

Tax Update

June 2009

STOP PRESS: 'VAT on service charges' case decided

The European Court of Justice (ECJ) has recently announced its decision in the case of RLRE Tellmer Property s.r.o. which confirms the Advocate General's earlier view that the supply of cleaning services to a tenant by a landlord is a separate taxable supply for VAT purposes.

The reasoning of the ECJ in this case means that it is increasingly likely that all service charges will be treated as separate taxable supplies, regardless of whether a landlord has previously opted to tax.

This decision is likely to have an impact on both landlords and tenants. Landlords will likely be required to account for VAT on all such charges, which could bring some, such as

landlords of sizeable residential portfolios, within the VAT 'net' for the very first time. For tenants, the addition of VAT will likely increase the overall net costs for many, particularly those who are unable to recover the VAT charged. However, some tenants may now be able to benefit from an opportunity to retrospectively recover 'VAT' incurred historically, even if this was not previously charged by the landlord in addition to the sum invoiced.

For more information, please contact

*David McDonnell on +44(0)20 7063 4315 or
david.mcdonnell@mazars.co.uk*

Interest-ing VAT news in difficult times

A recent High Court decision has ruled that UK taxpayers who have overpaid VAT because of a breach in European Community (EC) law are entitled to compound interest in addition to any tax refunds. This represents a major shift in the application and approach of the UK courts and could mean that many businesses are entitled to a large windfall.

Background

Where a VAT registered person pays too much output VAT, or fails to recover the correct amount of input VAT, owing to an error by HM Revenue & Customs (HMRC), statutory interest is usually payable to the taxpayer.

This statutory interest is lower than the Bank of England base rate (the current rate payable is 0%) and it was successfully argued that this does not properly reflect the true commercial "loss" to the taxpayer.

For more information, please contact

*Ebrahim Patel on +44(0)20 7063 4495 or ebrahim.patel@mazars.co.uk or
David McDonnell on +44(0)20 7063 4315 or david.mcdonnell@mazars.co.uk*

Implications for your business

Notwithstanding the High Court decision, HMRC currently does not accept that there is a right to compound interest and it is likely to lodge an appeal on this point. However, any businesses that have previously submitted retrospective claims for overpaid output VAT, or un-recovered input VAT, should now consider submitting a claim for compound interest. The amount of compound interest that may be due can often be significantly more than the principal sum repaid and many businesses have already lodged substantial claims for many hundreds of thousand, if not millions, of pounds.

Given the amounts of money potentially at stake, this really is an opportunity that all VAT registered businesses should take seriously and consider, especially given potential time limitation issues.

Controlled foreign company reforms

The objective of the controlled foreign companies (CFCs) legislation is to tax profits which have been diverted from the UK into an overseas 'controlled' company. This is subject to a range of exemptions, including where HMRC accepts the activities are genuine (the 'exempt activities test'), and where the territory is on a white list (an 'excluded country'). However, successful challenges in the European Court of Justice have prompted a reform of the UK's CFC rules (although HMRC has just won the Vodafone 2 case at the Court of Appeal).

The CFC reforms in Finance Bill 2009 are only temporary measures pending more sweeping changes to come – likely to be in 2011. The current proposals are limited to the abolition of the acceptable distribution policy (ADP) and the non-local holding company exemptions in the exempt activities test. Both changes are significant, but the repeal of the non-local holding company exemptions may have a significant impact on tiered group structures. There is a two-year transitional period for exempt international and superior holding companies but, given the conditions which must be met, groups must not assume they will be able to benefit from this. It is good news however that the exemption for local holding companies will now be retained. The changes apply from 1 July 2009 and there are transitional rules dealing with straddling accounting periods.

Key points to note are:

- The ADP exemption will be repealed for accounting periods beginning on or after 1 July 2009. It will still be possible to pay an ADP in respect of all accounting periods (including the first portion of the straddling period) ending before 1 July 2009. Where a CFC pays an ADP on or after 1 July 2009, it will not be exempt from tax under the distribution exemption.
 - The non-local holding company exemptions are abolished from 1 July 2009 (subject to transitional rules), but the local holding company exemption will now be retained.
 - A two-year transitional period to 1 July 2011 is available for 'qualifying holding companies' (QHCs) which meet certain additional tests in order to allow groups time to restructure. QHCs therefore cease being exempt under the international holding company or superior holding company exemptions from 1 July 2011.
- In order to be a 'qualifying holding company' the holding company must have been an exempt holding company throughout its last accounting period to end before 1 July 2009 (not including the deemed accounting period where an accounting period straddles 1 July 2009). In other words, it must have qualified as an exempt international or superior holding company. If a QHC satisfies certain additional requirements in the two-year transitional period as regards its income and ownership, it will continue to be exempt.

It follows that the holding company's last accounting period before 1 July 2009 will be critical in determining whether the two-year period of grace is available or not. Groups therefore need to be reviewing their overseas non-local holding companies to establish whether they meet the exempt activities test or not. This is not as easy as it might sound owing to the complexity of the CFC rules, for example, subjectivity in the 'main business test' and income tracing rules. In particular, any investment income of trading companies can have a detrimental impact on holding companies higher in the group structure meeting the exempt activities test – and the way the rules work mean this impact is magnified as you progress upwards through the tiers of holding companies. However, this is only the starting point, the next challenge is to ensure that the two-year transitional exemption continues to be met, so groups need to be reviewing their holding companies to make sure they continue to be exempt. If they do not, then their income will be taxable in the UK. Although their dividend income will, in most cases, be exempt under the distribution exemption, their non-dividend income will be taxable. Furthermore, in calculating the CFC's apportionable profits, it will be necessary to apply the whole range of UK legislation, including transfer pricing, loan relationships and anti-avoidance, to name but a few. This in itself will also add to compliance costs.

For more information, please contact

*Rosemary Blundell on +44(0) 115 943 5357 or
rosemary.blundell@mazars.co.uk*

The worldwide debt cap

UK companies may suffer a restriction in the amount of finance cost they can deduct in calculating their UK taxable profits for accounting periods beginning on or after 1 January 2010. The intention of the debt cap is to restrict the finance cost deduction of the UK members of a group to no more than the group's total finance costs. Although simple in concept, the rules for calculating a potential disallowance are complex. In part this is so the rules do not discriminate against companies that are resident in other member states of the EU.

The core of the rules is that the net financing cost deductible in computing profits or losses within the charge to UK tax should be no greater than the worldwide group's consolidated gross finance expense. The debt cap has been introduced in conjunction with the distribution exemption; the expressed reason being to limit the cost to the UK Treasury of the distribution exemption. A 'gateway' test prevents the debt cap applying where UK average net debt is less than 75% of the average worldwide gross debt.

The legislation is still evolving so caution must be taken as further significant changes are anticipated.

Key points are:

- A stand alone company which is not a member of a 75% group will never be subject to the debt cap legislation. So a joint venture company, for example, will not be affected.
- The rules require at least one member of the group to be other than a company that is micro, small or medium sized. This test needs to be applied annually, so groups at the margin of medium/large may move in and out of scope of the regime.

- Groups are excluded if they pass a 'gateway test' which requires the group's UK net debt to be no greater than 75% of its worldwide gross debt, ignoring companies with less than £3m net debt.
- When the debt cap provisions apply, the group's UK corporation tax relief for finance expense is restricted by the amount that the UK net finance expense exceeds the group's worldwide gross finance expense.
- When a group suffers a debt cap disallowance, and a UK group member has net finance income, some or all of the net finance income will be exempt from tax.
- Hence, in simplified terms, the net overall disallowance of tax deductible finance expense will be the excess of the aggregate net finance expense of the UK activity over the group's gross finance expense.
- There are exclusions for group treasury companies, short term loans and financial services sector companies.
- Anti-avoidance provisions apply to block the use of 'schemes' to get 'round the rules'.

The commencement date depends on the accounting date of the company: it will first apply to accounting periods of companies that commence on or after 1 January 2010. There is no splitting of accounting periods. So a group with a 31 March year end will first come within the legislation for its year to 31 March 2011. Planning should be considered now, particularly in conjunction with the post 30 June 2009 exemption for foreign dividend income.

For more information, please contact

*Richard Service on +44(0) 141 225 4935 or
richard.service@mazars.co.uk*

HMRC updates Code of Practice 9

On 27 May 2009 HM Revenue & Customs (HMRC) confirmed that an updated Code of Practice 9 (COP 9) had come into force with effect from 1 April 2009.

COP 9 relates to investigation cases where HMRC suspects serious fraud. Where COP 9 is issued, HMRC sets aside its right to prosecute for the underlying tax offence in return for a civil settlement of the liabilities arising. The procedure under which such cases are investigated is known as the Civil Investigation of Fraud (CIF) procedure.

The purpose of the newly updated COP 9 was to reflect the new penalty regime, applying across direct and indirect taxes which was introduced in the 2008 Finance Act.

For Income Tax, Corporation Tax, Capital Gains Tax and VAT purposes, the new penalty regime applies to periods beginning on or after 1 April 2008, where the return is due

on or after 1 April 2009. For other taxes and duties, the new penalty regime applies in respect of tax periods beginning on or after 1 April 2009, and for which the return is due on or after 1 April 2010.

For all other periods other than those stipulated above, the earlier penalty regime applies.

The CIF procedure itself remains unaltered for the time being, although it is our understanding that more wide-ranging changes may be on their way soon.

For more information, please contact

*Jon Claypole on +44(0) 20 7063 4323 or
jon.claypole@mazars.co.uk or*

*Stephen Outhwaite on +44(0) 113 387 8575 or
stephen.outhwaite@mazars.co.uk*

Distribution exemptions for dividends

Finance Bill 2009 includes provisions to introduce a distribution exemption for dividends received on or after 1 July 2009.

Under the proposals, dividends received by UK companies and UK permanent establishments that are large or medium sized will, in most cases, be exempt from tax regardless of the source. A significant change since the original proposals is that small companies will benefit fully from the distribution exemption (previously proposed to restrict the exemption to dividends from portfolio holdings).

Income distributions will be taxable but most will then qualify for an exemption (subject to anti-avoidance). There is no minimum shareholding requirement, or minimum period for which the shares have to be held.

- Capital distributions (e.g. from a company in liquidation) will continue to be taxed under the chargeable gains regime.
- Dividends will not be exempt if the payer gets a tax deduction, where the distribution is interest in excess of a commercial rate of interest or where the dividend is taxed under another 'head' e.g. as trading income.
- It will also be possible to opt out of the exemption, but this will only be likely to be of relevance where a controlled foreign company (CFC) pays an acceptable distribution policy (ADP) (for an accounting period (AP) beginning before 1 July 2009) or to obtain the treaty rate of withholding tax where the double taxation agreement (DTA) requires the dividend to be 'subject to tax' in the recipient's territory.
- A significant change to the original proposals is to include 'small' companies within the exemption, but with a different set of rules to large and medium sized companies. For small companies, the distribution exemption will apply provided certain conditions are met – principally that the paying company must be resident in a 'qualifying territory' and the payer should not obtain a tax deduction for the dividend. The small companies exemption has its own mini anti-avoidance rule in that the distribution must not be part of a tax advantage scheme.
- A 'small' company follows the Commission Recommendation 2003/361/EC of 6 May 2003 but with the modification that none of the following are 'small' companies:
 - Open ended investment companies.
 - Authorised unit trusts.
 - Insurance companies.
 - Friendly societies.

A 'small' company is one with:

- fewer than 50 employees; and
- annual turnover, or balance sheet total not exceeding €10 million.

As usual, these tests are applied to the group as a whole.

- For large and medium sized companies, there are five 'exempt classes' of dividend. Exemption need only be obtained under any one of the classes. However, it is advisable to check group shareholdings prior to dividend payments to confirm which exemption will apply, and also that it will not be denied by virtue of the anti-avoidance provisions. The five classes of exemption are:
 - Dividends and other distributions from controlled companies.
 - Dividends and other distributions in respect of non-redeemable ordinary shares.
 - Most portfolio dividends and other distributions.
 - Dividends derived from transactions not designed to reduce tax.
 - Dividends from shareholdings accounted for as liabilities.
- It may be necessary to seek advance clearance that the exemption will apply to some distributions.
- To prevent potential avoidance schemes, especially those involving diversion of profits overseas, there are three targeted anti-avoidance provisions in respect of specific exemptions whereby that exemption will not be available where tax avoidance is a purpose of a scheme of which the main purpose, or one of the main purposes, is to obtain a tax advantage. In addition, there are four general anti-avoidance rules.

Most dividends will be exempt, but it is always worth checking this will be the case by reviewing shareholding structures in a group and the rights attached to shares. Also, the anti-avoidance provisions could bite in unexpected situations, so these always need to be borne in mind. Where a disposal of a subsidiary is contemplated, it is important to bear in mind that the requirements to obtain substantial shareholdings exemption (SSE) differ from those to obtain the dividend exemption. In cases where SSE is not available, pre-sale planning through the extraction of exempt dividends will reduce the chargeable gain on the disposal.

For more information, please contact

*Rosemary Blundell on +44(0) 115 943 5357 or
rosemary.blundell@mazars.co.uk*