

Arctic justice

Although not entirely unexpected, there was much relief for accountants and many family businesses recently when five Law Lords announced their unanimous judgement on *Jones v Garnett*, otherwise known as 'the Arctic Systems case'. After losing an initial hearing before two Special Commissioners in 2004 and a subsequent High Court appeal in 2005, the taxpayers, Geoff and Diana Jones, succeeded in overturning the judgement at the Court of Appeal at the end of 2005. Finally, with the House of Lords also finding in favour of the Joneses, the three-year pursuit by HM Revenue & Customs (HMRC) has come to an end.

The Arctic Systems case

To recap, Mr Jones had been made redundant and decided to set up his own IT consultancy business. This was done via a company with Mr Jones as sole director and his wife as company secretary. Both subscribed for shares, which eventually were the means by which dividends were paid to both of them. Initially, the couple drew modest salaries and sought to minimise their Income Tax and National Insurance liabilities by reducing their remuneration to less than £10,000 pa, taking part of the remaining profits by way of dividends. HMRC argued that Mr Jones had created a settlement by allowing his wife to subscribe for shares and also by taking a depressed salary to leave higher profits for dividend purposes. In an effort to raise the rate of tax payable, HMRC then tried to tax Mr Jones on Mrs Jones' income.

HMRC argued that their efforts to seek a definitive ruling would only affect a small number of taxpayers. However, the accountancy profession pointed out that there are hundreds of husband and wife owned

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Forthcoming deadlines

November

▶30▶ Deadline for submission of corporation tax self assessment return form CT600 for companies with a 30 November 2006 year end.

December

▶30▶ Deadline to file your 2007 tax return electronically if you are an employee and wish to have a 2006/07 balancing payment of less than £2000 collected through your 2008/09 PAYE code. Date dependent on who is filing.

▶31▶ Deadline for submission of corporation tax self assessment return form CT600 for companies with a 31 December 2006 year end.

▶31▶ End of relevant year for taxable distance supplies to UK for VAT registration purposes.

▶31▶ End of relevant year for cross-border acquisitions of taxable goods in the UK for VAT registration purposes.

▶31▶ VAT reclaim deadline for UK claims by non-EU traders in respect of year ended 30 June 2007.

January

▶1▶ Corporation tax due for small companies for 31 March 2007 accounting period.

▶14▶ Deadline for submission of forms CT61 and payment of income tax for qualifying payments made in the quarter to 31 December 2007.

▶14▶ Installment of corporation tax due for large companies with 30 September 2007, 31 December 2007, 31 March 2008 and 30 June 2008 year ends.

▶19▶ Quarterly PAYE payment date for small employers. ▼

▶31▶ Balance of your 2006/07 personal tax due.

▶31▶ First instalment of payments on account for your 2007/08 personal tax due.

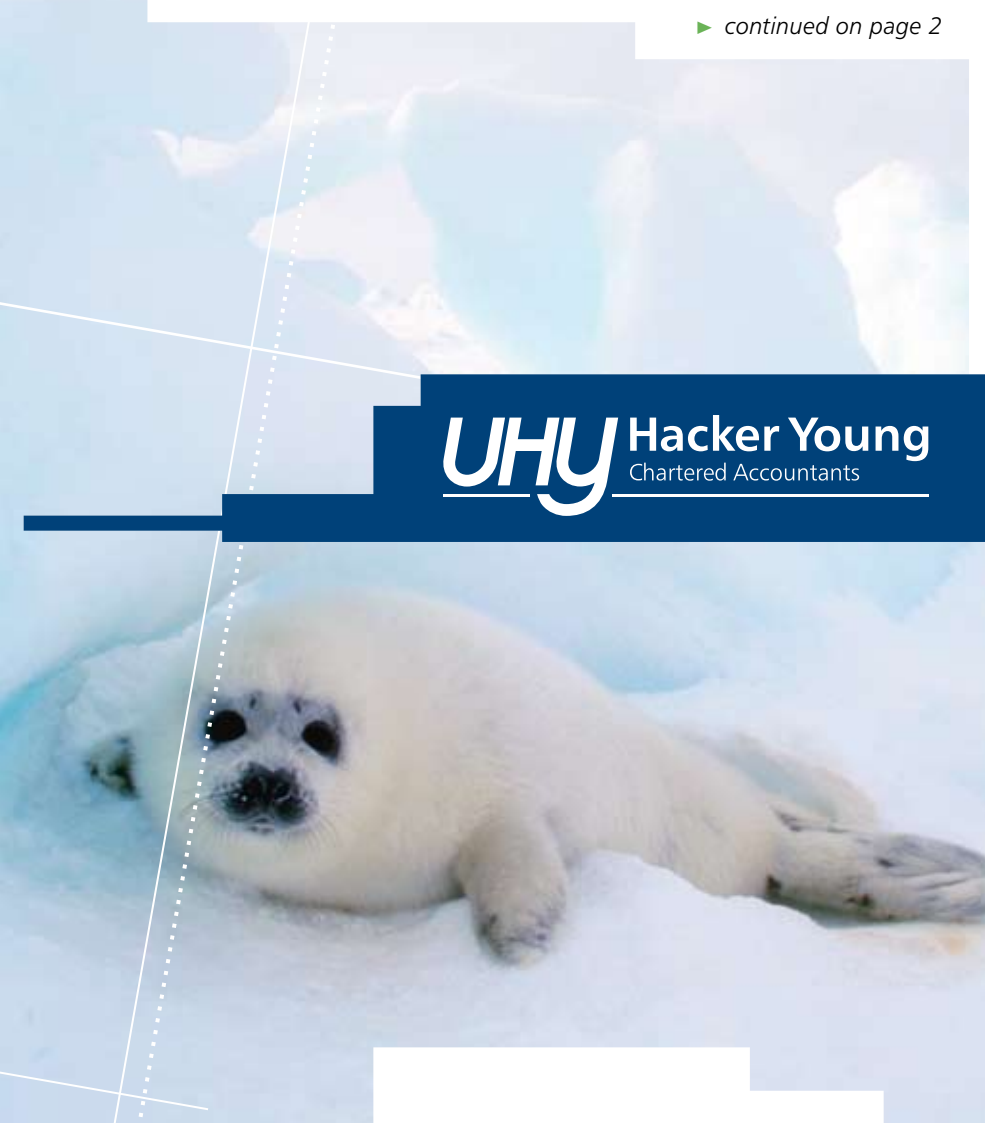
▶31▶ Deadline for submission of your 2006/07 partnership or personal self-assessment tax return with the tax due calculated.

▶31▶ Deadline for submission of corporation tax self assessment return form CT600 for companies with a 31 January 2007 year end.

▶31▶ Deadline for submission of VAT returns for the quarter to 31 December 2007.

Please see our website at www.uhy-uk.com for further forthcoming tax deadlines.

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companies registered at Companies House, many of which pay dividends to the proprietors, so the potential for incorrect personal self-assessment tax returns was huge. Thankfully, the House of Lords did not see eye to eye with HMRC so at least tax returns up to 5th April 2007 are now reasonably safe.

The future

But what of the future? Any result in the lower courts will now be bound by this House of Lords precedent and we doubt HMRC will want to go all the way to the House of Lords on another test case as this will take far too long. Whilst the Arctic Systems case journeyed through the Courts, we saw HMRC broaden their attack. From 1 April 2006, they removed the 0% rate band from small companies, having previously nullified its effect from 1 April 2004 by virtue of the special Non-Corporate Distribution rate (applying when dividends were paid to individual shareholders), as in the Arctic Systems case. Since then, HMRC have gone further by announcing that the small company corporation tax rate will be increased from 19% to 22% in 1% increments from 1 April 2007. Whether or not these existing changes will be sufficient to satisfy the appetite of HMRC, only time will tell, but beware forthcoming Budget announcements.

If you would like to discuss the implications of this House of Lords decision on your business, please contact your local UHY Hacker Young partner. ◀

Roy Maugham — tax partner, London

Research & development (R&D) tax credits — not the sole domain of blue-chip companies...

Nor does your business need a laboratory and white coats to qualify. Over recent years we have successfully made claims for our small business clients whilst handling their corporate tax affairs. Qualification, for which you must have a minimum R&D spend of £10,000 in a given accounting period, gives you an enhanced write off against your profit and loss account of up to 150% of actual costs for SMEs (175% from 1 April 2008). For larger companies this is currently 125%, increasing to 130% from 1 April 2008. Even if your business is loss making, you can surrender some of the loss for a tax refund worth up to 24% of actual expenditure.

However, interpreting what exactly constitutes R&D can be something of a 'grey' area. Below we have provided some clarity on the R&D tax credits scheme, outlining which costs qualify and which exemptions or clauses to be wary of.

So, what exactly constitutes R&D?

R&D is defined by the Department of Trade & Industry (DTI); the definition modifies accounting standard SSAP13 for tax purposes. In simple terms, R&D must provide a technological advance in overall knowledge or capability in a field of science or technology (not a company's own state of knowledge or capability alone) where there was scientific or technological uncertainty about its success. It can be a new or appreciable improvement to an existing process, material, device, product or service, and typically includes costs up to the development and testing of a prototype. R&D occurs even if two competing companies are working on the same idea in isolation, ie. trade secrets. Failed projects will still qualify, but the marketing and work on packaging for the item for example will not qualify as this does not resolve scientific issues.

Here are two illustrations of R&D from the DTI's guidelines:

- A firm's project involves finding a new active ingredient for weed-killer (an advance in overall knowledge or capability in the particular field of science or technology...), and developing a formula incorporating the new active ingredient for use in a commercial product.... Both of these would constitute an advance in science or technology.
- A company is seeking to make a water-breathable fabric for use in hiking gear. A test fabric with the required physical characteristics is produced through R&D. This new fabric is then produced in small quantities (not R&D) and market tested with a number of trial users. The user tests are not R&D, because they are concerned with testing

the commercial potential of the new material and assessing its appeal to users.

R&D costs that qualify include:

- employing staff who are directly and actively engaged in carrying out R&D, or paying a staff provider for staff who are directly and actively engaged in carrying out R&D;
- consumable or transformable materials used directly in carrying out R&D (broadly, physical materials which are consumed in the R&D process);
- power, water, fuel and computer software used directly in carrying out R&D.

Are there any exceptions or clauses limiting eligibility?

The SME scheme for R&D tax relief counts as notifiable state aid, and for that reason its availability is restricted to companies not in receipt of other notifiable state aids for the R&D project in question. Grants such as micro-enterprise awards are not always classed as notified state aid; the grant provider should be able to confirm its status.

You can currently go back six years to make a claim. However, the Finance Act 2006 introduced changes to limit the time to 12 months after the company return filing deadline (normally 24 months after the year end) and a transitional limit of 31 March 2008 for tax returns from 1 April 2002 to 31 March 2006 applies. Consequently, if you have not already done so, there are only a few months left to formulate and lodge your claim for periods up to 31 March 2006.

We know that preparation of R&D claims is labour intensive and additional time should be allowed, possibly even longer than for the basic return itself. A claim needs careful preparation and is subject to scrutiny and agreement by specialist HMRC teams, though the process is not as stringent as that in the US or Canada. Over 6,000 claims were received by HMRC in the year to April 2005.

We recently claimed for a client who is developing a programmable Smart Card. The research was part-funded by grant income and so relief had to be claimed under both the small and large company schemes, enabling our client to receive a much-needed refund from HMRC on one component, and on the other increasing the value of losses against future profits.

In addition to the enhanced reliefs described above, 100% capital allowances are available on qualifying R&D capital costs, regardless of whether the expenditure is capitalised or taken as a deduction in your profit and loss account.

Please contact your local UHY Hacker Young tax partner to discuss R&D tax credits in more detail. ◀

▲ **Rob Durrant-Walker** — tax manager, York



Foreign domicile— a hot topic

The UK's rather generous residence and domicile rules have been in place for many years and, until very recently, there had been no sign that the Government's long-running review of the system was ever likely to come to a conclusion. On 9 October 2007, however, the Chancellor stood up for his Pre-Budget Report and announced a series of changes that, if enacted, will radically alter the future tax treatment of non-domiciled individuals ('non-doms') and that will provide them (and their advisors) with a great deal to think about over the next few months.

Domicile rules in summary

'Domicile' is a concept under general law denoting the country regarded as an individual's permanent home. A domicile of origin is acquired at birth and is generally that of the individual's father. Although this can be displaced by a domicile of 'choice' or 'dependency', in practice such a change is not easily achieved. Someone born with a domicile within the UK is likely to remain UK-domiciled unless they become permanently resident elsewhere. Similarly, a foreign domiciliary may well be able to preserve their status despite long periods of UK residence. From the point of view of taxation the situation has been complicated by matters such as double tax treaties. With care and appropriate advice, however, a foreign domiciliary has historically been able to shelter non-UK source income and capital gains from UK tax by taking advantage

of what is known as 'the remittance basis'.

What effect will the latest announcement have?

The essence of the 9 October 2007 announcement is that, with effect from 6 April 2008, the favourable remittance basis regime will apply (subject to certain modifications) only if someone with foreign domicile has been resident in the UK for fewer than seven tax years. Those who exceed this limit will have to pay an annual fee of £30,000 for the remittance basis to apply; those who have been resident in the UK for 10 years or more may face a higher fee, the amount of which has yet to be fixed. In addition, those who use the remittance basis—whether by virtue of residence of less than seven tax years or as a result of paying the annual fee—will be denied the income tax personal allowance that is generally available to UK taxpayers (subject to an exemption for those with unremitted foreign income of less than £1,000).

The Chancellor unveiled a number of other changes that will affect the way in which the remittance basis works, the taxation of non-domiciliaries in relation to offshore trust and company structures, and the rules for determining whether an individual is resident here for a particular tax year. The announcements were lacking in detail, however, and it will not be until

draft legislation is published towards the end of the year that we will have a clearer idea of what will happen post-5 April 2008 (although even then there will be a consultation process and the possibility of further amendment).

What action should I take?

If you are a non-dom or non-resident, you will need to review your affairs in the light of these proposals. Those planning to come to the UK in the future will also need to be aware of their impact. It is likely that a significant number of non-doms will eventually decide that the £30,000 annual fee is not a price worth paying for taxation on the remittance basis. The decision, however, will rarely be a straightforward one. The sums will need to be calculated on an individual basis, bearing in mind that offshore structures may contain hidden tax charges. At the same time, of course, consideration will need to be given to the individual's intentions and the question of whether a claim to non-domiciled status continues to be appropriate.

Those likely to be affected by the new rules may want to hold back from reorganising their affairs to any great extent until the full details have become clear. However, you should

The Offshore Disclosure Facility ('the amnesty')—What should holders of offshore bank accounts be doing now?

After a blaze of publicity and a reported rush of registrations immediately prior to the deadline of 22 June 2007, things went rather quiet as far as the HM Revenue & Customs (HMRC) Offshore Disclosure Facility is concerned. For both those who registered and those who chose not to, however, there is plenty more to think about—not least the revelation that, having successfully forced the High Street banks to hand over details of customers who hold accounts with their offshore branches, HMRC has now asked 170 stockbrokers and wealth management firms to co-operate in a similar exercise.

Notification of 'an intention to make a disclosure' by 22 June 2007 was just the first step for those who decided to 'come clean' under the Offshore Disclosure Facility. The disclosure had to be made by 26 November 2007, it had to include a full summary of the tax due in respect of all irregularities, and it had to incorporate a declaration that the disclosure was correct and complete. The disclosure had to be accompanied by a settlement offer; payment of the tax together with interest and the 10% penalty had to be made at the same time. Those individuals and entities that met the 26 November deadline will be notified by HMRC, by 30 April 2008, as to whether their disclosure and

offer of financial settlement have been accepted, or, whether HMRC intend to investigate further.

HMRC will not accept a disclosure that they suspect is incomplete or materially wrong. Such cases, together with larger disclosures and those made by high-profile individuals, are likely to be subject to formal enquiries. A voluntary disclosure under the Facility does not protect the taxpayer from further HMRC action nor, in extreme cases, from prosecution (this is not a true amnesty). Clearly, those who registered under the Facility but then failed to make the appropriate disclosure by 26 November can also expect to receive an enquiry notice.

Holders of offshore bank accounts who did not register by 22 June fall into two categories—those who believed that they had correctly returned their income and gains and those who are hoping to evade detection. If you were, and are still, sure that you have no further tax to pay (for

example, because any offshore income has been correctly returned, or because you are not UK-domiciled and have not remitted any foreign income) you can probably sleep soundly. If you have any doubts, however, please take further advice.

What should I do?

For those simply keeping their fingers crossed, we would advise you to consider your position very carefully. HMRC received details of about 400,000 offshore account holders from the banks. They estimate that approximately 100,000 of these will yield further tax, of which some 60,000 have registered under the Offshore Disclosure Facility. That leaves them with about 40,000 cases to identify. HMRC have been working on this throughout the registration period and are already targeting a list of those suspected of serious fraud. Such cases will be dealt with by specialist investigation teams who will pass the most serious on to the prosecution team. It goes without saying that those who could have used the Disclosure Facility but chose not to are likely to face penalties higher than the 10% offered to those who came clean. Nevertheless, those who co-operate will still be treated more favourably and the way in which an enquiry or investigation, particularly the most serious, is handled can have a significant impact on the outcome. Just as before the 'amnesty' was announced, taxpayers making a voluntary disclosure will be treated less severely than those who are contacted by HMRC beforehand.

The Offshore Disclosure Facility was a first for the UK tax authorities and, from their point of view, it has already proved a success. Some 60,000 taxpayers have volunteered the fact that they have further tax to pay with minimal effort on the part of HMRC. Attention and resources can now be focussed on those who have not registered and who will be regarded from the outset as deliberate evaders of tax. Particularly where the sums involved are significant, these individuals should not expect an easy ride from HMRC.

It is anticipated that HMRC's renewed efforts with regard to stockbrokers and wealth management firms will, in due course, yield information relating to customers in a higher wealth bracket (including those who have conducted extensive sharedealings offshore) and that the tax yield, particularly now the 'amnesty' has passed, will be significant. If you are having second thoughts about your position, whether prompted by an approach from HMRC or just a feeling that the net is closing in, we strongly advise you to speak to us now. ◀

Mark Giddens — trust partner, London

STOP PRESS ▶ it has been revealed that HMRC is considering a second 'amnesty' for offshore account holders. This is unlikely to be as generous as the first and it will have to be worded such that those who come forward early are not disadvantaged. In the meantime the risk of enquiry remains and voluntary disclosure of liabilities is still strongly recommended.

bear in mind that there will then be a relatively small window of opportunity to make changes before April. We will be looking to review the affairs of clients and to provide further guidance generally as soon as we have a clearer idea of what will happen. There will, no doubt, be planning opportunities available, whether under the existing legislation or where there are gaps in the post-5 April 2008 regime. If you would like further information or assistance, please get in touch now with your usual UHY Hacker Young partner.

As a final point...

it should be mentioned that a foreign domicile for the purposes of income and Capital Gains Tax does not equate to a foreign domicile for Inheritance Tax. Inheritance Tax has its own concept of deemed domicile under which, in practice, residence here for just 15 years can bring overseas assets within the scope of UK death duties. Careful advice before this point is reached can secure significant tax savings. ◀

Mark Giddens — trust partner, London

VAT round-up

The following is a summary of recent VAT issues to hit the news:

Hotel deposits

The European Court of Justice has recently reviewed a case regarding the VAT liability of deposits retained by hotels when a customer fails to take up a reserved room. Supported by long-standing, and perhaps out-of-date case-law, HM Revenue & Customs (HMRC) have always argued that the service provided by a hotel should include keeping a room available for a possible late arrival and, therefore, a deposit is standard-rated irrespective of whether the customer takes up the room or not. However, in a recent case brought by a French hotel group, the European Court of Justice reversed that long-standing position and held that the retention by a hotel of a non-refundable deposit in the case of a customer 'no-show' is compensatory in nature and not payment for any kind of reservation service. As such the retained deposit is outside the scope of VAT.

Hotels that have accounted for output VAT on retained deposits in the past may be entitled to claim a refund of that VAT from HMRC. ◀

Partial exemption

VAT law on partial exemption refers to the recovery of input VAT based on the 'use' of costs; with 'use' generally being interpreted by the Courts as practical or physical use. However, in a case involving St Helens School, HMRC managed to persuade the Court that 'use' meant 'economic use', and that the costs in question had to be related to the proportionate income generated from the taxable and exempt activities. This decision significantly reduced the school's recovery of input VAT. Not surprisingly, the fact that this argument was in direct contradiction to the fundamental concepts of VAT did not seem to worry HMRC, nor did the fact that they had argued the exact opposite in previous cases, when it suited them, to raise additional revenue.

In the current climate, HMRC are energetically exploiting their successes against VAT avoidance to attack quite genuine arrangements where they can see a revenue-raising angle. In particular, any partially exempt business needs to monitor its VAT recovery calculations regularly to be prepared for a visit from the VAT inspector. ◀

VAT registrations

At last, HMRC seem to be taking the debacle over VAT registrations seriously. Treasury spokespeople have put their heads above the parapet and promised improvements in due course. That must be why they are closing two of the four registration units in the name of efficiency and 'response time management'. Like the Guinness advert, we wait...

Consultations

UHY Hacker Young's VAT specialists are currently involved in several formal Consultations with HMRC through our professional institutes. We are representing the interests of the mid-tier sector and owner-managed businesses in particular, in diverse areas such as:

- Powers, deterrents & safeguards
- Appeals & costs
- The future of the Option to Tax
- Correcting errors and the Voluntary Disclosure process
- Advance clearances
- The EU intrastat reporting system

Damages claims against HMRC

For a long time, HMRC have resisted taxpayers' claims for damages arising as a result of errors, on the grounds that they had no duty of care towards taxpayers and could not be held liable for errors by their Officers. However, when Neil Martin, a builder, sued HMRC for damages after errors were made in his Construction Industry Scheme application, the Court of Appeal found that HMRC does have a duty of care to taxpayers in certain circumstances and so were liable for damages. HMRC are expected to seek leave to appeal to the House of Lords in a bid to keep the floodgates tightly shut, however, the attitude of the Courts towards poor quality service from HMRC is clearly changing. ◀

▲ **Simon Newark** — VAT partner, London

Industrial Building Allowances

In the last issue of Tax Update, we reported on the Chancellor's plans to gradually withdraw relief for expenditure on industrial and agricultural buildings, over four years, from 1 April 2007, and abolish balancing charges and other allowances with effect from 21 March 2007. Since the announcement of these plans, the importance of establishing your entitlement to the relief and, indeed, the relevance of identifying the components of your building that qualify for the ongoing plant and machinery allowances, have been highlighted by a recent High Court case; Maco Doors and Windows Hardware (UK) Ltd.

Maco imported hardware, eg. locks, handles and other fittings, for double glazed doors and windows from its Austrian parent company. Although it did not subject the hardware to a process itself, which would have enabled it to qualify for Industrial Buildings Allowances (IBA), Maco stored the hardware products which would later be used to manufacture the doors and windows. Maco argued that the area used for storage was utilised as part of their trade, despite the company's revenue coming purely from the sale of the goods and not from storage services. The Court of Appeal agreed and held that IBAs should be allowed in respect of the building used for storage because the storage supported Maco's wholesale trading and was, therefore, officially part of its trade.

Before the Maco case, many thought that retail and some wholesale businesses owning a warehouse were unlikely to qualify for IBAs. Quite often, therefore, a business would set up a special company within its group, which would own the warehouse and establish a relevant trade to claim the allowances. The Maco case indicates, however, that part of a wider trade may nevertheless qualify.

If you own a building, such as a warehouse, and have not been claiming allowances because you thought you did not have a relevant trade, we suggest you discuss this with the UHY Hacker Young partner who deals with your tax affairs as soon as possible. If HM Revenue & Customs accept that the tax returns for your business or company contained an 'error or mistake', it may be possible to claim up to six years relief. ◀

Roy Maugham — tax partner, London

Victims of flooding

HM Revenue & Customs (HMRC) has set up a new helpline for anyone affected by this summer's floods. The helpline, on 0845 3000 157, has been set up to provide flood victims with help and advice on a range of tax problems they may be facing.

In addition to considering waiving interest and surcharges on tax paid late due to the floods, HMRC may also agree to:

- defer collecting tax or agree instalment arrangements due to severe hardship;
- introduce practical arrangements where records have been lost in the flooding;
- suspend debt collection proceedings;
- defer compliance checks and investigations;
- not charge penalties where HMRC are satisfied that taxpayers have missed deadlines as a result of the flooding. ◀

Roy Maugham — tax partner, London

All change for Capital Gains Tax (CGT) and Inheritance Tax (IHT)?

In his Pre-Budget report, announced on 9 October 2007, the Chancellor revealed his proposed changes to CGT and IHT. We have produced a Taxflash, outlining these changes, which is available in the Resources section of our website: www.uhy-uk.com. A full summary of the Chancellor's Pre-Budget report is also available in the Resources area. If you would prefer a hard copy of the CGT & IHT Taxflash, or the Pre-Budget report, please contact Georgina Blythe on 020 7216 4693 or at g.blythe@uhy-uk.com ◀

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