Tolley®CPD

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CONTENTS

Personal tax ... 5
PAYE error (Lecture P1106 – 16.09 minutes) ... 5
Late filing of P35 (Lecture P1106 – 16.09 minutes) ... 6
Employee rewards using loans (Lecture P1106 – 16.09 minutes) ... 6
Contractor rewards using loan scheme (Lecture P1106 – 16.09 minutes) ... 7
Guidance on disguised remuneration schemes and the loan charge ... 8
Compensation for mis-selling of a financial derivative (Lecture P1106 – 16.09 minutes) ... 9

Capital Taxes ... 11
Entrepreneurs' Relief On Share Disposals (Lecture P1107 – 13.18 minutes) ... 11
Banking of entrepreneurs relief from April 2019 (Lecture P1108 – 11.41 minutes) ... 15
Negative earn-outs (Lecture B1108 – 27.28 minutes) ... 20
Non-UK resident capital gains taxation (Lecture P1109 – 23.25 minutes) ... 23
Payment window for residential property (Lecture P1110 – 10.01 minutes) ... 26
Transfer of s32 buyout pension policy (Lecture P1106 – 16.09 minutes) ... 27
Business relief for livery stables (Lecture P1106 – 16.09 minutes) ... 28
Gift with reservation of benefit (Lecture P1106 – 16.09 minutes) ... 29
SDLT first time buyers' relief guidance updated ... 30

Administration ... 31
High income child benefit charge penalty case reviews ... 31
Successful Discovery and no PPR ... 31
Consultation on harmonising amendments to tax returns ... 33

Deadlines ... 34

News ... 35
Finance Bill 2019: Committee stage completed ... 35
Consultation on the taxation of trusts ... 36
Consultation on stamp duty and SDRT consideration rules ... 37

Business Taxation ... 39
Capital allowance for structures and buildings (Lecture B1106 - 20.15 minutes) ... 39
Vehicle-battery charging at workplace (Lecture B1107 – 9.59 minutes) ... 43
Consultation on Digital Services Tax (Lecture B1106 - 20.15 minutes) ... 44
Corporate loss relief – additional guidance ... 48

VAT ... 50
Subsidy and third party consideration ... 50
Aborted takeover (Lecture B1106 - 20.15 minutes) ... 51
Supplies closely related to the supply of education (Lecture B1106 - 20.15 minutes) ... 52
Domestic reverse charge for construction services (Lecture B1106 - 20.15 minutes) ... 52
Input tax recovery (Lecture B1109 – 14.26 minutes) ... 54
Management charges – beware of the VAT issues (Lecture B1110 – 11.17 minutes) ... 57

Personal tax

PAYE error (Lecture P1106 – 16.09 minutes)

Summary –A self-assessment tax return should not have been used as a means of collecting known amounts of PAYE underpayments.

Michael Griffiths was a lorry driver who had always had his tax collected through PAYE. He had never filed nor been asked to file a self-assessment tax return until 2013/14.

On 31 May 2014 Mr Griffiths was sent a PAYE tax calculation for the tax year 2013/14. The calculation was issued automatically by computer and showed an overpayment of £579.80. On 1 June 2014, HMRC issued a payable order in respect of the "overpayment" which was actually paid to Mr Griffiths on 3 June 2014.

On 2 June 2014, the day before receiving this money, a revised PAYE calculation was sent to Mr Griffiths showing an underpayment of tax of £581.60 so in fact Mr Griffiths had underpaid his tax by 80 pence.

Having contacted HMRC, he was initially told that the underpayment would be collected through a change in his PAYE coding and so he assumed that the matter had been dealt with. Normally, the underpayment would have been "coded out", but Mr Griffiths' income at the time was so low that HMRC were unable to do this. Some eight months later, HMRC issued a "voluntary payment letter" which stated that they would issue him with a self-assessment return if he did not pay the £581.60. On phoning HMRC, Mr Griffiths was once again reassured that the money could, and would, be coded out but never was.

Much later, on 28 July 2016 HMRC issued a notice to file a self-assessment tax return.

Mr Griffiths was confused and unsure what to do. A combination of receiving the self-assessment filing notice combined with the subsequent receipt of penalty notices at a time when numerous scams were in the news, he was worried. He instructed an agent, who submitted the outstanding tax return in June 2017 but also appealed to the First Tier Tribunal against the penalty notices arguing that:

- The penalties were not due because the notice to file a tax return was invalid;
- There was a "reasonable excuse" for any failure to submit the return on time.

Decision

The First Tier Tribunal concluded that, as a P800 tax calculation had been issued HMRC was already aware of how much income Mr Griffith owed. This was not a matter that needed to be established (s8 TMA 1970), and so the notice to file a return was not made for the reason mandated by legislation. The notice was invalid, and so to were the related penalties.

Even if this had not been the case, the First Tier Tribunal concluded that Mr Griffiths had a reasonable excuse for the delay in filing his return. They referred to the fact that HMRC should have taken "the experience, knowledge and other attributes of the particular taxpayer" into account, as well as the fact that at the time, seeking help from HMRC would have involved calling the helpline whose performance, according to the National Audit

Office, "at the time was abysmal; half of calls to HMRC were not answered". Taking account of all the circumstances, including the fact that Mr Griffiths believed everything had been sorted out and would be dealt with through PAYE and all of this was happening at a time when scammers pretending to be HMRC were in the news, Mr Griffiths did have a reasonable excuse.

Michael Kenzie Griffiths v HMRC (TC06697)

Late filing of P35 (Lecture P1106 – 16.09 minutes)

Summary – The taxpayer company did not have a reasonable excuse for the late filing of its P35 for 2010/11.

George Edwards Consulting Ltd had overpaid PAYE of about £5,000 for the three years to 2009/10 and had sought repayment or set off the amount from HMRC.

HMRC was suspicious about why overpayments had been made. It turned out that the company had set up a system of paying a set amount of PAYE each month to HMRC based on one-twelfth of the estimated amount due for the year. Those calculations were consistently over-prudent and, as a result, the company had paid too much PAYE. HMRC agreed to repay the excess on receipt of the P35 for 2010/11.

The company's director refused to submit this saying that it was not worth the expense of asking his accountant to prepare the document. The return was finally submitted on 30 January 2015.

The company appealed against penalties under s98A TMA for late filing of form P35 for 2010/11 arguing that it had a reasonable excuse for not filing the return.

Decision

The First Tier Tribunal said that the obligation to submit form P35 is absolute; it is not dependent on its being commercially advantageous.

The Tribunal noted the irony that, in attempting to save the £400 cost of preparing the P35, the company had landed itself with a penalty of £1,200.

The company's appeal was dismissed.

George Edwards Consulting Ltd v HMRC TC6760)
Adapted from case summary in taxation (15 November 2018)

Employee rewards using loans (Lecture P1106 – 16.09 minutes)

On 9 November, HMRC published the GAAR advisory panel's opinion on arrangements designed to reward an employee through a third party, enhanced by loans with creditor rights transferred to an employer financed retirement benefit scheme. Unsurprisingly, the panel's conclusion was that the arrangements were not a reasonable course of action in relation to the relevant tax provisions.

The arrangements

The taxpayer was the operations manager, executive director and 50% shareholder of a company.

In August 2014 he resigned from his employment and executive directorship but was appointed as a non-executive director. At the same time he took up an employment contract with an agency, which then provided his services back to the company under a contract for services.

It was reported that a typical month would involve the agency:

- Invoicing the company a net amount of about £10,400 for the taxpayer's work;
- Paying the taxpayer a gross salary equivalent to about £990 (National Minimum Wage) but also making interest free, "discretionary" loans totalling about £7,500 to the taxpayer that were repayable on demand;
- Transferring the creditor rights to those loans to an employer financed retirement benefit scheme set up for the purpose.

The opinion

The GAAR advisory panel concluded that the intended outcome of the arrangements was that the company continued to receive the benefit of the taxpayer's services and the taxpayer continued to have funds made available to him in return for those services. They stated that the new arrangement resulted in:

- The company continuing to claim a corporation tax deduction for the amounts paid for the taxpayer's services;
- A post tax return to the employee of 79% - 82% against a standard employment post tax return of 48% - 56%.

In summing up, the Panel's opinion concluded that the arrangement sought, in an abusive way through a series of contrived steps, to reduce the normal incidence of tax on the taxpayer's continuing reward for services stating that: the:

- Entering into of the tax arrangements was not a reasonable course of action in relation to the relevant tax provisions; and
- Carrying out of the tax arrangements was not a reasonable course of action in relation to the relevant tax provisions.

www.gov.uk/government/publications/gaar-advisory-panel-opinion-employee-rewards-using-loans

Contractor rewards using loan scheme (Lecture P1106 – 16.09 minutes)

On 9 November, HMRC published a second GAAR advisory panel's opinion, on a contractor loan scheme involving the transfer of creditor rights to an employer financed retirement benefit scheme.

Once again, the panel's conclusion was that the entering into and carrying out of the arrangements was not a reasonable course of action in relation to the relevant tax provisions.

The arrangements in outline

Prior to the arrangements, the taxpayer's services were provided to a third party via his own personal services company.

Following termination of the arrangements he was employed by a third party agency employer company who provided the taxpayer's services to the company for a gross salary of about £8,000 (again equivalent to the national minimum wage), followed by an interest-free loan of around £83,000, repayable on demand, and paid in monthly instalments. Once again the creditor rights in the loans were then transferred to an employer financed retirement benefit scheme (EFRBS) set up for the purpose.

The taxpayer argued that the interest-free loan of £83,000 fell outside the disguised remuneration provisions.

HMRC argued that the taxpayer was liable to income tax and NICs on employment income of around £91,000, rather than only on the national minimum wage element of around £8,000. HMRC also contended the liability owed to the EFRBS by the taxpayer was never intended to be met.

The opinion

The GAAR advisory panel stated that the post tax return to the taxpayer of these arrangements was consistent with the promise in marketing material associated to the scheme of 79% - 82%, against a standard employment post tax return of 48% - 56%.

The panel noted that the taxpayer and the marketed scheme promoter had adopted a series of 'artificially contrived steps to gain a tax advantage concluding that the:

- entering into of the tax arrangements was not a reasonable course of action in relation to the relevant tax provisions; and
- carrying out of the tax arrangements was not a reasonable course of action in relation to the relevant tax provisions.

www.gov.uk/government/publications/gaar-advisory-panel-opinion-contractor-rewards-using-loans

Guidance on disguised remuneration schemes and the loan charge

HMRC has published a guide for employers and individuals affected by the loan charge on disguised remuneration loans that remain outstanding on 5 April 2019.

Remember, people who use these schemes have their salary paid in loans, instead of being paid in the usual way as salary, benefits or bonuses. These loans are paid in such a way that means it is unlikely that they will ever have to be repaid. In other words, the person receiving money from a loan scheme gets to keep it all and, they do not pay any tax on this money, even though it is clearly income.

If an employer set up such a scheme then the tax liabilities will fall to them and not the employee. HMRC will only seek payment from the employee if it cannot be collected from the employer, for example where the employer no longer exists or is offshore. In these circumstances HMRC would collect the liabilities owed from the employee who benefited from the scheme.

HMRC is encouraging people in these schemes to come forward and settle their tax affairs before the loan charge applies. They can:

- repay the original loan;
- agree a settlement with HMRC;
- pay the loan charge when it comes in to force.

www.gov.uk/government/publications/loan-schemes-and-the-loan-charge-an-overview/tax-avoidance-loan-schemes-and-the-loan-charge

Compensation for the mis-selling of a financial derivative (Lecture P1106 – 16.09 minutes)

Summary - Redress payments made to compensate for the mis-selling of financial products were found to be revenue in nature rather than capital items and so taxable as income

The Appellants were seven brothers who ran a property letting business. Three of the brothers held the legal titles to the properties but it was common ground that they held those properties in equal shares for all of the brothers.

In 2001 the brothers approached their bank, National Westminster Bank plc., to restructure an existing loan in order to raise capital to expand the property business. At the time, the loan was self-financing and rental values were rising. The bank made it a condition of restructuring the loan that they enter into a swap agreement. The Gadhavi brothers had no understanding of interest rate hedging products and were provided with little information about how they worked or the risks involved. They made payments under the swaps for several years and those payments were deducted as revenue expenses of the property business.

Following the financial crash, interest rates fell dramatically, but the brothers were locked into a high fixed rate under the swaps. Ultimately, the costs of the swaps resulted in the failure of the business. The properties had to be sold and by the end of the 2011/12 tax year the business had ceased.

In 2012 the FCA identified failings in the way nine banks, including NatWest, had sold swaps and other interest rate hedging products to clients. The banks agreed to carry out reviews of their sales of such products to customers subject to the supervision of independent reviewers appointed under the Financial Services and Markets Act 2000. The reviews resulted in the banks agreeing to pay redress sums to large numbers of unsophisticated customers including the brothers in this case.

The issue to be decided was how these payments should be treated for tax:

- HMRC treated the redress payments and associated interest as revenue and so subject to income tax;
- The brothers argued that the payments were capital in nature and not taxable.

Decision

The First Tier Tribunal said that the aim of redress was to put the customer in the position they would have been had they not used the product. The Tribunal said that the swaps related to loans taken out to expand their property letting business and fell within s264 ITTOIA 2005 with the sums payable being deducted as a revenue expense for tax purposes. Consequently, the basic redress payment must reverse these deductions and so be taxable as a revenue receipt.

In addition, the interest element of the payment was held be a supplement of the basic sum, not a separate payment that was part of an overall package. They were liable to income tax as a post-cessation receipt, but subject to a credit for the basic rate tax deducted at source on the interest element.

The appeal was dismissed.

Gadhavi and others v HMRC (TC06762)

Capital Taxes

Entrepreneurs’ Relief On Share Disposals (Lecture P1107 – 13.18 minutes)

Before we start, somewhat confusingly Entrepreneurs’ Relief (ER) is neither a ‘relief’ nor is it reserved for ‘entrepreneurs’.

A claim for ER gives individuals access to a 10% rate of CGT on qualifying gains, up to a lifetime limit of £10 million. ER therefore halves the CGT rate for higher-rate taxpayers.

This means that ER is in fact more of a ‘special CGT rate’ than a relief (no gains are being ‘relieved’ here any more – all of them are still chargeable). And the fact that this special CGT rate can be claimed by humble company employees means that it is not exclusively reserved for the go-getting Dragons among us. But I guess the Government has more pressing things on its agenda than a renaming exercise. And we’ve kinda gotten used to it.

ER can also be claimed by Trustees in certain limited circumstances. ER is not, however, available to companies to reduce the CT rate on corporate gains.

‘Qualifying gains’ generally means gains on the disposal of either a sole trade business, an interest in a trading partnership or certain shares in trading companies. No ER is available on a transfer of goodwill to a related party (for example on an incorporation) since December 2014. ER is also available on certain “associated disposals”, most commonly where an individual disposes of an asset used in the business as part of his withdrawal from that business.

These notes will concern themselves with disposals of shares. This article will discuss ER on share disposals in general and will highlight some practical points and common pitfalls which practitioners should be wary of. The article that follows will cover the changes to ER on share disposals which will be introduced from 6 April 2019.

The ER rules for shares

Historically ER has been available on a disposal of shares where, for a period of at least 12 months prior to the disposal:

- The individual disposing of shares owns at least 5% of the ordinary share capital of the company; and
- The individual disposing of shares is an officer or employee or the company (or another company in the same group); and
- The company is a trading company (or the holding company of a trading group).

ER is not automatic. The taxpayer must submit a formal claim for ER no later than the first anniversary of the 31 January following the tax year in which the disposal takes place (being 31 January 2020 for disposals in 2017/18). In most cases the ER claim is made on the relevant SA return although there is an online “Claim for Entrepreneurs’ Relief” form for claims made outside the return. The claim can be amended or revoked within the time limit.

From 6 April 2019, the minimum period that certain conditions must be met is increased from 12 months to two years. However, the 12-month rule remains where the taxpayer's business ceased, or his personal company ceased to be a trading company before 29 October 2019.

The 5% test

Prior to 29 October 2019, the shareholder was required to have at least 5% of the ordinary share capital throughout a period of 12 months immediately prior to disposal. This requires an entitlement to at least 5% of the voting rights. The 5% test is measured by reference to the nominal value of the shares rather than the number of shares in issue (although in many cases this will give the same result).

Shares carrying a right to a fixed-rate dividend will not qualify for ER. Following the McQuillan decision at the UTT in 2017, it has been confirmed that ordinary shares which do not carry dividend rights can qualify for ER as, despite HMRC arguing otherwise, 'nil' is not a fixed-rate. These shares must however carry voting rights.

A dilution of shares below 5% at any point in the qualifying period before the disposal will lead to a denial of ER.

From 29 October 2019, the taxpayer must have at least 5% of the ordinary share capital and voting power but also 5% of the profits on distribution and 5% of the assets on a winding up.

There is a real concern that the requirement to have at least 5% of the profits on distribution will affect companies with alphabet shares. Normal practice is to make sure that dividends on each class are independently declarable. It will be important to check the company's Articles of Association as many allow directors to pay differing dividend rates on different classes of share; indeed shareholders may be guaranteed nothing. It would seem that the 5% distribution test could prove problematic for such companies. Until we receive clarification on this point from HMRC, it would seem prudent to avoid creating alphabet shares where there is real value in the taxpayer's company and so entitlement to entrepreneurs' relief is important.

5% test – additional point

A husband and wife are separate taxpayers for ER and there is no aggregation of holdings for the 5% test. This means that if a husband holds 4% of a company and his wife owns 2%, and both work for the company, neither of them will be entitled to ER on a disposal of their shares. In this case thought should be given to placing all shares in one name by means of an inter-spouse transfer. ER would then be available after 12 months have elapsed.

The same is true for non-married couples although this arrangement is slightly more problematic as the process of transferring the shares between the couple is not CGT and IHT exempt.

In cases where one spouse or partner already has a 5% holding (for example if the husband holds 6% of a company and his wife owns 2% and both work for the company), a transfer of the wife's 2% to the husband would give entitlement to ER on the full 8% straight away.

The 5% test does not apply to disposals of shares acquired under the Enterprise Management Incentive (EMI) Scheme. In this case ER can be claimed irrespective of the size of the holding. In addition, the 12-month qualifying period for EMI shares starts from the date the EMI options were originally granted, so disposals immediately after the exercise of the EMI options will normally qualify for ER.

The 'officer or employee' test

There is no minimum hour stipulation, so full or part-time employees or directors will be eligible.

Where the shareholder claims ER on the basis that he is an employee, it is not uncommon for HMRC to look at PAYE records for the preceding 12 months to check the veracity of this claim. However, there is little to support HMRC's view than an employee needs to receive any payment from the company in order for an ER claim to be substantiated. The Courts have not upheld this view in employment-status cases and have found that individuals acting as employees are still employees even though they received no payment. But there is no point walking the tightrope here. Prudent advice is for employees with 5% or more of the shares to be paid as this ends the argument.

In the case of officers (including directors), simply being an office-holder is sufficient and payment of remuneration is not required. A little care must be taken here if an individual is to be appointed as a Company Secretary because although this role ticks the box as far as being an 'officer' is concerned, some company constitutions have rendered the Co-Sec role obsolete. Where a shareholder is appointed to a role which doesn't exist, it is hard to sustain a claim that he is an officer. Articles should be checked (and if necessary amended) before a Company Secretary is appointed.

What is clear is that the shareholder must remain an officer or employee of the company for the whole of the 12 months up to the disposal. This period increases to 24 months for disposals that take place from 6 April 2019.

The importance of this was highlighted in the FTT case of JK Moore v HMRC (2016). Mr Moore was a director and founder shareholder of a company. After some disagreements with his fellow shareholder-directors it was decided that Mr Moore should resign from the Board. The company agreed to acquire his shares via a buy-back. Mr Moore resigned his directorship in February. The contract for the repurchase of shares was not executed until May. Mr Moore's ER claim was subsequently denied as he had not been an officer or employee for the full 12 months leading up to the disposal.

This was careless but it is easy to see how this could have been overlooked in a case where feelings were perhaps running a little high. In hindsight, arrangements should have been made for Mr Moore to remain as an officer or employee of the company in some capacity until the contracts for the share disposal had been signed. This is not difficult to organise, but it does require somebody to engage in a bit of fore-thought.

The 'trading company' test

According to S.165A TCGA 1992, "a trading company is a company carrying on trading activities whose activities do not include, to a substantial extent, activities other than trading activities".

HMRC guidance tells us that “substantial” means more than 20%. The “20% test” is applied to several different criteria such as turnover, profits, asset base and directors’ time. A holistic view is then taken.

Practitioners need to keep an eye on this because as a company develops and the nature of its business changes, it is feasible for profits to be reinvested in more investment-based activities such as property letting (or simply retained as cash). There might then come a point where the 20% test is tipped in HMRC’s favour which could then lead to a denial of ER on a sale of shares. An annual ‘ER review’ of the company accounts should be within the tax practitioner’s duty of care.

Practitioners should also bear in mind that HMRC’s non-statutory business clearance service (NSBCS) can be used to verify that a company has trading status. This can be helpful where cash balances are high. [See page CG64100 of the HMRC CGT Manual]. This is perhaps the first port of call before a decision is made to reduce the cash mountain by paying a taxable dividend. Clearance under the NSBCS can only be used by the company. Individual shareholders who are anxious to know whether their shares qualify will therefore have to piggy-back on the company’s clearance application.

In companies where letting activities are becoming more prominent (due to good rental returns and capital growth), thought should be given to hiving-out this part of the business into a separate company. This will protect the ER position for the original shares.

There is no territorial restriction on where the trade is carried on (or indeed where the shares are registered). Shares in foreign companies are therefore eligible for ER.

On this point it has been confirmed that where gains on foreign shares have been subject to a remittance basis claim, ER is available to tax the gains at 10% when the proceeds are remitted to the UK. This is however subject to an ER claim being made by the normal time limit. This means that gains made in 2017/18 would need to be accompanied by an ER claim no later than January 2020 even though the gain may not have been remitted by that point.

The sensible course of action here is that if a client makes qualifying gains which are then sheltered by a remittance basis claim, a protective ER claim should also be made “just in case”.

Protective claims should also be considered for individuals making a qualifying share disposal in a non-resident tax year where it is likely that they will resume residence within 5 years of leaving. In this case the gain will be taxed in the year of return under the temporary non-residents rules. ER will only be available if a claim was made within the normal time limit.

The company must be a trading company throughout the 12 months up to the disposal, extended to 24 months from 6 April 2019. This is an interesting rule because it opens-up the possibility for companies whose shares would not be eligible for ER due to the nature of its business, to change that business and trigger eligibility for ER 12 (or 24) months later. This is not always easy to do of course. However, a company with a rental business which switched to letting-out qualifying furnished holiday accommodation would only need to satisfy the FHA criteria for 12 months for the shares to qualify for ER, extended to 24 months from 6 April 2019. The previous non-trading history would be wiped-away.

The need to be a trading company for the qualifying period before the share disposal is relaxed where the company is wound up and the shareholder receives a capital distribution on a disposal of the shares.

In this case ER is available provided that:

- The capital distribution takes place within three years of the cessation of the company's trade; and

- The shareholder had a 5% interest and was an officer or employee of the company for the 12 months (24 months from 6 April 2019) before the company ceased trading.

Practitioners seeking to secure ER on a winding-up should have regard to the "anti-phoenixing" rules introduced with effect from 6 April 2016. These provisions prevent shareholders from winding-up Company A, paying CGT at 10% on the accumulated cash reserves which are paid out as capital, then setting up Company B to do the same thing. In this case the distribution from Company A would be treated as income and taxed at 32.5% or 38.1%.

The lifetime limit

The maximum amount of qualifying gains that may benefit from ER is restricted to a lifetime limit of £10 million. Practitioners should therefore keep a record of the gains against which clients have previously made a claim.

This limit is not index-linked and there seem to be no plans to increase it. The limit is effectively £20 million for a couple, so where qualifying gains exceed £10 million, the opportunity to use both spouse's limits should not be wasted. The potential tax saving here is £1 million that is not to be sniffed at.

Contributed by Steve Sanders

Banking of entrepreneurs relief from April 2019 (Lecture P1108 – 11.41 minutes)

An Entrepreneurs' relief dilemma

As mentioned in the previous article, a dilution of shares below 5% at any point in the 12-months before the disposal will lead to a denial of entrepreneurs' relief (ER). Remember this period extends to 24 months for disposals taking place from 6 April 2019.

For example, Ernie has shares in a trading company in which he is a director. Ernie has held the shares since the company was founded. His shareholding is sufficiently large that a disposal of shares will qualify for ER.

The company has been looking for an injection of finance and has located external investors who will subscribe for shares in the company and help it grow. The issue of new shares will mean that Ernie's shareholding will be diluted to less than 5%. Ernie's shares will therefore be taken out of the range of ER and his CGT exposure on a sale of those shares will double.

Ernie would rather retain his investment and stay with the company to help support and grow the business. However he accepts that for CGT reasons he may be better off exiting the company earlier than planned.

Ernie could consider engineering a disposal to crystallise ER while retaining his shares by either:

- Gifting his shares to a settlor-interested trust (which has IHT considerations and is potentially fee-heavy); or

- Selling his shares and buying them back which means a) finding a buyer and then b) waiting 31 days to avoid the impact of the share matching rules which leaves him exposed to share movements in the waiting-period. His wife could buy the shares back sooner, but this still isn't ideal.

Whichever way you look at it, there is no comfortable solution.

This scenario (or something similar) was presented to the Government who responded with the announcement of a consultation under the title "Financing growth in innovative firms: allowing Entrepreneurs' Relief on gains before dilution". The consultation ended in May 2018 and draft legislation followed in July 2018.

The Government agreed with many respondents and accepts that the present rules are a "perverse consequence" of a company becoming successful and wishing to issue more shares. It was recognised that the requirement to satisfy the 5% rule until disposal can act as a disincentive for existing shareholders to accept external investment. In practice this often means that the original entrepreneurs, like Ernie, who founded the company do not benefit from ER because their share interest has been diluted by the time it is their turn to exit.

A very sensible solution

The solution to the problem comes in the form of ER 'banking'.

The draft clauses to the Finance Bill 2018/19 allow ER to be banked in circumstances where an individual loses his entitlement to the relief by reason of his shareholding falling below the 5% threshold.

The individual can make an election that treats his shares as having been disposed of immediately before their eligibility for ER is lost for an amount equal to their market value at that point. The deemed disposal will crystallise a gain that is eligible for ER. [If the deemed disposal would give rise to a loss, no election is possible.]

Having 'sold' the shares, the individual is then treated as having immediately reacquired them at the same value. An unexpectedly generous clause says that the market value of the shares can be based on a percentage of the full value of the company. For example, if Ernie has a 25% holding and the company is worth £2 million, his shares would be deemed to be worth 25% of £2 million. There would be no need to value the 25% holding on a discounted minority basis (as there would be if, for example, the shares were being given away).

This has the benefit of;

- Increasing the amount of the gain which is eligible for ER;
- Reducing future gains which are not eligible for ER; and
- Making the valuation exercise far less painful than it might otherwise have been.

Deferring the deemed gain

The disposal at market value triggers a gain that is eligible for ER. A CGT charge arises. Tax is then due at 10%.

Clearly this is a 'dry' tax charge as the individual does not have any cash proceeds from which to meet the liability.

In this case the individual can make an election to postpone the charge until the shares are sold. The effect of the election is that no gain is treated as having arisen at the time that ER is 'banked'. Instead the notional gain that would have arisen on the deemed disposal is deferred. This deferred gain is crystallised on the date that the shares are sold.

The effect of such an election is that two chargeable gains will arise on an eventual disposal of the shares, these being;

1) The deemed gain arising immediately before the relevant share issue. This gain will qualify for ER; and

2) The gain arising between the date of the relevant share issue and the sale of the shares (being sales proceeds less the non-discounted value of the shares at the date of the election). This gain will not qualify for ER as the 5% test will not be satisfied.

There is little point adding gains 1) and 2) together as these gains will be taxed at separate CGT rates.

In relation to the gain at 2) above, it is of course possible that the individual will acquire more shares in the intervening period, taking his holding back above 5%. In this case ER would be available on this disposal if a 5% holding has been held for at least 12 months, or 24 months from 6 April 2019.

If only part of the shareholding is sold, only that same part of the deferred gain falls into charge. The rest of the gain continues to be deferred.

Example

Ernie subscribed £50,000 in 2010 for a 25% shareholding (2,500 shares) in Trade Co Ltd. He is a director. On 30 April 2019, Trade Co Ltd issued new shares to external investors such that Ernie's shareholding in the company became diluted to 4%. He made an election under S.169SC TCGA 1992 to be treated as having disposed of his shares immediately before the new shares were issued. The value of Trade Co at that date was agreed to be £2 million.

Ernie also elected under S.169SD TCGA 1992 for the notional gain to be deferred until the sale of his shares in Trade Co Ltd. Ernie sold 1,000 of his Trade Co shares in June 2020 for £300,000.

Show the chargeable gains arising in 2020/21.

Solution

There is a deemed disposal and reacquisition of shares at market value on 30 April 2019 as follows:

		£
MV of 25% shareholding	£2 million x 25% (no discount)	500,000
Less: Base Cost		(50,000)
Notional gain (deferred)		450,000
CGT base cost of 2,500 shares at 30 April 2019		500,000

Sale of 1,000 shares in June 2020:

		£
Sales proceeds		300,000
Less: Base Cost (1,000 shares)	1,000 / 2,500 x £500,000	(200,000)
Chargeable gain		100,000
Deferred gain crystallised June 2020	1,000 / 2,500 x £450,000	180,000

The deferred gain (£180,000) will be eligible for ER. The gain arising on the actual share sale (£100,000) will not qualify for ER because Ernie only has a 4% interest.

Capital losses

Where the sale of the shares gives rise to a capital loss, this loss can be set-off against the crystallised gain on the deemed disposal. This is because the effect of the postponement election is to treat the gain and loss as arising in the same tax year. This is only possible if the deemed gain is deferred. If no postponement election had been made – and CGT was paid in the tax year of the notional disposal – the later loss cannot be carried back against the earlier gain.

Losses on a share disposal could be caused by the shares falling in value between the date of the deemed disposal and the date of sale. However, bear in mind here that the shares have been ‘over-valued’ on the deemed disposal as no account was taken of discounts for minority holdings. Once ER has been ‘banked’, the CGT base cost for the shareholding is more than the shares would fetch if sold on the open market at that date. Capital losses on a disposal may not therefore be all that surprising.

The required elections

There are two elections in this scenario:

1. The 'banking election' (author's tag) which triggers the deemed gain at market value. This election must be made no later than the self-assessment filing deadline being 31 January following the tax year in which the deemed disposal takes place; and

2. The 'postponement election' (author's tag again) which defers the gain and effectively drops it into the tax year in which the shares are sold. This election should be made within four years of the end of the tax year of the deemed disposal.

The postponement election can only be made if the banking election has been made (which is somewhat obvious but the draftsman found reason to make this clear). Both elections are irrevocable.

It seems likely that both elections will be made at the same time via the SA return. After all, if a postponement election is not made by the SA filing date, HMRC will expect to receive the tax.

It should also be noted that if a postponement election has been made, when the deferred gain crystallises it will only qualify for ER if a claim is made. This claim should be made within the normal ER time limit which is the anniversary of the 31 January following the tax year in which the gain is charged. In plain English this means that if the client sells his shares in 2020/21, an ER claim in relation to the deferred gain should be made by 31 January 2023.

If shares are sold in bunches so that part of the deferred gain crystallises each time, an ER claim must be made in respect of every gain which becomes chargeable.

The conditions

Not all shareholders can bank their ER entitlements.

A banking election can only be made if the reason for the dilution of the claimant's shares is the issue of new shares by the company. There is no restriction on the type of shares issued by the company (for example, relief is still available if the new shares are not ordinary shares carrying voting rights).

This new share issue must be for cash and (as is standard nowadays), it must be for genuine commercial reasons and must not form part of an arrangement for the avoidance of tax. It seems that the government expects companies to use the new share capital for the purpose of the trade.

Elections to bank ER can only be made where there is a 'relevant share issue' on or after 6 April 2019. Therefore, companies who are currently seeking external investment which would put shareholders in the position where their holdings would be diluted to less than 5%, might want to put their funding plans on hold until April 2019 (or at least get all their ducks in a row now with a view to issuing the shares to their investors on 6 April 2019).

A banking election cannot be made just because a shareholder disposes of some shares and that disposal takes his shareholding below 5%. Shareholders in this position should either retain a 5% shareholding or simply sell the lot.

Finally here I am told that it is not uncommon for Shareholder Agreements to have been drafted so as to prohibit the dilution of certain shareholdings below 5% in order that eligibility for ER is preserved. Presumably clauses to this effect will no longer be necessary after April 2019.

Contributed by Steve Sanders

Negative earn-outs (Lecture B1108 – 27.28 minutes)

In the past, whenever a private company was sold on an earn-out basis, it was relatively common for the deal to be structured so that the earn-out payment was satisfied by an issue of shares or loan notes in the purchasing company that fell to be dealt with under S138A TCGA 1992. Under business asset taper relief, this arrangement had a number of beneficial tax consequences:

- the gain which would have arisen on that part of the original shares attributable to the earn-out right under the rule in Marren v Ingles (1980) was deferred;
- the subsequent issue of shares or loan notes by the purchasing company was treated as the conversion of a non-QCB security so that the capital gains charge was postponed still further; and
- a gain, computed by reference to an appropriate part of the vendor's shares, only came into charge when the shares or loan notes in the purchasing company were eventually disposed of.

The impact of this was that all the vendor's gains would typically attract business asset taper. It should be remembered that, with a cash-based earn-out, taper was only available to reduce the gain on the original disposal and never on the subsequent ones (an earn-out right not being a qualifying business asset).

With the replacement of business asset taper by entrepreneurs' relief and changes in both the entrepreneurs' relief limit and the CGT rate, it is thought that future corporate disposals involving earn-outs should more often take the form of cash deals. The main reason is that, where S138A TCGA 1992 applies, entrepreneurs' relief is virtually never available on the earn-out element and so it will make sense to maximise the vendor's initial gain, given that this is the one time when the 10% rate can be claimed. Since the remaining gains are likely to be charged at 20%, a higher upfront gain and a lower deferred charge will normally represent good tax and cash flow planning.

Illustration

Tom formed Tom Industries Ltd in April 1996, subscribing for the entire share capital of 10,000 ordinary shares of £1 each at par. On 1 July 2015, he sold his shareholding to a plc.

The sale contract provided for:

- an initial cash consideration of £2,800,000 to be paid on completion; and

- a deferred earn-out consideration based on defined profits for the 12 months ended 30 June 2016, which was to be satisfied in the form of loan notes from the plc. (the maximum earn-out consideration was set at £2,200,000).

Tom continued to act as managing director of Tom Industries Ltd during the earn-out period (for which he was appropriately remunerated).

Tom's earn-out right was valued at £1,200,000 as at 1 July 2015. On the assumptions that the actual earn-out consideration turns out to be £1,650,000 for the 12 months ended 30 June 2016, that the loan notes were received by Tom on 1 November 2016 and that the loan notes were redeemed on 1 May 2017, Tom's CGT computations proceed as follows:

2015/16

	£
Sale proceeds	2,800,000
Less: Cost $\frac{2,800,000}{2,800,000 + 1,200,000} \times 10,000$	7,000
	2,793,000
Less: Annual CGT exemption	(11,100)
	2,781,900

CGT @ 10% £278,190

2017/18

	£
Earn-out proceeds	1,650,000
Less: Cost (10,000 – 7,000)	(3,000)
Less: Annual CGT exemption	(11,300)
	1,635,700

CGT @ 20% £327,140

Tom's aggregate CGT liability for this transaction amounts to £278,190 + £327,140 = £605,330.

If, however, Tom's earn-out deal had been structured in cash so that the payment of £1,650,000 was made on 1 May 2017, the tax position changes significantly:

2015/16

	£
Sale proceeds (2,800,000 + 1,200,000)	4,000,000
Less: Cost	(10,000)
	3,990,000
Less: Annual CGT exemption	(11,100)
	3,978,900

CGT @ 10% £397,890

2017/18

	£
Earn-out proceeds	1,650,000
Less: Cost	(1,200,000)
	450,000
Less: Annual CGT exemption	(11,300)
	438,700

CGT @ 20% £87,740

Tom's total CGT liability is now £397,890 + £87,740 = £485,630, a saving of £119,700. Even though Tom has paid more tax initially, the overall saving will certainly be worth having.

Interestingly, it may be possible to save even more tax. This is achieved by having what is sometimes referred to as a 'negative earn-out'. That is to say, the sale price is set at the maximum possible figure (£2,800,000 + £2,200,000 = £5,000,000 in the example involving Tom above). Only the basic amount of £2,800,000 is paid upfront, with the remainder to be handed over in deferred cash at the earn-out date. However, this deferred cash amount is reduced if the earn-out targets are not fully met.Provided that the transaction is structured this way round, one achieves a similar economic effect between the parties to an earn-out, but the tax calculation is now based on the full £5,000,000 sale price. If less than this is received, then, under S48 TCGA 1992, it is possible to reopen the computation and adjust the sale proceeds figure to the actual receipt.

The advantages of this arrangement are that:

- the taxpayer qualifies for entrepreneurs' relief on the full amount received (subject, of course, to the £10,000,000 limit); and
- it is unnecessary to find a valuer to do the complicated exercise of working out the Marren v Ingles (1980) figures.

This is because the taxpayer has moved into the realm of deferred consideration rather than unascertainable consideration. In the Tom example, the taxpayer will save an additional £43,000 of CGT.

Contributed by Robert Jamieson

Non-UK resident capital gains taxation **(Lecture P1109 – 23.25 minutes)**

Background

On 6 July 2018, following a consultation process which started last year, the Government published a draft Finance Bill containing their detailed proposals for extending the scope of the taxation of capital gains from UK property.

Currently, non-UK residents (other than, essentially, non-close companies) are taxed on gains made on the disposal of UK residential property. In addition, companies, corporate partnerships and certain collective investment schemes, wherever resident, are taxed on gains made on the disposal of UK residential property where ATED applies – this is known as the ATED-related CGT charge and is levied at 28%.

Gains on UK commercial property investments made by non-UK residents are, at present, outside the scope of a UK tax charge.

With effect from 6 April 2019, the Government will widen the capital gains charge to encompass all non-UK residents (with very limited exemptions) and to take in:

- all forms of UK property (i.e. commercial as well as residential); together with
- entities such as shares which, directly or indirectly, derive at least 75% of their value from UK property interests.

Draft legislation has also been published to bring non-UK resident corporate landlords within the scope of corporation tax (rather than income tax) in connection with their UK property income. This move is planned to take effect from 6 April 2020 and is primarily intended to bring such taxpayers within the ambit of the corporate tax regimes for loss relief, loan relationships and the recent interest relief restrictions.

Overview of the new measures

The new rules will apply to direct and indirect disposals of UK property interests taking place on or after 6 April 2019, regardless of whether the disposal is by a company or some other person. The existing NRCGT regime for the sale of UK residential property will be subsumed into one overall regime covering disposals of all forms of UK property and so will effectively disappear. The ATED-related CGT legislation is also being abolished. This process will be achieved through a consolidation rewrite of the whole of Part 1 of TCGA 1992 – hopefully, it will not throw out any unintended changes of meaning!

Where the non-UK resident is a company (or some other entity which would be within the scope of corporation tax if they were UK-resident), any gain will be chargeable to corporation tax. For others, the charge will be to CGT.

This will give rise to a noteworthy simplification of the rates of tax applied to the sale of UK property interests:

- the standard corporation tax rate (currently 19%) will apply to companies on the sale of all UK property;
- individuals will pay CGT at 18% or 28% (depending on whether they are basic or higher rate taxpayers) on the sale of UK residential property and at 10% or 20% on the sale of UK commercial property; and
- the ATED-related CGT charge will disappear completely as part of the abolition of those rules.

For disposals which would not have been within the charge to UK tax before these legislative changes (for instance, the disposal of UK commercial property by a non-UK resident), the allowable cost to be set against the sale proceeds will be taken, for property owned as at 5 April 2019, to be the property's market value on that date.

However, a taxpayer will have the facility to elect to use the property's original cost instead of its market value on 5 April 2019, if that would give rise to a loss or to a lower gain than under rebasing.

For disposals already within the charge to UK tax, the current basis of taxation will continue to apply so that, for example, 5 April 2015 will still be the rebasing point for disposals currently within the NRCGT regime. An original cost election is also possible. A further refinement is that such a taxpayer can make a straight-line time-apportionment of the gain so that only the proportion of the gain arising after 5 April 2015 is brought into charge.

Other aspects of the capital gains rules will still be in point, including:

- the offset of losses from other disposals against gains;
- reliefs such as rollover relief and the no gain no loss relief on intra-group transfers;
- exemptions such as the annual CGT exemption or the substantial shareholding exemption (SSE); and
- existing anti-avoidance legislation (e.g. for depreciatory transactions).

The new charges will apply to all non-UK residents other than those who are generally exempt from UK taxation such as qualifying overseas pension schemes. Thus, if a foreign pension fund makes a disposal of a UK property investment held for the purposes of the scheme, any resulting gain would not normally be charged to tax.

A TAAR will seek to counteract any arrangements entered into on or after 6 July 2018, which aim to circumvent this new taxation regime.

Indirect disposals of UK property

In addition to being subject to UK tax on gains made on direct disposals of UK property, non-UK residents are going to be taxed on gains made on the disposal of entities – regardless of where the entity is resident – which themselves, directly or indirectly, hold UK property, unless the entity uses the asset in its trade (or acquired it for such use). This move represents a considerable expansion of the UK's capital gains regime.

The taxation charge will apply to the disposal of shareholdings and other interests in entities where at least 75% of the entity's gross asset value at the date of disposal is derived directly or indirectly from UK property. In most cases, one will be looking at disposals of shares in companies. Where the company whose shares are being disposed of itself holds subsidiaries and other investments, it will be necessary to drill down to the level of the underlying property assets owned by the group in order to see whether or not the 75% test has been met.

Under the original consultation, indirect disposals were subject to taxation even if the company in question used the property in its trade. However, following representations from interested parties, the Government have amended these proposals so that gains on the disposal of the company's shares will be exempt from the new charge where the property held by the company is used for the purposes of its trade (or was acquired for such use). The trade must have been carried on commercially with a view to profit for at least one year prior to the disposal and it must be expected to continue after the disposal for more than an insignificant period of time.

The charge will only apply to persons who held an interest of at least 25% in the company at any time during the two years leading up to the disposal. It should be noted that this 'look-back' period represents a change from the Government's original proposals where a five-year period was mooted. In assessing the percentage owned by the relevant person, interests held by connected parties must be aggregated. The definition of 'connected' does not include partners in a partnership, but it will cover the situation where two or more persons are 'acting together' to secure or exercise control of a company.

As with direct disposals, rebasing to market value on 5 April 2019 will apply for shares held as at that date. There is also an option to use original cost. However, unlike direct disposals, any loss arising from an original cost election will not be an allowable loss.

It should be noted that indirect disposals could potentially qualify for the SSE. It is possible that 'property-rich' companies, which are not regarded as trading for the purposes of this new capital gains charge, may still be regarded as trading companies for SSE purposes (especially following the relaxations brought in by F(No2)A 2017). In such cases, an indirect disposal could be eligible for the relief.

Finally, there is an anti-forestalling rule which aims to counteract arrangements entered into on or after 22 November 2017 seeking to make use of double taxation treaties to avoid the new charge if any tax advantage obtained is 'contrary to the object and purpose' of the relevant treaty. This operates in addition to the TAAR referred to above.

Contributed by Robert Jamieson

Payment window for residential property (Lecture P1110 – 10.01 minutes)

As part of the standard self-assessment process, UK-resident taxpayers have to pay CGT due on gains realised on the sale of chargeable assets. This takes place between 10 and 22 months after the making of the disposal.

In 2015, the Government announced that they would introduce, with effect from 6 April 2019, a requirement that CGT on gains from the sale or other disposal of residential property should become payable within 30 days of the disposal transaction being completed. This will be treated as a payment on account towards the person's liability for the tax year in which the disposal is made.

However, on 22 November 2017, the Chancellor announced that the introduction of this new regime would be deferred to 6 April 2020. A consultation entitled 'Capital Gains Tax: Payment Window For Residential Property Gains (Payment On Account)' was conducted between 11 April 2018 and 6 June 2018. This sought views on the details of the proposed scheme for UK residents and on changes to a similar arrangement for some non-UK residents. Respondents to the consultation document were mainly concerned about two matters:

- the practicability of making accurate calculations within the 30-day window; and
- the treatment of allowable losses.

On 6 July 2018, a draft Finance Bill was published. This contains a new Schedule (Sch 2) which sets out the circumstances when a return of a residential property disposal must be delivered to HMRC and deals with the calculation of the amount payable on account of the disponor's liability to CGT for the tax year in which the disposal takes place.

The general rule is that a return must be delivered to HMRC within 30 days following the day on which completion takes place. A payment on account of the tax liability should be made at the same time. This self-assessed calculation of the payment due can take into consideration unused losses and the person's annual CGT exemption. The rate of tax for individuals (18% or 28%) is determined after making a reasonable estimate of that person's taxable income for the year.

For disposals involving UK residents, the new reporting and payment legislation will not apply where the gain on the disposal (or the total gain where more than one disposal is made in the tax year) is not chargeable to CGT because:

- the gain is sheltered by principal private residence relief, an allowable loss or the annual CGT exemption;
- the gain arises from the disposal of a foreign residential property which is situated in a country covered by a CGT double taxation agreement; or
- the remittance basis is in point.

In their response to the consultation document, the Tax Faculty made the following comment:

> 'Taxpayers may well incur additional compliance costs as they will be required to submit a provisional tax computation within 30 days of completion, with a second computation being required when . . . further costs or information have come to light or subsequent capital events have occurred necessitating a revised computation and then the final report on the self-assessment. As an alternative to a computation of the gain, a system similar to that in other countries – where a fixed percentage of the sale proceeds (is) paid over on account of the CGT with a repayment/additional payment being made once the detailed computation has been submitted – could be an elective option for taxpayers.'

Sadly, this sensible suggestion seems unlikely to be adopted by the Government.

Contributed by Robert Jamieson

Transfer of s32 buyout pension policy (Lecture P1106 – 16.09 minutes)

Summary – A transfer from a s32 buyout pension policy to a personal pension policy, with a statement of wishes identifying two sons as beneficiaries, was a transfer of value for IHT.

Mrs Staveley and her husband built up a company of which she was a director. They divorced and, as part of her settlement in 2000, she gave up her role in the company and was granted her pension in the form of a s32 buyout policy (S32 FA 1981). This allowed her to invest the fund as she chose but any surplus on her death would be returned to the company.

In October 2006, two months before her death in December, aged 56, Mrs Staveley transferred the s32 policy to a personal pension policy. If Mrs Staveley's pension had remained in the original policy, on her death, a lump sum would have been payable to her estate and chargeable to IHT. Under the Personal Pension Policy, Mrs Staveley nominated her two sons as her beneficiaries in relation to the death benefit. Consequently, if the purchase exemption applied, her sons would receive the death benefit free of IHT.

She did not draw any benefit from the new policy.

HMRC looked to charge both events to tax arguing that:

- the transfer to the new personal pension plan was a transfer of value (s3(1) IHTA 1984);
- failing to withdraw benefits was a further transfer as the sons' estates had increased in value (s3(3) IHTA 1984)

The personal representatives' appeals had been successful at the First-tier Tribunal and Upper Tribunal, so HMRC took the case to the Court of Appeal.

The main issue was whether Mrs Staveley had made the transfer 'with the intention of giving her sons a gratuitous benefit'.

Decision

The Court of Appeal found that the rights that the sons had acquired under the PPP were different from those they had as beneficiaries under the will; their rights under the will were only indirect and might be reduced by other liabilities of the estate or other gifts. More generally, the court considered that it could not have been Parliament's intention to allow s10(1) to apply in all circumstances where the donor has, in some way, donated the same asset previously. The court added that the exclusion of 'any' gratuitous benefit was widely drafted and suggested that s 10(1) was intended to be narrowly construed.

The court also found that Mrs Staveley's omission to draw benefits after the transfer had been both an associated operation within the meaning of s268 IHTA 1984 (since 'operation' 'included an omission') and one intended to confer a gratuitous benefit. The judge said the tribunal had been wrong to decide there had been no intent linking the omission to take pension benefits and the transfer to the personal pension. Both transactions formed part of the same disposition. Therefore, there was a conferral of a benefit and a newly conferred right because the beneficiaries acquired the new rights under the personal pension scheme rules. HMRC's appeal was allowed.

CRC v Parry and others, Court of Appeal, 16 October 2018
Adapted from case summary in Taxation (1 November 2018)

Business relief for livery stables (Lecture P1106 – 16.09 minutes)

Summary – The Upper Tribunal agreed with the First Tier Tribunal that the livery business ran on 30 acres of land qualified for 100% business relief.

As Robert Jamieson reminded us last month, Mrs Vigne ran a livery stable on some 30 acres of land taking in horses in the spring, summer and early autumn but then closed for the winter. On death, the business was valued on a net asset basis including her valuable land. She claimed 100% business relief which HMRC denied, arguing that her business was one of 'wholly or mainly of making or holding investments' meaning that relief was not available.

The First Tier Tribunal had concluded that no properly informed observer could have concluded that her livery business was wholly or mainly a business of holding investments. They concluded that Mrs Vigne had a business, she was providing services relating to that business and 100% business relief was allowed.

HMRC appealed to the Upper Tribunal. In HMRC's view, the business was an actively managed letting business and that the additional services were not sufficient for the business to qualify for 100% business relief.

Decision

The Upper Tribunal found that the First Tier Tribunal had explicitly addressed the issue of whether the livery activity was one of wholly or mainly a business of holding investments. On the basis of the evidence before it, the First Tier Tribunal were entitled to reach their conclusion that 100% business relief applied to the deceased's livery business as it provided 'significantly more than the mere right to occupy a particular parcel of land'.

HMRC v The personal representatives of the estate of M. Vigne [2018] UKUT 357

Gift with reservation of benefit (Lecture P1106 – 16.09 minutes)

Summary - The grant of a sub-lease with covenants reflecting those included in the head lease was a gift with reservation of benefit.

The issue was whether a reversionary long sub-lease of a valuable London residential property, granted on favourable terms by Lady Hood to her three sons in 1997, was property subject to a reservation when she died in 2008, four years before the sub-lease would have fallen into her possession. If the sub-lease was property subject to a reservation, it formed part of her estate chargeable to IHT on her death. If the sub-lease was not property subject to a reservation in her estate, it escaped IHT on her death, because it was not deemed by s102 to be part of her estate and the original grant of the sub-lease was a potentially exempt transfer (PET) which she had survived by more than seven years, and which consequently became an exempt transfer.

The case turned on whether the sons' enjoyment of the sub-lease was 'to the exclusion, or virtually to the entire exclusion … of any benefit [to the donor] by contract or otherwise'. HMRC contended that this test was not satisfied, because the sons entered into a direct covenant with their mother in the sub-lease to observe and perform the provisions in the head lease as if they had been repeated in full (subject to any necessary modifications) in the sub-lease.

The executors argued, however, that the donated property was the sons' sub-leasehold, which from the outset had the sub-tenants' covenants in the sub-lease imprinted on it. They said that had the sons assigned their sub-leasehold estate, the assignee would have acquired it subject to their covenants.

Decision

Agreeing with the executors, the court observed that the gift made by Lady Hood was a gift of an interest in land subject to, and with the benefit of, the obligations that the parties agreed to undertake in the sub-lease.

However, the court did not agree that this identification of the subject matter of the gift excluded the operation of s102. It noted that in her capacity as the intermediate lessor of the property, Lady Hood had the benefit of the positive covenants given by her sons.

Although those benefits were future ones (they would only come into force when the sub-lease fell into possession in March 2012), they would then endure for the benefit of Lady Hood (or her estate after her death) until 2076 or the prior termination of either the head lease or the sub-lease. 'This was undoubtedly a benefit to Lady Hood of real, and more than minimal, value; and, crucially, it had no prior existence before the grant of the sub-lease.'

The court added that the fact that the benefit to the donor was inseparable from the gift itself only went to show the closeness of the connection between the gift and the benefit, as in Buzzoni [2014] 1 WLR 3040. It also noted that both Nichols [1975] 1 WLR 534 and Ingram [2010] 1 AC 293 were authorities for the proposition that if the gift of a leasehold interest is accompanied by positive covenants which confer additional benefits on the donor, there is a reservation of benefit within s 102(1) (b).

Viscount Hood (executor of the estate of Lady Hood) v HMRC [2018] EWCA Civ 2405
Adapted from case summary in Tax Journal (9 November 2018)

SDLT first time buyers' relief guidance updated

Budget 2017 introduced relief from SDLT for first time buyers from 22 November 2017 when purchasing residential property for £500,000 or less, provided the purchaser intends to occupy the property as their only or main residence.

On 29 October 2018 the relief was extended, retrospectively from 22 November 2017, to first time buyers purchasing through approved shared ownership schemes who choose to pay SDLT in stages.

HMRC has updated its guidance that outlines the application of SDLT rates for first-time buyers claiming relief in respect of the grant of a shared ownership lease as follows:

- Where a market value election is made, the SDLT rates for first-time buyers apply to the relevant consideration under that treatment and no SDLT will be due on any rent paid under the lease. A market value election can only be made at the time the initial lease is granted by the scheme provider and, once made, cannot be withdrawn;

- Where the purchaser chooses instead to pay SDLT in stages, the SDLT rates for first-time buyers will apply to the actual consideration (the premium) paid for the initial share purchased, provided the market value of the property as referenced in the lease is £500,000 or less. No SDLT will be payable on the rental payments. The relief applies only to the first transaction, when the lease is granted by the scheme provider.

'Staircasing' transactions (purchases of further shares in the property) will not lead to the withdrawal of the relief claimed on the grant of the lease, even if the total paid for all the transactions exceeds £500,000.

Where a market value election is not made, no further SDLT will be due until the purchaser increases their ownership share in the property over 80%. The normal rules for shared ownership, including the standard SDLT residential rates and method of calculation, will apply to the transaction that takes the purchaser's ownership share over 80% and any subsequent ‘staircasing’ transactions.

https://www.gov.uk/government/publications/stamp-duty-land-tax-relief-for-first-time-buyers-guidance-note

Administration

High income child benefit charge penalty case reviews

HMRC has announced that it is reviewing cases where a 'Failure to Notify' penalty was issued for the tax years 2013/14, 2014/15, and 2015/16, to customers who did not register for the High Income Child Benefit Charge. Where HMRC finds that the customer had a reasonable excuse for not meeting their tax obligation, it will issue refunds.

The review will include families who made a claim for Child Benefit before High Income Child Benefit Charge was introduced, and where one partner's income subsequently increased to be over £50,000 in or after the 2013/14 tax year. This is because the higher earner in a household who pays the charge may not be the same person claiming Child Benefit on behalf of the household.

The review will not include anyone who received communications from HMRC about High Income Child Benefit Charge or claimed Child Benefit after the charge was introduced in 2012/13.

Alongside this, HMRC is already writing to customers who might be liable to High Income Child Benefit Charge in 2016/17 and 2017/18, to help them meet their tax obligations in time to avoid paying a penalty.

www.gov.uk/government/news/hmrc-to-review-high-income-child-benefit-charge-penalty-cases

Successful Discovery and no PPR

Summary – HMRC's discovery assessment was valid and so the taxpayer was not entitled to private residence relief on the sale of her property.

Prior to buying a derelict property in London in July 2006, Katie Lo lived in a rented property on the Isle of Wight with her mother and sister. Having bought the London property, she moved to Southampton to attend university and only visited her London property at weekends and during some of her university holidays when she slept on a mattress. She was not on the electoral roll in London, and had applied for a council tax exemption on the basis that the property was unfurnished and uninhabitable. She had also applied for a loan, repayable in late 2007, to undertake the repair work, but used the bulk of this to repay her mother some of the original acquisition costs so her funding to buy her property did not extend beyond November 2007. She had applied for planning permission but this was declined and soon after, she made plans to sell her property that completed in July 2007.

Katie contended that the flat was her main residence. On that basis, assuming that she was eligible for PPR relief and that that relief would cover her gain, she had not filed a tax return reporting the substantial gain on disposal.

There is no evidence of any contact between HMRC and Katie Lo for almost five years following the sale. Contact was originally made by HMRC in 2012 following HMRC's interest in her mother's tax affairs.

Having made initial enquiries into Katie's transactions, in April 2014, HMRC wrote to her accountant stating:

> "I take the view that [the property] was not your client's Principle (sic) Private Residence. Rather than contending that a liability to Capital Gains Tax arises on the disposal I believe that there are sufficient grounds to continue my investigation on the basis that Miss Lo failed to notify chargeability; that this, apparently "one-off" transaction was in the nature of a trade."

HMRC wrote a letter to Katie requesting information and explaining that they needed to ensure that any tax that was due was not time barred for recovery action. They stated that under s29 TMA 1970, the time limit under which HMRC may raise an assessment to collect tax lost due to the careless behaviour of a taxpayer is extended from the normal 4 years to 6 years following the end of the tax year to which that tax relates, so by 5 April 2014 the time limit for raising an assessment for 2007/08 would expire. To protect HMRC's position an estimated assessment was made.

On 8 September 2014, HMRC further concluded that Katie Lo was not trading, but that the property was not her principal private residence. HMRC stated that a further Discovery Assessment would not be raised until Katie Lo had had the opportunity to provide her calculation of the chargeable gain.

On 26 January 2015, HMRC issued a discovery assessment for CGT of £105,293.86, and raised a penalty notice of £21,058 for failure to notify liability. Katie Lo appealed.

Both parties agreed that there had been a discovery but not when the discovery was made:

- Katie Lo argued that the discovery had been when HMRC had 'made an enquiry of [the Appellant] in May 2012 and it was concluded that [the Appellant] had failed to notify chargeability. The papers were referred to Local Compliance Fraud.' She further argued that this discovery had become stale through inaction as it was not until April 2014 that HMRC first decided to raise an assessment.

- HMRC originally concluded that the funds received from the property sale constituted a trading profit but that the relevant discovery was made in September 2014, when they concluded that Katie Lo had made a capital gain;

Decision

The First Tier Tribunal decided that the fact that the Appellant had failed to notify chargeability was not sufficient by itself to constitute a discovery. At that stage what tax was actually due was unknown. The Tribunal concluded that a s29 discovery was not made in late 2012 as there were more questions to be asked before decision could be made as to which tax was due and how much.

The First Tier Tribunal stated that HMRC bear the burden of establishing that they have satisfied the provisions of s29 TMA 1970, and in particular that they made a discovery that enables them to take advantage of the extended time limits set out in s36 TMA 1970.

The Tribunal agreed with HMRC and concluded that a:

- first discovery was made in April 2014 (that the property sale was in the nature of trade and that trading income had not been assessed);
- second, relevant, discovery was made in September 2014 when HMRC formed the view that chargeable gains had been made which had not been assessed.

This second discovery was new in the sense of being original as it differed from HMRC's first discovery. As the assessment under appeal was raised on 26 January 2015, the Tribunal considered that on that date, the relevant discovery was still new and had not become 'stale'. The Tribunal concluded that Katie did not meet the standard of a hypothetical reasonable person, and that her failure to notify chargeability was negligent and HMRC had satisfied all of the criteria to be able to raise an assessment under s29 TMA 1970.

The First Tier Tribunal accepted that Katie had stayed at the property on most weekends and during some of the university vacations but they rejected the claim that she had intended to make the property her home. The Tribunal concluded that there was no time between 14 July 2006 and 12 July 2007 when Katie realistically intended to make the property her permanent home and that she purchased the property knowing that "it was a good deal" and knowing that it would increase in value once the elderly tenant left the property. With no credible plan as to how she would finance her occupation of the property after repayment of the business loan, she could not have had an expectation that she would occupy it with any degree of permanency. They also concluded that she knew that the property would be even more valuable if planning permission could be obtained for the long strip of land at the end of the garden. Cumulatively 'the picture painted by the appellant did not ring true'. PPR relief was denied

Katie Lo v HMRC (TC06767)

Consultation on harmonising amendments to tax returns

HMRC is calling for evidence until 6 February 2019 on the different processes that exist across the various taxes for making amendments to tax returns, with a view to introducing a more consistent digital experience for taxpayers. While this document looks mainly at ITSA, CTSA and VAT returns, HMRC also invites comments on other taxes and duties.

This call for evidence outlines the current way in which amendments to returns are made:

- income tax self-assessment is fairly prescriptive;
- corporation tax self-assessment has no prescribed format or content of an amended return and no official form for amending returns;
- a VAT return cannot be re-submitted. If a taxpayer discovers an error after filing a return, they may be able to make an amendment on their next VAT return.

HMRC aims to develop 'a consistent digital approach, whilst still accommodating the digitally assisted and excluded, to make it simple for taxpayers to see their returns and make amendments where necessary'.

www.gov.uk/government/consultations/amendments-to-tax-returns

Deadlines

1 December 2018

- Payment of corporation tax liabilities for accounting periods ended 28 February 2018 for SME companies not liable to pay by instalments;

7 December 2018

- Due date for VAT returns and electronic payment for 31 October 2018

14 December 2018;

- Quarterly corporation tax instalment for large companies (depending on year end);

19 December 2018

- Pay PAYE, NIC, construction industry scheme and student loan liabilities for month ended 5 December 2018 if not paying electronically;
- File monthly CIS return.

21 December 2018

- File online monthly EC sales list;
- Submit supplementary intrastat declarations for October 2018;

22 December 2018

- PAYE, NIC, CIS and student loan liabilities should have cleared with HMRC;

30 December 2018

- Deadline for submission of online self-assessment tax returns if underpayments are to be collected by a PAYE coding adjustment;

31 December 2018

- Accounts to Companies House for private companies with 31 March 2018 year ends and public limited companies with 30 June 2018 year ends;
- File CTSA returns for companies with periods ended 31 December 2017;
- End of CT61 quarterly reporting period;
- Year end for taxable distance supplies to UK for VAT registration;

News

Finance Bill 2019: Committee stage completed

On 19 and 20 November, a committee of the whole House agreed the following without amendment:

- Clauses 5, 6, 8, 9 and 10 (income tax thresholds and reliefs);
- Clause 15 and Schedule 3 (offshore receipts in respect of intangible property);
- Clause 16 and Schedule 4 (avoidance involving profit fragmentation arrangements);
- Clause 19 (hybrid and other mismatches: scope of Chapter 8 and 'financial instrument');
- Clause 20 (controlled foreign companies: finance company exemption and control);
- Clause 22 and Schedule 7 (payment of CGT exit charges);
- Clause 23 and Schedule 8 (corporation tax exit charges);
- Clause 38 and Schedule 15 (entrepreneurs' relief);
- Clauses 39 and 40 (gift aid and charities);
- Clauses 41 and 42 (SDLT: first-time buyers in cases of shared ownership);
- Clauses 46 and 47 (stamp duty and SDRT);
- Clauses 68 to 78 (carbon emissions tax);
- Clause 89 (minor amendments in consequence of EU withdrawal);
- Clause 90 (emissions reduction trading scheme: preparatory expenditure);
- Clause 62 and Schedule 18 (remote gaming duty and gaming duty).

Amendments to date

Clause 61: start date for the increase in the rate of remote gaming duty to 21% has been brought forward to 1 April 2019 (originally due to take effect on 1 October 2019).

Clause 83: Requires the Treasury to report to the House of Commons on how it would exercise powers to require disclosure of information about certain cross-border tax arrangements to comply with the EU's directive on tax planning intermediaries, in various scenarios involving withdrawal from the EU with or without negotiated agreements;

New clauses

New Clause 5: requiring the Treasury to review the social and regional effects of the tax avoidance provisions of the Bill and report to the House of Commons;

New Clause 12: requiring the Treasury to review the public health effects of the remote gaming duty and gaming duty changes and report to the House of Commons within six months of royal assent to Finance Act 2019; and

New Clause 14, requiring the Treasury to review the effectiveness of the tax avoidance provisions of the Bill.

Remainder of the Bill

The remainder of the Bill will go to a Public Bill Committee (PBC) starting on 27 November. The PBC must conclude its consideration by 11 December.

services.parliament.uk/bills/2017-19/financeno3.html
Adapted from Tolley Guidance

https://www.lexisnexis.com/tolley/guidance/ownermanagedbusiness/linkAlertDoc.faces?csi=363613&lni=8T5S-1N42-D6MY-P50Y-00000-00&pqid=27728510&view=GLPCALIST

Consultation on the taxation of trusts

At Autumn Budget 2017 it was announced that in 2018 the government would consult on how to make the taxation of trusts simpler, fairer and more transparent. HMRC is now consulting until 30 January 2019 on a review of the government's principles for taxing trusts, and sets out nine broad questions on which views are invited.

1. The government seeks views on whether the principles of transparency, fairness and neutrality, and simplicity constitute a reasonable approach to ensure an effective trust taxation system; including views on how to balance fairness with simplicity where the two principles could lead to different outcomes;

2. There is already significant activity under way in relation to trust transparency. However, government seeks views and evidence on whether there are other measures it could take to enhance transparency still further;

3. The government seeks views and evidence on the benefits and disadvantages of the UK's current approach to defining the territorial scope of trusts and any other potential options;

4. The government seeks views and evidence on the reasons a UK resident and/or domiciled person might have for choosing to use a non-resident trust rather than a UK resident trust;

5. The government seeks views and evidence on any current uses of non- resident trusts for avoidance and evasion, and on the options for measures to address this in future;

6. The government seeks views and evidence on the case for and against targeted reform to the Inheritance Tax regime as it applies to trusts; and broad suggestions as to what any reform should look like and how it would meet the fairness and neutrality principle;

7. The government seeks views and evidence on:

    a. the case for and against targeted reform in relation to any of the possible exceptions to the principle of fairness and neutrality

    b. any other areas of trust taxation not mentioned there that would benefit from reform in line with the fairness and neutrality principle.

8. The government seeks views and evidence on options for the simplification of Vulnerable Beneficiary Trusts, including their interaction with '18 to 25' trusts;

9. The government seeks views and evidence on any other ways in which HMRC's approach to trust taxation would benefit from simplification and/or alignment, where that would not have disproportionate additional consequences.

www.gov.uk/government/consultations/the-of-taxation-of-trusts-a-review

Consultation on stamp duty and SDRT consideration rules

HMRC is consulting until 30 January 2019 on introducing a general connected party market value rule for transfers of securities, and applying the SDRT definition of consideration to stamp duty.

The government introduced a targeted market value rule effective from Budget Day 2018 to tackle contrived arrangements involving the transfer of publicly listed securities to companies to which the transferor is connected. Such transfers will be chargeable to stamp duty or SDRT based on the higher of the amount of the consideration for the transfer, or the market value of the securities.

This consultation proposes three further changes to the stamp duty and SDRT consideration rules:

1. extending the new market value rule to unlisted securities and connected party transfers other than to companies;

2. aligning the stamp duty and SDRT definitions of 'consideration' by adopting the SDRT 'money or money's worth' definition;

3. aligning the stamp duty and SDRT treatment of contingent, uncertain and unascertainable payments.

The government does not intend to extend the market value rule to transfers between unconnected parties.

The ‘money or money’s worth’ definition of consideration for SDRT includes cash and the value of any type of non-cash consideration that could be bought and sold in the open market. This is broader than the stamp duty definition, which comprises only cash, debt or the value of any other stock or marketable securities.

Unlike stamp duty, SDRT does not have rules for situations where the consideration is not known on the date on which the transaction takes place. The ‘money or money’s worth’ method allows consideration to be estimated. Adopting the SDRT approach could mean having to value the unknown part of the consideration for stamp duty purposes. The consultation considers the option of adopting the SDLT approach, which uses money or money’s worth, but also permits reasonable estimates of unknown consideration to be used, which can be adjusted later.

www.gov.uk/government/consultations/stamp-taxes-on-shares-consideration-rules

Adapted from Tolley Tax Guidance

Business Taxation

Capital allowance for structures and buildings (Lecture B1106 - 20.15 minutes)

Since the abolition of industrial buildings allowance there has been no relief available for structures and buildings. Responding to a longstanding request from business representative groups and looking to improve the UK's international competitiveness, the government is introducing a new Structures and Buildings Allowance (SBA) for non-residential structures and buildings

The relief available

Businesses chargeable to income tax and companies chargeable to corporation tax will be able to claim 2% straight line on qualifying costs, time apportioned for short accounting periods, over a fixed 50 year period. The 50 years will start running from when a structure or building first comes into use.

If relief is not claimed, it will not be able to be carried forward to a later period and will be lost. This will simplify the claim process by ensuring that a consistent amount of relief is available each year over the whole of the 50-year qualifying period for each qualifying spend.

Qualifying structures

Capital expenditure on the construction of new qualifying structures and buildings, as well renovations or conversions of existing qualifying structures or buildings will qualify. Where a structure or building is renovated or converted so that it becomes a qualifying asset, the expenditure will qualify for a separate 2% relief over the next 50 years.

The relief will be available for UK and overseas commercial structures and buildings including offices, retail and wholesale premises, hotels, care homes, walls, bridges, tunnels, factories and warehouses.

Where a structure or building is divided into separate parts, some of which qualify, an appropriate proportion of expenditure will qualify for relief. SBA will not be due where 10% or less of the costs would meet the conditions for relief.

Expenditure on dwellings will not qualify for the new allowance so that excludes residential property, university, school and military accommodation and prisons. In addition, there will be no relief for expenditure on workplaces that are an integral part of a dwelling, such as home-offices. Shared areas which cover both use as a dwelling and commercial use will not qualify. The government welcomes views on the appropriate definition of a dwelling.

Qualifying costs

Relief will be limited to the costs of physically constructing the structure or building. This will include the costs of demolition or land alterations necessary for construction, and direct costs required to bring the asset into existence. However, it will exclude the cost of the land, stamp duty land tax and legal costs and any planning permission that is required.

The relief will apply to newly constructed commercial structures and buildings where all the contracts (not letters of intent) for the physical construction works of the structure or building (including any contract for preparatory works) are made in writing, and are entered into (signed and dated by the bound parties) on or after 29 October 2018. Where construction is undertaken by an internal workforce, for example by contract or on payroll, the relief will apply where that physical work commenced on or after 29 October 2018.

Any costs that qualify as plant and machinery should continue to be treated as such with the taxpayer claiming AIA, FYAs and WDAs as appropriate.

If a business buys an unused asset constructed by a developer, the qualifying cost will be the price paid less any amount relating to land. Clearly, a valuation will be required to separate the amount of the land cost from the cost of the structure or building.

Additional costs

Capital expenditure undertaken on a structure or building after the date on which it enters into use will qualify for the SBA, but treated as a new, separate asset. Its 50-year life will extend beyond the writing down period of the original construction costs on that structure or building.

Activity yet to commence

Where an asset is being constructed for a qualifying activity that has not yet commenced, then expenditure will not qualify if incurred more than seven years before that qualifying activity commences.

Damaged structures and repair

Where a structure or building is damaged and can no longer be used for qualifying activity, allowances will remain available for a period of two years, allowing reconstruction work to take place. If the reconstruction takes longer allowances will not be available after that two-year period until the reconstructed structure or building comes back into qualifying use. This two-year period may be extended up to five years where the structure or building substantially no longer exists following extensive damage.

Any new expenditure on reconstruction will qualify for relief in its own right, and will qualify for relief at the rate of 2% annually over the following 50 years. The total eligible cost will be net of any costs covered by compensation or insurance etc.

Where a structure or building is demolished, and the owner decides not to replace that building, it can continue to claim the SBA on that asset, for the remaining term of the previous structure or building.

Example

Company A builds a new commercial building on which the construction costs were £50m. 10 years later, there is a fire, which causes heavy damage. The building is partially insured, and insurance payments will cover £10m of the £12m rebuilding costs.

At the time of the fire, Company A is claiming SBA at a rate of £1m per year (50m x 2%).

For the period after the fire, Company A continues to claim £1m per annum while it decides on a replacement.

Whatever happens, it may claim £1m pa over the remaining 40 years.

- If it rebuilds, it will continue to claim £1m for the remaining 40 years of the original building, The net cost, after insurance payments received, is £2m and this will be treated as a new qualifying structure eligible for relief at a rate of 2% over 50 years.

- If it does not rebuild, it may continue to receive a "shadow SBA" on the original construction costs of £1m pa.

Sale of the asset and subsequent use

There will be no balancing adjustments on sale. When calculating any gain on disposal, the allowable cost of the asset will be reduced by the total amount of relief that they have claimed.

Provided that the asset is used for a qualifying purpose, the buyer will continue to claim the same 2% allowance annually until the full 50-year period has expired. The relief will be apportioned in the year of sale. To ensure that relief is given on an agreed amount, there will be a need to retain evidence of actual costs incurred where a building or structure has qualified for relief and provide this to a purchaser.

Example

Company A buys a new office building from a developer at a total cost of £15m of which £5m relates to the land. It brings it into use for the purposes of its trade at the beginning of its accounting period ending on 31 December 2021.

On 31 December 2030 the building is sold to Company B for use in its trade. The price paid was £12m of which £7m relates to the land.

Company A's annual writing down allowance will be £200,000 (£10m x 2%).

By sale, Company A will have claimed 10 years of allowance totalling £2m. The allowable cost when calculating its capital loss on the land and building the original cost, including land of £15m less the £2m allowances claimed.

		£
Proceeds		12,000,000
Original cost	15,000,000	
Less SBAs	(2,000,000)	
		(13,000,000)
Capital loss		1,000,000

The price paid by Company B is irrelevant for SBA purposes. Company B will be entitled to claim SBA on the original construction costs of £10m for the remaining part of the 50 years.

If in 2032 Company B decides that the building needs improvement and it becomes unoccupied for two years during a £4m renovation project. The company can continue to claim the original £200,000 allowance because this period it is less than two years (or up to five years where the building substantially no longer exists following extensive damage). When the building is brought back into use, then a separate SBA of £80,000 (£4m x 2%) can also be claimed once renovated.

Changes in the use of the structure or building

Where a structure or building that was originally used for a qualifying activity undergoes a change in use and becomes a dwelling then SBAs will no longer be available for the period for which the structure or building is in use as a dwelling. If a qualifying activity resumes in the building after a period of time then allowances will recommence but no relief will be given for the period of non-qualifying use. Apportionment will be needed where there is a change in use part way through a period.

Leases

Where the granting of a lease is substantially no different from a purchase of the interest in land, the SBA will be allocated to the lessee. In more complex cases, the allowances will remain with the lessor if the term of the lease is less than 35 years.

If the term is longer, a calculation will be required. Where the amount paid as a capital sum for a lease is ≥ 75% of the sum of that capital amount and the value of the retained interest in the property, then the lessee will become entitled to the full amount of the SBA. (i.e. ≥ 75% has effectively been applied in calculating the gain).

Example

Company X owns a building on which it claims the SBA.

It grants a lease over the entire building to Company Y that will use it in its trade. The term of the lease is 40 years and Company X will receives a premium of £50 million but only a token rent is payable. Company X’s retained interest in the property is agreed to be £10 million.

To check the relevant percentage that applies, the standard part disposal calculation needs to be performed and so the premium needs splitting between income and capital. 78% of the premium, or £39 million, is treated as capital gains disposal proceeds (calculated as 2% x (40-1)).

The proportion of the capital gains base cost that is deducted in working out the gain on granting the lease is calculated:

$$\frac{\text{Disposal proceeds}}{\text{Disposal proceeds + Value of asset retained}}$$

This is 39 / (39 + 10), approximately 80%.

Because the lease is for over 35 years and more than 75% of the capital gains base cost is applied in calculating the gain, this means that Company X is no longer entitled to claim SBA. Company Y will be able to claim instead.

If only part of the property is subject to a lease, the test will apply only to that part and allowances will transfer if the capital sum is ≥ 75% of the value of that part.

Where a person is entitled to SBAs in respect of an asset that they lease, and the lease expires or terminates before the end of the 50 years, then the SBAs will be able to be transferred to the person holding the retained interest, as long as they hold their interest as part of a qualifying activity.

Anti avoidance

Rules will be included in the legislation to prevent manipulation of the relief for a tax advantage. In particular, there will be rules to:

- Prevent relief through attempts to manipulate contracts, such as by revoking agreed contracts for construction works entered into before 29 October 2018,

- Disallow leases being used to give more than one party separate interests in the same structure or building.

Views welcome

The government welcomes views on the following aspects of the SBA:

1. To ensure the necessary exclusion of residential use, are there specific types of buildings or activities for which the draft legislation should provide?

2. It has been necessary to reflect situations where the grant of a lease is akin to a sale of a property interest. Is the proposed boundary of 35 years for the transfer of the SBA from a lessor to a lessee appropriate?

3. Are there specific issues regarding overseas property that require provision in the draft legislation?

4. The government has proposed a period of disuse during which the structure or buildings retains its eligibility for relief – up to two years ordinarily, or up to five years where it substantially no longer exists following extensive damage. Are there any significant practical problems would prevent the proposed policy from working?

www.gov.uk/government/publications/capital-allowances-for-structures-and-buildings-technical-note

Vehicle-battery charging at workplace (Lecture B1107 – 9.59 minutes)

One of the current issues limiting the adoption of all-electric or plug-in hybrid vehicles by the general public is the worry about where they can be recharged. Many residential areas have very limited charging facilities, especially where on-street parking is the only option available.

If an employer provides battery charging facilities (including electricity) for a vehicle which is not a taxable car or van because it belongs to a member of staff, the employee has hitherto been subject to an income tax and NIC benefit in kind charge.

Company cars and vans are exempt from this, given that the relevant benefit figure comprehends all vehicle-related costs.

In his Budget on 22 November 2017, the Chancellor announced that, with effect from 6 April 2018, there would be no benefit tax charge on electricity and other facilities that employers provided for the purpose of charging employees' own all-electric and plug-in hybrid vehicles. Somewhat surprisingly, this new exemption was not included in FA 2018.

This omission has now been rectified by the publication on 6 July 2018 of the draft Finance Bill that contains details of a new S237A ITEPA 2003. As expected, the legislation is short and to the point. The first two subsections read as follows:

> '(1) No liability to income tax arises in respect of the provision, at or near an employee's workplace, of facilities for charging a battery of a vehicle used by the employee (including a vehicle used by the employee as a passenger).
>
> (2) Subsection (1) applies only if the facilities are made available generally to the employer's employees at that workplace.'

S237A ITEPA 2003 applies where the relevant facilities are made available 'at or near' the workplace. The words 'at or near' are not defined in the legislation. However, it is understood that HMRC will adopt the same approach with this new section as they do for S237 ITEPA 2003 (parking provision and expenses). Thus, as long as the charging facilities made available are within a reasonable distance from the place of work, having regard to the nature of the locality, the exemption will apply. See Para EIM21685 of the Employment Income Manual for the details of HMRC's interpretation of 'at or near' in the context of parking facilities.

Notice that the new exemption does not extend to the reimbursement by employers of costs incurred by individuals when recharging vehicles away from the workplace.

Contributed by Robert Jamieson

Consultation on Digital Services Tax (Lecture B1106 - 20.15 minutes)

On 8 November 2018, the government issued a consultation document on the introduction of a digital services tax (DST). The proposal is that DST will be introduced in Finance Act 2020 and will come into effect from April 2020. The summary below sets out what the consultation proposes. The government emphasise that this is a temporary tax that will be replaced by a global solution based on the OECD BEPS project and is also subject to review in 2025.

The consultation document states that DST is looking to address the concern that multinational companies have highly-digitised business models which create value from user participation in a territory but that the profit from that value is not being taxed in that territory.

What is the DST?

The DST is a 2% tax on the UK revenues of digital businesses that are considered to derive significant value from the participation of their users. These businesses are ones, which provide social media platforms, search engines or online marketplaces ('in-scope' business activities) and will apply to the revenues linked to the participation of a UK user base. Businesses could be incorporated or unincorporated.

DST will only apply if a business has in-scope business activities which, on a group basis:

- generate more than £500m global revenue annually;
- are linked to the participation of UK users and which generate more than £25m annual revenues.

Any UK taxable revenues below £25m will be free from the DST. There will also be a 'safe harbour' as defined below.

The tax will be deductible against UK corporation tax under general principles of being wholly and exclusively for the purpose of its trade but will not be creditable. There may therefore not be a deduction against UK corporation tax if the DST is paid by an overseas group company that is not subject to UK corporation tax.

Definition of user participation

The DST is based on taxing value created by UK users' participation in the relevant digital businesses, so what is user participation?

The consultation notes that users have a role beyond creating demand for a product, they now also contribute to what the business is offering in a number of ways:

- by creating the content that the digital business has on their platforms;
- by using the online platforms for significant periods of time and thereby generating data which the business can use to collecting data on their activities;
- by building networks with other users by sharing online content or rating products etc;
- by providing ratings for goods and services which build the brand and is then the content sold by the online business.

The DST is intended to focus on businesses where these functions are the central value driver of the business.

A lot of digital businesses will benefit from more than one of the above user participations e.g. Facebook's content is generated by users, but they then collect data on users' activities and use that to promote other relevant content to the user. Other digital businesses may have user participation activities, but their main business activity is the direct sale of goods services and value is created by developing, producing and marketing the goods or services, these businesses are not intended to be covered by DST.

The government's proposal is to define the business activities that derive most value from user participation and tax the revenues that those activities generate when they are linked to a UK user, whatever characteristics those revenues have i.e. they could be in the form of subscription fees or through online advertising income etc.

In-scope business activities

As noted above, in-scope business activities are the provision of a social media platform, the provision of a search engine and the provision of an online marketplace.

The consultation then provides further examples of these activities as follows:

Provision of a social media platform

This would include those platforms that build social or business communities online, blogging or discussion platforms, content sharing platforms for videos etc., review platforms and dating platforms.

Provision of a search engine

This would cover situations where the search engine generates income by advertising directly against search results or where the income derives from using the search engine as access to websites.

Provision of an online marketplace

This would not cover the activity of the sale of goods online where the business has legal ownership of the goods being sold but would cover businesses that for example take commission from matching third-party buyers and sellers of physical goods or which allow third parties to list products and communicate with buyers.

The expectation is that businesses will isolate the in-scope business activities and pay the DST on revenues that those activities generate for the group where linked with UK users.

Activities not in-scope

Activities which should not be in-scope therefore include the sale of goods online, the provision of financial or payments services, the direct sale of online content e.g. TV or music subscriptions and online games where the business owns the content but the consultation notes that there will need to be further review where online games also create value from the high level of user participation.

Revenues that will be taxed

DST will apply to third party revenues that are generated from in-scope activities from whatever channel e.g. from subscriptions fees, sales of data, delivery fees, advertising revenues and these could be in UK or non-UK entities. Any apportionment of the income between in-scope and out-of-scope activities would be on a just and reasonable basis.

There will be no allowable costs for DST and revenues declared will be net of VAT.

UK revenues

Once the business has established the in-scope activities and the revenues they generate, they will need to confirm which are linked to the participation of UK users.

A user can be a company, individual or any other legal person.

Where revenue is derived from online advertising, UK revenue will be defined as revenue from adverts displayed at UK users or has involved a UK user action e.g. a click. Where revenue is derived from other forms e.g. subscription, commission etc. it will depend on whether the payment comes from a UK user, or relates to a transaction that involves a UK user.

Generally, a UK user will be one that is normally resident in the UK and therefore is primarily located in the UK when participating in the in-scope business activity. However, the consultation says it will allow business to look at other determinants e.g. where the IP address of the user is located or the delivery or payment address of the user. The consultation notes that there could be some difficult areas where the user location may be hard to establish and is taking views on this, for examples where user location is not tracked or where a UK user signs up for online content whilst abroad for work or holidays.

DST would tax transactions where only one user is based in the UK but would look at relief if the revenue was also subject to DST in another country.

Safe harbour

The DST is based on gross revenues and DST may therefore be disproportionately high on businesses with low profit margins or losses. To counteract this a safe harbour is proposed in the consultation document.

Businesses will be able to elect to calculate their DST liability according to the following formula:

> *'Profit margin' multiplied by 'in-scope revenues (less £25m allowance)' multiplied by 'X'*

X would be set at a level that would not be less than 0.8 so that a safe harbour is only of benefit to businesses with very low profit margins.

The profit margin could not be less than 0% and would be based on a UK and business activity-specific profit margin and not on consolidated accounts figures. There would be several issues in terms of calculating this profit margin including which costs could be taken into account, which period the profit margin relates to and the treatment of any exceptional items. The consultation therefore is proposing to explore this calculation further.

Example

A business has in-scope revenues from UK users of £100m and so would pay DST of £1.5m (£100m - £25m allowance x 2%).

The businesses profit margin is 1%; the safe harbour DST would therefore be £0.6m (1% x £75m (£100m - £25m allowance) x 0.8).

Reporting and paying the DST

Every company that is chargeable to DST will need to notify HMRC that it is liable and self-assess the amount of DST, regardless of whether it is a UK or non-UK company. The consultation is reviewing the option of a nominated company for a group.

Reporting will be done annually matching with accounting periods for corporation tax returns and returns will need to be filed by the end of the calendar year following the end of the accounting period.

The consultation does not consider the reporting treatment of non-incorporated entities.

Payments of DST will be made quarterly on the same payment schedule as Very Large Corporate Quarterly Instalment Payments.

Anti-avoidance and penalties

Anti-avoidance provisions would be introduced to:

- address the risk that taxpayers accelerate the recognition of revenue before 1 April 2020 so it is outside the scope of the DST (anti-forestalling rules); and

- prevent taxpayers artificially re-characterising revenue streams so they fall outside the relevant business activity.

The government is also considering introducing new penalties for the DST as a preventative measure.

Contributed by Joanne Houghton

Corporate loss relief – additional guidance

HMRC have issued two further guidance documents on corporate loss relief:

- Amended draft guidance on commencement provisions, and

- Draft guidance on administrative requirements

Amended draft guidance on commencement provisions

This guidance deals with the method of apportionment of profits and losses under the corporate loss rules for an accounting period that straddles 1 April 2017, the commencement date of the new corporate loss rules.

Essentially, any apportionment would be made on a just and reasonable basis that would normally be on a time basis worked out on days. There are however situations where apportioning on days would not be appropriate and the guidance provides examples when apportionment could be made based on an alternative basis.

Allocation to pre-1 April 2017 and post-1 April 2017 is only for the purposes of the corporate loss relief rules in terms of utilisation of losses and any relevant loss restriction. But the calculation of the apportionment may interact with the allocation of group relief and the guidance also provides worked examples to illustrate when group relief may also be calculated on a just and reasonable basis to accommodate this interaction.

There are additional rules that apply where a company is also affected by the corporate interest restrictions in TIOPA 2010, Part 10 and where both provisions require apportionment, consistency is required.

Draft guidance on administrative requirements

The draft guidance confirms that any company that wishes to use carried forward losses against their profits will need to specify the amount of their deductions allowance in their corporation tax return. This is regardless of whether the restriction of the £5m deduction allowance applies to the company. If a company does not specify the amount of the deductions allowance then any losses carried forward will be restricted to 50% of the relevant profits.

In addition, if the company has carried forward losses of a type that can only be deducted from a particular type of profit, the company will need to show how it has divided its deductions allowance between its trading and non-trading profits. This would therefore apply for example if there were trading losses carried forward at 1 April 2017 which can only be relieved against profits of the same trade.

The CT600 form has not been updated to include any sections for these declarations but the guidance notes that they can be shown in the tax computations accompanying the return.

Where there is a group of two or more companies and one company is utilising carried forward losses or surrendering them as group relief for carried forward losses, the group will need to nominate a nominated company for the purposes of the group deductions allowance. That company must submit a group allowance allocation statement for each of the periods for which it is the nominated company.

Where a company is a stand-alone company for part of the period and a member of a group for the remainder of the period, the individual company will have to show the of its total deductions allowance for the period in its tax return. If there are carried forward losses which can only be used against profits of a certain type, then the split of the allowance will also need to be shown in the tax computations which form part of the return.

The guidance includes an example template for a group allowance allocation statement.

Contributed by Joanne Houghton

VAT

Subsidy and third party consideration

Summary – The taxable amount for a supply of goods was the amount due from the customer for that supply, as detailed on the retail receipt.

This was an appeal by Dixons Carphone Plc against a decision by HMRC concerning the taxable amount of certain types of supplies involving consumer credit arrangements made by retail entities within the Dixons VAT group ("DSG"), and whether DSG was entitled to make an adjustment to the calculation of their daily gross takings under the bespoke retail scheme agreement which applied to DSG.

The case summary explains how the transactions worked:

- A consumer buys goods in a DSG store and pays a deposit to DSG;
- The balance of the cost of the purchase is funded by a loan, provided by a third party company, LaSer;
- The customer gives authority to LaSer to pay the money borrowed to DSG;
- Where the customer loan is on favourable terms (to the consumer), the amount paid by LaSer to DSG is a lower amount than that authorised by the consumer, following deduction of an amount described as a "Subsidy". The favourable terms are generally interest free arrangements, including "Buy Now, Pay Later" arrangements, whereby the customer pays no interest on the amount borrowed if the full amount of credit is repaid by the customer within the "Pay Later" offer period.

The issue to decide is whether the Subsidy aspect of the calculation of the payment to be made by LaSer to DSG under the Retailer Contract between them is taken into account in determining and so reducing the taxable value of the supply of goods from DSG to the customer.

- Dixons Carphone Plc contended that the taxable amount should be the amount it received from LaSer, so net of the subsidy;
- HMRC's case is that this was a sale of goods between DSG and the customer with no third-party consideration and the Subsidy should not be deducted.

Decision

The First Tier Tribunal confirmed, and both parties agreed, that it is only if LaSer was providing consideration (and not merely transferring funds) that the Subsidy could have any bearing on the taxable amount of the supply (Article 73 of the VAT Directive; Regulation 38 of the VAT Regulations).

The Tribunal noted that the contract between Dixons Carphone Plc. and LaSer was for credit facilities 'for use by customers of Dixons Carphone Plc. to purchase goods' only. The documentation between LaSer and customers made it clear that LaSer was providing a loan of the 'amount of credit'. There was no direct link between the supply to the customer and the movement of funds from LaSer to Dixons Carphone Plc. LaSer's obligation was to pay to Dixons Carphone Plc. money that belonged to customers.

The Tribunal stated:

> "There is no obligation on DSG under any of the contractual documents to supply goods to customers in return for the payments made by LaSer"

They concluded that as the payments made by LaSer did not amount to consideration for the supplies by DSG to consumer, the amount of any payment (including any deduction of the Subsidy) between LaSer and DSG cannot affect the taxable amount of those supplies and, therefore, the amount of such payment does not affect the bespoke retail scheme agreement used by Dixons

There was no third-party consideration and the appeal was dismissed.

Dixons Carphone PLC v HMRC (TC06731)

Aborted takeover **(Lecture B1106 - 20.15 minutes)**

Summary - As the holding company had intended that it would provide taxable management services for an acquired subsidiary, such preparatory acts could be an economic activity even though the subsidiary was never acquired.

Ryanair had incurred input tax on expenditure relating to professional services incurred on a proposed takeover bid for all the shares of Aer Lingus.

After the takeover, Ryanair had intended to get involved in the management of the new subsidiary by providing taxable management services to that airline. However, due competition legislation, Ryanair had only been able to acquire part of the share capital but had sought to deduct the relevant input tax relating to the professional services. The Irish tax authorities denied the claim.

Decision

The CJEU was satisfied that Ryanair was a taxable person when it incurred the input VAT in question. A company that carries out preparatory acts as part of a proposed acquisition of shares in another company, with the intention of pursuing an economic activity is a taxable person.

The provision of management services was an economic activity and it did not matter that this activity was not actually carried out due to the failed takeover. The only issue was whether the exclusive reason for the expenditure was to be found in the intended economic activity. This would be for the Irish courts to decide.

Ryanair v HMRC (Case C-249/17)
Adapted from Tax Journal (26 October 2018)

Supplies closely related to the supply of education (Lecture B1106 - 20.15 minutes)

Summary - Even if Loughborough Students' Union was an eligible body, it was not an eligible body making supplies that were "closely related" to the supply of education. The supply of stationery, art materials and other items were not exempt supplies.

Loughborough Students' Union operates a range of commercial activities on its campuses, mainly bars and catering but it also has three retail outlets. Although most of the customers are students, there is no restriction on other people using the shops and there is no distinction at point of sale between student and non-student sales.

Loughborough Students' Union had appealed HMRC's decision to deny its claim for repayment of output tax in respect of sales of stationery, art materials and other items from their shops. They maintained that the sales were exempt supplies as supplies closely related to the supply of education

The relevant EU provisions are contained in Articles 132 – 134 of the Principal VAT Directive. Schedule 9 Group 6 implements these articles into domestic law and provides for exempting where the supply is by an eligible of body and is the supply of goods or services which are closely related to the principal supply by or to the eligible body making the principal supply provided. In addition, the goods or services must be for the direct use of students receiving the principal supply.

Decision

The Upper Tribunal concluded that regardless of whether Loughborough Students' Union was an eligible body (group 6 para 1(e)), it could only claim the exemption on supplies closely related to education. The Tribunal found that Loughborough Students' Union's supplies were not closely related to education within item 4. The food, newspapers and household goods were 'ends in themselves' and not ancillary to education: 'the education provided by the university would be just as good if the students did not buy these items'. The art materials could be closely related to the courses offered by the university but there was no evidence as to what these art materials were or how they related to the course work that the students may be undertaking. The supply of stationery, art materials and other items were not exempt supplies.

Loughborough Students' Union v HMRC [2018] UKUT 0343 (TCC)

Domestic reverse charge for construction services (Lecture B1106 - 20.15 minutes)

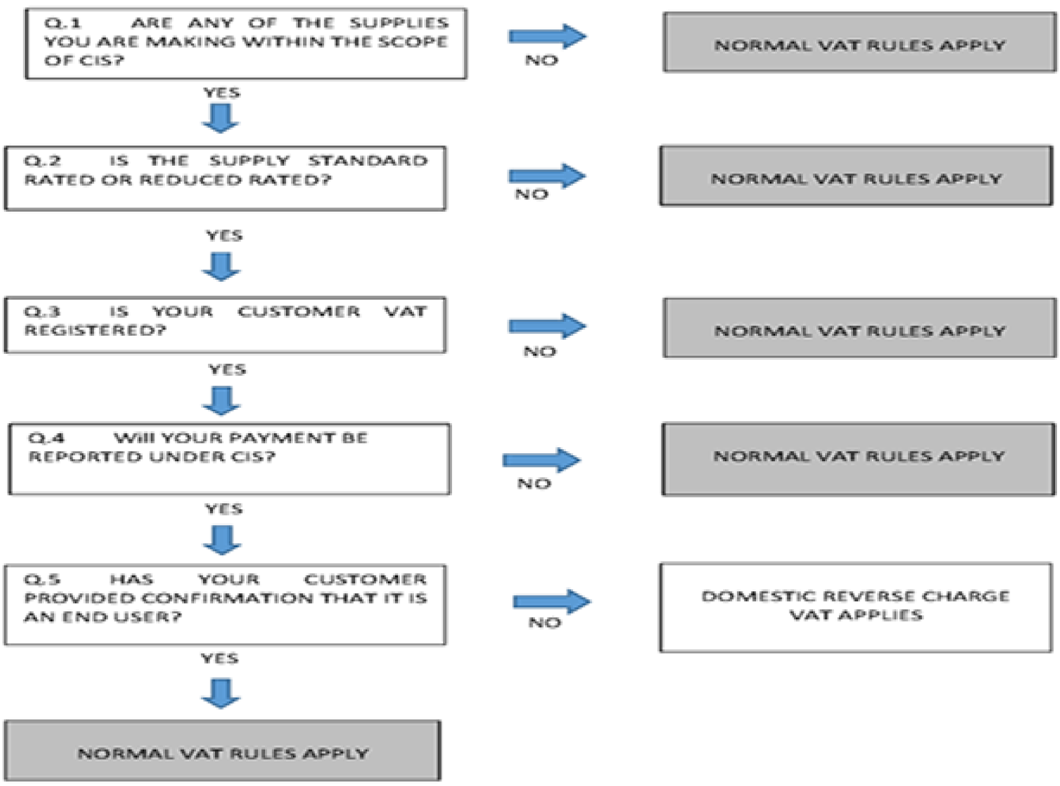
VAT fraud in construction sector labour supply chains presents a significant risk to the Exchequer. Organised criminal gangs fraudulently take over or create shell companies to steal VAT whilst operating alongside actual construction services. This is commonly referred to as 'missing trader' fraud.

Proposed revisions

From 1 October 2019, a statutory instrument will introduce a VAT reverse charge on the supply of specified building and construction services as well as goods supplied with those services. Rather than the supplier charging and accounting for the VAT, the recipient of those supplies accounts for the VAT.

Supplies that will be affected

The domestic reverse charge will affect supplies at the standard or reduced rates if payments must be reported through the Construction Industry Scheme (CIS). Supplies between sub-contractors and contractors, as defined by CIS, will be subject to the reverse charge unless they are supplied to a contractor who is an end user. End users will usually be recipients who use the building or construction services for themselves, rather than to sell the services on as part of their business. Those connected to end users, including landlords or tenants, can be treated as end users so intra-group and leasing re-charges of building and construction services connected to the end user are also excluded from the reverse charge. If the end user does not provide its supplier with confirmation of its end user status, it will still be responsible for accounting for the reverse charge. Annexe 1 to the guidance provides a useful summary flowchart:



How a domestic reverse charge operates

A domestic reverse charge means that the customer receiving the supply of specified construction services must account for the VAT due rather than the supplier. In turn, the customer deducts the VAT due on the supply as an input, meaning no net tax is payable to HMRC. This removes the scope to evade any VAT owing to HMRC.

A domestic reverse charge only applies to supplies between UK taxable persons therefore unless the customer is registered or liable to be registered for VAT it will not apply.

Implementation of the reverse charge

HMRC understands the difficulties businesses may have in implementing the domestic reverse charge and will apply a light touch in dealing with related errors that occur in the first 6 months after introduction, where businesses are trying to comply with the new legislation. However, businesses that knowingly claim end user status when the domestic reverse charge should have applied will still be liable for the output tax that should have been paid and may be liable for penalties.

The guidance provides detail as to the types of building and construction services that need to be accounted for under the new system as well as a list of services that are excluded if supplied on their own. This list is not exhaustive.

Mixed supplies

The legislation is designed so that if there is a reverse charge element in a supply then the whole supply will be subject to the domestic reverse charge. This is to make it simpler for both supplier and customer and to avoid the need to apportion or split out the supply.

If in doubt, provided the recipient is VAT registered and the payments are subject to CIS, it is recommended that the reverse charge should apply.

Further guidance

Detailed guidance on the other domestic reverse charge measures can be found in Domestic reverse charge procedure (VAT Notice 735).

www.gov.uk/government/publications/vat-reverse-charge-for-building-and-construction-services-guidance-note

Input tax recovery **(Lecture B1109 – 14.26 minutes)**

Many clients and advisers find the difference between exempt and zero-rated difficult to understand – they are very different in the VAT world – a zero-rated sale effectively charges VAT at 0% so therefore input tax can be reclaimed on related expenses, and the income is included as a taxable sale as far as the £85,000 registration threshold is concerned for a non-registered business. But it is also very important to understand the difference between non-business, private and exempt use, both in relation to buying and selling goods.

This session is based on practical examples.

Exempt use - Example 1

Foxwood Golf Club has purchased some very sophisticated grass cutting equipment to use on the courses at a cost of £100,000 plus VAT. The club is a non-profit making members club and is registered for VAT.

Most of the golf playing income is exempt from VAT, including joining fees, members' subscriptions and individual green fees. The only taxable golf income is likely to be from corporate green fees eg the Lexis Nexis Annual Golf Day ie booked by a business rather than individuals.

The input tax of £20,000 on the equipment relates to both taxable and exempt sales so is classed as 'residual input tax' for partial exemption purposes. This means that some VAT is claimed and the amount claimed is usually based on the standard method:

$$\text{Input tax to claim} = \frac{\text{Taxable sales (excluding VAT)}}{\text{Taxable plus exempt sales}} \times \text{Residual input tax}$$

The standard method should produce a favourable result for our club because the taxable sales figure will include bar and catering sales which is often as much as 30% of total income, whereas the corporate green fees revenue could be less than 1% of total income. The committee should encourage corporate bookings because they ensure input tax on course costs is residual rather than wholly exempt where no input tax would be claimed.

Planning tip – a small amount of VATable income for a mainly exempt activity means that some input tax will be claimed.

Annual adjustment

Here is a VAT poser: if Foxwood's taxable sales for the March VAT quarter are £30,000 and the total exempt income is £250,000, and this is the period when it bought the grass cutter, how much input tax will the club claim on the equipment?

The answer is: you don't know. The amount claimed with the quarterly calculation will be £2,200 ie £30,000/£280,000 is 10.71% - this percentage is rounded up to the nearest whole number ie 11% x £20,000 = £2,200. But the final amount claimed will depend on the partial exemption annual adjustment calculation, which is made at the end of March, April or May (depending on the VAT periods adopted by the business), so March in the case of Foxwood. The annual adjustment could produce a residual input tax figure that is either higher or lower than the quarterly amounts claimed and the taxpayer has the choice of either adjusting the VAT on the return that coincides with the end of the tax year (March, April or May) or the following period.

The figures in my example are like many sporting clubs ie where a lot of exempt subscriptions and joining fees are received in the first calendar VAT quarter, and a lot of spending also takes place in the same period when there is cash to burn. This means that a low percentage of input tax will be claimed on the quarterly return because of the higher than usual exempt income but this will sort itself out with an input tax windfall when the annual adjustment calculation is carried out. I know that some advisers think the annual adjustment process is a waste of time but it makes a significant difference when income is received on a fluctuating basis, as is the case with many sports clubs.

Private use - Example 2

Smith and Smith Solicitors have an office in two acres of land just outside Hereford. They have purchased the same grass cutting equipment as Foxwood Golf Club for £100,000 plus VAT. It will be used by the business during the week but taken home by the partners every weekend to use on their private houses. How much input tax can Smith and Smith claim on the purchase of the equipment?

This is an example of when it is important to be clear about the difference between 'private use' and 'non-business use' – the use of the grass cutter by the partners is private use, which means there are two alternative ways of dealing with the VAT:

Input tax apportionment – this is the easier route. It seems that 5/7 of total use will be for business purposes (weekday use ie 5 days out of 7), so input tax of £14,285.71 can be claimed. The other 2/7 is not input tax because it is relevant to private use.

The Lennartz mechanism – this method has had many twists and turns over the years but it means that input tax is fully claimed when goods have both business and private use and then output tax is paid over the life of the asset to adjust for private use. However, it cannot be used for ships, aircrafts and interests in land or buildings, known as 'non-Lennartz assets'.

Note – if the use of goods is for a 'non-business' rather than a 'private' purpose, it cannot benefit from the Lennartz option.

The result of Lennartz accounting will be the same as with input tax apportionment but with a cash flow advantage to the business:

All Lennartz adjustments are made over a five-year period (60 months) unless the business knows that the goods will be disposed of before five years have passed e.g. our business might have a policy of changing its grass cutting equipment every three years, so adjustments will be made over three years (36 months).

Assuming the 2/7 private use applies for five years, the output tax adjustment made by Smith and Smith each quarter will be as follows: £20,000 input tax x 2/7 divided by 20 VAT quarters = £285.71

At the end of five years, the business will have claimed £20,000 input tax on the initial purchase of the grass cutting equipment and then accounted for output tax of £5,714.20 (£285.71 x 20 quarters) – a net claim of £14,285.80 being the same as with input tax apportionment (apart from 9 pence of rounding differences).

Non-business use - Example 3

Animal Homeless Charity is VAT registered because it has taxable sales from a charity shop. It uses a van to collect and deliver stock for the shop but it is also used to collect stray dogs and find them new homes, which is a non-business activity. The van was purchased for £10,000 plus VAT.

The Lennartz mechanism is not available because there is no private use of the van – only a combination of taxable and non-business use. Input tax apportionment is the only way of deciding how much can be claimed

Non-business activities are most commonly found within organisations such as local authorities, charities and further education establishments. Any method can be used by the charity to apportion its input tax but the calculations must be fair and reasonable to properly reflect use for taxable activities.

Tip for repair costs

There is good news for Foxwood, Smith and Smith and Animal Charity as far as repair and maintenance costs are concerned. Even though the taxable use of the grass cutter and van is less than 100% of total use in all cases, a full input tax claim can still be made on repair and maintenance costs i.e. no deduction is needed for private or non-business use (VAT Notice 700/64, para 5.1). The logic of HMRC (previously Customs and Excise) has always been that assets need to be in good working and properly maintained in order to do any business use, hence the 100% claim being allowed.

Selling the goods

A twist to the tale is that if only a percentage of the VAT was claimed on the purchase of an item because of the non-business or private use adjustments, output tax is only payable on the same percentage when it is sold (HMRC Input Tax Manual – VIT25240). The logic is that the initial input tax block took that part of the asset out of the business, so no output tax is payable when it is sold. So, if Smith and Smith sold their cutter for £30,000 plus VAT, the VAT would be calculated as follows: £30,000 x 20% x 5/7 = £4,285.71.

However, not such good news for Foxwood Golf Club: even though it only claimed perhaps 35% input tax on the grass cutting equipment due to the restrictions of partial exemption, it must still account for output tax at 20% when it is sold in the future. However, if the equipment had been wholly used for exempt purposes, and no input tax claimed, the onward sale would have been exempt from VAT and not subject to output tax (VATA1994, Sch 9, Group 14).

Contributed by Neil Warren

Management charges – beware of the VAT issues (Lecture B1110 – 11.17 minutes)

Introduction

What exactly is a management service or management charge? They are often used as a way of reallocating costs or profits between two separate businesses; for example, a holding company might incur wage costs and professional fees and want to recharge these costs between its trading subsidiaries. It is important to recognise that these charges can have important VAT implications, and I will consider two practical situations in this session.

Holding company situation

Holding Company Ltd owns 60% share capital in Trading Company A. It has no employees or assets, but needs cash to pay dividends to its shareholders. It cannot extract the money from A by getting A to declare a dividend because this will mean payments to the other 40% shareholders, so it uses its right to raise an 'annual management charge' to A for £150,000. It pays corporation tax on the fee and then A gets a deduction against its own profits. So far, so good. However, should the holding company be VAT registered on the basis that it makes annual taxable supplies exceeding £85,000? After all, management services are standard rated when charged to a UK business.

Solution

To add a twist, let us assume that Trading Company A is partially exempt so a £30,000 annual VAT charge on a management fee would create some irrecoverable input tax. This creates the potential problem of both a late registration penalty for Holding Company Ltd (HMRC has the power to correct a late registration up to 20 years) and irrecoverable input tax for A. The challenge is to consider exactly what Holding Company Ltd does in return for its payment of £150,000.

What is a management charge?

A key message with VAT is that the tax always depends on what happens in practice, rather than what an invoice, contract or other document says. In most cases, both will be the same. The key challenge is to therefore ask if Holding Company Ltd is really providing management services to Trading Company A? Is it actually making taxable sales that exceed £85,000 and therefore requires it to be VAT registered? Or is the reality that the annual payment of £150,000 is outside the scope of VAT because there are no supplies of goods or services in the equation? Outside the scope income is ignored as far as the threshold is concerned.

HMRC guidance

The good news is that HMRC ‘s guidance caters very well for this situation, and the best reference is policy note VATSC55400, within the Supply and Consideration Manual. Don’t forget that the internal guidance is directed at HMRC officers dealing with taxpayers, which is different to the public notices that give information to business owners and advisers. See Extract from HMRC guidance VATSC55400.

The policy note gives examples of when it considers that management charges are not being made e.g. no staff are employed by the holding company; common directors exist between the two companies; the holding company has no premises or assets and it is not clear what supplies are covered by the management charge.

Extract from HMRC guidance VATSC55400

> “With holding companies, ‘management charges’ may be the only supplies that actually appear to be made. If these relate to supplies actually made, the holding company is entitled to register for VAT and claim input tax. Therefore it is necessary to check that supplies are actually being made in order to confirm the registration is valid.”

HMRC’s policy note is not targeted at providing a happy ending to late registration challenges such as Holding Company Ltd but to prevent holding companies getting a VAT number and reclaiming input tax if they are not making genuine supplies.

Case law – Stirling Investments (TC374)

Here are the facts of an important case lost by HMRC in the First Tier Tribunal:

A married couple carried out an investment business as a partnership and a similar business as a company. Both entities were registered for VAT.

The company sold two properties in 2006 and the profit was transferred to the partnership through a management charge for £525,000 plus VAT. However, the Stirlings overlooked the fact that the company was partially exempt so could not claim input tax on costs relevant to exempt property sales, including this management fee. In effect, the partnership had charged and accounted for output tax on the management fee, which was disallowed as input tax by HMRC against the company.

The company's adviser successfully argued that the £525,000 payment was not a management charge but was actually a dividend, a way of getting profits out of the company and into the pockets of the Stirlings. There was no management service being provided by the partnership in terms of costs, salaries and other overheads being incurred and recharged. And dividends are outside the scope of VAT.

Trading companies making charges

Bill and Ben each own 50% shares in a profitable property management business (VAT registered) with net assets of £200,000 on the balance sheet.

A separate company does property maintenance work (not VAT registered) with 1/3 share each owned by Bill, Ben and Bob. Annual taxable sales are £75,000 but the company does not make a big profit. In order to increase profits and allow Bob to receive a dividend, a sales invoice for £30,000 was raised to the management company on 31 March 2017 and again on 31 March 2018, described as being for 'management services'.

The annual taxable sales of the maintenance company therefore exceeded the registration threshold on 31 March 2017, with a registration date of 1 May 2017. What is the solution?

The maintenance company has a VAT problem because annual taxable sales including the management charge exceed the compulsory registration threshold. Its customers are all private householders unable to claim input tax, so a 20% (or 1/6) VAT hit on sales would be a big issue. However, the key fact was the motive behind the fee: it was not reflective of any supplies of goods or services made between the companies and only a way of moving profits for dividend purposes. The management fee did not relate to taxable sales and therefore could be ignored as far as the VAT threshold is concerned.

Conclusion

The key message is that great care is needed when transferring funds between businesses. What do these transfers actually relate to and is there a VAT issue? Forgetting about VAT on any business deal is not recommended!

Contributed by Neil Warren