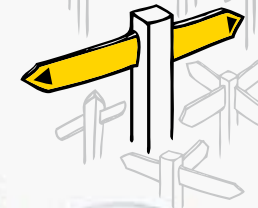


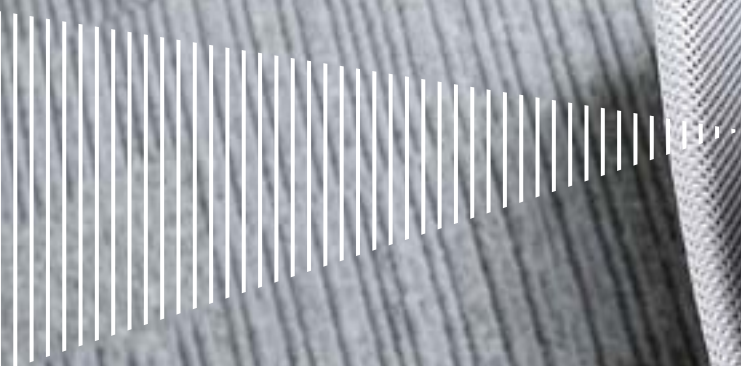


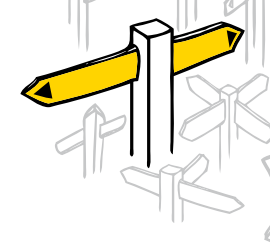
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# Under the Spotlight

Tax risk and dispute  
resolution insights  
December 2011





# Welcome ...

... to the December edition of *Under the Spotlight*.

In this edition we look at a wide range of topics, including;

- ▶ Successfully resolving disputes: an insight into how the recently refreshed Litigation and Settlement Strategy and launch of Alternative Dispute Resolution have changed the landscape for resolving tax disputes with HMRC
- ▶ UK-Switzerland withholding tax agreement: an explanation of how the recently announced agreement is expected to operate, and highlighting some important questions that remain unanswered
- ▶ A tougher approach: consideration of the impact of the HMRC discussion document Civil Investigation of Fraud on the way HMRC investigates cases of potential fraud
- ▶ A never ending voyage of discovery: an insight into the recent case law surrounding discovery assessments

As always we are grateful for your feedback, so please do let us know what you think.

**For more information, or if you would like a free of charge initial consultation, please contact our 24 hour helpline: 0800 917 4122, or one of our TCRM specialists.**



Chris Oates

## **Partner – Tax Controversy and Risk Management**

Chris leads Ernst & Young's London Tax Controversy & Risk Management practice. Prior to joining Ernst & Young, Chris spent over 20 years at HMRC, in the Large Business Service office, and latterly in charge of teams in Special Civil Investigations offices, which handle the most serious cases involving tax avoidance and evasion. Since joining Ernst & Young over ten years ago, Chris has helped clients from FTSE 100 to high-net-worth individuals, to successfully manage the enquiry process with HMRC.



Helen Maddaford

## **Partner – Financial Services**

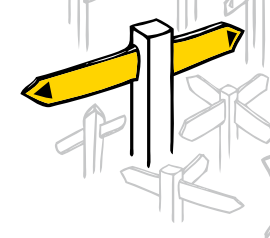
Helen leads Ernst & Young's Financial Services Tax Controversy & Risk Management team. Having originally trained as a tax lawyer at a 'Magic Circle' firm, prior to joining Ernst & Young Helen spent 11 years at a major UK bank in the group tax function, and latterly in the investment bank. During this time, her roles included being head of tax risk for the group corporate tax team. Helen has considerable experience of successfully handling contentious issues in the financial services sector at every stage, from initial implementation to resolution.

## **Struggling to keep up to date with tax news?**

As part of our commitment to help our clients respond to the changing tax environment, we have launched Midweek tax news, Ernst & Young's weekly tax publication. The purpose of Midweek tax news is to provide you with a succinct overview of the key UK tax developments that have occurred in the last week, to allow you to stay up-to-date on tax issues that may have an impact on your business. Midweek tax news is delivered direct to your inbox: [click here](#) to see a recent edition. If you would like to receive Midweek tax news, please contact your usual Ernst & Young advisor or email us: [eytaxnews@uk.ey.com](mailto:eytaxnews@uk.ey.com)

# Successfully resolving tax disputes with HMRC

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Changing the mindset so that disputes are approached differently is far from easy, and will not happen overnight. HMRC will be working on this in the coming months as it rolls out its new guidance to its staff. In the meantime it will be up to those handling particular tax disputes, on both sides, to seize the opportunities for more effective disputes handling. There are opportunities both for collaborative working of tax disputes generally, and for using ADR in particular cases.

## Opportunities for collaborative working

With the refreshed LSS, HMRC now undertakes to work with taxpayers to:

- ▶ Set out clearly what are the points in dispute, with agreed timescales for reaching key decision points
- ▶ Understand fully the relevant facts and law, sharing and testing the strengths and weaknesses of respective arguments
- ▶ Consider potential alternative views of the facts and law which could provide a basis for settlement
- ▶ Continue to work collaboratively, even in cases which are headed for the courts.

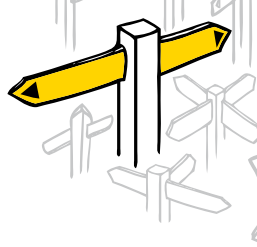
Geoff Lloyd considers how the recently refreshed Litigation and Settlement Strategy and launch of Alternative Dispute Resolution have changed the landscape for resolving tax disputes with HMRC.

In July 2011 HMRC released its 'refreshed' Litigation and Settlement Strategy (LSS), followed a month later by draft guidance on both the LSS and on Alternative Dispute Resolution (ADR) for tax disputes. These documents provide a toolkit for resolving disputes collaboratively across the whole range of taxes and duties, and make clear that HMRC sees a collaborative approach as the norm to be applied from the beginning to the end of any enquiry or dispute.

Adopting a collaborative approach does not mean either side 'going soft' or setting aside legal safeguards to protect taxpayers' rights in an enquiry. It simply means getting to an acceptable answer as cost effectively as possible.

Indeed the impetus behind HMRC's new approach has been a need for greater efficiency in handling disputes. It is all too common for an enquiry to get off on the wrong footing because the point in dispute is unclear, or for a dispute to become entrenched because people dig their heels in too early and are unwilling to consider an alternative perspective. This can waste time and resource on both sides.

'It will be up to those handling particular tax disputes, on both sides, to seize the opportunities for more effective disputes handling.'



An extraordinarily large number of disputes get bogged down because the points in dispute are not clear, or because each side makes different assumptions about the underlying facts. Tying down areas of agreement and disagreement, preferably with a detailed decision tree mapping out in advance how the various disputed points fit together with the consequences of reaching each alternative answer, can make sure the dispute is well focused and reduce the risk of long argument over things that may not be relevant.

It is not always easy to see the relevance of particular HMRC information requests or lines of enquiry. This is covered in some detail in HMRC's draft LSS guidance, with a best practice model for use in large and complex cases where the taxpayer is cooperating with the enquiry. This model envisages a high level discussion of the legal issues in dispute, before detailed fact-finding, together with a shared approach to determining what factual information is relevant.

Traditionally tax professionals have tended to be uncomfortable with the idea of fully sharing their tax technical analysis in case that gives away a tactical advantage if the dispute reaches the Tribunal. But experience shows that a willingness to share and test each other's arguments is much more likely to get quickly to a satisfactory solution, even if only by developing the best case on each side to be tested in court.

One of the main problems seen with the LSS to date is that - unintentionally - it encouraged some HMRC staff to take an intransigent approach to issues in dispute. The refreshed LSS makes clear that HMRC claims no monopoly on understanding what is the right answer, and encourages wider exploration of how the courts might

approach the relevant facts and law as a way of opening up alternative avenues for settlement. Experience of handling tax disputes in brainstorming mode is that this stands a much better chance of speedy resolution than simply multiplying or strengthening arguments in defence of an opening position.

### Opportunities for Alternative Dispute Resolution

Earlier editions of Under the Spotlight have highlighted Ernst & Young's positive experience of HMRC's ADR pilots. ADR brings a structured approach to collaborative working practices and guarantees a fresh perspective, whether through dispute resolution experts on each side or use of an external mediator.

It is clear from the detailed guidance now published by HMRC that the pilot has been successful and that HMRC is now open to ADR for suitable large and complex tax disputes more generally.

Issues most likely to be suitable for an ADR process are those where:

- ▶ The dispute has reached an impasse as a result of a breakdown in collaborative working
- ▶ There is a lack of clarity or understanding of respective positions
- ▶ There is likely to be a range of possible ways of interpreting the relevant facts and/or law
- ▶ The dispute is headed for litigation and ADR could provide a more cost effective, or more certain, outcome
- ▶ The impact on other taxpayers is likely to be limited and there is no need for a precedent to be established

- ▶ It would help to narrow down the issues to be litigated, or improve the quality of evidence to be presented to the Tribunal.

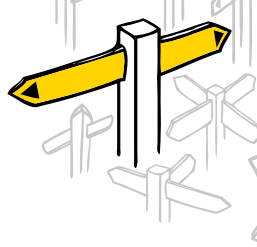
### What this means for taxpayers

Collaborative working practices, and structured ADR processes in particular, call for time and resource, as well as significant changes in mindset. It will inevitably take time for best practice to become the norm. In the meantime, the new LSS and ADR guidance should reassure taxpayers that HMRC will be receptive to positive attempts to reach agreement. The new guidance will also provide a useful yardstick to press for best practice to be applied in particular cases.

Geoff Lloyd has recently joined Ernst & Young as Executive Director in the Tax Controversy & Risk Management Team, based in our London office. Geoff was previously Director, Dispute Resolution at HMRC, where he developed HMRC's strategy for collaborative dispute resolution, the use of ADR for tax disputes, and the relaunch of the HMRC Litigation and Settlement Strategy.



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# UK-Switzerland withholding tax agreement

Helen Maddaford, Alberto Lissi and Rob Osborne explain how the agreement is expected to operate and the decisions that those affected by the agreement will need to make.

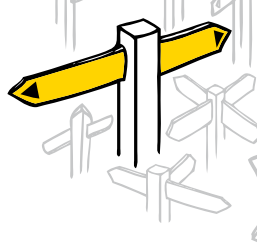
Following an announcement in late August, on 6 October an agreement between the UK and Switzerland was signed which will create a new withholding tax on Swiss bank accounts. This closely followed a similar agreement between Germany and Switzerland (published on 21 September), and it is anticipated that Switzerland will negotiate further agreements with other countries in due course.

Provided the agreement becomes law in both countries, the regime is expected to start on 1 January 2013 and is designed around two key principles – the preservation of banking secrecy and UK tax compliance. Unless they authorise their bank to disclose their identity and information about their account to the tax authority (or they terminate their relationship with the bank), UK resident individuals with assets in Swiss accounts will be subject to a withholding tax made up of two elements; a one-off payment to regularise the past, and an ongoing withholding tax for the future. Banks will be required to 'look through' companies and trusts if they consider, based on the information available to them, that a

UK individual is the beneficial owner of the account. Genuine discretionary trusts are outside the scope of the agreement.

For the past there will be a lump-sum one-off payment of between 19% and 34% of the assets held on 31 December 2010. The rate will be determined by a formula that takes into account how long the individual has been with the bank, the history of the account since 2003, and the amount on deposit on 31 December 2010. There will be no separate charge for interest or penalties. The payment will generally discharge UK tax liabilities arising on the amounts held in the account on 31 December 2010 and there is scope for individuals to top up their account to discharge liabilities on amounts that were withdrawn before that date. In certain cases, the one-off payment will not completely discharge the liability to UK tax but will be treated by HMRC as a payment on account.

'There will be no separate charge for interest or penalties.'



For example, where the individual is subject to a tax investigation which started before they instructed their bank to deduct the payment, or where the individual has been contacted or participated in one of HMRC's disclosure facilities.

For the future there will be a withholding tax of 48% on interest, 40% on dividends, 48% on other income, and 27% on capital gains, which will generally discharge all UK tax liabilities. The rates will change in the future as UK rates change. Both elements of the withholding tax will be calculated and deducted by the Swiss bank and will be paid over to HMRC via the Swiss Federal Tax Administration without revealing the identity of the UK resident account holder.

Special rules will apply to individuals domiciled outside the UK. These include the ability to opt out of the lump-sum one-off payment for the past and special rules to calculate the withholding tax for the future that will apply only to UK income and taxable remittances to the UK. In order to qualify for the special rules, non-domiciled individuals will need to provide their bank with a declaration provided by a professional advisor to confirm their non-domiciled status.

HMRC has not offered any kind of assurance against criminal investigation of non compliant taxpayers before the agreement comes into force.

Against this background, banks with Swiss operations and/or private banking clients in Germany or the UK with Swiss accounts will need to take action in the short term. There will be a substantial operational burden to address in Switzerland and banks will need to train their staff and provide appropriate communications to customers. They will also want to assess the wider business impact, as we believe the agreements reinforce some trends already evident, including looking at the location of business, the quality of client reporting, and the range of products offered.

Individuals affected by the regime will need to assess their options. Those that are already fully compliant may want to authorise disclosure to avoid double taxation. Others who are not fully compliant may decide to regularise their affairs by disclosing irregularities to HMRC under the usual provisions or, where available, under the Liechtenstein Disclosure Facility (LDF). Indeed the LDF team in HMRC has seen a significant increase in registrations since August. [We summarised some of the key benefits of the LDF in the March 2011 edition of Under the Spotlight].



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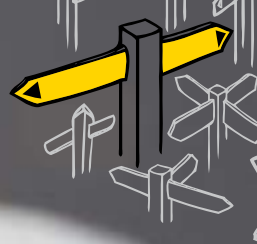
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'Those that are already fully compliant may want to authorise disclosure to avoid double taxation.'





# A tougher approach

Rob Brockwell considers how the HMRC discussion document on Civil Investigation of Fraud (CIF) proposes major changes to the way HMRC investigates cases of potential fraud.

In August this year HMRC issued a discussion document outlining proposals for updating and strengthening the way in which they carry out enquiries into cases of potential fraud. This is the result of concerns that the current approach, which has been operating since 2005, 'lacks teeth'. The document proposes a number of significant changes and it is expected that, following the consultation process, the changes will be implemented with effect from 1 January 2012.

## Background

In cases of potential fraud, HMRC has the option to carry out a criminal investigation with a view to prosecuting the fraud. However, this is an expensive process and, in most cases, HMRC chooses not to conduct a criminal investigation but instead investigates the suspected fraud using civil procedures with a view to reaching a financial settlement.

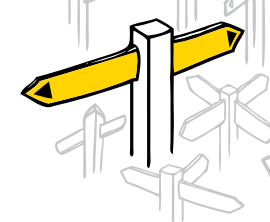
Until 2005 the approach to such investigations was that HMRC would accept a financial settlement, and would not pursue a criminal prosecution, if the taxpayer, in response to a challenge by HMRC, made a full and complete disclosure of all tax irregularities. Whilst this did not take away the threat of prosecution entirely, it gave the taxpayer assurance that as long as they cooperated and made a full disclosure of all omissions, they would not be subject to criminal proceedings. This procedure also had the benefit of enabling HMRC to investigate and settle cases very cost effectively.

This long established practice was changed in 2005 following difficulties with the procedure that came to light through a Court of Appeal case (*Regina v Gill & Gill*). In brief, this case established that HMRC's offer to accept a monetary settlement where a full disclosure was made by a taxpayer in return for HMRC not taking criminal proceedings, meant that any evidence obtained through the disclosure process could not be used in evidence in court.

For a short while HMRC dealt with this problem by making their interviews with taxpayers compliant with the Police & Criminal Evidence Act (PACE), including taped interviews. This was not found to be practical, and, in 2005, changes were made to the procedures for investigating fraud.

Under the revised procedures HMRC would, as previously, first decide whether a case should be investigated using civil or criminal procedures. Once it was decided a case should be investigated using civil procedures, the taxpayer would again be challenged and offered the opportunity to make a full disclosure. However, the major difference was that at this stage the taxpayer was given a guarantee that they would not be prosecuted for any tax offences that had been committed up until the date of the challenge.

Whilst this removed the evidential problem caused by *Gill & Gill*, it was seen by many as being a weakening of HMRC's ability to investigate fraud by removing the criminal underpinning of HMRC's approach.



'... we feel that the CDF is a positive step in helping HMRC carry out their investigation of fraud more effectively.'

### **Contractual Disclosure Facility (CDF)**

HMRC's solution to this problem is the CDF. In brief, this is intended to work as follows:

- ▶ As before, HMRC will first consider whether the case is one that it wishes to investigate criminally or if it thinks it is appropriate for civil proceedings.
- ▶ Having decided that a case is appropriate for civil proceedings HMRC will contact the taxpayer saying that they are suspected of tax fraud and offering them the opportunity to enter into a contract to disclose that fraud in return for certainty that HMRC would not carry out a criminal investigation.
- ▶ The contract would require the taxpayer to:
  - ▶ Make an admission of fraud.
  - ▶ Provide a general description of what had happened.
  - ▶ Explain the period covered and the broadly the amounts involved.
- ▶ The taxpayer will have 60 days in which to decide whether to enter the contract and make the outline disclosure.
- ▶ If a taxpayer decides not to enter into the contract either because they do not believe they have committed fraud or because they decide against cooperating, HMRC have an option to start their own investigation, and the possibility of criminal prosecution remains.

In the main the CDF seems a sensible way forward for HMRC, and should help to avoid some of the problems it has seen since 2005 with non-cooperation where taxpayers have already been given a guarantee that they will not be prosecuted.

There are one or two areas that could cause problems:

- ▶ The CDF requires an admission of fraud in order to be able to obtain the certainty that HMRC will not take criminal proceedings. In practice, there are a number of cases where it will not be clear whether fraud has been committed, even if a taxpayer accepts that their tax returns are incorrect. As it stands, cases such as this will not be eligible for the CDF. Whilst we understand why HMRC has taken this approach, a more flexible approach, for example a statement that fraud "may" have been committed, would make the CDF a more useful tool for both HMRC and taxpayers.
- ▶ The 60 day time limit for agreeing to enter into the CDF and making the outline disclosure, is very tight, particularly, for example, where the case is passed to a specialist advisor some weeks after the initial challenge is made. A 90 day time limit may be more appropriate.

### **Conclusion**

These comments notwithstanding, we feel that the CDF is a positive step in helping HMRC carry out its investigation of fraud more effectively. Combined with the recently announced increase in HMRC resource being dedicated to fraud investigation, a reorganisation of HMRC's teams involved in fraud investigation work and a target of a five-fold increase in the number of criminal prosecutions for tax fraud, the CDF shows that HMRC is looking to make life considerably more difficult for anyone involved in the fraudulent evasion of income tax.



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# A never ending voyage of discovery

Andrew Hinsley discusses the issues raised in the recent case law surrounding discovery assessments

## Introduction

The debate around the thorny issue of whether HMRC can make a discovery assessment where it considers tax has been under-assessed once the enquiry window has closed shows no sign of abating. The recent case of *Charlton & Ors v HMRC* (2011) related to whether HMRC could make a valid discovery assessment to deny artificial capital losses generated through the use of a marketed avoidance scheme. The losses arose from the purchase, partial surrender and sale of a second-holder insurance policy using a scheme similar but not identical to that used by Mr Drummond in the case of *Jason Drummond v The Commissioners for HMRC* (2009), which the Court of Appeal determined was ineffective.

The Tribunal did not consider it was material to their decision to understand how the scheme operated. The appellants' returns gave sufficient information to reach an understanding of the scheme, and included the scheme disclosure number, but did not refer to the fact that at the time of submission of the return the Special Commissioners had found against Mr Drummond. HMRC accepted that an enquiry should have been raised but was not, due to various administrative failures.

The Tribunal found in favour of the taxpayers, notwithstanding that this meant these particular individuals benefited from the scheme because of an administrative failure by HMRC in their specific circumstances, whereas all other users had the potential benefit denied.

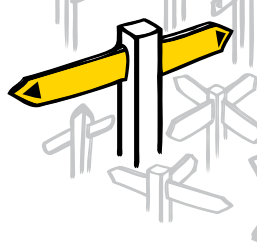
There were three key issues which the Tribunal addressed:

- ▶ the interpretation of 'Discovery'
- ▶ what is meant by 'insufficiency', and
- ▶ could the inspector have been reasonably aware of the insufficiency.

The taxpayers lost on the first two points but were successful on the third.

'HMRC argued it was sufficient that the Inspector had simply changed his mind and that the authorities that required new facts were only relevant when the initial assessment had been the subject of a section 54 TMA 1970 agreement.'

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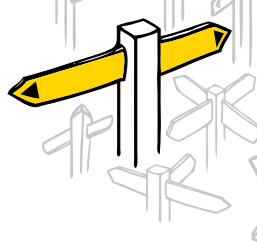


## Interpretation of 'Discovery'

The taxpayers contended that to justify a discovery assessment something new had to emerge. HMRC argued it was sufficient that the Inspector had simply changed his mind and that the authorities that required new facts were only relevant when the initial assessment had been the subject of a section 54 TMA 1970 agreement. The Tribunal, without hesitation, considered HMRC's contention was correct. The Tribunal considered that Viscount Simmonds' judgement in the House of Lords decision in *Cenlon Finance Co. Limited v Ellwood (Inspector of Taxes)* was absolutely clear.

"I can see no reason for saying that a discovery of undercharge can only arise where a new fact has been discovered. The words are apt to include any case in which for any reason it newly appears that the taxpayer has been undercharged and the context supports rather than detracts from this interpretation."

The Tribunal considered it was important to trace through the history of this case law conclusion, as one or two references in very recent cases appeared to throw doubt on those conclusions.



### **What is meant by 'insufficiency'?**

The Tribunal also held that the reference to the 'insufficiency in the original assessment' in the discovery legislation does not mean that the Inspector has to demonstrate that the understatement is certain or bound to be sustained on appeal. The Tribunal considered that the 'more likely than not' test put forward by the Special Commissioner in the case of *Corbally-Stourton v HMRC* (2008) was broadly correct in principle, but thought that the test provided for a slightly lower threshold. The Tribunal held that the officer merely needs to consider in a 'bona fide' manner - that as he now views the matter - he has reason to believe there has been an under-assessment, and that there is a reasonable likelihood the new assessment would be sustained on appeal.

### **Could the Inspector have been reasonably aware of the 'insufficiency'?**

The Tribunal reaffirmed the *Veltema* judgment that the test is not whether the Inspector should have concluded that he should open an enquiry, but what he could have been expected to know about the insufficiency from the information the legislation deemed available to him.

HMRC contended that the test in section 29(5) TMA 1970 required the taxpayer to have made it clear to the notional Inspector that there was an actual insufficiency in the self-assessments made in the returns, not that there might be an insufficiency. The Tribunal, however, made it clear that the extent to which it was necessary for the taxpayer to disclose information relevant to whether there was an insufficiency would vary from case to case.

A key issue addressed by the Tribunal was whether it was correct, as HMRC contended, that the test required one to consider what the average inspector (armed only with the information permitted to him by section 29(6) TMA 1970) would have known in relation to tax law, and that it was wrong to assume that he might do any technical research. Essentially this proposition requires the Inspector to address the issue entirely on his own, in a 'dark room' and solely by reference to his assumed pre-existing knowledge of the law. Whilst the notional officer might appreciate that a scheme had been effected, he could then only be expected to conclude that 'some tax schemes work and others do not' and, therefore, could not be said to be aware of an actual insufficiency. Consequently, if the notional officer was out of his depth, that was simply unfortunate but it did not preclude a discovery assessment.

The Tribunal rejected this proposition. They considered the HMRC officer should be assumed to be at liberty to refer to legislation, textbooks and HMRC manuals, and to consult internally with specialist colleagues.

### **Conclusion**

The case is yet another twist in the long running discovery saga. The decision, in reaffirming long established case law principle that a change of mind can amount to a 'discovery', reverses recent decisions that suggested that some new facts had to emerge for there to be a discovery.

The decision is also potentially significant in certain circumstances such as the use of a tax avoidance scheme, where an obvious question mark arises as to whether

it works. In such cases it should be presumed that the Inspector would research the matter and/or consult internally before concluding whether or not there is an insufficiency. By not taking such action, HMRC is likely to be precluded from making a discovery in the event that in the future the decision is revisited and a change of heart arises.

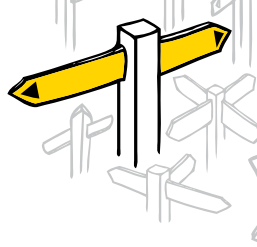
This line of reasoning by the Tribunal appears to be a more pragmatic approach to the legislation than HMRC's alternative interpretation that the average notional inspector can only reach a conclusion on whether there is an insufficiency based on his own limited personal knowledge. If such a view was held to be correct, it would almost always be open to HMRC to make a discovery unless the disclosure in the return made clear reference to the prospect of an actual insufficiency, as opposed to merely presenting the relevant facts.

The Tribunal was, however, at pains to stress that the case was determined on its own facts and that there will be a spectrum of scenarios. In complex cases that do not involve outright avoidance, the Tribunal considered it may be necessary to flag areas of doubt that might otherwise be easily missed, even by the above average officer.

HMRC has appealed the decision and the case will be heard by the Upper Tribunal (though a date has not yet been set) so this will not be the last word on the subject. It may be that a Supreme Court decision is required to bring the certainty taxpayers crave.



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## What is Tax Controversy & Risk Management?

The Tax Controversy & Risk Management (TCRM) practice at Ernst & Young consists of teams who specialise in the management and resolution of contentious issues and disputes with tax authorities, both in the UK and worldwide, for our financial services clients and clients in other industries.

In addition to assisting with all types of HMRC investigations, TCRM also conducts health checks to ensure that clients' systems and procedures are robust enough to withstand HMRC scrutiny, should they be selected for enquiry.

TCRM includes a number of former senior tax authority officials who have worked in specialist offices (including Special Investigations, Large Business Service and Anti Avoidance Group and Local Compliance).

It is for this reason that TCRM has a wealth of insight into the world of tax enquiries and dispute resolution, with a proven track record of steering clients through difficult enquiries and complex negotiations to reach successful outcomes. TCRM works side by side with their subject matter professionals to bring practical and technical expertise to their engagements.

Below are particular areas of specialism that TCRM deal with on a day-to-day basis:

- ▶ Enquiry management and resolution
- ▶ Tax enquiry clear-ups
- ▶ Company residence reviews
- ▶ HMRC systems and process reviews
- ▶ Tax strategy reviews
- ▶ Tax transaction assurance

For further information, please contact one of the TCRM professionals listed below.

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