emoluments may be shown in box 1.8 with a deduction in box 1.31. An explanatory note should be added in Additional Information. See Agreement (7) below.

Box 1.35 This may be used by individuals in receipt of foreign emoluments to claim relief for "corresponding payments". Payments which are relieved in terms of tax may be claimed at Q15 on the Return. An accompanying note should be made in Additional Information setting out details of the payments.

Agreements

1. Continuation of full in-year gross-up

Full in-year gross-up computations may be prepared and used on the Self Assessment Tax Return for individuals who are contractually entitled to net cash and non-cash emoluments, and to have their UK tax liability met by the employer.

2. P11D filing date

Where an employer has entered into an agreement with the Inland Revenue under Regulation 102 Statutory Instrument (SI) 1993 No.744, the "Modified PAYE Arrangement", and the relevant employees agree, forms P11D need not be filed until 31 January of the year following the Return year.

3. Schedules of P11D information

An employer may agree with the local Inspector to submit P11D information in the form of a schedule. Schedules should follow the layout of form P11D and use the same box numbers. A certificate should be provided stating that the particulars are fully and truly stated according to the best of his knowledge and belief. The Inland Revenue will not accept a copy of the Employment Pages boxes 1.12 - 1.23 as a substitute P11D.

4. Performance Bonuses

The Inland Revenue has accepted that an Inspector may enter into an operational agreement with a taxpayer or adviser to:

- accept cash or receipts basis for the treatment of bonuses, as opposed to apportioning bonuses over the performance period, or
- accept accounting period bonuses or calendar year bonuses as being co-terminous with a fiscal year, or
- apportion only years of arrival and departure, with mid-assignment years being taxed on receipts basis.

The basis agreed must be applied consistently.

5. Global Settlements

The Inland Revenue no longer operates arrangements which allow employers to offset the tax overpayments and underpayments of different employees and remit a single balancing payment. However, where a number of employees are all underpaid, an employer may remit one sum together with a schedule showing the Unique Taxpayer References of the taxpayers and the amount with which they are to be credited.

6. Payments on Account

The Inland Revenue have agreed that employees covered by an arrangement made under Regulation 102 SI 1993 No.744, the "Modified PAYE Arrangement", need not make payments on account.

7. Double Taxation Treaty Exemption

Help Sheets IR302 and IR304 require a declaration of the amount of income which is claimed to be treaty exempt. The Inland Revenue have agreed to accept a best estimate of exempt income. However, where a claim is made in respect of a "Students/ Business Apprentices" Article, precise figures are required so that a comparison can be made with the accepted levels published in Statement of Practice 4/1986.

8. Multiple Employments

An individual who holds two or more employments which are not "associated" for the purposes of paragraph 2(3) Schedule 12 and Section 416 Income and Corporation Taxes Act (ICTA) 1988, need complete Employment Pages only in respect of employments from which:

- he receives emoluments in the year and remits them to the UK, **or**
- he remits emoluments to the UK which were received in an earlier year.

Where the employments are "associated" Employment Pages should be completed for all of them although the amount of detail required may vary. You should contact the local Inspector for advice.

9. Tax Return for years of arrival and departure

In the year of arrival an employee is likely to be Not Resident (NR) before coming to the UK and Resident and Ordinarily Resident (R/OR) or Resident and Not Ordinarily Resident (R/NOR) thereafter. In the year of departure this order will be reversed; R/OR or R/NOR to the date of emigration and NR thereafter. Only report emoluments arising:

- after the date of arrival in the arrival year, **or**
- before the date of departure in the year of departure

on the Employment Pages.

The following exceptions apply:

- if, in the year of arrival, but before the assignment commenced, the foreign national has worked in the UK, emoluments arising from those UK duties should be included on the Employment Pages,
- if, in the year of departure following permanent emigration, the individual works in the UK, emoluments arising from those UK duties should be included on the Employment Pages.

Associated Points

Cessation of Employment or Permanent Emigration

Where an employee completes his assignment and permanently leaves the UK during the reporting year, form P85 should be sent to the Tax Office. A Tax Return may be requested so that in-year settlement can be computed. If Returns for the year are not available, a copy of the previous year's form, annotated with the correct dates, may be filed. Updated computer generated forms may be used. There is no statutory obligation for the Tax Return to be sent back before the normal filing date for the year.

Contact with the Inspector

Agreement should be reached with the local Inspector before Tax Returns prepared on the basis of an Agreement or practice described above are filed. Any technical view taken or basis used in the Tax Return which diverges from that set out in Notes on Employment should be described in "Additional Information".

Further Information

Tax advisers with practical difficulties may write to:

IR Personal Tax Division
Sapphire House
550 Streetsbrook Road
Solihull
West Midlands
B91 1QU

SELF ASSESSMENT - CALCULATION OF PAYMENTS ON ACCOUNT FOR 1997-98: THE 80% PROPORTION

It has been pointed out to us that the section in the tax calculation working sheet of the 1996-97 return which helps taxpayers to decide whether they have to make payments on account for 1997-98 (boxes W64A to W69), could produce the wrong result for a small number of taxpayers.

We are grateful to those accountants who have drawn this to our attention, in particular a firm in Belfast who we think were the first to notice it.

Taxpayers who may be affected will be those who have most of their tax deducted at source, and who also

- are treated as having paid notional tax (for example on UK scrip dividends) - entered in box W44 of the tax calculation working sheet, and/or
- made payments under charitable covenants, annuities or Gift Aid - entered in box W48 of the working sheet.

So self-employed taxpayers are unlikely to be affected unless a large proportion of their total taxable income has suffered deduction of tax at source.

Under Section 59A Taxes Management Act 1970 payments on account are calculated by reference to a 'relevant amount' of the income tax assessed for the previous year. The relevant amount is the amount by which the total income tax contained in a person's self assessment, after allowances and reliefs, exceeds the amount of tax deducted at source (including, for example, notional tax on scrip dividends etc).

Taxpayers will not have to make payments on account for 1997-98 if 80% or more of their total income tax assessed for 1996-97 was tax deducted at source (or alternatively if their total income tax less deductions at source for 1996-97 was below £500). In order to establish the total income tax for 1996-97 for this purpose all amounts assessed need to be reflected, including notional tax and the tax recoverable on charitable covenants etc.

The note on box W44 of the tax calculation working sheet explains that notional tax is not repayable, and so has to be calculated as an allowance given in terms of tax rather than being regarded as tax deducted at source. This reflects the fact that, for the purposes of the Self Assessment calculation there is a distinction between tax paid at source,which is available for repayment, and tax which is not repayable. In the Self Assessment calculation therefore the figure for total income tax in box W47 is reduced for the amount of non-repayable tax. But that amount needs to be added back to the figure for total income tax in calculating the 80% proportion to establish whether payments on account need to be made.

In the case of payments under charitable covenants, annuities or Gift Aid, the recoverable tax (at basic rate) on these amounts is added back at box W48 in arriving at the total income tax due, as explained in the note on box W48, and the same adjustment also needs to be made to the total income tax figure in the calculation of the payments on account.

Boxes W66 to W69 in the tax calculation working sheet are used to calculate whether or not payments on account are needed (once it has been established that the amount in box W65 is equal to or more than £500). For this purpose box W66 includes the amount of income tax due after allowances and reliefs, described as the amount 'from box W47'. However box W47 does not include notional tax (as in box W44) or recoverable tax on charitable covenants, annuities and Gift Aid payments (as in box W48). The amount entered in box W66 should therefore include not just the amount from box W47 but also the amount from box W48, and the amount from box W44 less the figure in box 4.74 (notional partnership tax) which is already reflected in this aspect of the calculation of the payments on account, at box W64A.

Revenue staff involved in capturing returns have been alerted to the problem. Where such a return is identified during processing, they will amend the figures to ensure the right result in the calculation of payments on account. Agents are asked to draw their local Inspector's attention to any return that may require this approach to be adopted during processing.

USE OF 'PENCE' IN SELF ASSESSMENT TAX RETURNS

We have recently received a number of letters asking us to clarify our policy regarding the inclusion of 'pence' in entries in Self Assessment Tax Returns. Having reviewed the issue we now accept that the guidance in the 1996-97 return form is not as clear as it ought to have been. We are sorry for this, and for any inconvenience that it may have caused.

The statement below explains the correct position. It also explains the action we have taken to ensure that taxpayers do not receive unnecessary 'Revenue corrections' - corrections whose only purpose is to 'correct' rounding adjustments made in good faith, on the basis of the guidance in the return.

When entering figures in the SA tax return should I enter precise figures, including pence, or should the figures be rounded to pounds in some way?

We believe that people generally expect financial calculations to be as precise as possible. So whether we are calculating an amount of tax payable to us, or a repayment due to a taxpayer, our tax calculations will result in a figure that includes both pounds and pence. And as our software calculates figures in pounds and pence we have asked commercial software designers to do the same (whether designing software for use with the Electronic Lodgement Service or to generate substitute returns).

Nonetheless, we have had a long standing practice of allowing taxpayers to round certain figures, by excluding pence, when completing a Tax Return. This practice applies where tax has been deducted at source and allows taxpayers to round down income and to round up the associated tax credit.

We realise now that our message - “please do not include pence” - on the 1996-97 Tax Return is not as clear as it should have been. What we **meant** to say was “please do not include pence - by rounding down your income and gains and rounding up your tax credits and tax deductions” following the long established practice. (Where an entry in a particular box in the Tax Return requires the aggregation of income and credits from several sources, it is the aggregate figure that should be rounded.) And we should have made it clear that pence could be included in returns generated using return software. (Some commercial software packages require precise figures to be entered, others work to rounded pounds.)

We also realise that, in the first few months of returns processing, taxpayers may have received correction notices (forms SA302) where they followed the instruction in the return literally, and just ignored pence, because our software works to the penny. We regret any inconvenience this may have caused. Our policy now is:

- to accept paper returns which have been completed without pence, and
- to ensure that our staff do not “correct” returns for small amounts or include pence which you have deliberately excluded in accordance with the Tax Return guidance.

Guidance has been issued to the offices dealing with returns so that the appropriate procedures are in place before the first filing peak in September 1997.

Where calculating tax, any rounded figures will be accepted and, unless some other discrepancy is identified, those figures will appear on the taxpayer’s statement in due course. Our staff, and not the system, decide when to correct figures and when to accept them. That helps us deal with the variety of ways taxpayers are completing their returns in this first year of Self Assessment.

If there is an obvious mistake to be corrected, our software will calculate the liability automatically, using the return entries with the exception of box 18.3 and any corrected figures. The automatic calculation will include pounds and pence.

We will modify the Tax Return guidance for 1997-98 to make it clear how we expect taxpayers to complete the return.

VENTURE CAPITAL TRUST SCHEME: CO-INVESTMENT AND THE CONTROL RULE

In the venture capital industry it is not uncommon for two or more concerns (“co-investors”) to invest in a company alongside each other. Where one of them is a Venture Capital Trust (VCT) co-investment may carry with it a risk that the VCT’s holding will not be a qualifying holding. This article explains why this is so, and in particular gives our views on the application of Section 839(7) Income and Corporation Taxes Act (ICTA) 1988 in situations involving co-investment.

It may be helpful to begin by sketching in the background. A VCT needs to ensure that by the end of a certain period at least 70% of its invested funds take the form of qualifying holdings. That is, holdings of shares or securities in companies which satisfy certain requirements which are set out in Schedule 28B, ICTA 1988. One of these requirements, to be found in paragraph 9(1)(b) of that Schedule, is that the company invested in must not be under the control of another company. Such a company could, of course, be the VCT itself. To prevent this condition from being sidestepped, the requirement is extended to cover control by another company and any person or persons connected with that other company. Paragraph 13(4) applies Section 839 to decide whether a person is connected with a company for this purpose.

For the purpose of determining whether the company invested in is controlled by another company, paragraph 13(2) applies Section 416(2)-(6) ICTA 1988, subject to the modification mentioned in the next paragraph. Section 416(2) defines control widely, to cover possession of (or entitlement to acquire) the greater part of the company’s issued share capital or voting power, entitlement to the greater part of the company’s income if the whole of that income were to be distributed and entitlement to the greater part of the company’s assets if it were to be wound up.

It was recognised that in some circumstances these tests would make it difficult for worthwhile investment to qualify, so under Section 161, Finance Act 1996 a modification was made. This provides that in applying the control rule certain preference shares and loans are to be left out of account. This relaxation gives a VCT a way of investing in a company, or of co-investing in it with another person, as much as the company needs (subject to the £1,000,000 limit on the VCT's own investment), even if the amounts invested constitute the greater part of its capital.

In view of the freedom provided by this relaxation, it may not be necessary to consider whether the investments made by the VCT and any co-investor are, in aggregate, sufficient to give them control of the company as defined. But if it is necessary, the question will be whether they are "connected" with each other by virtue of their **"acting together to secure or exercise control"** of the investee company (Section 839(7)). If they are, the VCT's investment in that company will not be a qualifying holding.

The sort of co-investment with which this article is concerned may occur, for example, where a venture capital house has a policy of offering each investment opportunity to all investing companies in its group or associated with it, or where an investment is syndicated among otherwise unconnected venture capital companies. This article gives our view on the application of Section 839(7) in such circumstances. It addresses only those circumstances, and no part of it should be assumed to be relevant in any other context.

Where venture capital companies which co-invest in a company have no connection with each other and do not create any mechanism which would facilitate the employment of their combined voting power, it is unlikely that they could be said to be acting together as set out in Section 839(7). Syndicating an investment would not, in itself, normally cause the parties to be regarded as connected.

Among the factors that we would view as possible indications that co-investors might be "acting together" in relation to a company are:

- equal shares by the parties in the entire voting share capital of the company;
- the fact that the company was newly formed and was financed wholly by the parties;
- the use by both parties of the same investment manager; or
- the promotion of the VCT by a company which is in the same group as the co-investing company.

Where any of these factors is present the Inspector can be expected to scrutinise the arrangements carefully.

Of the factors listed above, the third (the use of a common manager) calls for special comment. Where the co-investors together will hold the greater part of the company's issued ordinary share capital, they will be aware of that from the outset. The appointment by each of them of the same person to manage their respective investments will assist communication between them, and it is likely that the manager would have to take on the role of ironing out any disagreements between them. In these circumstances we see the appointment of a common manager as creating a mechanism of the type referred to above.

A company which is hoping to receive funding from a VCT may apply to its own Inspector of Taxes for a provisional view as to whether it will satisfy the requirements set out in Schedule 28B. Where the VCT has a co-investor and there is a possibility of joint control, the company will need to obtain from prospective investors copies of any documents or draft documents bearing on their relationship so that they can be produced to the Inspector. We consider that where any of the circumstances listed above are present, the onus will be on the VCT to show that each of the co-investors intends to use its voting power in its own interests and without regard for the interests and wishes of the other.

Of course, if the VCT's investment in an investee company is not a qualifying holding at the outset, it is still possible for it to become a qualifying holding at some later time if changes can be made which would bring it within the rules. Furthermore, the failure of a holding to qualify will not normally be of any consequence, even if it causes the proportion of funds invested in qualifying holdings to go below 70%, if it is rectified within the initial period (up to three years) during which the approval of a VCT is only provisional.

interpretations

FURNISHED HOLIDAY LETTINGS - SECTIONS 503/504 ICTA 1988 AND LOSS RELIEF CLAIMS UNDER SECTION 381 ICTA 1988

We have been asked, following the Special Commissioners Decision in ***Brown v Richardson - (1997) Sp C 129 -*** for our views where losses are claimed in furnished holiday letting cases (Sections 503/504 Income and Corporation Taxes Act (ICTA) 1988) under Section 381 ICTA 1988.

Brown v Richardson

In ***Brown v Richardson***, the taxpayer acquired, with his wife, a property in Cornwall which was funded - including the cost of furniture and fittings - entirely by a mortgage secured on his main residence. The mortgage application indicated that part of the advance was required to purchase a "holiday home". Under the terms of a partnership agreement, profits from the Cornwall property were to be split equally between husband and wife, but any losses were to be allocated wholly to the husband. Loss relief, which arose primarily because of the significant finance charges, was claimed for the years 1992-93 to 1995-96 inclusive under Section 381 ICTA 1988.

The Special Commissioner rejected the argument advanced by the taxpayer that the word "profits" in Section 504(2) means the profits as calculated for tax purposes. Instead he took the view that profits should be defined in commercial terms, as distinct from profits which may be charged to tax under a particular Schedule or Case in a Schedule. In this case, the Special Commissioner found that the taxpayer's expectation of making an income profit was unrealistic.

Furthermore, the Special Commissioner decided that the taxpayer bought the property primarily as a holiday home (for the years in question, he and his family occupied the property in Cornwall for periods not exceeding 6 weeks in any 365 day period). Although the letting of this property was "commercial" (a letting agent, for instance, was engaged at the outset), it was *"...effected, however, with a view to generating revenue to offset costs rather than with a view to the realisation of profits."* Consequently, the letting failed to qualify for relief.

General approach

Cases of this kind turn on their own particular facts. In this one, there was evidence on which the Special Commissioner could come to his decision. But the decision supports our view that:

- "profits" in Section 504(2) means the "commercial" and not the "tax adjusted" profit;
- a taxpayer's expressed intentions are not necessarily conclusive. There may be evidence which points to a motive other than the income profit motive (such as a holiday or retirement home, or a long term capital profit on the disposal of the property);
- where there is evidence to suggest that a property or caravan was acquired primarily as a holiday or second home, the letting activity is likely to be carried on with a view to generating income to offset costs rather than with a view to the realisation of profits. This principle may apply equally to claims for losses incurred in some trading activities such as farming and other activities where there may be non-commercial considerations;
- claimants may fail the test in Section 504(2) where, as in ***Brown v Richardson***, the size of the mortgage used to purchase the property or caravan is so large that the projected profitability is jeopardised or the commercial credibility of the scheme as a whole is, consequently, questionable even though individual lettings are on a commercial basis.

In these cases, we would expect a written business plan to be prepared *at the outset* as was so in the earlier Special Commissioners case of ***Walls v Livesey - (1995) Sp C 4***. The figures in such a plan must be credible. In ***Brown v Richardson***, the taxpayer made no formal projections of the expected income but said he had made projections which (as an accountant) he was able to carry in his head. However, his projections did not take into account inflation or contingent expenses and showed a fall in general expenses after excluding agents commission.

Section 381 ICTA 1988

Where the claim is under Section 381 and Section 504(2) *is* satisfied, the loss claim may fail the stricter test of Section 381(4). For that test to be satisfied, there must be a reasonable expectation of profits in the period concerned or in a "reasonable time thereafter".

We take the view that this test must be considered for each year for which relief under Section 381 is claimed and that it is necessary to look at the year of loss and whatever, on the facts, is a reasonable time thereafter. In ***Walls v Livesey***, the Special Commissioner observed that relief under Section 381 is available so long as profits may be expected not later than a reasonable time after the end of the four year period for which claims under this section are possible. We do not construe the section in this way, although on the particular facts in ***Walls v Livesey***, relief may be available in those circumstances. Indeed, in that case, on the facts as found, a profit could reasonably have been expected in a significantly shorter period.

We consider that "reasonable time" depends on the facts and, particularly, the nature of the loss making activity. In general, our view is that this should be a fairly short period. But, in the context of capital intensive activities, such as furnished holiday lettings, we would normally expect there to be a reasonable and realistic expectation of profits emerging within five years from the date of the commencement of the activities.

miscellaneous

DOUBLE TAXATION RELIEF: UNDERLYING TAX IN RESPECT OF PRE-MERGER PROFITS

Under Double Taxation Agreements and domestic law, in Section 790(6) Income and Corporation Taxes Act (ICTA) 1988, if a UK company receives a dividend from an overseas company the UK company may claim credit relief for underlying tax. This is tax paid by the overseas company on the profits out of which it pays the dividend to the UK company. It is a condition of the relief that the UK company controls at least 10% of the voting power in the overseas company which pays the dividend.

Under Section 801(2) and (3) ICTA 1988 relief is also allowed for underlying tax paid at lower levels in a chain of companies. Relief is allowed for underlying tax paid by a company which pays a dividend to the company above it in the chain. The 10% control test mentioned above must be satisfied for each link in the chain.

Both Double Taxation Agreements and domestic law require that, if relief for underlying tax is to be allowed, the tax is paid by the same company which pays the dividend. That condition may not be satisfied if overseas company A earns profits and pays tax on them but then merges with overseas company B in such a way that company A ceases to exist and its undistributed profits are taken over by company B. If company B then pays a dividend to a UK company out of profits earned by and taxed on company A, then the UK company may not be able to obtain relief for underlying tax paid on those profits. This is because there is no common identity between the company which paid the tax on those profits (company A) and the company which pays the dividend out of those profits to the UK company (company B). Similar problems arise if the merger takes place at a lower level in the chain.

We have recently had occasion to consider the effect of a merger between two overseas companies where the merger was governed by the company law of New Jersey (Sec 14A: 10-1 to 10-8). A merger took place between corporations X and Y, and corporation Y was the "surviving corporation". We accepted that the effect of the New Jersey law was that corporation X continued to exist post-merger in surviving corporation Y, albeit in altered form. Consequently we agreed that the tax paid before the merger by corporation X in respect of profits that were distributed after the merger by corporation Y could be regarded as tax paid by corporation Y for the purposes of a claim to relief for underlying tax.

Claims that other foreign company laws concerning mergers should lead to the same conclusion should be sent, as part of the claim to relief for the underlying tax concerned, to:

DT (Rates) Section
Financial Intermediaries and Claims Office
Fitz Roy House
PO Box 46
Nottingham NG2 1BD.

The claim should be supported by expert evidence about the true construction of the relevant foreign law, together with copies of any authorities cited in support, including relevant Court decisions.

MILK QUOTA CUT COMPENSATION

In 1991 there was a permanent cut in milk quota. Compensation for the cut was paid in 5 instalments over the period 1992 to 1996. These instalments are capital receipts and are liable to Capital Gains Tax in the year of receipt (CG77924).

Following a visit from the European Court of Auditors and the revision of guidance issued by the European Commission, the amounts of compensation paid in the years 1993 to 1996 (instalments 2 to 5 of the 1991 cut) were recalculated. The outcome of this recalculation was an additional payment to all those who had their quota cut in 1991.

A single payment was made to producers covering the four instalments affected. To the extent that this payment represents compensation for the milk quota cut, it is a capital receipt liable to Capital Gains Tax in the year of receipt (normally 1996-97 but a few payments were made in 1997-98).

The payment also included an element described as "compensation in lieu of interest", calculated at London Interbank rates (LIBOR) + 1%. The right to the compensation existed throughout but the amounts were, initially, wrongly computed. The additional element is payment which has become due because the creditor has not had his money at the due date. As such, this amount is interest liable to income tax under Case III of Schedule D for the year in which it is received.

The Intervention Board has provided farmers with a breakdown of the total distinguishing the interest.

PENSION SCHEMES OFFICE: SYNOPSIS OF UPDATES

The Pension Schemes Office (PSO) has recently issued four further Updates to all practitioners on the PSO mailing list: Updates No 28 and 29 were issued on 29 August 1997 and Updates No 30 and 31 on 5 September 1997.

PSO Update No 28 covers the issue of the new version of the Practice Notes known as the IR12(1997). The new edition incorporates all the changes announced in earlier PSO Updates, since the issue of the previous version of the Practice Notes in January 1995, together with various other changes and clarifications of existing practice.

PSO Update No 29 is concerned with a number of miscellaneous topics:

- Applications for tax approval of occupational pension schemes - The opportunity has been taken to remind everyone of what constitutes a valid application for tax approval, and the timescale for submission of applications if approval is to be granted from the date of commencement of the scheme.

- Rule amendments : The Pensions Act 1995 - Explains the effect of The Pensions Act on pension schemes. In particular, whether specific arrangements or rules required by that Act are treated as alterations for the purposes of the Taxes Act and whether other alterations/changes should be notified to the PSO.

- Large self-administered schemes - Although the Information Powers Regulations (Statutory Instrument (SI) 1995 No 3103) require the submission of actuarial valuation reports (AVRs) within 2 years of the effective date of the valuation without the need for PSO requests or reminders, the Update advises that the PSO propose to issue one reminder to the practitioner and one to the scheme administrator before the AVR or certificate becomes overdue. The new procedures started on 1 October 1997 for AVRs subject to the Regulations, but earlier AVRs, with effective dates prior to 1 January 1996 which are still outstanding, will be pursued under the old reminding procedure leading to the possible withdrawal of approval for continued failure.

- Small self-administered schemes (SSAS) - The Update notifies the withdrawal, with effect from 27 November 1997, of the concession referred to at Note 3 of the form PS7012 whereby further time was allowed for the production of a copy of the lease. From that date a copy of the lease must accompany the notification and the form PS7012 is being amended accordingly.

- Reporting of chargeable events - Advises that it is the responsibility of administrators to ensure that chargeable events are reported to the Inspector of Taxes who deals with the tax affairs of the pension scheme on the specified form 1(SF)(3/97) within 30 days of the end of the tax year in which the event(s) occur (Regulation 10 of the Information Powers Regulations refers). Copies of the specified form should be requested from the Inspector of Taxes as one will not be issued automatically.

- PSO reference numbers - Reminds customers to quote the SF reference number of a pension scheme in all correspondence about that scheme. If it is not known quote the name of the principal employer as well as the scheme title.

- Performance targets - Sets out the main PSO performance results for the year 1996-97 and the targets for the year 1997-98.

PSO Update No 30 is concerned with Self Assessment and exempt approved self-administered schemes.

PSO Update No 31 is concerned with two topics: “Use of pension schemes for tax avoidance” and “Subordinated loan agreements”. The first extends the requirement to obtain prior written PSO consent to cover transfers **from** small self-administered schemes to any of the arrangements listed in paragraph 10.23 of the Practice Notes (IR12 1997) as well as transfers **to** such schemes. The second topic relates to loans by trustees to a member of a Self Regulating Organisation (SRO). Such loans may need to meet certain specific requirements of the SRO. However, a loan made by the trustees of a small self-administered scheme must not be the subject of any requirements which would prevent the immediate repayment of the loan.

INLAND REVENUE REORGANISATION: LARGE BUSINESS OFFICE

An Advisory Group was formed in May 1995 by the Deputy Chairman, Steve Matheson, to look at the work, staffing and organisation of the 70 Tax Districts responsible for the Department’s largest and most complex cases.

In November 1995, the Advisory Group published its first report setting out a number of options for change, including a recommendation that the 70 Districts should eventually be brought together within a single management structure.

As an interim step, from 1 April 1996, the 70 Districts were brigaded into 15 Large Business Offices (LBOs) within the existing Regional Executive Office structure.

Since their formation, the LBOs have adopted a new operating structure with greater sharing of resources and work, and more widespread teamworking than previously. They have also increasingly co-ordinated an integrated approach to all aspects of work for each major group of companies with which they deal, as well as developing peer group support techniques to review and discuss working cases, and to improve quality.

These developments have substantially progressed the Department’s continuing drive to understand better the large corporate sector and to help that sector comply with its tax obligations.

The Departmental Management Board has now agreed that the change programme should proceed to the next stage, and that all of the LBOs should be brought under a single command by 1 April 1998.

Once in place, this new single structure will be called the Large Business Office (LBO). The Controller will be Marjorie Williams, currently Controller of the Large Groups Office.

The Management Board believes that this next step will further improve operational efficiency and accountability and make these Offices even better able to respond to new challenges in the areas in which they work.

Inland Revenue Statements of Practice and Extra-Statutory Concessions issued between 1 August 1997 and 30 September 1997.

There are no Extra Statutory Concessions or Statements of Practice for this period.

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 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, Jeremy Sherwood, Room 402, 22 Kingsway, London WC2B 6NR. 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 1997 is £20. 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".

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Inland Revenue

This is a copy of an article to be published in the October issue of Tax Bulletin. As this was a late item, please note that it is not included in the information sheet.

CALCULATION OF PAYMENTS ON ACCOUNT FOR 1997-98: THE 80% PROPORTION

It has been pointed out to us that the section in the tax calculation working sheet of the 1996-97 return which helps taxpayers to decide whether they have to make payments on account for 1997-98 (boxes W64A to W69), could produce the wrong result for a small number of taxpayers.

We are grateful to those accountants who have drawn this to our attention, in particular a firm in Belfast who we think were the first to notice it.

Taxpayers who may be affected will be those who have most of their tax deducted at source, and who also

- are treated as having paid notional tax (for example on UK scrip dividends) - entered in box W44 of the tax calculation working sheet, and/or
- made payments under charitable covenants, annuities or Gift Aid - entered in box W48 of the working sheet.

So self-employed taxpayers are unlikely to be affected unless a large proportion of their total taxable income has suffered deduction of tax at source.

Under Section 59A Taxes Management Act 1970 payments on account are calculated by reference to a 'relevant amount' of the income tax assessed for the previous year. The relevant amount is the amount by which the total income tax contained in a person's self assessment, after allowances and reliefs, exceeds the amount of tax deducted at source (including, for example, notional tax on scrip dividends etc.).

Taxpayers will not have to make payments on account for 1997-98 if 80% or more of their total income tax assessed for 1996-97 was tax deducted at source (or alternatively if their total income tax less deductions at source for 1996-97 was below £500). In order to establish the total income tax for 1996-97 for this purpose all amounts assessed need to be reflected, including notional tax and the tax recoverable on charitable covenants etc.

The note on box W44 of the tax calculation working sheet explains that notional tax is not repayable, and so has to be calculated as an allowance given in terms of tax rather than being regarded as tax deducted at source. This reflects the fact that, for the purposes of the Self Assessment calculation there is a distinction between tax paid at source ,which is available for repayment, and tax which is not repayable. In the Self Assessment calculation therefore the figure for total income tax in box W47 is reduced for the amount of non-repayable tax. But that amount needs to be added back to the figure for total income tax in calculating the 80% proportion to establish whether payments on account need to be made.

In the case of payments under charitable covenants, annuities or Gift Aid, the recoverable tax (at basic rate) on these amounts is added back at box W48 in arriving at the total income tax due, as explained in the note on box W48, and the same adjustment also needs to be made to the total income tax figure in the calculation of the payments on account.

Boxes W66 to W69 in the tax calculation working sheet are used to calculate whether or not payments on account are needed (once it has been established that the amount in box W65 is equal to or more than £500). For this purpose box W66 includes the amount of income tax due after allowances and reliefs, described as the amount 'from box W47'. However box W47 does not include notional tax (as in box W44) or recoverable tax on charitable covenants, annuities and Gift Aid payments (as in box W48). The amount entered in box W66 should therefore include not just the amount from box W47 but also the amount from box W48, and the amount from box W44 <u>less</u> the figure in box 4.74 (notional partnership tax) which is already reflected in this aspect of the calculation of the payments on account, at box W64A.

Revenue staff involved in capturing returns have been alerted to the problem. Where such a return is identified during processing, they will amend the figures to ensure the right result in the calculation of payments on account. Agents are asked to draw their local Inspector's attention to any return that may require this approach to be adopted during processing.