CONTENTS

PERSONAL TAX 2
Guidance on the 10% starting rate for "savings income" 2
Labour backbenchers revolt over tax increase for lower paid 3
FB 2008 - proposed amendment to abolition of income tax starting rate 5
Removing the £8,500 threshold - consultation response 6
Not all employee expenses need receipts 6
Employers' tax and NIC free payments to homeworkers—increase in guideline rate 7
Budget 2008 announcements - charities 7
Employers Annual Return (P35) - meaning of service company 7
Practical implications of new day counting and residence rules *(Lecture P472)* 9
The Remittance Basis Charge And Changes *(Lecture P473)* 11
Closing The Perceived Loopholes *(Lecture P474)* 13

CAPITAL GAINS TAX 16
Entrepreneurs relief – pitfalls and opportunities 16
Purchase of Own Shares and TR745 *(Lecture B473)* 18

INHERITANCE TAX AND TRUSTS 20
BPR and Share Reorganisations *(Lecture P475)* 20
Burden and another v United Kingdom 22

ADMINISTRATION 23
Tax return gets a new look for Spring 23
Extension of clearances HMRC provide to all business customers 23
HMRC: Debt Management and Banking *(Lecture P471)* 24

BUSINESS TAX 29
Capital Allowances — Integral Features *(Lecture B471)* 29

CORPORATION TAX 32
Phoenix Companies, Concession C16 and ITA 2007, s 684 *(Lecture B474)* 32
How do VCT and EIS investments affect company performance? *(Lecture B472)* 34

VALUE ADDED TAX 38
VAT on Share Issues - S*ecurenta* C-437/06 38
Problems and opportunities created by the flat rate scheme 40
MOTs and disbursements 42
Claude Fenton (Holdings) Ltd 20558 43
VAT: transfers of going concern *(Lecture B475)* 43
Revenue & Customs Brief 24/2008 – Rewrite of the option to tax 48
Nicholas Spence 20563 50
Marks & Spencer plc v Customs and Excise Commissioners (No 2) 51

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Personal Tax

Guidance on the 10% starting rate for "savings income"

Most taxable income (up to the basic rate limit of £36,000) is taxed at the basic rate of 20%, but there is a special 10% starting rate for "savings income" (that is bank and building society interest) that you may be entitled to. The rate at which your saving income is taxable will depend on how much earnings you receive. If your earnings are less than your personal allowance plus £2,320, then some or all of your savings income will be taxable at 10%.

If you have a mixture of earnings and savings income you have to work out if you are entitled to have any of the savings income taxed at 10% . Any savings income above £2,320 will be taxed at 20%. The examples below show how the 10% rate kicks in.

If your only taxable income is savings income, you are entitled to have the first £2,320 of income above your personal allowance taxed at 10% . Any savings income above £2,320 will be taxed at 20%.

Banks and building societies will automatically deduct tax at a rate of 20% from the interest you earn. So if you are entitled to have any of your savings income taxed at 10% you will be able to claim some tax back from HMRC.

Example 1

Emily has a earned income of £10,000 and, because she is under 65, her personal allowance is £5,435. Emily's taxable income is £4,565.

Tax is payable at 20% on the £4,565.

Total tax = £913

Example 2

Hector has no earnings at all, but he does have savings income of £10,000. Hector's personal allowance is £5,435 because he is under 65. Hector's taxable income is £4,565.

The first £2,320 of taxable income is taxed at the special starting rate for savings of 10% and the rest is taxed at 20% . The calculation below shows how this is worked out

£2,320 x 10% = £232

£2,245 x 20% = £449

Total Tax = £681

Hector's bank will have taken tax off all of his interest at 20% so they will have taken off £2,000 (£10,000 x 20% = £2,000). But Hector is only due to pay £681 tax. This means he can claim a repayment of tax from HMRC of £1,319 (£2,000 – £681)

Example 3

Lynn has earnings income of £4,000 and savings income of £6,000. Lynn's personal allowance is £5,435 because she is under 65. Lynn's taxable income is £4,565.

Lynn's personal allowance is firstly used against her earnings of £4,000 so none of her earnings are taxable. All of Lynn's taxable income is savings income.

The first £2,320 of taxable income is taxed at the special starting rate for savings of 10% and the rest is taxed at 20%. The calculation below shows how this is worked out.

£2,320 x 10% = £232

£2,245 x 20% = £449

Total Tax = £681

Lynn's bank will have taken tax off all of her interest at 20% so they will have taken off £1,200 (£6,000 x 20% = £1,200). But Lynn is only due to pay £681 tax. This means she can claim a repayment of tax from HMRC of £519 (£1,200 – £681).

Example 4

Deryn has earnings £20,000 and savings income of £5,000. Deryn's personal allowance is £5,435 because she is under 65. Deryn's taxable income is £19,565.

After taking the personal allowance off her earnings, the amount of earnings that is taxable is more than £2,320 (£20,000 – £5,435 = £14,565) so none of her savings income is taxed at 10% . All of her income is taxed at 20% , and she cannot claim any tax back from HMRC.

Example 5

Fernando has earnings of £6,000 and savings income of £4,000. Fernando's personal allowance is £5,435 because he is under 65. Fernando's taxable income is £4,565.

Fernando's personal allowance is all used against his earnings of £6,000 so only £565 (£6,000 – £5,435) is taxable. The rest of the starting rate limit (£2,320 – £565 = £1,755) can be used against savings income. Fernando's earnings must be taxed before his savings.

Earnings £565 x 20% = £113

Savings £1,755 x 10% = £175.50

Savings £2,245 (£4,000 – 1,755) x 20% = £449

Total tax = £737.50

Fernando's bank will have taken tax off all of his interest at 20% so they will have taken off £800 (£4,000 x 20% = £800). But Fernando is only due to pay £737.50 tax. This means he can claim a repayment of tax from HMRC of £62.50 (£800 – £737.50).

HMRC Brief 28/2008 11 April 2008

Labour backbenchers revolt over tax increase for lower paid

Labour party bosses were reported to have told MPs by text that were expected to support the Finance Bill, after backbenchers mounted a protest at the 'disproportionate impact' of the abolition of the 10p starting rate of income tax on people 'who can ill afford to be made worse off'.

The 'main losers' from the abolition of the 10 per cent starting rate are those below the age of 65 with an income under £18,500 who are in childless households, people who 'seem an unreasonable target for raising additional tax revenues to fund the benefits of tax simplification and meeting the needs of children in poverty', a House of Commons Treasury Committee report concluded.

John McFall, the committee's chairman, said: 'While tax simplification is a laudable aim, it seems strange that the abolition of the 10 pence starting rate of income tax disadvantages mainly low income households. As such, the Government must ensure that these people are identified, and appropriate help given to them to ensure they receive the benefits to which they are entitled.'

MPs 'dismayed'

A House of Commons early day motion tabled on 2 April, calling on the chancellor to correct the change had been signed by 30 MPs, including 26 Labour members, before it was withdrawn on the following day. The motion read:

'That this House notes that, despite assurances to the contrary, many people are being made worse off by the abolition of the 10 pence tax rate; notes with concern that this is having a disproportionate impact on people who can ill afford to be made worse off; accepts that this was not the intention of the Government but is dismayed at the response to the plight of those adversely affected; and calls on the Chancellor of the Exchequer to bring forward measures to correct this damaging change to the taxation system.'

The winners and losers from tax and NIC changes announced in last year's budget will feel the difference this month. PwC calculated that in a fictional family the following changes will take effect for 2008/09:

- Grandfather, aged 80, in receipt of a pension of £12,000, is £117 better off thanks to an increase in his age-related personal allowance which more than makes up for the loss of the 10 per cent starting rate of tax;
- Grandson, aged 28, is married with a two-year old son. His wife does not work but he has a salary of £27,000. He is £233 better off. He gains more from the two per cent reduction in the basic rate of tax than he loses from the abolition of the starting rate. His income is not high enough to incur higher NICs. His tax credits remain unchanged;
- Father, aged 58, earning a salary of £50,000, has a company car costing £20,000 rated at 185 g/km for which his employer provides free private petrol. He is £97 worse off because his gains on income tax (reduced by higher charges on the car and fuel benefits) are eroded by extra NICs;
- Mother is 57 and has taken early retirement. She has a pension of £6,500 and bank interest of £500. She is £86 worse off. The continuation of the 10 per cent rate on savings income helps her but she loses out on her pension income and does not benefit from the higher personal allowance;
- Daughter, aged 21, is coming to the end of her university course. She earns £8,000 a year from a part-time job, working for 25 weeks in the year. She will be £156 worse off, after a small reduction in NICs, due to the loss of the 10 per cent band.

The FT quoted Labour MP and former social security minister Frank Field as saying that the changes were 'deeply shocking' and would hit the very people whom the government had urged to work their way out of poverty.

The CIOT's Low Income Tax Reform Group said: 'If you are on a low income the benefit of the [reduction in the basic rate] is outweighed by the removal of the 10 per cent band. That will result in people whose annual income is around £15,000 or less paying more tax from 6 April than they are now.' LITRG provided the examples shown in the **TABLE**, in a news item headed 'more tax to pay if you're poor'.

Income	Tax/NIC in 2007/08	Tax/NI in 2008/09
£7,000	£375	£482
£10,000	£1,311	£1,412
£15,000	£2,961	£2,962
£30,000	£7,911	£7,612

Responding to some press reports suggesting that increased tax credits will offset the income tax increases, LITRG pointed out that 'there are many in this situation who are not entitled to tax credits, and many others who are eligible but do not claim them.' Examples included school-leavers searching for their first employment, those leaving university with loan debt, and most childless people aged 25 or over who work less than 30 hours a week.

'Pensioners aged 60 to 64 lose out because they do not benefit from the big increase in the age allowance for the over-65s, which is meant to compensate for the loss of the starting rate,' LITRG said.

The Treasury Committee report, released on 7 April, expressed concern over the 'poor take-up rate' of working tax credit among eligible families without children, given that working tax credits are 'intended to mitigate for low-income households the effect of this removal of the starting rate'. Ministers were reported to be refusing to back down in the row as TPT went to press.

From an article by Andrew Goodall

FB 2008 - proposed amendment to abolition of income tax starting rate

The following amendment to Clause 3 of the Finance Bill was tabled on 21 April by the Labour MPs listed below.

CLAUSE 3 - AMENDMENT 5

Clause 3(6), leave out subsection (6) and insert—

> '(6A) The amendments made by this section shall not have effect until such date as may be appointed by order made by the Treasury.
>
> (6B) No such order may be made until the Chancellor of the Exchequer lays before Parliament a statement that, in his opinion, measures have been taken to ensure that no person is worse off by reason of the person's income not being sufficient to secure that the effect of the abolition of the starting rate is offset by the reduction of the basic rate.
>
> (6C) The power to make an order under subsection (6A) shall be exercisable by statutory instrument which shall be subject to annulment in pursuance of a resolution of the House of Commons.'.

Mr Frank Field	Jim Dobbin	Mr Peter Kilfoyle	Mr Marsha Singh
Kate Hoey	Jim Dowd	Andrew Mackinlay	Geraldine Smith
John Cruddas	Paul Farrelly	Mr David Marshall	Ms Gisela Stuart
Mrs Ann Cryer	Mark Fisher	Chris McCafferty	David Taylor
Janet Anderson	Paul Flynn	John McDonnell	Mrs Betty Williams
Jon Trickett	Dr Ian Gibson	Ms Diane Abbott	Mike Wood
John Battle	Mr Roger Godsiff	Mrs Linda Riordan	Alan Simpson
Ms Karen Buck	Mr Fabian Hamilton	Mr Austin Mitchell	Mr David Drew
Michael Connarty	Mr Dai Havard	Mr Greg Pope	Ms Katy Clark
Jeremy Corbyn	Mr George Howarth	Mr Gordon Prentice	

This clause was subsequently withdrawn after the Prime Minister promised that the lower paid would receive a retrospective adjustment to compensate them for the loss of the 10% band. Full details are expected later in the year.

Removing the £8,500 threshold - consultation response

Consultation ended on 17 March. HM Revenue & Customs (HMRC) is grateful to those who have taken the time to respond and are also grateful to those employers and organisations who took the time to meet with us.

HMRC believes that there has been a constructive dialogue on the subject of payrolling. Over the next few months we will be considering the responses received in detail and will provide a further update at the Pre Budget Report.

Although the consultation predominantly focused on the administrative benefits of putting benefits in kind and expense payments through the payroll, HMRC also sought views on the impact of the £8,500 threshold, above which tax is payable on benefits in kind.

The responses to the consultation indicate that the removal of the £8,500 threshold, would have an adverse impact on low paid employees and possibly the voluntary sector. The Government has therefore confirmed that it will retain the £8,500 threshold.

Not all employee expenses need receipts

Following recent revelations that HMRC's staff, like MP's need not produce receipts for all their expense claims, employers may like to know that HMRC will afford the same treatment to employees.

HMRC's latest internal guidance in its Employment Income Manual (EIM) indicates that employers can be allowed to agree their own “in-house” set of scale rate payments which may be paid to employees to reimburse them for business expenses. Once a scale rate has been agreed, it may be paid without the normal requirement for employers to inspect employees' receipts, and employees in turn need not keep and account for their receipts.

Although HMRC suggests that subsistence and cleaning would normally be the sort of expense covered by a scale rate, AccountingWEB.co.uk's tax editor, Nichola Ross Martin says that she "can see no reason why employer should not use scale rates across the board for other expenses particular those of travel and accommodation, especially when employees are incurring similar costs on a regular basis. HMRC allow this practice for overseas travel expenses after all."

She sites the following as an example where a scale rate payment described in EIM05200 might apply in practice:

Example

The firm of Accountants-R-Us LLP (ARU) is based in Guildford, Surrey. It has many clients in central London, and it constantly reimburses staff for their travel between the office and central London. Under the current system, staff submit monthly travel and subsistence expense claims (with receipts). Applying HMRC’s new guidance, ARU sets a scale rate payment for London journeys by taking the average of a random sample of 10% of employees’ expenses claims for a month. It pays this rate for each journey without any need for a full expense claim (or receipts).

ARU, could also set the scale rate to cover travel, subsistence and even accommodation for journeys in the UK. Employees would then only need to be able to quantify their business trips and be paid the agreed rate.

HMRC did not make a fuss of the changes made to its UK scale rates guidance and the hyperlinks to http://www.hmrc.gov.uk/manuals/eimanual/EIM05200.htm from the manual updates section are not working. What has been well publicised though are changes made in the case of overseas business

travel. A set of benchmark scale rate has been published in a set of tables, with detailed to assist employer calculations.

Employers' tax and NIC free payments to homeworkers—increase in guideline rate

From 6 April 2008, HMRC has increased the tax and NIC free guideline rate employers can pay home working employees without keeping records from £2 to £3 per week.

Employers can reimburse their employees who work regularly from home for the additional household expenses they incur without incurring an extra tax or NICs charge. The additional expenses that the employer may reimburse are those connected with the day to day running of the employee's home. This might include additional costs of heating and lighting the work area, or additional insurance costs.

Because it might be difficult for employers to calculate the exact additional costs, HMRC has published a guideline rate that can be paid without the employer having to justify the amount paid or the employee having to keep any records to demonstrate the additional expenditure. The guideline rate is not a maximum amount and greater amounts can be paid where there is evidence to justify them.

Further guidance is available in the Employment Income Manual.

Budget 2008 announcements - charities

For donations made by donors on or after 6 April 2008, charities will claim Gift Aid repayments at the new basic tax rate of 20% but they will also be entitled to a transitional relief worth 3p for every £1 donation they receive under the Gift Aid scheme. This transitional relief has been provided by Government to allow charities to adjust to the fall in basic rate tax from 22% to 20%, and will be paid in respect of all qualifying Gift Aid donations made to charities between 6 April 2008 and 5 April 2011. This means that for every pound donated under the Gift Aid scheme the charity will continue to receive 28p. Charities don't have to do anything extra to benefit from this transitional relief; HMRC will pay it automatically along with Gift Aid tax repayments.

Employers Annual Return (P35) - meaning of service company

2007-08 P35: Question 6 – meaning of service company

Question 6 relating to service companies on this year's for P35 Employers Annual Return has caused considerable confusion, for which we apologise.

Following the introduction of the Managed Service Company legislation with effect from April 2007, it was necessary to change the question on the P35 in order that it relates both to the Managed Service Company legislation and to the Intermediaries legislation (sometimes known as IR35).

What will happen now?

HM Revenue & Customs (HMRC) will not use the answers to Question 6 on the 2007-08 P35 to risk profile individual employers for a compliance review.

If you have already submitted your P35 and think you may have completed Question 6 incorrectly, you do not need to amend it.

If you have not yet submitted your P35, you should complete Question 6 in regard to the guidance below.

Clarification of Question 6

Question 6 is deliberately in two parts. The first question narrows those employers who need to consider whether the second question applies. If the answer to the first question is no, the answer to the second question will similarly be no.

The term service company relates to limited companies, limited liability partnerships and general partnerships within the range of the Intermediaries legislation (IR35) or the Managed Service Company legislation (Chapters 8 or 9 ITEPA, respectively).

The first question should be answered yes if:

- an individual personally performs services for a client and the services are provided not under a contract directly between the client and the worker but under arrangements involving the limited company, limited liability partnership or general partnership (the service company)
- the limited company, limited liability partnership or general partnership's (the service company) business consists wholly or mainly of providing the services of individuals to clients

The second question should only be answered yes if income has been treated as deemed employment income and PAYE (Pay As You Earn)/National Insurance (NI) deducted in accordance with the Managed Service Company or Intermediaries legislation(IR35).

HMRC Press release – April 2008

At this point it may be worth noting that page TR4 of the 2007-08 self-assessment tax return form has a section entitled 'service companies' that includes just one box for completion and the accompanying instruction:

> 'Total amount of any income included anywhere on this tax return, derived from the provision of your services through a service company – read page TRG 15 of the guide.'

This is an odd question, because if the income has already been declared on the tax return, why do HMRC need to have that information duplicated in another box?

HMRC do have the power to ask for returns under the Taxes Acts that may be in such form as the board prescribe (TMA 1970, s 113), but TMA 1970, s 8(1) says:

> 'For the purpose of establishing the amounts in which a person is chargeable to income tax and capital gains tax for a year of assessment and the amount payable by him by way of income tax for that year, he may be required by a notice given to him by an officer of the board –
>
>> 'a) to make and deliver to the officer a return containing such information as may reasonably be required in pursuance of the notice.'

Some tax advisers believe that HMRC have over-stepped their powers in asking a question which appears to have no bearing on the taxpayer's tax liability for the year.

If this view is correct, the taxpayer should not answer the question and should not be subject to penalties if he omits the requested information.

Assuming HMRC do have the power under TMA 1970, s 8 to ask such a question, we need to refer to the tax return guide (SA 150) for further guidance. The instruction on page TRG 15 of SA 150 says:

> 'You should complete this box if you have received any form of income (including employment income and dividends) during the year in question from a company through which you provided your services personally and of which you are a sole or joint shareholder.'

This guidance is expanded on page TRG 16:

> 'Complete this box if the company's income is derived:
>
> - wholly or mainly from services provided to third parties by you personally; or

- wholly or mainly from services provided to third parties by you personally and your fellow shareholders and your shareholding is directly linked to the level of company profit you generate (that is, linked to the amount paid by third parties in respect of your personal services).

‘Do not complete this box if you are a shareholder and company officer of a company and the company’s income is derived wholly or mainly from the provision of the services of company employees whose total income is treated as employment income, or derived wholly or mainly from the manufacture/provision of goods.’

This guidance does not provide the taxpayer with much clarity as it raises more questions than it answers. The ICAEW Tax Faculty and the CIOT have pressed HMRC to provide better guidance, and we understand that revised guidance for the self-assessment tax return is about to be released.

Even with the revised guidance, we are left with the clear distinction between services provided personally, and the provision of goods. This seems to force us to find a definition of ‘services’ before we can start to complete the question. Sadly there is no clear definition and guidance is needed in this regard.

Extracted from an article by Rebecca Cave writing in Taxation, May 2008

Practical implications of new day counting and residence rules

UK resident

You will be treated as ‘resident’ in the UK in any of the following situations:

- You are physically present for any reason for 183 days or more in a tax year (practice prior to 6 April 2008 ignores days of arrival and departure),
- You have visited the UK for an average of 91 days per annum over a period of four consecutive tax years. You will be regarded as ‘resident’ from the beginning of the fifth year

With the previous practice of ignoring days of arrival and departure the ability to enter and leave UK on consecutive days or the same day without counting skews results when looking at the day count to determine residence. Evidently manipulation also skews tax results.

The recent case of Robert Gaines Cooper demonstrated with the difference between his day count and that of HMRC. Additionally our rules are dissimilar to other jurisdictions. All these factors have therefore acted an agent for change.

Alistair Darling announced in the Pre Budget Report that days of arrival and departure would count as days in the UK for the purpose of determining residence. Additionally a day where an individual both arrived and departed would also count as a day in the UK.

Individuals who had previously not been classified as resident because they were not present in the UK for over 91 days might well have become resident under these new tests. The proposals would have meant that the number of people who regularly travel in and out of the UK would have been caught under the new rules.

Consider the number of people from the EU who regularly travel in and out of the UK. They would have become resident in potentially at least two jurisdictions with the tax consequences resulting therefrom such as tax returns and taxation in two jurisdictions

The current proposal is that from 6 April 2008 a day will be counted for the purposes of the two residence tests if the individual is in the UK at midnight

There is an exemption for passengers who are in transit between two places outside the UK and are present at midnight for the purposes of travel. To take advantage of the exemption it is important that any transit in the UK must not be for another purpose. Both work and social reasons count as not for the purpose of travel.

The original tests would have caught people by design and by accident. It might be interpreted that by announcing the worse case scenario and then compromising to get what was wanted in first place a subtle strategy was applied.

However individuals such as trans border lorry drivers and air crew would have potentially been caught as the proposals were originally drafted. The explanatory notes to the Finance Bill give a number of examples of how HMRC presumably intend to apply these rules and they follow.

Example 1 – Peter

Peter works for the Jersey arm of HSBC and is travelling from Jersey to Frankfurt. He flies from Jersey to Gatwick and will catch his onward flight the next day to Frankfurt from London City airport. He travels from Gatwick to Canary Wharf for a meeting with several other HSBC colleagues before staying overnight in a nearby hotel. The meeting with colleagues is not an activity substantially related to completing travel to a foreign destination.

The transit passenger provisions will not apply.

Example 2 – John

John works for the Jersey arm of HSBC and is travelling from Jersey to Frankfurt via Gatwick and London City airport. In lobby of his hotel near London City Airport, he unexpectedly spots another colleague who has just arrived from Paris. They have a couple of pints together and their conversation covers a number of business-related issues. Peter then travels to London City airport to catch his onward connection. This meeting was not planned and therefore it can be considered that John's activities in the UK substantially related to completing travel to a foreign destination.

The transit passenger provisions will apply.

Example 3 – Shirley

Shirley lives in Guernsey and is travelling to New Zealand by way of Gatwick and Heathrow. She has planned to spend most of the day with her daughter and grandchildren, who live in Crawley and will also spend the night there before travelling to Heathrow for her onward flight. Her visit is not an activity substantially related to completing travel to a foreign destination.

The transit passenger provisions will not apply

Example 4 – Phil

Phil lives in Guernsey and is travelling to New Zealand by way of Gatwick and Heathrow. His flight from Guernsey is delayed by fog and he arrives too late to make his onward connection to New Zealand that day. His son had already arranged to meet him at Gatwick and drive him to Heathrow, now he drives him to a hotel near Heathrow instead where Phil will stay overnight before catching his rearranged flight. At the hotel they have a snack together. These activities are substantially related to completing travel to a foreign destination – Phil would have eaten in the hotel even if he had been unaccompanied.

The transit passenger provisions will apply.

Example 5 – George

George lives in the Isle of Man and is flying to New York on business via Manchester. He has made an appointment with a consultant orthopaedic surgeon based in Manchester to carry out a number of tests. He will stay in the clinic overnight before travelling on to New York the following afternoon. The appointment is not an activity substantially related to completing travel to a foreign destination.

The transit passenger provisions will not apply.

Example 6 – Tony

Tony lives in Jersey and is travelling to Oslo. He does not fly and travels to the UK by ferry before continuing to London by train. He stays overnight at a West End hotel, having prearranged dinner and a trip to the theatre with friends. The next day he travels to Newcastle by train, where he boards a ferry to Oslo. His UK activities are not substantially related to completing travel to a foreign destination.

The transit passenger provisions will not apply.

It will be interesting to see whether the pattern of working in the UK for frequent visitors will change significantly to accommodate the new rules.

Care will need to be exercised over coming years to ensure that when days are counted to determine the residence of an individual that the correct rules are used for the correct year. There will be significant scope for mistakes with record keeping and answering questionnaires used by advisers to determine a client's residence status.

Additionally consideration needs to be given to who will deal with a client's affairs so that they have the appropriate level of knowledge and records will be able to withstand HMRC scrutiny in an enquiry.

Rule Of Thumb over Travel

In April 2007 HMRC and the profession agreed a rule of thumb dealing with the day counting in respect of short haul and long haul flights.

Where this rule of thumb refers to morning or afternoon departures or arrivals what is meant is the times the planes (boats or trains) actually left and arrived.

When calculating whether or not a flight is long haul in nature we are considering time spent in the air. However, where flights are not direct a one hour foreign transfer addition may be added to the airtime to determine whether or not the travel should be regarded as long haul in nature.

Short Haul Travel

Short Haul Travel means a flight or journey lasting for less than 7 hours in duration.

- Morning departure = overseas workday
- Afternoon departure = UK workday
- Morning arrival = UK workday
- Afternoon arrival = overseas workday

Long Haul Travel

Long haul travel means a flight or journey lasting for more than 7 hours in duration

- Morning departure = overseas workday
- Afternoon departure = ½ UK workday and ½ overseas workday
- Morning arrival = ½ overseas workday and ½ UK workday
- Afternoon arrival = overseas workday

Article by Tony Jenkins

Lecture P472 (18.20 Minutes)

The Remittance Basis Charge And Changes

For a long time for non domiciled individuals and non ordinarily resident individuals there has been an advantageous basis of the taxation in the remittance basis. Under the remittance basis an individual would only be taxed in the UK if the relevant type of income or gains was remitted to the UK. Different definitions applied to different types of income

The proposals in the Pre Budget Report were that there would be a £30,000 charge for individuals to access the remittance basis. This was specifically an annual charge to access the basis and not a charge on income or gains

There would be a de minimis limit of £1,000 under which individuals would not have to pay the charge to access the basis.

As the charge was not a tax there would be very real double taxation for American citizens who would be paying an additional charge with no relief for double taxation under the DTA. The charge

was not a tax and therefore not creditable under the US-UK double tax treaty. Additionally such individuals coming to the UK with their family would be subject to a number of charges which increased the overall burden.

In the Budget the Chancellor confirmed that from 6 April 2008 the £30,000 charge will be on specifically nominated unremitted income and gains. It will only apply to adult non-UK domiciled individuals and/or not ordinarily resident individuals who are claiming the remittance basis of taxation. It will only apply if the individual is UK Resident for 7 of last 10 tax years including the current tax year.

There have been 3 main changes from the original proposals:

- There will be no charge if unremitted income and gains is less than £2,000 rather than the original proposal of £1,000
- The charge applies to adults only not including minors as originally suggested
- The charge is an actual tax charge on unremitted income and gains rather than a charge to access a particular basis of taxation – This would appear to solve the problem of the credit against US tax for US citizens – This has been confirmed by a well known American law firm but not by the US Treasury

The charge will be payable through self-assessment system.

Payment from overseas does not create a taxable remittance but payment into the UK and then onwards to HMRC will be treated as a taxable remittance.

A taxpayer can choose each year whether to opt for remittance basis

The taxpayer will be able to choose which unremitted income or gains the £30k is paid on. They will not be taxed again on the same income or gains if it is eventually remitted to the UK.

Under dual contract arrangements income from the overseas contract is only taxed under the remittance basis so this will need to be considered for such arrangements.

Overseas work for individuals who are not ordinarily resident in the UK is taxed on the remittance basis and such individuals will therefore need to consider the impact of these provisions.

There will be no provisions currently existing in equalisation contracts for equalised employees which will need to be included.

There will clearly need to be additional record keeping in respect of the nominated income or gains.

From 6 April 2008 if an individual is claiming the remittance basis they will not get the personal allowance or the annual CGT exemption. The same de minims limit of £2,000 applies here as well:

There are a number of considerations to be borne in mind:

- Too low a de minimis limit has been set and will catch more people than potentially was originally intended.
- The loss of the allowances and the annual exemption impacts more significantly the lower the income/gains
- There will be a high marginal rate of tax for many individuals remitting income or gains to the UK if their overall level of income or gains is not significant
- The very rich will not be significantly affected
- There will be practical problems for non doms who work here and send money home and then remit to the UK
- We are likely to get lots of queries from individuals who can't really afford accountants' fees

The legislation in Schedule 22 of the Finance Act 2003 applies predominantly in respect of individuals who are resident and ordinarily resident in the UK . It does not deal very successfully with those individuals who are not within this category.

The changes to be implemented have arisen out of the residence and domicile review. A new Chapter 5A will be introduced to Part 7 of ITEPA 2003 which will ensure that an appropriate

proportion of gains arising from Employment Related Securities will be taxed in the UK where the remittance basis applies to the relevant employee. There will be an apportionment of the gains where there are duties in the UK and abroad and income tax will apply to the extent that they are remitted to the UK.

Article by Tony Jenkins

Lecture P473 (15.52 Minutes)

Closing The Perceived Loopholes

There are a number of areas in the treatment of residence and domicile that HMRC perceive as loopholes. Naturally advisors and clients perceive these as tax planning opportunities to take advantage of. This year' Finance Bill contains provisions that will close these "loopholes"

The Ceased Source Loophole

The 'ceased source' loophole is where foreign savings and investment income and gains cannot currently be taxed when remitted to the UK if the source of the income or gain no longer exists in that year. For example, with foreign bank interest, tax can be side-stepped by closing that bank account at the end of the tax year, transferring the interest to a new bank account, and then remitting it to the UK tax-free as the source of the interest no longer exists

Where the remittance basis claimed for a year, the income of that year will be liable to tax if it is remitted to the UK, even where the source of the income has ceased in a previous year.

This has been familiar tax planning with many advisers and clients. Advisers will need to take special care to ensure that clients are alerted to the change in the legislation that operates from 6 April 2008.

The Cash Only Loophole

The remittance basis is defined in the tax legislation differently depending upon whether employment income, investment income or capital gains are being remitted to the UK. The definitions for employment income and capital gains are much tighter than for investment income

The 'cash only' loophole which means HMRC can currently only tax foreign savings and investment income if it is brought into the UK as cash. If a remittance basis taxpayer turns foreign investment income into an asset outside the UK and then imports that asset, no UK tax can be charged on the income unless and until the asset is sold or turned into cash in the UK.

The new legislation will ensure that money, property and services derived from relevant foreign income brought into the UK will be treated as a remittance and taxed accordingly.

There are provisions which protect assets owned on 11 March 2008 and assets in the UK on 5 April 2008.

There are also rules which deal with a number of necessary exemptions.
There are a number of exemptions for:

- Personal effects
- Assets costing less than £1,000
- Assets brought into the UK for repair and restoration and
- Assets in the UK for less than a total nine month period purchased out of relevant foreign income

These are referred to as the personal effects rule, the less than £1,000 rule, the repair rule, and the temporary importation rule. A number of practical consequences follow.

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There is currently no upper limit on the personal effects that can be brought into the UK which appears slightly baffling bearing in mind the £1,000 rule for other assets and the potential for jewellery, watches etc to be worth well in excess of say £1,000.

The £1,000 threshold for other assets would appear to be far too low and it will be difficult to police the borderline as assets nowadays can be bought at varying prices.

There appears to be no way to police the temporary importation deadline as the assets can be simply retransported out of the UK before the 9 month deadline and reimported.

Any asset owned on 11 March 2008 will be exempt from a charge under the remittance basis, for so long as that individual owns it.

Any asset in the UK on 5 April 2008 will also be exempt from a charge under the remittance basis, for so long as the current owner owns it.

The existing charge that arises if such an asset is sold in the UK will remain.

The Claims Mechanism

Previously claiming the remittance basis allowed certain income to be taxed only when remitted but if the arising basis applied in that year the remitted income could be remitted tax free.

Foreign savings and investment income arising in a year in which the remittance basis is claimed will be taxed if it is remitted to the UK, irrespective of the year in which it is remitted and whether or not a claim to the remittance basis is made in the year in which the remittance is made

Mixed Funds

For many years there has been the concept of the mixed funds so that if different sources of income and capital were mixed up in one pot you could not identify what was income or capital and therefore could not plan to remit only one source such as capital which would not be taxable in the UK.

Conversely well advised taxpayers would segregate different sources in different bank accounts and therefore be able to specifically identify different source.

The draft legislation issued in advance of the Budget indicated that the legislation would give a statutory order of identification in respect of mixed funds.

Remittances would be taxable as income first and the sequence in which items are to be applied was as follows:

- Employment income
- Relevant foreign earnings
- Relevant foreign income
- Foreign chargeable gains
- Other income or capital

Extreme care needs to be exercised in this area as the original proposals are no longer valid as they have been superseded by a new order in the Finance Bill. Additionally it is clearly stated in the Finance Bill that there will be other items inserted into the order during the course of the passage of the Finance Bill through Parliament. The current order is:

- Employment income (other than relevant foreign earnings, foreign specific employment income and employment income subject to a foreign tax);
- Relevant foreign earnings (other than employment income subject to a foreign tax);
- Foreign specific employment income (other than employment income subject to foreign tax) relevant foreign income (other than relevant foreign income subject to a foreign tax);
- Foreign chargeable gains (other than foreign chargeable gains subject to a foreign tax);

- Employment income subject to a foreign tax;
- Relevant foreign income subject to a foreign tax;
- Foreign chargeable gains subject to a foreign tax; and
- Any income or capital (including income or capital already taxed in the UK) not included in the previous eight categories

This process must, if necessary, be carried out first for the tax year in which the remittance was made, and then in relation to income or capital for previous tax years.

For example, foreign chargeable gains for the tax year in which the remittance was made are treated as remitted in preference to relevant foreign earnings in turn being treated as remitted in preference to foreign chargeable gains for the immediately prior year.

Gifts

It has been possible for many years to gift money to another individual and for that individual to remit that money to the UK without the funds being taxable on the donor. This was confirmed in Carter v Sharon in 1932. HMRC have not liked this practice as it allows funds to be relatively easily remitted to the UK without being taxed.

The new rules apply where an individual arranges for money or property to be brought into the UK, or services and benefits to be provided in the UK that was funded out of untaxed foreign income or gains.

Where that individual, or their immediate family, benefits in any way then that individual will be taxed under the remittance basis rules. Carter v Sharon arrangements would appear to all right provided none of the relevant parties benefit.

The definition of an individual's 'immediate family' will be limited to:

- spouses, civil partners
- individuals living together as spouses or civil partners and their children or grandchildren under 18

It will also cover:

- close companies, or foreign companies that would be close if in the UK, of which any of them are participators and
- trusts of which any of them are settlors or beneficiaries

Article by Tony Jenkins

Lecture P474 (19.47 Minutes)

Capital Gains Tax

Entrepreneurs relief – pitfalls and opportunities

This article provides commentary on some potential pitfalls and planning opportunities that present themsleves following the introduction of entrepreneurs relief.

Tax increase for clients

Between 2007–08 and 2008–09 sellers face a tax increase, albeit possibly quite a modest one as can be seen in the following example.

Example

Mr Pedantic, a higher rate taxpayer, finally completes the sale of his shares in Drawn Out Sale Limited for £300,000 (after costs) on 30 April 2008. He subscribed for 1,000 shares at par of £1 per share in September 1988.

The workings below show the CGT position assuming that he had sold in before 6 April 2008 and also post 5 April 2008.

Pre 6 April 2008	£	**Post 5 April 2008**	£
Proceeds	300,000	Proceeds	300,000
Cost	(1,000)	Cost	(1,000)
Indexation allowance @ 50%	(500)		
	298,500		299,000
BATR @ 75%	(223,875)	Entrepreneurs' relief (4/9)	(132,889)
Annual exemption	(9,200)	Annual exemption	(9,600)
Taxable	£65,425	Taxable	£156,511
CGT @ 40%	£26,170	CGT @ 18%	£28,172

Mr Pedantic does not understand why his liability has increased by £2,002 (nearly 8%) and so reconciles the differences as follows:

	£
Loss of indexation allowance 500 @ 10%	50
AE relieved at 18% not 40% (£9,200 @ 22%)	2,024
Increase in AE (£400 @ 18%)	(72)
	£2,002

Overall, anyone entitled to entrepreneurs' relief who makes a gain of more than £17,280 will be worse off. The type of planning that made use of crystallising a gain on goodwill on incorporation of, say, four times the annual exemption, will now no longer be appropriate. Such planning does still work, but is less attractive because the amounts involved are less.

Family companies

Is the £1 million lifetime limit sufficient to encourage entrepreneurial activity as opposed to a higher limit?

Given that the shareholding requirement is only 5%, then it is conceivable that there could be a company sale with 20 shareholders, all of whom are fully qualifying for entrepreneurs' relief such that a gain of £20 million would be taxed at 10%.

Whilst this is possible, the more common scenario at the moment is that many shareholders who believe that they will qualify for the 10% tax rate do not in fact qualify as they do not hold the required 5% interest in the compnay or they are neither an officer or employee of the company.

For advisors, there is clear danger of negligence actions being brought if they have not advised their clients on the actions necessary to achieve qualification for entrepreneurs' relief on a sale.

Companies v partnerships

It is interesting that whilst shareholders are required to hold at least 5% of the shares, there is no such requirement for partners; therefore, whilst a company is limited to 20 individuals all qualifying for entrepreneurs' relief, it would seem that a partnership could have 1,000 partners, all of whom would qualify for the relief. This must favour limited liability partnerships (LLPs) over limited companies where the intention is to develop a business for sale. This is particularly likely to be the case for service sector businesses that do not require a significant external investment from third party shareholders. It must also suggest that start ups are better dealt with through partnerships. Presumably, little thought was given to the position of LLPs when the draft legislation was being prepared, given that it was based on the old retirement relief legislation which pre-dated LLPs.

Associated disposals

This concept is taken from the retirement relief legislation and deals with the position where assets are owned outside of a company. Historically, this would tend to be a property although it could also be intangible assets such as goodwill or intellectual property rights.

Entrepreneurs' relief is extended to the gain on the associated disposal of the asset outside of the company as long as that disposal takes place at the same time as the disposal of the shares in the company itself.

Investment assets

Of even greater concern is where the asset outside of the company has been let to the company for a commercial rent or royalty as this will prevent entrepreneurs' relief from applying (TCGA 1992, s 169P). Unfortunately, the draft legislation does not only consider the position from 6 April 2008 onwards, but rather seems to go back indefinitely. Therefore, assets owned outside of companies that were let during the BATR regime will now have restricted entitlement to entrepreneurs' relief. One of the issues for advisors to consider is how best to clean up the historic position such that this is not a problem on an eventual sale.

It is worth highlighting that the particular example released on Budget Day (Number 6) is at best described as unclear on this point. This suggests that this issue is not well appreciated, although the Finance Bill explanatory notes refer to the payment of rent turning the asset into an 'investment'. As such, the drafting is intentional albeit poorly done.

From an article by John Endacott writing in Taxation

Purchase of Own Shares and TR745

Conditions for capital treatment

As a general rule, when a company buys back its own shares from a shareholder, any payment in excess of the capital originally subscribed for the shares falls to be treated as an income distribution, such as on a purchase of own shares by a quoted company. However, there is an exception in the case of unquoted trading companies. If certain conditions are satisfied, the vendor is treated as receiving a capital payment instead (unless the vendor is a share dealer, in which case the receipt is treated as trading income). Those conditions include a 'trade benefit' test, as well as requirements as to residence, length of ownership of the shares and the degree (if any) to which the vendor remains connected with the company. The tax legislation specifically dealing with the purchase of own shares by an unquoted trading company is contained in ICTA 1988, ss 219-229.

The 'substantial reduction' test

Two separate arithmetic tests must be satisfied before capital treatment can apply to the purchase of own shares, which are relevant if the vendor retains an interest in the company following the share sale. First, the vendor's interest as a shareholder in the company must be substantially reduced (ICTA 1988, s 221(1)). The combined interests of the vendor (and any associates) are taken into account for this purpose. The term 'substantially reduced' broadly means that the nominal value of shares owned by the vendor and associates immediately after the purchase, expressed as a fraction of the company's share capital at that time, does not exceed 75% of the corresponding fraction immediately before the purchase.

There is a further condition to be satisfied, broadly in terms of the vendor's interest in the company's profits. Even if the substantial reduction test is met in terms of share capital, it is not regarded as satisfied if the vendor shareholder's interest in the company's profits available for distribution exceeds 75% of the corresponding fraction immediately before the purchase. 'Profits available for distribution' has the meaning given in Companies Act 1985, Part VIII, except that the amount is increased by £100 per company plus any fixed distributions to which the shareholder may be entitled. To that figure is added the excess of all sums payable on share purchases (or redemptions or repayments) over distributable profits available immediately before the purchase.

The 'no continuing connection' test

The second arithmetic test to be satisfied in order to qualify for capital treatment on a purchase of own shares requires that the vendor must not be connected with the company (or a group company) immediately after the purchase (ICTA 1988, s 223).

'Connection' is broadly defined in terms of direct or indirect ownership or entitlement to acquire (now and in the future) more than 30% of the company's ordinary share capital, loan capital (except in limited circumstances involving money lending companies), voting power or the entitlement of equity holders to assets available for distribution on a winding up of the company. The rights of associates are also taken into account for these purposes. The vendor is also connected with the company if he 'controls' it, within the meaning given in ITA 2007, s 995 (previously ICTA 1988, s 840), i.e. broadly a person's power to secure that the company's affairs are conducted in accordance with his wishes, through shareholdings, voting or other powers in respect of the company (ICTA 1988, s 228).

TR745

Technical Release 745 ('The purchase by a company of its own shares') was issued by the ICAEW in April 1989. TR745 contains the text of exchanges of correspondence and meeting notes between the Institute and the Inland Revenue (as it then was), and provides clarification on various aspects of own share purchases.

Satisfying the arithmetic tests

- **'Phased' purchases**

  For a purchase of own shares to be valid under company law, the company must make full cash payment on purchase. The transfer of a company asset, loaning back the sale proceeds to the company or simply leaving the proceeds outstanding on loan account strictly does not represent 'payment' for these purposes. In such circumstances, the shares are not treated as cancelled and the vendor retains legal ownership of the shares (CTM 17505).

An alternative to the 'loan back' following the purchase of the vendor's entire shareholding is a 'phased' purchase, i.e. the purchase of shares in tranches. Clearance applications are in strictness required in respect of each purchase. HMRC accept (subject to the 'trade benefit' test being satisfied) that it is possible for the vendor to make a series of disposals phased over a period (ICAEW Technical Release 745). However, for the transactions to be eligible for capital treatment, the 'substantial reduction' and 'no continuing connection' tests must be satisfied on each occasion.

- **Contracts with multiple completion**

  A company purchase of its own shares by instalments is prohibited under company law. However, a company may enter into a single, unconditional share sale contract with the vendor, with completion taking place on different dates in respect of separate tranches of shares within the agreement. The effect is that the 'substantial reduction' test mentioned above need only be considered once (i.e. at the contract date), and not at the date of each completion.

The vendor must also satisfy the 'no continuing connection' test. However, if the vendor loses beneficial ownership of the shares at the contract date, he will only remain connected with the company if there is ongoing ownership of or entitlement to more than 30% of its issued ordinary shares, loan capital, voting rights and/or assets on a winding up (nb the rights and powers of any associates must also be taken into account). Completion of the contract in stages does not create a debt for connection purposes. In the event that the company defaults on a stage of the purchase, the vendor could sue under breach of contract for the right to enforce specific performance.

HMRC may be prepared to accept that a multiple completion contract is possible, provided that beneficial ownership passes at the contract date. TR745 states:

> "(a) [The Revenue] confirm that payment by instalments is prohibited. But they are advised that a company may contract to buy in shares for completion to take place for particular numbers of shares included in the sale on different dates without contravention of the Companies Acts."
>
> "(b) [The Revenue] take the view that **as the beneficial ownership of the shares is regarded as passed at the date of the contract**, a disposal for capital gains purposes by the vendor will have taken place at that time notwithstanding payments at a later date... (emphasis added – see below).

The date of disposal for capital gains purposes is normally when the unconditional contract is made (TCGA 1992, s 28(1)), notwithstanding that payments are made at later dates. This means that the tax liability arising from the disposal could fall due before the consideration for all the shares is received.

A change of mind?

In spite of the views expressed by HMRC in TR745, the writer has recently become aware of instances in which HMRC have refused to give clearance in respect of single unconditional contracts with completion over different tranches of shares on different dates. The grounds for HMRC's refusal is understood to be company law, along the lines that between the contract being entered into and the purchase price being fully paid, the vendor remains entitled to vote in respect of the shares.

The above is really a matter of company law, and the position (at least from HMRC's perspective) is not free from doubt. Nevertheless, it should be possible to ensure the unconditional contract stipulates that the vendor does not retain any beneficial entitlement over the shares.

However, it should be noted that loss of beneficial ownership of the shares not only effectively means that the vendor shareholder is unable to exercise voting rights in relation to the shares, but that participation in dividends paid after the contract date will not be possible. The vendor shareholder would need to consent to the waiver of rights to any dividends or other shareholder rights when entering into the agreement and will therefore probably wish to take legal advice to ensure that the contract offers appropriate safeguards to protect his position. In addition, HMRC will no doubt insist that the contract satisfies this particular requirement.

Article by Mark McLaughlin

Lecture B473 (13.01Minutes)

Inheritance Tax and Trusts

BPR and Share Reorganisations

Ownership periods

The availability of Business Property Relief (BPR) for Inheritance Tax (IHT) purposes is subject to a general requirement that the business property must have been owned for a minimum period of two years (IHTA 1984, s 106). However, there are certain exceptions to this basic two-year ownership requirement, in connection with the following:

- replacement property (s 107);
- acquisitions on death (s 108); and
- successive transfers (s 109).

The 'replacement property' exception to the two-year ownership test is the subject of these notes and the accompanying lecture.

Replacement property

The general rule regarding replacement property is that business property satisfies the ownership condition if two conditions are satisfied (s 107(1)):

"(*a*) it replaced other property and it, that other property and any property directly or indirectly replaced by that other property were owned by the transferor for periods which together comprised at least two years falling within the five years immediately preceding the transfer of value, and

(*b*) any other property concerned was such that, had the transfer of value been made immediately before it was replaced, it would (apart from section 106) have been relevant business property in relation to the transfer."

The 'replacement property' rule may be helpful in certain circumstances:

- *Incorporation of a business* (i.e. the acquisition of the business by a company controlled by the former business owner);
- *Partnerships changes* - resulting from the formation, alteration or dissolution of a partnership (e.g. retiring from one partnership to form another);
- *Company reorganisations, etc* – the ownership period of unquoted shares which would (under the CGT rules in TCGA 1992, ss 126-136) be identified with other qualifying shares previously owned may be treated as including the ownership period of the original shares (s 107(4)).

The replacement property rule is subject to a potential limitation in relief in some cases. The BPR available is restricted to what it would have been had the replacement or any one or more of the replacements not been made (s 107(2)). However, for situations within either of the first two bullet points above, this potential restriction in BPR is disregarded (s 107(3)).

HMRC accept that for the purposes of the ownership test, the business carried on need not be the same throughout. Replacements may take place during the five year period, and the businesses may be entirely different (e.g. the sale of a florists, followed by the acquisition of a newsagent business a few months later). However, a business must have been carried on throughout the ownership period (see IHTM25303).

The above 'company reorganisation' exception to the replacement property rule applies to unquoted company shares. In broad terms, if shares are received in respect of other shares in a capital reorganisation or company amalgamation or reconstruction, the ownership period of the earlier shares counts towards the two-year ownership test if those shares would have qualified for BPR.

The Executors of Mrs Mary Dugan-Chapman & anor v Revenue & Customs Commissioners

The recent IHT case *The Executors of Mrs Mary Dugan-Chapman & anor v Revenue & Customs Commissioners* ((2008) SpC666) concerned a BPR claim that relied on the 'company reorganisation' exception to the two-year ownership rule. In that case, Mrs Dugan-Chapman (Mrs DC) was allotted one million ordinary shares in the company on 27 December 2002, two days before her death.

The main issue in this case was broadly whether those shares could be identified for BPR purposes with other shares in the company which she had held for at least two years prior to her death, as having arisen from a reorganisation within TCGA 1992, s 126. Unfortunately, the Special Commissioner dismissed the executors' appeal against HMRC's determination that the value of those shares could not be reduced by BPR.

HMRC had contended that the shares were issued as the result of a simple subscription for shares. There was insufficient evidence or documentation to support the executors' argument that a reorganisation had actually taken place. For example, only Mrs DC took shares on 27 December 2002. A rights issue would involve the other shareholders renouncing their pro-rata entitlement, so that Mrs DC could acquire the full million shares. There was no mention in the documentation relating to the share issue of any offer having been made to the other shareholders.

IHT planning with Directors' Loan Accounts

It is worth noting in the above case that 300,000 shares had been allotted to Mrs DC on 23 December 2002 (i.e. six days before her death) as a pro-rata entitlement on a rights issue, following the conversion of a loan account of £300,000 that Mrs DC had with the company. It was agreed that those shares qualified for BPR (i.e. as a result of IHTA 1984, s 107(4)).

Whilst the above case is a useful reminder that director's loan account balances do not themselves qualify for BPR, it also provides a useful potential planning point on how to address the problem. Existing shareholders in family or owner-managed businesses who have loaned funds to their company may wish to exchange those funds for additional shares in the company.

A straightforward subscription for further shares will mean that those additional shares must be owned for at least two years in order to qualify for BPR. This two-year ownership requirement will not present difficulties in most cases. However, for shareholders who are elderly and/or in ill health, it may be much less certain that the owner will satisfy the ownership test. In those circumstances, arranging for the further shares to be issued in accordance with the 'company reorganisation' rule in IHTA 1984, s 107 could help to secure BPR that may not otherwise be due.

The 'Duomatic' principle

A further interesting point raised in the *Executors of Mrs Mary Dugan-Chapman* case was whether the 'Duomatic principle' applied. The executors stated that the company conducted its affairs with relative informality. They raised the principle established in *Re: Duomatic Ltd* ([1969] 2Ch 365), which broadly allows certain formalities to be treated as having been satisfied. They argued that the rights issue had effectively taken place so that events should be interpreted as if it had. The Special Commissioner referred to a case (*EIC Services Ltd v Phipps* [2003] BCC 931) in which a judge (Neuberger J) previously summed up the Duomatic principle as follows:

"The essence of the *Duomatic* principle, as I see it, is that, where the articles of a company require a course to be approved by a group or shareholders at a general meeting, that requirement can be avoided if all members of the group, being aware of the relevant facts either give their approval to that course or so conduct themselves afterwards as to make it inequitable for them to deny that they have given their approval. Whether the approval is given in advance or after the event, whether it is characterised as agreement ratification waiver or estopped and neither members of the group give their consent in different ways at different times, does not matter."

The executors of Mrs Dugan-Chapman were unsuccessful on the application of the principle in the specific circumstances of the case. The Special Commissioner held that the *Duomatic* principle could not be applied to re-write the transaction and give the character of a rights issue to what was essentially a share subscription. There had been some confusion in the events resulting in the share issue, and it was not possible to select the event giving rise to the most suitable IHT result, and apply the principle to it. The company's members must understand the relevant facts.

However, the *Duomatic* principle could be particularly helpful in the context of small, owner-managed companies. In reality, the affairs of many companies are conducted without a great deal of formality or regular shareholders' meetings. For example, it may be possible to argue that the *Duomatic* principle applies if a director's bonus has not been determined by a company resolution, but had nevertheless been approved less formally by the business owners. HMRC appear to recognise the principle in circumstances such as this (see the *Employment Income Manual* at paragraph 42300).

Article by Mark McLaughlin

Lecture P475 (17.10 Minutes)

Burden and another v United Kingdom

The much publicised case of the two elderly sisters who claimed the inheritance tax regime discriminated against them because they were sisters living together, was heard in the European Court of Human Rights on 29 April 2008.

The sisters were born in 1918 and 1925 respectively. They have lived together all their lives in a house which they inherited from their parents. They own the property in joint names. The value of the house means that each sister's one-half share is worth more than the current inheritance tax exemption.

The sisters complained to the ECHR that they were begin discriminated against under articles 1 and 14 of the First Protocol to the European Convention on Human Rights, in that when one of them died, the survivor would have to pay significant inheritance tax which would not be faced by the survivor of a marriage or a civil partnership.

The court ruled that the essence of the connection between siblings was consanguinity. Close family members, however, are not permitted to marry or form civil partnerships. The fact that the sisters had chosen to live together did not alter that essential difference. Furthermore, marriage gave rise to social, personal and legal consequences, and was widely regarded as giving particular status on those who enter into it. There could be no analogy between married and civil partners on the one hand, and heterosexual or homosexual partners who chose to live together but not enter a legally binding agreement. It was true that different Member States had different systems for inheritance tax, but in principle, Member States were free to devise different rules in the field of tax policy.

It followed that, for the purposes of article 14, co-habiting sisters could not be compared with a married or civil partnership couple. Thus there was no discrimination and article 14 had not been violated.

The court had also been asked to rule on the UK Government's argument that the applicants had failed to make use of an available domestic remedy. According to the Government, under the Human Rights Act the applicants could have applied to a court for a declaration that the legislation in question was incompatible with the convention, which would have given a discretionary power to the relevant Government minister to take steps to amend the offending legal provision. The ECHR said that if the Government were legally obliged to implement such changes, applicants would be required first to exhaust that remedy before making an application to the Court. However, as that was not as yet the case, the ECHR considered that the applicants had not failed to exhaust domestic remedies. This effectively means that those wishing to take a claim to the ECHR will no longer have to go through the UK courts first.

Burden and another v UK, European Court of Human Rights, 29 April 2008

Administration

Tax return gets a new look for Spring

HMRC (NAT) 16/08

Millions of new look tax returns have been dropping onto doormats over the past few weeks, following a revamp of the main self assessment (SA) tax return.

The new look return now has fewer questions, simpler language and an improved layout. It's designed to be easier to understand and complete for all SA customers but, in particular, for those who are self-employed or who don't use an accountant to complete their return.

Other changes to the paper return include—

- A new page for additional information – questions completed by relatively few people about less common types of income and reliefs have been moved to a new, separate "Additional Information" page, which is included in the return pack.
- A new short, self-employment page – a two-page form with fewer boxes to complete is being introduced for smaller, straightforward businesses with an annual turnover below £64,000.
- An increased "three line account" threshold – the limit for completing simpler, abbreviated accounts information has been doubled to £30,000.
- Reordered questions – a person's main source of income is now at the front of the return, rather than the end, ensuring customers answer questions most relevant to them first.

A redesigned version of the online SA return is also now available.

All the changes have been made following a successful two-year pilot, which involved more than 7,000 SA customers.

From this year, there are also changes to the SA deadlines – paper returns must now be filed by 31 October, while the deadline for online returns remains at 31 January.

Extension of clearances HMRC provide to all business customers

At Pre-Budget Report 2007, as part of the review of links with Large Business, we announced that from April 2008 HMRC would provide business with our view of the tax consequences of significant commercial issues wherever there is uncertainty, regardless of when the legislation was enacted. We also committed to responding to clearance applications within 28 days as the norm.

Today we announce that the extended clearances service has been rolled out to all business customers

This includes—

- business customers whose tax affairs are handled by the Large Business Service (LBS);
- business customers, across all sectors, whose tax affairs are handled by offices elsewhere in the department.

Guidance on the clearances process and how to apply is available.

For all businesses

We will—

- remove the four Finance Act restriction that direct tax clearance applications were subject to under Code of Practice 10 (COP10);
- ask them to demonstrate the commercial significance of the transaction where the clearance relates to direct tax legislation older than the last four Finance Acts; and
- respond within 28 calendar days, as the norm.

Contacts

Business customers whose tax affairs are handled by the LBS should continue to send their applications to their Client Relationship Manager (CRM).

All other business customers should send their applications to HMRC Clearances Team, Alexander House, 21 Victoria Avenue, Southend-on-Sea, Essex SS99 1BD

Email—HMRC Clearances Team

Other guidance on information and advice

COP10 and VAT Notice 700/6 will remain in place for our customers who are not covered by the new clearances process to provide guidance on how to seek information and advice from HMRC. We will be reviewing these documents over the next year to provide more consistent guidance on the information and advice available to our customers.

HMRC Guidance Note 11 April 2008

HMRC: Debt Management and Banking

In 2006/7 HMRC collected net tax receipts of some £423 billion, an increase of over £25 billion. As an indication of the importance of the function the total collected is over 80% of the UK's budgeted income.

This article focuses on the collection function of the Debt Management team and in particular what taxpayers can expect when they are not paying their tax on time. Bear in mind though that when the Debt Management officers are pursuing payment they will also often be taking responsibility for getting missing tax returns submitted. This may involve the issue of tax determinations and/or the pursuit of penalties.

The collection function is centred on

- Accounts Offices in Cumbernauld and Shipley
- Enforcement and Insolvency Service which mainly operates from Worthing
- Debt Management Offices which are local

Initially there will be system generated demands for payment and the typical first direct contact with the defaulter will be from the Debt Management Telephone Centre. The approach is to categorise each case as "can't pay" or "won't pay" at an early stage. Before looking at this in more detail there is another group the "not sure the demand is correct" bunch. It is important to realise that the person looking for payment will have very limited ability to change the amounts demanded. They will probably arrange a short suspension of action but the office to which tax returns are submitted should be contacted and the doubts or difficulties explained. Correction may be straightforward and swift but action may be needed to challenge HMRC's position, for example:

- completing a tax return
- amending a tax return
- submitting an appeal or claim and postponement request which may possibly be late

This is an issue in relation to all action taken by the Debt Management and Enforcement teams. If you do not agree the figures then the focus will be to get a suspension of the action or adjournment of

hearings to enable disputes to be resolved. For the system to work well there needs to be close liaison between the Tax and the Debt Management offices but even in large cases this is often not apparent.

Back to the "can't pays". Depending on the amounts involved, such persons are likely to receive a more sympathetic treatment in view of their:

- proactive approach to highlighting and dealing with the problem
- normally good compliance record
- age or poor health
- domestic problems
- business problems
- current and future financial position

These factors need to be set out clearly from the outset. Commitments to pay the full amount within 3 months will normally be accepted without the need to provide much financial detail. This approach seems to be largely based on the fact that enforcement proceedings are likely to take longer than this. Other time to pay arrangements will normally require the submission of detailed information of the debtor's income, expenses, assets and liabilities on form 36A-1.

Appropriate interest will always be pursued but by concession if a time to pay arrangement is fulfilled the relevant surcharges will be waived. A payment arrangement can be made at any time up to the start of enforcement action.

For individuals, the amounts to be paid will be based on the disposable income available and in SA cases the minimum acceptable payment will be 25% of uncommitted discretionary income. It is expected that overdue returns will be submitted within a month and full compliance in future will be sought. The officer's approach will be to get the arrears (including interest) paid in as short a time as is practical and generally within a year. It is unlikely that arrangements exceeding 36 months will be accepted.

It is interesting to note that the Debt Management Banking Manual at paragraph 800120 sets out the average monthly spending from the Office for National Statistics to help the officer's decision making process. These are regularly updated.

Expenditure category	Couple with no children (£)	Couple with children (£)	Single person (£)	Single parent (£)
Telephone	18	30	19	25
Mobile phone	20	20	20	20
Fares & motoring	173	181	171	179
Housekeeping	314	461	191	322
Children	0	38	0	59
Health	17	13	20	9
Pets	12	14	10	9
Repairs & maintenance	35	20	24	20
Other discretionary expenditure	61	76	47	63

DMBM800130 included a detailed questionnaire for use in business cases. It should be noted that significantly less time given is given to clear PAYE and VAT arrears on the basis that these amounts were only being held on behalf of HMRC.

The officer is told to take a decision on the arrangements after taking into account the interests of:

- the Exchequer
- fairness to the customer
- fairness to all customers

The officer is instructed not to refuse time to pay because a commercial loan has not been applied for.

The "won't pay" defaulters will be fast tracked towards enforcement action. The charity TaxAid have considerable experience in dealing with tax debt, particularly for individuals with limited income. In responding to a recent HMRC consultation document they say:

> *"Our experience suggests that officials frequently over-estimate their ability to distinguish a "can't pay" from a "won't pay"…. even where key indicators are present (for example poor health, business failure..) the process is often seen as hostile, discouraging further co-operation and a lack of contact turning them into "won't payers".*
>
> *"Clients are not uniformly encouraged to provide and income and expenditure account at an early point that would provide evidence of their circumstances... Open questioning about circumstances from suitably qualified staff would avoid unnecessary "won't payers" and help establish sustainable payment options…"*

So even if the officers are not asking the right questions they need to be given the answers to the questions that should have been asked.

Instructions and guidance on time to pay are at DMBM800000 et seq.

Where there has been no payment agreement or this has broken down a relatively senior officer will determine the best enforcement action to take and a specific day will be targeted. The manual states that:

> *"The Department's preferred enforcement routes are distraint or, for smaller value cases, summary proceedings".*

Distraint (a power enshrined in Magna Carta) is seen as quick and effective. Summary proceedings (that is in the Magistrates Court) are seen as "easy, effective and relatively cheap but there are strict monetary and time limits". County Court proceedings are seen as potentially "very effective, particularly for larger cases but cases can be lengthy and expensive".

A comprehensive checklist is worked through by the officer and the customer should then be contacted directly. If appropriate relevant warning letters will then be issued.

Instructions and guidance on pre enforcement at DMBM580000 et seq.

Distraint involves seizing and selling a debtor's goods in settlement of outstanding HMRC debts, including costs. It is an immediate remedy which does not require the sanction of a court. The office manager is instructed to carefully and closely manage the whole process.

There will be a warning letter about taking distraint action but the officers will call without appointment. They have no right to force their way in into the defaulter's premises without a court order and these are rarely sought. If entry is refused then attempts will be made to secure co-operation but if this is not forthcoming generally other methods of enforcement will be considered.

If entry is gained and payment in full is not made then the process of legally taking possession of goods may begin. If the amounts are disputed then the onus is on the defaulter to immediately contact the tax office dealing with their returns to either resolve the situation or to call off the visitors. Assuming the action continues then a list of goods is prepared by the officers with a view to sale at auction. Normally 5 working days are then given to pay the tax or agree time to pay arrangements. If the position is not resolved the goods will be removed for auction.

There are many pages of instructions on what goods can and cannot be seized including some fascinating and potentially useful detail for example with TVs, DVDs etc:

> *"If the equipment has a remote control you must ensure you list it separately on the inventory, otherwise you have not seized it and cannot subsequently remove it".*

There will usually be considerable scope for limiting the household goods to be listed, principally because jointly owned assets are exempt. Motor vehicles are the assets most commonly listed. The good news is that only about 1 visit in 1000 results in any goods being sold at auction.

Clauses 122 to 125 of the 2008 Finance Bill provide for the replacement of the current distraint arrangements with the "Taking Control of Goods" procedures which are set out in Schedule 12. These proposals are to ensure the same approach could be taken in relation to all taxes and the opportunity is as usual taken to tidy up a number of points. Interestingly the Debt Management officer now termed "enforcement agent" "may enter relevant premises to search for and take control of goods." It is also proposed that proceedings can be taken for both direct and indirect taxes in the same action.

Instructions and guidance on distraint are at DMBM655000 et seq.

The total of debts referred to the Magistrates' Court must be less than £2,000 and less than a year overdue. HMRC will issue a summons (form SP24) specifying the tax due and setting out details of the court hearing. If there is a dispute on the amount claimed an adjournment would normally be arranged. If there is no dispute; payment is not made and no time to pay is agreed then the matter will be heard by the magistrates. The officer will present certificates of debt detailing the amounts involved and the magistrates will be asked to make an order for the amount plus costs. Section 70(1)TMA 1970 provides that the certificate must be accepted by the magistrate as sufficient (but not conclusive) evidence that the amounts are due. The magistrates may order that the amount be paid by specified instalments. The magistrates order does not appear on the defaulter's credit record.

If payment is not made as ordered then a bailiff will visit the premises to legally take possession of goods to cover the debt. If this does not prove possible then bankruptcy or winding up may be considered.

Instructions and guidance on summary proceedings are at DMBM675000 et seq.

For larger debts and where distraint is not appropriate the officer will issue a County Court claim setting out the amounts HMRC believe to be due. A response pack contains forms for contesting the claim or requesting time to pay. If no response is received then the court will almost certainly enter judgement against the defaulter and immediate payment will be demanded. If payment is not made then various orders and summons may be sought which could result in imprisonment for contempt of court. Generally if initial court action does not produce payment then bankruptcy or winding up procedures will be considered by Enforcement Office.

If the amount is disputed then because of S70 TMA 1970 referred to earlier it will invariably be prudent to deal with this with the relevant tax office rather than the court. Having said that experience shows that with appropriate legal advice considerable time can be bought through the court. The Debt Management officers who attend court typically have little knowledge of tax or of court procedures and even less ring-craft.

If judgement is given a request can be made to the court for time to pay. Once judgement is made details are included in the court register which is open to credit reference agencies. This affects the ability to obtain future credit and is often a major issue for the defaulter.

Instructions and guidance on County Court proceedings are at DMBM665000 et seq.

In cases where despite all the efforts of the local office more than £2,000 is still owing the papers may be passed to Enforcement Office to consider bankruptcy or winding up proceedings. They will attempt to obtain immediate payment or satisfactory instalment arrangements which will typically be less than a year. If this is not successful then proceedings are likely to be taken. In negotiating it is important to realise that HMRC do not act like an ordinary creditor. It is common for Enforcement Office to commence proceedings which on the face of it will not result in benefits to the Exchequer outweighing the costs. This is to ensure the defaulter and the public at large is made aware of the serious consequences of not paying your tax on time.

The process initially involves the issue of a statutory demand followed after 3 weeks by the filing of a petition with details of the Bankruptcy Court hearing.

Instructions and guidance on Insolvency and Enforcement Office are at INS9000 et seq.

It is clear that after the 2005 merger HMRC's tax collection has been significantly improved from the Exchequer's perspective. In common with many other functions the service has become more

centralised with a high level of automatic processes and very detailed procedures. TaxAid again have some interesting comments on the way things are now:

- officers frequently exaggerate the powers of HMRC and the duties of taxpayers
- officers frequently jump to adverse conclusions and do not ask open questions
- there is little evidence of joined up debt management across the different parts of HMRC
- HMRC frequently demands conduct from taxpayers that is far beyond what it can itself deliver
- Many examples are seen of debt enforcement having severe health consequences on individuals

TaxAid conclude that:

> "*We believe there will be greater public support for HMRC .. if it takes greater steps to address the impression that the organisation and its officers too often convey*".

HMRC have published a number of leaflets on tax collection. These can be found at http://www.hmrc.gov.uk/leaflets/c14.htm.

See also www.taxaid.org.uk

Article by Chris Chadburn

Lecture P471 (12.33 Minutes)

Business Tax

Capital Allowances — Integral Features

A recap

The Finance Bill introduces a new Chapter 10A to the Capital Allowances Act 2001 (CAA), which includes a new special rate pool with a writing-down allowance of 10% per annum on a reducing balance basis. Special rate expenditure includes long-life asset expenditure, expenditure on thermal insulation as per the amended CAA, s 28 and expenditure on integral features. Integral features will be defined in CAA, s 33A.

The list

In the Finance Bill is the following list of assets being integral features for the purposes of s 33A:

- an electrical system (including a lighting system);
- a cold water system;
- a space or water heating system, a powered system of ventilation, air cooling or air purification, and any floor or ceiling comprised in such a system;
- a lift, an escalator or a moving walkway; and
- external solar shading.

All items on the list will, through s 33A(2), be deemed as being plant and machinery and therefore qualify for allowances. References to electrical systems, cold water systems, space and water heating systems *et al*, and lifts, escalators and moving walkways will be removed from List C of CAA, s 23(4) as a result.

Active façades

This final version of the list replicates the draft legislation published in December with one exception — active façades, which are excluded. In the background notes to the Finance Bill it states that 'it is already accepted that the external skin of the active façade system is not eligible (as it is basically a window and so excluded by section 33(A)(6) of this clause) but that the inner skin is eligible, because it is, in effect, creating a duct within which the cooling/heating air circulates'. Therefore HMRC's view is that the inner skin of the active façade will qualify as an integral feature by virtue of being part of the air cooling or heating system.

Future amendment

Finally, whilst on the list, s 33A provides for the amendment of the list by HM Treasury, limited to the removal of items that would otherwise qualify for plant and machinery allowances and the addition of items that would not otherwise be qualifying expenditure. This provides flexibility for HM Treasury to expand the types of asset qualifying for plant and machinery allowances generally through the introduction of previously non-qualifying items into the special rate pool. It would also potentially appear to allow reclassification of plant and machinery on the integral features list to qualify for a higher rate of allowances through the general pool. The ability to vary the list will hopefully allow the Treasury to easily add further 'green' assets, such as solar shading, to the list. On a positive note, the wording of s 33A provides protection for businesses that HM Treasury cannot remove items qualifying for allowances by virtue of the deeming provision in s 33A from the integral features list without the need for further primary legislation.

Capital allowance essentials

At this juncture it is worth reminding ourselves of the key capital allowance essentials that still apply for taxpayers incurring capital expenditure on property. As well as the new integral features rules, the existing rules, set out in CAA, ss 21 to 23, for determining whether an asset qualifies for plant and machinery allowances will still apply. As noted earlier, certain items have been removed from s 23 and included in s 33A as integral features. That leaves a huge amount of scope for assets that you would encounter in a typical property where the ss 21 to 23 rules will be relevant.

Sections 21 to 23 form the basic statutory rules for determining whether assets qualify for plant and machinery allowances. Taxpayers often believe that expenditure on assets included in s 23 List C is expenditure on plant or machinery. This, unfortunately, is not correct. List C simply provides an exemption from being classed as buildings or structures under ss 21 and 22. Thereafter, consideration needs to be given to the case law tests that determine whether an asset is plant or machinery.

For the avoidance of doubt, items that are integral features do not have to satisfy the case law tests noted above.

Repairs

The Finance Bill introduces new rules for determining what is a repair and what is a replacement of an integral feature. These rules will not apply to the repair of non-integral features.

The rules state that expenditure incurred by a person on an integral feature is expenditure on the replacement of the asset in two scenarios:

- the expenditure is more than 50% of the cost of replacing the integral feature at the time the expenditure is incurred; or
- the initial expenditure is not more than 50% of the cost of replacing the integral feature at the time the expenditure is incurred, but within the 12-month period starting with the initial expenditure further expenditure is incurred, the aggregate of the amounts being more than 50% of the cost of replacing the integral feature.

These rules will, with regard to integral features, override any other rules in tax law or accounting practice on what is capital or revenue expenditure. In addition, it would appear that the Finance Bill does not limit this rule to expenditure on assets that were originally acquired after April 2008, but applies to all expenditure on assets that are on the list in s 33A. This would mean that all expenditure on 'repairs' of items on the integral features list needs to be considered in light of these new rules, regardless of when the original asset was acquired. Given that no allowances would have been available in an office building for, say, general lighting, it does seem unfair that the repair of the lighting may well be caught by the provisions of s 33B.

The compliance burden in this area could be significant. Apart from anything else, at the outset of any project involving repairs to a building the taxpayer will need to calculate an estimated replacement cost for any integral feature that will be affected by the works. This calculation will be an additional one purely required for tax purposes. And it may not be a straightforward one. The integral features list refers to systems, with no guidance being provided as to where a system begins and ends. So, for example, if a company has three floors as a tenant in a multi-storey building and decides to repair/replace the electrical wiring and some of the lighting to only one of their floors, does this company assess 'the system' on that floor back to the local distribution board, or the cost for all three floors? You would hope it is the latter but it is unclear.

Having said all of that, and assuming the Government is going to stick to its guns on this, there is a simple solution that could alleviate the compliance burden for many taxpayers. HMRC could provide an option to 'opt in' to the integral features code irrespective of the level of 'repairs' expenditure. Opting in would remove the burden of considering the overall replacement cost of the system and provide the taxpayer with relief at the 10% rate. For taxpayers with commercial property depreciated over, say, 25 years, who would, in normal circumstances, 'capitalise' all expenditure into the asset, this would give a reasonable rate of relief, whilst avoiding the compliance burden at the outset and the need to track amortisation. It is hoped further consideration is given to the approach on repairs to integral features as the Finance Bill continues its passage through Parliament. As currently drafted, it is hard to know how this fits into the Government's aim of simplicity and removing administrative burdens.

Transfers between unconnected parties

There are several items on the integral features list that would not have generally attracted allowances under the old regime; for example, in an office building, general electrical and lighting systems and cold water systems. If a taxpayer acquires the qualifying interest in land from an unconnected party, it has acquired the fixed plant and machinery (fixtures) in that building, including integral features. As these items will be included within the sale of the building, the buyer will be incurring expenditure on the provision of an integral feature of a building and will therefore be able to claim allowances on these items on a just and reasonable apportionment of the sale price. The buyer will not be restricted by a prior claimant's restriction on these assets, because these assets are likely to have been non-qualifying expenditure in all prior owners' hands and therefore the expenditure could never have been included in any general pool. Hence, in respect of these assets, the CAA, s 185 restriction will not apply and a CAA, s 198 election cannot be entered into.

Transfers between connected parties

The availability of allowances on integral features, that were non-qualifying expenditure under the old regime, in respect of property sales will not be available for sales between connected parties (as defined in CAA, s 575). The Finance Bill introduces a provision at para 15 of Sch 26 that provides that if the buyer and seller are connected persons, any expenditure by the buyer on integral features that were not qualifying assets at the time the seller acquired them will not be qualifying expenditure for the buyer. The paragraph is also drafted so as to catch chains of sales between connected parties.

Intra-group transfers of previously qualifying integral features

When transferring property, including integral features, items that previously sat in the general pool but are now integral features (such as heating systems and lifts) will attract allowances at a lower rate for the buyer than they would for the seller. Therefore, para 16 of Sch 26 includes provisions to allow for a buyer and seller within the same chargeable gains group to jointly elect that a transfer of such an item will be at a price which gives rise to neither a balancing charge nor a balancing allowance for the seller, and the buyer's expenditure will not be special rate expenditure but will be allocated to the buyer's general pool (therefore attracting allowances at the faster rate).

Splitting assets between the two pools

The reality here is that dealing with integral features on the transfer of existing buildings will not be a simple process. Ownership of property assets pre and post April 2008 will require consideration of two sets of complicated rules. If it is then decided to sell the property interest, disposal values, elections and entitlements will need to be determined under two different codes.

From an article by David Woodward and Harinder Soor writing in Taxation

Lecture B471 (19.25 Minutes)

Corporation Tax

Phoenix Companies, Concession C16 and ITA 2007, s 684

Taper relief for capital gains tax purposes disappeared from 6 April 2008. However, it is being replaced by entrepreneurs' relief in Finance Act 2008. 'Phoenix' companies therefore look set to continue to some extent.

Phoenix companies are broadly companies which are set up to trade for a limited time period (commonly just over two years, under the taper relief regime), before being wound up. The trader would then re-commence the same or a similar business through a new company, and repeat the cycle.

However, it seems that HMRC have recently become more alert to phoenix company arrangements.

Extra Statutory Concession C16

Part of the process commonly involves an application being made to HMRC under ESC C16 for distributions to shareholders during an informal winding up of the company to be treated like capital payments under a formal liquidation, rather than dividends liable to income tax.

Under the Companies Act, it is unlawful to return capital to shareholders other than on a winding up (see 'Come in C16, your time is up' by Philip Ridgway in Tax Adviser, August 2007). However, this legal dilemma is shortly to be resolved following changes to be introduced in Companies Act 2006. A private company will be able to reduce its share capital by special resolution, supported by a solvency statement (CA 2006, s 641). This will allow a company to reduce its capital in any way it chooses, including repaying share capital in excess of the company's 'wants'. Certain conditions are attached to the capital reduction procedure. However, the same tax treatment will broadly apply to capital repayments under the Companies Act 2006 rules as under the present tax treatment under ESC C16.

Unfortunately, the Government announced on 7 November 2007 that the commencement date for certain Companies Act 2006 provisions originally due to commence on 1 October 2008 was being put back to 1 October 2009. This includes the share capital reduction provisions in CA 2006, s 641. Whilst the ESC C16 procedure will eventually become a thing of the past, it is therefore going to be with us for some time yet.

Concession C16 conditions

Certain assurances must be given as part of the ESC C16 application process, before HMRC will agree to apply the Concession. Those conditions are as follows:

> "The company
>
> - does not intend to trade or carry on business in future; and
> - intends to collect its debts, pay off its creditors and distribute any balance of its assets to its shareholders (or has already done so); and
> - intends to seek or accept striking off and dissolution."
>
> "The company and its shareholders agree that
>
> - they will supply such information as is necessary to determine, and will pay, any corporation tax liability on income and capital gains; and
> - the shareholders will pay any capital gains tax liability (or corporation tax in the case of a corporate shareholder) in respect of any amount distributed to them in cash or otherwise as if the distributions had been made during a winding up."

Further conditions…

The Company Taxation Manual (at paragraph CTM36220) outlines two additional conditions that HMRC will consider before applying ESC C16. One of these is that the company is not the subject of an investigation. The other condition is that:

> "The company is not one which, if the distributions were made in a winding up, would be reported to the Anti-Avoidance Group (Intelligence) Clearance and Counteraction Team in respect of Section 703 ICTA 1988 [now ITA 2007, s 684] under sub-paragraphs (e) or (f) of CTM36875."

The Company Taxation Manual (at CTM36875 paragraph (e) (now point 5)) states:

> "The transfer or sale by a company of its assets or business to another company having some or all of the same shareholders followed by a liquidation of the company whose assets etc have been acquired…"

New HMRC practice?

In Taxline (March 2008), David Whiscombe pointed out the following:

> "…we are finding that before sanctioning ESC C16, HMRC are now routinely seeking two additional undertakings not set out in the concession. These are to the effect that:
>
> - the company will not transfer or sell its assets or business to another company having some or all of the same shareholders; and
> - the arrangement is not a reconstruction in which some or all of the shareholders in the original company retain an interest in the second company."

These conditions are broadly the same as those described in sub-paragraphs (e) and (f) of CTM36875.

It therefore seems that HMRC are now actively seeking assurances from the company's shareholders in respect of the above conditions, which are additional to those contained in Concession C16. This is presumably with a view to denying applications capital distribution treatment in respect of phoenix companies.

Implications

As mentioned, the additional condition in the first bullet point suggests that HMRC will refuse to apply ESC C16 in a 'phoenix company' situation. HMRC's Company Taxation Manual seems to support this treatment. The company owner may decide to incur the additional expense of a formal liquidation, rather than risking a refusal by HMRC to apply ESC C16 and drawing attention to the matter.

However, there is still the issue of the 'transactions in securities' anti-avoidance rules mentioned above. An 'ordinary' liquidation (in which a company is wound up following the complete cessation of business or the transfer of business to unconnected business) is outside the scope of ITA 2007, s 684. However, phoenix companies are potentially caught. The Company Taxation Manual (at paragraph CTM 36850) warns of HMRC's approach in this regard:

> "When considering applications for dissolution under the Companies Act to be treated as the equivalent of a distribution in a formal winding up under ESCC16 the instructions at CTM36220 are to be followed and cases within CTM36875 referred to AAG Clearance and Counteraction Team."

Care is therefore needed when dealing with owner-managed companies which are wound up, if the business is to be continued in a newly-formed company. A sale of company shares to another company is also at risk under the transactions in securities rules, if the vendor has a substantial interest in that company. A clearance procedure is available (ITA 2007, s 701), which is particularly important in cases of uncertainty.

'Phoenix' companies

Following the Pre Budget Report 2007 announcement of a proposed capital gains tax rate to 18% from 6 April 2008, and also the withdrawal of taper relief and indexation allowance from that date, many company owners looked for possible ways to effectively 'bank' their accrued entitlement to business asset taper relief (and possibly indexation allowance, up to April 1998) by triggering a disposal of their shares by 5 April 2008.

However, winding up the company and re-commencing the same business in a new company under the same ownership may not be a valid way for the business owner to successfully achieve this objective. If a business is transferred to substantially the same owners as before, HMRC are likely to

challenge the winding up as involving a transaction in securities, unless for example the business is transferred as part of a genuine company reconstruction within TCGA 1992, ss 136 and 139, and by applying Insolvency Act 1986, s 110.

The anti-avoidance provisions regarding transactions in securities are fairly widely drawn in respect of a 'relevant company' (i.e. broadly including a close company). The rules can apply to the receipt by a shareholder of consideration in the form of a transfer of assets available for distribution (ITA 2007, s 689, derived from 'circumstance D' in ICTA 1988, s 704).

The rules can also apply to consideration relating to a transfer of distributable assets from one close company to another, where the consideration is the issue of share capital or loan notes (ITA 2007, s 690, derived from 'circumstance E' in ICTA 1988, s 704). This can catch a company reorganisation involving the transfer of Company A's trade and assets to Company B, which results in the distributable reserves of Company A being represented by capital in Company B. In the case of non-redeemable share capital, the anti-avoidance rules apply as and when the share capital of Company B is repaid, and 'repaid' in this context includes distributions in a winding up or dissolution of the company.

Advance clearance

For cases in which ITA 2007, s 684 could apply, an application for clearance in advance under ITA 2007, s 701 should be made to HMRC's Business Tax Clearance Team. If the taxpayer can show that the winding up is being conducted for bona fide commercial reasons and that obtaining a tax advantage was not a main purpose, section 684 will not be invoked, provided that full disclosure has been made in the clearance application.

Article by Mark McLAughlin

Lecture B474 (17.10 Minutes)

How do VCT and EIS investments affect company performance?

Changes from April 2008

Finance Bill 2008, Sch 1 renames the rate of relief applicable to EIS (now 'the EIS rate') differentiating it from the savings rate which would have potentially given relief at the lower 10% starting rate for savings on a portion; EIS relief is still given at 20% in full. The maximum relief under ITA 2007, s 158(2)(b) is increased to £500,000 from £400,000. The maximum for VCTs is unchanged at £200,000 at 30%. So, the maximum potential income tax relief would be £100,000 for EIS and £60,000 for VCT.

Capital gains tax

Capital gains tax deferral relief for EIS is referenced in the new TCGA 1992, ss 169H to 169S covering entrepreneurs' relief, and in detail in transitional provisions in Finance Bill 2008, Sch 3 para 7. The net amount of gain *after* entrepreneurs' relief can be deferred on subscription to the corresponding amount for EIS shares. This is an improvement on the previous regime where pre-taper gains were eligible for deferral. If a gain which would have qualified for business taper under the 'old' regime had been deferred by reinvesting into EIS shares before 5 April 2008, it will not necessarily qualify for entrepreneurs' relief under the new regime once it is crystallised — it would have to qualify under the entrepreneurs' relief rules had they applied at the time of the original gain (see HMRC's FAQs). So, you or your clients need to continue to keep those records pertaining to the circumstances of the original gain.

Gains on EIS and VCT shares are exempt from capital gains tax as long as the investment itself was within qualifying limits; but there are no loss reliefs for VCTs.

The EIS condoc

At Budget time, HM Treasury issued a consultation document on the future of the EIS scheme. The 'condoc' covers areas including the following subject areas.

- Whether the list of excluded activities has any anomalies.

- Views on the rules regarding the time within which funds must be employed in the business (currently 80% of funds must be used within twelve months of the issue of shares or of commencement of trading if later).
- Input into the rules regarding denial of relief for connected persons with the company (generally these are employees/directors or their associates who are remunerated at the time shares are issued, or investors holding more than 30% of OSC).

The three-year qualifying period is also open for comment together with more appropriate ways of treating breaches of the qualifying rules. Responses are invited by 20 June 2008.

HMRC's research

HMRC Research Report 44, *Study of the Impact of the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) on Company Performance* (http://snipurl.com/24hjw) was prepared by the Institute for Employment Studies and Exeter University on behalf of HMRC, and issued on Budget Day.

Survival

The report states that 'survival rates for EIS and VCT supported companies were lower than those recorded in … unsupported companies. However, for companies receiving both EIS and VCT support, survival rates were broadly comparable with those of unsupported companies. However, non-survival is measured imperfectly, and refers to all companies not currently trading which might include genuine failure alongside a host of other reasons'.

As a whole, around one quarter of VCT and EIS companies are either non-survivors or not trading. The failure rate peaks at around two years. 40% of companies which received investments pre-1997 are no longer trading (10% for 2004).

By way of comparison, the authors refer to information from Barclays stating that 34% of UK start-ups financed by Barclays were not trading after two years, rising to 83% non-trading after ten years, although these figures are not part of Report 44's control group. Whereas survival rates for EIS and VCT companies were fairly constant over time, for unsupported companies and recipients of joint EIS/VCT funding, survival rates increased over time. But though the overall survival rate was lower for supported companies, 'it is important that these findings are interpreted within the context of the target community of young, growth-orientated small companies in higher risk trades'.

Profitability and productivity

On this subject, the report noted the following points.

- 'VCT and EIS investments are generally associated with lower profit margins.
- 'The larger the size of company receiving EIS or VCT investment, the lower their real gross profit levels.
- 'On average, the older a VCT recipient company is, the higher their profit margins are.
- 'The VCT scheme appeared to have no statistical effect on labour productivity.
- 'For EIS only, the scheme was associated with lower gearing and higher labour productivity.'

It was interesting to note that in contrasting the initial data sets of recipients and control group that only the control group had an average operating profit that was positive. For VCTs there was a median *operating loss* of £88,000, and for EIS this loss figure was £31,000. It was assumed in the report that the explanation was likely to be one of companies being at an early stage of growth with high set-up costs, rather than merely being of overall poor quality.

General capacity building

In the 'key findings' part of the report, the following points were made.

- 'Investments made under EIS and VCT, but particularly EIS, tended to be associated with general capacity building (growth in fixed assets and employment) and an expansion in sales.

- 'EIS and VCT were, in general, found to be associated with higher (real) fixed asset formation, … sales turnover and employment.
- 'Company size of EIS and VCT scheme investments was found to be positively related to fixed asset accumulation and employment.
- 'Age of company receiving EIS investments tended to be positively associated with gearing (the ratio of company debt commitments to equity ownership), employment and fixed asset accumulation.'

The schemes promote capacity building (real assets and employment growth) particularly in EIS. In materiality, this effect is small but is nevertheless important because it strengthens the *future* capacity of the economy; this being more important than short term profit.

Sector and age

The key findings under these headings are below.

- 'Companies operating in multiple sectors (i.e. having more than one sic code) with EIS investment were associated with higher sales and employment.
- 'Scheme investments in business services companies were associated with higher fixed asset formation (VCT only) and higher employment.
- 'In contrast to business services, “other” service sector companies performed relatively poorly in terms of associations with sales (VCT only) and labour productivity (EIS only).
- 'Age of the company receiving EIS investments was associated with gearing, employment and fixed asset accumulation.
- 'Age of company receiving VCT investments tended to enhance both employment and profit margins.'

In broad summary, survival rates were lower for VCT/EIS companies; fixed asset, turnover and employment were higher; and profit margins were lower. However, these are generalisations and within the statistical spread there are companies who bucked the trend and performed better than others in the control group. Also, the sample is of quite young companies less than ten years old and the authors say that 'we may well be measuring the immaturity of these companies'. A longer time series study in the future would be necessary to determine whether 'outcomes in terms of company performance justify the transfer payments of tax receipts forgone'. There 'remains a serious deficiency in our knowledge regarding the efficacy of tax-based interventions in the market for risk capital'.

55% of VCT companies (59% of EIS) receive their first investment within two years of incorporation. Companies are increasingly using VCT finance in their first year, with this being the opposite case for EIS. The change in VCT investment is likely to be because of professional fund managers' behaviour, with VCT being fund based unlike most EIS investments.

Other information sources

While VCTs are fund based, EIS are traditionally single company investments but there are now a small number of fund-based EIS portfolio investments available through providers such as Allenbridge. Bestinvest publish the performance of their VCTs where possible as IRR (internal rates of return).

Back in April 2003, the Inland Revenue (as it then was) published Research Report 2 entitled *Research into the Enterprise Investment Scheme and Venture Capital Trusts*. It revealed that, notably, 22% of EIS investors had lost all or the majority of their money, 10% had lost part, with 20% making a 'modest' profit, and 18% a substantial profit. There was a roughly similar pattern in that report for changes in VCT share values. But that report did not reflect *total* investment returns as dividends are not included. Only 20% of EIS investors in the sample received dividends as opposed to 80% of VCT investors.

However, unlike the more recent report, the 2003 study did not compare the results with a control group, and it should be noted that the earlier report's results were only for the period 1994 to 2000–01, the latter stages of which were affected by the start of the bursting of the 'dot.com' bubble.

Nevertheless, Report 2 concluded that the schemes were successful because their chief objective worked in attracting finance to those companies that would not otherwise have been injected — more than half of investors in both schemes stated that they would not have invested in the absence of the schemes, and 68% of investors under both schemes would consider investing again. There is another factor with EIS schemes that does not apply to VCTs, in that some investors are also looking to invest their time and expertise in a particular business.

The PWC report, *Enterprise in the UK: Impact of the UK tax regime for private companies*, released in October 2007, suggested that only 35% of its respondents thought that the UK tax system was supportive and encouraged enterprise, with the level of tax and its complexity cited as the main reasons for this view (smaller companies being more likely to be critical in their views). Around 75% of those studied were *aware* of the VCT and EIS schemes (the Government wishes to raise awareness still further), but had considered them irrelevant.

Conclusion

The 2003 Report 2 indicated that the EIS and VCT schemes were successful in that they were directing investors' money into small businesses that would not otherwise have received it; so, to that extent, they satisfied the Government's aims. The new study, Report 44, says it is inconclusive whether the opportunity cost of the tax foregone is outweighed by the wider economic benefits.

For our clients, the reports help them and us to quantify the extent of the risk. Nevertheless, aside from the casual investor, for the EIS scheme it also has a valuable secondary function of enticing business angels with capital and expertise.

From an article by Rob Durrant-Walker writing in Taxation

Lecture B472 (14.11Minutes)

Value Added Tax

VAT on Share Issues - S*ecurenta* C-437/06

On the face of it, the outcome of this case is a simple restatement of the basic rule that VAT cannot be recovered if it is attributable to non-economic or private activities. Nevertheless, the case may have a profound impact on VAT recovery by holding companies.

The facts

Securenta was a German investment company which had raised capital by the issue of shares and 'atypical silent partnerships'. The money raised was invested in land, securities and other 'investments of all types'. This meant, as the ECJ said, that Securenta carried out three types of activities:

- non-economic activities;
- exempt economic activities; and
- taxable economic activities.

In 1994 Securenta incurred VAT of over DM 6 million (about £2.5 million) which was not attributable to specific outputs but was incurred in connection with its issue of shares and silent partnerships. The German tax authorities only allowed recovery of about one sixth of this VAT.

The ECJ judgment

The ECJ ruled that the VAT on expenditure incurred on raising capital could only be recovered 'to the extent that the expenditure is attributable to the taxpayer's economic activity.

The only exception to this is the principle under *Lennartz* C-97/90 which allows VAT to be recovered on goods for mixed private and business use because there is a later tax charge on the private use of them. The VAT incurred is then fully attributable to business, including deemed business, activities.

Kretztechnik AG C-365/03

In May 2005 the ECJ ruled in Kretztechnik AG C-365/03 that the issue of shares was not a supply at all. Further, where the shares were issued to raise capital for the business, it was part of the business' overheads and recoverable to the extent that the business was taxable.

Not only was this seen as good news for companies contemplating share issues but also, no doubt, led to claims to recover VAT incurred on share issues in previous years.

The decision in *Kretztechnik* does not really deal with the situation of a company which has mixed business and non-business activities. It certainly appears that Securenta overlooked this, as the company based its claim to VAT recovery on the *Kretztechnik* case, even though a large part of Securenta's activities comprised holding shares in other companies.

Non-economic activities

In past cases the question was: how much of the VAT can a mixed holding company recover? It seems the ECJ was pressed to rule that receipts from non-economic activities should go into the denominator of the partial exemption fraction, thus restricting VAT recovery. In its judgments, the ECJ concentrated on explaining why such treatment is not appropriate. Income from non-economic activities does not go into the partial exemption calculation because that calculation deals only with business income.

The wrong question

Cibo is a particularly misleading case. Cibo was a holding company which provided taxable services to its subsidiaries. It incurred VAT on the costs of the acquisition of shares. The majority of its income was from dividends. The ECJ ruled that the receipt of dividends was outside the scope of VAT and must be excluded from the partial exemption fraction. Applying a business/non-business split should have resulted in recovery of only a small proportion of overhead VAT. But the implication from the judgment is that Cibo had full recovery.

The ECJ is only expected to answer questions it is asked. In *Cibo* the French court did not specifically ask about business/non-business apportionment and the ECJ gave no reply on this point. The ECJ does say at paragraph 35 that businesses can only deduct VAT attributable to taxable transactions but, as the ECJ refers to Sixth Directive, Article 17(5) for authority, it is clearly thinking of the partial exemption split and not the earlier business/non-business split.

It is not surprising if, following *Cibo* and *Kretztechnik,* some mixed holding companies have fully recovered VAT on share issues. A company which might otherwise have been a pure holding company may have decided to provide management services to its subsidiaries simply to ensure that it was registrable and it may have assumed that it was entitled to full VAT recovery.

This is not a surprising approach but it is not right. As the ECJ ruled in *Securenta*, there must be a business/non-business apportionment. The *Cibo* ruling is not wrong: indeed, it was quoted extensively by the ECJ in *Securenta* (although, curiously, the Court did not cite *Kretztechnik)*. But *Cibo* is not authority that no business/non-business apportionment is required either.

What are economic activities?

For a taxpayer with some non-economic activities and overhead VAT incurred on a share issue (or indeed on anything), it is not a question of whether there should be a business/non-business apportionment: it is a question of how to calculate it. To do this, firstly in respect of the activities to which the VAT is attributable, the taxpayer must identify which of those activities are business and which are not.

Secondly, if there are non-business activities, the taxpayer needs to calculate the apportionment.

Bad news for acronyms?

The sort of companies which will need to rethink their input tax entitlement on flotations will be those which hold shares in other companies with which they are not VAT-grouped. They fall into 2 categories:

1. holding companies with non-UK subsidiaries (such as many companies listed on AIM);
2. investment companies investing in shares and securities (such as VCTs).

Both of these carry on non-economic activities — the holding of shares and securities — and neither of them can VAT-group.

Securenta itself was an investment company. But how does the *BBL* decision fit into the picture? In that case the ECJ ruled that the activities of a SICAV were economic (albeit exempt). SICAVs, says the ECJ, for a fee assemble and manage portfolios of securities on behalf of their subscribers and are, therefore, taxable persons. It seems there is a line to be drawn between the kind of collective investment carried on by Securenta and the activities of a SICAV. That line may depend on whether the investment company is in the business of merely managing investments for others in return for a fee paid by the investor. In any event, the judgment in *Securenta* implies that Securenta's holding of securities was a non-economic activity.

Apart from the possibility that the ECJ in *Securenta* may not have been asked the right question and did not direct its mind to the issue, the judgment implies that Securenta's holding of securities was a non-economic activity. It may be that the line depends on whether or not the investment company sees itself as merely in the business of managing investments for others in return for a fee paid by the investor.

To the extent that VCTs, OEICs, AUTs and all other kinds of investment fall on the Securenta side of the line, they are not in business and must do a business/non-business attribution on their overhead input tax before carrying out their partial exemption calculation. If they are on the SICAV side of the line, they are in business but must still carry out the partial exemption apportionment. Missing out the first apportionment might not give a greatly different result, as the activities of a SICAV are mostly exempt.

VAT groups

Holding companies which are part of a VAT group may well be insulated from the *Securenta* decision. The VAT Directive treats companies within a group as a 'single taxable person' (Article 11). Surely it is clear that the VAT on the costs of raising capital for use by another company within the group to generate taxable trading income is incurred for a business purpose.

The apportionment calculation

In *Securenta* the ECJ pointed out that as the Sixth VAT Directive has no mechanism for a business/non-business split, it is within the discretion of individual Member States who could choose to use:

- an investment formula;
- a transaction formula; or
- 'any other appropriate formula'.

No method of apportionment is specified in legislation but HMRC authorises taxpayers to use any 'fair and reasonable method': see *Notice 700*, paragraph 33. This would seem to be more favourable to the taxpayer than the ECJ requires.

The *Securenta* judgment does not use the words 'fair and reasonable' but it does require the apportionment to objectively reflect the part of the expenditure actually to be attributed to the two kinds of activity (business and non-business). The raising of capital did not take place to generate a management charge but to generate as much income in the form of dividends as possible. The apportionment of the expenses on the raising of capital should reflect this.

What happens next?

The two *Kretztechnik Briefs* issued by HMRC did not anticipate the question of what happens when a company issuing shares carries on non-economic activities as well as business activities. But if HMRC was not conscious of the issue back in 2005 it was well aware of it by 2007, as the UK Government chose to intervene in *Securenta*, putting forward a similar view to the one that the ECJ adopted.

I expect that HMRC will shortly qualify its earlier two *Business Briefs* by pointing out that companies issuing shares must carry out the business/non-business apportionment (on a fair and reasonable basis) if they incur VAT on raising capital partly for non-business purposes.

Invitation to disclose?

Will HMRC also invite taxpayers to voluntarily disclose where in the last three years they may have reclaimed too much tax on a share issue because they carried out no such business/non-business apportionment? Taxpayers might well claim that they were misled by *Briefs 12* and *21* into not realising that there should be a business/non-business apportionment.

From an article by Barbara Mosedale

Problems and opportunities created by the flat rate scheme

How the scheme works

Let's just recap on the basic principles of the scheme.

- Available to small business with taxable turnover ≤£150,000 per annum (VAT exclusive) and total turnover ≤£187,500 (this limit includes exempt and non-business income).
- A business charges VAT to its customers in the normal way.
- Business applies a given flat rate percentage to its gross income for the VAT period which becomes the VAT payable for the period.
- The flat rate percentage depends on the category of business to which the taxpayer belongs.
- 1% reduction in the relevant flat rate percentage for a business in its first registration year
- There is no input tax to reclaim unless it relates to capital expenditure > £2,000 including VAT.

Advantages of the scheme

In theory, ignoring the use of technology, it saves time by

- not having to analyse purchase invoices between net, VAT and gross figures
- for most, a VAT return can be completed by just knowing the gross sales figure for the period

However, the major benefit is that it undoubtedly produces clear tax savings for certain businesses

Definite winner

- If a business has two or more activities, the flat rate percentage to adopt is based on the activity with the greatest level of turnover — good news if a lower flat rate applies to the main activity.
- Certain flat rate percentages actually do appear to be very generous (9.5% rate for hotels, 8.5% for general builders, 11% rate for 'business services that are not listed elsewhere'.
- The 1% discount for newly registered businesses is worth £1,762.50 for a business with the maximum level of taxable sales allowed by the scheme (£150,000 x 1.175 x 1%).

Disadvantages of the scheme

There are some big pitfalls that every adviser needs to fully appreciate.

- The gross sales figure to which the flat rate percentage is applied includes zero-rated and exempt income earned by the business. This means a business will pay tax on sales where no VAT has been charged! The scheme is therefore unsuitable for businesses who have an unpredictable level of zero-rated or exempt sales, e.g. some builders.
- The flat rate scheme does not have negative percentages — it is therefore unsuitable for any repayment trader;The end result for scheme users is always a VAT payment.

The scheme can be totally unsuitable for a business with specific trading features that result in higher than usual input tax figures.

Dangers of ignoring the scheme

Advisers should review the benefits of the flat rate scheme for each eligible client on an annual basis. The reason for this is because the fast moving economy means that a business could change its flat rate category on a regular basis. Equally important, it is vital that the benefits of the scheme are regularly reviewed for existing users.

HMRC's approach to the scheme

The biggest nightmare for any taxpayer using the scheme would be if an HMRC officer made a routine visit and told the taxpayer he had chosen the wrong flat rate percentage (too low) and he wanted to issue a retrospective assessment for the last three years.

When the scheme was first introduced, HMRC clearly publicised their policy concerning the flat rate categories chosen by a taxpayer. I quote directly from HMRC's *VAT Notice 733* (paragraph 4.3):

> 'If we approve you to join the scheme, we will not change your choice of sector retrospectively as long as your choice was reasonable. It will be sensible to keep a record of why you chose your sector in case you need to show us that your choice was reasonable.'

To their credit, I have not heard any horror stories about HMRC's visiting officers hunting for easy assessments by unfairly reclassifying flat rate categories and going against the spirit of paragraph 4.3. I have heard of a few cases where officers have 'tested the waters' with an alternative proposal — but nothing too heavy! This is quite correct because the aim should be to encourage more users — not less.

As a point of interest, VAT tribunal cases on the flat rate scheme have been quite rare. However, one of the most well publicised decisions related to *Chilly Wizard Ice Cream Co Ltd* (19977) and whether their outdoor kiosks qualified for a 2% flat rate for 'retailers of food' or the much less favourable rate of 12% for 'catering services'. The decision favoured the taxpayer at 2%!

From an article by Neil Warren

MOTs and disbursements

This case featured a variation on the usual MOT test arrangements which highlighted the difficulties in applying the law in this area to achieve a sensible and fair VAT result. Such were the difficulties that Counsel for HMRC invited the Tribunal Chairman, Howard Nowlan, to give his views on the application of the law more generally than just to the facts of this case. Mr Nowlan includes that analysis in his decision, including suggested wording for notices to be displayed in garages that cannot themselves offer MOT tests but which arrange them for their customers.

The appellants run a non-MOT-approved garage. At the relevant time Mr Lower's father ran an MOT-approved garage, Alfriston Motors, about four miles from the appellants' premises. The appellants could have arranged for MOT testing to be done at any of four more local garages but because of the family connection they chose Alfriston. As is typical, Alfriston charged the full MOT test fee of £44 to direct customers but partly because of the cost of transporting cars between the appellants' premises and Alfriston (given the four closer competitors) and partly to keep its business ticking over, Alfriston could not afford to charge the appellants the full £44 and was prepared to enter into arrangements that recognised the transport costs.

It was agreed that the appellants would arrange tests for their customers and Alfriston would charge the full £44, which would be passed on by the appellants (thus satisfying the disbursement rules). Separately, the appellants would charge Alfriston £15 (including VAT) for the transport service (involving keeping a member of staff available to do the transport work and an eight-mile round trip each time, with a possible extra round trip if the test could not be carried out immediately). It is more normal for the MOT-approved garage to do the test at a discounted rate and for the non-approved garage to both pass on that fee and charge a VAT-inclusive fee to the customer for arranging the test and transporting the car. However, the appellants thought that disclosing the arrangement fee (in order to satisfy the disbursement rules) was likely to lose them business and confuse customers in general.

HMRC nevertheless interpreted these arrangements as a disguised discount and expected the appellants to account for VAT on the full MOT test fee, because the discount had not been disclosed to the customer (as required by the disbursement rules). Indeed, HMRC also argued that as the appellants had not acted as agent for their customers, they had made two taxable supplies and should account for VAT on £59, not just £44.

The Tribunal held that the arrangements were entirely valid and that the appellants had acted as their customers' agent, so that the appellants only had to account for VAT in respect of the £15 (which was in any case recoverable by Alfriston, said the Tribunal).

HMRC had apparently taken its view on the "disguised discount" because Business Brief 12/96 states that if a MOT-approved garage offers a discount, that cannot be treated as if the non-approved garage had charged a VAT-inclusive fee for performing a service for the MOT-approved garage or the customer. HMRC interpreted this as meaning that if the non-approved garage actually performs a service for the approved garage, that must be a disguised discount. The Tribunal described this as an "extraordinary leap".

So far as agency was concerned, the Tribunal was satisfied that the arrangements between the appellants and their customers established an agency relationship, that being a better interpretation of the facts than to conclude that the appellants sub-contracted the MOT testing, which was not what their customers would have expected. Insofar as the appellants did not comply with the legal requirements of agency (such as keeping customers' prepayments in separate trust accounts), the Tribunal held that this made them "bad agents" rather than making them not agents at all.

The appeal was allowed.

Kevin John Lower and Suzanne Jane Lower 20567

Claude Fenton (Holdings) Ltd 20558

The Tribunal was sympathetic with the appellant's computer problems and the fact that it had suffered a default surcharge of more than £10,000 despite having paid its VAT only one day late. However, the true reason for the default was that the appellant's accounts staff did not notice that the payment would be delayed an extra day by a bank holiday. This was not a reasonable excuse in a large company with experienced accounting staff.

The Tribunal decided to comment—

> "We would add that the point that strikes us as hard in this case is not so much our reluctance to accept that a minor and unfortunate slip on the part of the people responsible for making the payment was a "reasonable excuse", but rather the totally disproportionate cost imposed on the appellant for merely being one day late in making payment. No argument was addressed to us under the Human Rights Act, and on the issue of whether the relevant VAT legislation may be flawed because it contains no discretion or safety valve to preclude the imposition of such disproportionate penalties in circumstances such as these. That feature nevertheless strikes us as the feature that makes this case seem unfair."

Appeal dismissed.

VAT: transfers of going concern

This article examines developments in the area of transfers of a business for VAT. There are two important, but separate, rules which apply to a transfer of a business:

Under s.49 VATA 1994, the transferee of a business as a going concern is treated as the successor of the transferor. This feeds through to Sch.1 para.1(2), which provides that a taxable person (someone who is registered for VAT or who ought to be registered) who transfers a business as a going concern also transfers the turnover history with it. If the taxable turnover for the 12 months to the date of transfer exceeds the registration threshold, the transferee is compulsorily registrable from the date of transfer, and does not enjoy a period of VAT-free sales before the threshold is reached.

Under art.5 SI 1995/1268, the transfer of a business as a going concern is treated as neither a supply of goods nor a supply of services, and is therefore VAT-free. The law sets out a number of conditions for this "non-supply" treatment to apply:

(1) Subject to paragraph (2) below, there shall be treated as neither a supply of goods nor a supply of services the following supplies by a person of assets of his business—

- (a) their supply to a person to whom he transfers his business as a going concern where—
  - (i) the assets are to be used by the transferee in carrying on the same kind of business, whether or not as part of any existing business, as that carried on by the transferor, and
  - (ii) in a case where the transferor is a taxable person, the transferee is already, or immediately becomes as a result of the transfer, a taxable person or a person defined as such in section 3(1) of the Manx Act;
- (b) their supply to a person to whom he transfers part of his business as a going concern where—
  - (i) that part is capable of separate operation,
  - (ii) the assets are to be used by the transferee in carrying on the same kind of business, whether or not as part of any existing business, as that carried on by the transferor in relation to that part, and
  - (iii) in a case where the transferor is a taxable person, the transferee is already, or immediately becomes as a result of the transfer, a taxable person or a person defined as such in section 3(1) of the Manx Act.

(2) A supply of assets shall not be treated as neither a supply of goods nor a supply of services by virtue of paragraph (1) above to the extent that it consists of—

(a) a grant which would, but for an election which the transferor has made, fall within item 1 of Group 1 of Schedule 9 to the Act; or

(b) a grant of a fee simple which falls within paragraph (a) of item 1 of Group 1 of Schedule 9 to the Act,

unless the conditions contained in paragraph (2A) below are satisfied.

(2A) The conditions referred to in paragraph (2) above are that the transferee has, no later than the relevant date—

(a) made an election in relation to the land which has effect on the relevant date and has given any written notification of the election required by paragraph 3(6) of Schedule 10 to the Act; and

(b) notified the transferor that paragraph (2B) below does not apply to him.

(2B) This paragraph applies to a transferee where—

(a) the supply of the asset that is to be transferred to him would become, in relation to him, a capital item as described in regulation 113 of the Value Added Tax Regulations 1995 if the supply of that asset to him—

(i) were to be treated as neither a supply of goods nor a supply of services; or

(ii) were not so treated; and

(b) his supplies of that asset will, or would fall, to be exempt supplies by virtue of paragraph 2(3AA) of Schedule 10 to the Act.

In summary, for the transfer to be outside the scope of VAT:

- the assets transferred must constitute a business which is a going concern at the time of the transfer;
- the transferee must use the assets in the same kind of business;
- if the transferor was a taxable person, the transferee must be a taxable person at the time of the transfer;
- if the transfer includes taxable land (freehold commercial building less than 3 years old, or any property subject to an option to tax exercised by the transferor), then the transferee must opt to tax and notify HMRC of the option no later than the date of the transfer.

If any of the first three conditions are breached, VAT must be charged on any VATable assets included in the transfer. If the fourth condition is breached, VAT must be charged on the land alone, but the remainder can still be "de-supplied".

There is no definition in the law of a "transfer as a going concern". The courts have looked to precedent cases, for example the 1968 employment law case of *Kenmir v Frizzell*, for guidance on what the expression means. In that case the judge said "*in deciding whether a transaction amounted to the transfer of a business, regard must be had to its substance rather than its form, and consideration must be given to the whole of the circumstances ... In the end the vital consideration is whether the effect of the transaction was to put the transferee in possession of a going concern, the activities of which he could carry on without interruption.*"

Note that the two important VAT provisions – the effect on registration liability and the de-supplying of the transfer of assets – are not directly related to each other. It is perfectly possible for one to apply without the other. It is also important to recognise which set of rules is relevant to a dispute, because the consequences are different and the arguments are also different.

Recent developments

This article considers three main areas of recent developments:

- Cases about output tax liability (SI 1995/1268)
- Cases about registration liability (Sch.1 para.1(2))
- HMRC's conclusion of its long-running consultation on the rules

Output tax liability?

In 2003 Dartford Council (D) entered into an agreement with a development company (P) under which P would develop a site belonging to D. D had waived exemption on the site. In 2004 D and P entered into an agreement with a supermarket (S) under which a warehouse would be constructed on the site and leased to S. In 2005 D agreed to sell the freehold of the site, subject to the existing lease to S, to another company (G). HMRC assessed the sale of the site as taxable; D argued that it was the transfer of a going concern.

HMRC argued that D was not carrying on the economic activity of renting the land to S before the sale, because it only had an "intention" to lease the warehouse once it was completed.

The Tribunal commented that the Customs officers (and the Customs solicitors who prepared the appeal) did not understand the status of an "agreement to lease" in law: under generally applicable precedent, it was as good as a lease. The Tribunal was in no doubt that D had a property rental business that was transferred to G as a going concern.

VAT Tribunal (20,423): *Dartford Borough Council*

A restaurant owner sold his business to another individual and did not account for VAT on the sale price, which was split £235,000 for freehold premises, £10,000 for an interest in a store room, £30,000 for goodwill, £40,000 for fixtures and fittings and £200 for stock. HMRC argued that VAT should have been charged on the goodwill, fixtures, fittings and stock; the trader contended that the sale was a TOGC.

The Tribunal pointed out a curious clause in the sale contract: "*If VAT is payable (whether obligatory or optional) in respect of any payments due to be made under this Agreement then the Seller shall in addition to such payments pay VAT thereon at the rate applicable thereto.*" This appeared in a list of clauses which required the purchaser, not the seller, to pay additional costs in certain circumstances. It would be normal for such a clause to be inserted to protect the vendor from the VAT liability, because the effect of s.19 VATA 1994 is to imply such a clause into contracts anyway. The Tribunal chairman speculated as to whether the purchaser's solicitor had amended the contract (and the vendor's solicitor had perhaps not noticed the effect). This meant that the cost of the VAT would fall on the vendor, who would not be able to recover it from anyone.

HMRC's case was based on the fact that the purchaser did not operate the restaurant himself, but let it to a manager for an informal rent of between 15% and 20% of the turnover.

The trader tried three arguments:

- It was no business of the vendor how the purchaser operated the business: it had been sold as a going concern.
- The new owner actually ran the business, but used a manager to do so. This was a detail which should not upset the TOGC treatment.
- Because the manager had registered for VAT with a start date 11 days after the transaction, the business must have been operated by the new owner personally for those 11 days.

The Tribunal described the first of these arguments as "simply wrong in law". The second argument failed because the manager was not acting as an employee but as a trader in his own right: as he paid no VAT to the owner, it was clear that he was running the business and the owner was renting the premises to him on an informal licence.

The third line was described as "a chancer's argument". There was no evidence to support the contention at all. It was much more likely that the manager had made a small error in the date from which he started to trade.

The appeal was therefore dismissed: the vendor would have to account for VAT, which he could not charge on to the purchaser; the purchaser would not in any case have been able to recover it, because he was making an exempt supply of the premises to the manager. He was either not making use of the goodwill and fixtures, or they were being absorbed into a principal exempt supply.

At first sight, HMRC's argument (that this was not a TOGC) would mean that the manager would not have needed to register so quickly; but the conditions for TOGC registration in s.49 and Sch.1 do not quite match up with SI 1995/1268, and it is likely that the trader in this circumstance would

suffer the “double whammy” of having to register straight away and being charged VAT on the transfer.

VAT Tribunal (20,462): *Abdurrahman Tezgel (Trading As Master Chef)*

Registration liability

A Greek restaurant was run as a partnership. The owners decided to move to different premises and at the same time incorporated a company, which was the operator of the new restaurant. HMRC ruled that the business had been transferred as a going concern and the company was therefore registrable immediately after the transfer.

One of the factors that counted in HMRC’s favour was the fact that a name board from the old restaurant was taken and put up outside the new premises, showing “established 1986”. The Tribunal agreed with HMRC that the closure of business for two weeks and the change of legal status did not prevent the two businesses being regarded as the same for VAT purposes.

HMRC applied for costs on the basis that the appeal with frivolous. The Tribunal did not regard the case as hopeless and declined to award costs.

VAT Tribunal (20,387): *Steliana’s and Saphos Ltd*

A pub was owned by a brewery, M, and let to a tenant-manager, G. The brewery sold the freehold to a new landlord, L, who immediately let it to a new manager, H. HMRC ruled that H should have registered for VAT from the date of the transfer, on the basis that he had acquired the business as a going concern.

The Tribunal considered a number of facts, including the removal of the bar and cellar equipment by M following the sale and the prohibition of the sale of prepared food that the local authority had served on G because of the run-down and unhygienic state of the pub. The short break in trading for refurbishment was not conclusive, but the Tribunal did not think that H could have carried on the trade immediately after the transfer. He had acquired assets, not a business.

The Tribunal also quote the following extract from Notice 700/9/02:

> “*There must not be a series of immediately consecutive transfers of the business. Where A sells its assets to B who immediately sells those assets on to C, because B has not carried on the business the TOGC provisions do not apply to any of the transactions. This means that the sales take their normal VAT liability (taxable or exempt).*”

The Tribunal chairman appears not to realise that this passage refers to a different TOGC rule: the “de-supplying” of the transfer of the assets. The “successive transfers” rule has been held in other cases not to have any effect on the registration liability: it only prevents the transfer of the business from being treated as outside the scope of VAT.

VAT Tribunal (20,392): *Lee Scott Harrison*

A hairdressing business operated as a partnership from two premises. There was an acrimonious falling out between the partners: one took over one of the premises, some of the staff and customers, and the other two were left with the remainder. They incorporated a company to operate the remaining business through.

They appealed against a ruling from HMRC that the business had been transferred to the company as a going concern, which meant that they did not have an initial period without having to charge VAT. The Tribunal agreed with HMRC: in spite of the changes and upheavals arising from the departure of one of the partners and some of the staff, the business that the company took over was still part of the business of the predecessor partnership and was capable of separate operation. It was not merely a collection of assets. It was registrable immediately after the transfer.

VAT Tribunal (20,503): *Brookes Hair Ltd*

TOGC consultation

A consultation on the operation of the transfer of going concern provisions was announced in Business Brief 13/00. This review ran initially until August 2005, when preliminary responses were published; in light of the length of time that had elapsed, and the emergence of important developments such as the ECJ decision in *Zita Modes* (Case C-497/01), a further period of consultation was announced.

The results of this consultation have now been published, setting out the comments of respondents and HMRC's views on those comments. It does not appear that there will be significant changes to the current rules or practice, but the guidance in Notice 700/9 has been updated and improved (new version issued late April 2008).

Some of the examples and guidance given are illuminating, for example:

- HMRC will not define "significant break in trading" or give a minimum period for which the transferee must operate the business in order to protect the TOGC position – context is important, and a "one size fits all" approach is not appropriate;
- HMRC point out that it is possible for a transfer to fail the conditions for a non-supply in SI 1995/1268, but nevertheless to meet the conditions for transferring registration liability:

HMRC were asked to comment on two scenarios involving leased assets:

(a) Where the owner of an undertaking, a factory or a retail outlet, runs the undertaking himself, but then ceases to trade and leases the premises to a tenant who runs the factory or retail outlet, which may or may not continue the same kind of business. HMRC say this is not a TOGC as the assets (property, perhaps fixtures and fittings) have been leased, not transferred, and the property lease is a new asset.

(b) A pub tenant surrenders a lease (typically to a brewery), the premises are leased to a new tenant, and no transfer of assets takes place between the first and second tenant. There may be a transfer of assets (for example glasses or wet stock) from the first tenant to the brewery, and a transfer from the brewery to the second tenant. HMRC say this is not a TOGC of assets. If glasses, wet stock, and other assets are transferred between tenants, there can be a TOGC of assets between them (*S Lagumina and A Bottiglieri t/a La Piazza* and *Andrew Thomas Harper*).

HMRC comment

In the scenarios outlined in (a) and (b) above we would consider there not to have been a TOGC of assets to be treated as 'not a supply' under SI 1995/1268, article 5. However in terms of considering whether the new tenant in scenarios (a) or (b) was liable to register for VAT immediately upon the transfer (under s49 and Schedule 1 VAT Act 1994), they probably would be.

The following is a brief summary of some of the other points raised by the summary of responses:

- the new notice will clarify the circumstances in which HMRC will, and will not, give rulings on TOGC issues;
- HMRC cannot disclose confidential information about another business (e.g. whether it has registered, whether it has opted to tax) but can confirm information that the other business has supplied, provided sufficient information is given to HMRC to make that confirmation possible;
- reasons are given for rejecting suggestions such as allowing a joint election for TOGC treatment between buyer and seller in certain circumstances, or requiring the buyer to give a certificate of intention to carry on the same type of business (extra compliance costs were expected to outweigh the greater certainty that might have resulted in some cases);
- HMRC regard the information provided to applicants for VAT registration about TOGCs and the effect on registration, and also about the need for registration in order to protect the non-VATable status of a TOGC, to be adequate and they do not propose to change or increase it;
- there is no need to align the operation of the TOGC rules with the TUPE (transfer of undertakings protection of employment) rules;
- HMRC are satisfied that their current policy is correct in relation to surrenders of leases, grants of leases out of a freehold, transfers of an empty property and successive transfers of a property (not generally regarded as capable of being a TOGC), and also the transfer of a single property with a sitting tenant (regarded as capable of being a TOGC as part of a property letting business);
- HMRC believe that the problems of making sure that an option is made and notified by the correct date has diminished as more people become aware of the rules in the cases of

Chalegrove Properties and *Higher Education Statistics Agency*, and they do not propose to change them;

- the new notice will clarify a rule that some people may not know, that a partly-let building can be wholly regarded as a TOGC on transfer even though much of it is empty.

The issue which does not appear to be addressed at all is the condition in the UK law that requires the transferee to carry on the same type of business as the transferor. The point of the *Zita Modes* case was that the transferee did not have an administrative licence to carry on the same trade as the transferor, so the authorities denied TOGC treatment. The ECJ ruled that it was not permissible to deny the treatment in that circumstance, because the relief was for the transfer of a "totality of assets" which would be used in a business activity and not simply be liquidated by the purchaser.

HMRC commented in 2005 that they did not regard the Zita Modes decision as in any way calling into question the UK law. They rely on the actual answer to the question referred, which is set out in para.46 of the ECJ judgment (with emphasis added):

The answer to the first and second questions must therefore be that Article 5(8) of the Sixth Directive must be interpreted as meaning that when a Member State has made use of the option in the first sentence of that paragraph to consider that for the purposes of VAT no supply of goods has taken place in the event of a transfer of a totality of assets, that no-supply rule applies – without prejudice to use of the possibility of restricting its application in the circumstances laid down in the second sentence of the same paragraph – to any transfer of a business or an independent part of an undertaking, including tangible elements and, as the case may be, intangible elements which, together, constitute an undertaking or a part of an undertaking capable of carrying on an independent economic activity. The transferee must however intend to operate the business or the part of the undertaking transferred and not simply to immediately liquidate the activity concerned and sell the stock, if any.

However, HMRC have consistently ignored the immediately preceding paragraph, which says:

On the other hand, nothing in Article 5(8) of the Sixth Directive requires that the transferee pursue prior to the transfer the same type of economic activity as the transferor.

Looking at the judgment as a whole, and also the Advocate-General's opinion, it seems more likely that the underlined words in para.46 mean "use the assets transferred in a business" rather than "operate exactly the same business". However, after 8 years of reviewing, it seems unlikely that there will be any change in the UK's attitude or law. It would be interesting to see a case referred back to the ECJ on this particular point.

Article by Mike Thexton

Lecture B475 (26.35 Minutes)

Revenue & Customs Brief 24/2008 – Rewrite of the option to tax

This Brief announces the introduction of a new Schedule 10 to the VAT Act 1994 that becomes effective from the 1 June 2008 following the announcement in Budget Note 79 at Budget 2008.

Background

Schedule 10 to the VAT Act 1994 deals primarily with the option to tax supplies of land and buildings and was introduced following the European Court's ruling that the UK had to tax the construction of non-domestic buildings. Following a series of amendments needed to block various avoidance schemes; this legislation has become increasingly more complex to follow. The new Schedule 10 has been rewritten in the Tax Law rewrite style, which greatly improves the layout of the legislation as well as simplifying the language.

In addition, in 1995 changes were made to Schedule 10 that allowed revocation of an option to tax 20 years after it had been made. This means the first options eligible for revocation will take place in 2009. This new legislation therefore also includes the rules for revocation and also some changes necessary for its smooth operation. Finally, in line with suggestions received from business, the new legislation includes several changes designed to facilitate business.

During its development, this new legislation has been subject to two public consultations in 2004 and 2005 and legislation was introduced in the Finance Act 2006 to enable the existing Schedule 10 to be replaced by statutory instrument. A further, limited consultation on the initial drafts of the proposed legislation took place in August 2007 with all those who replied to the earlier public consultations.

What is being published?

In addition to a Treasury Order (SI 2008/1146) being laid containing the new Schedule 10, we are also publishing an Information Sheet 03/08 which includes guidance for the changes, together with the tertiary legislation (elements of the guidance which have the force of law). This document also includes destination and derivation tables to help business navigate its way around the changes. An update to Public Notice 742A Opting to tax land and buildings, to include the material in the Information Sheet, will be issued within two months.

Legislative changes

The following areas have changed or are new:

- new rules for relevant associates
- introduction of certificates to disapply an option to tax for buildings to be converted into dwellings and land supplied to housing associations
- introduction of disapplication of the option to tax for intermediaries supplying buildings to be converted into dwellings etc
- revised definition of occupation, including a new exclusion for automatic teller machines
- introduction of a new way to opt to tax (a real estate election) which does not require individual notifications of each option (see other changes section below)
- extension and changes to the cooling off period
- automatic revocation of an option to tax after six years if no interest has been held in a property during that time
- introduction of rules governing the revocation of an option to tax after 20 years
- provision that in future, an option to tax applies to both the land and buildings on the same site - with a special transitional rule for existing options
- a new ability to exclude a new building and land within its curtilage from an option to tax
- new appeal rights
- repeal of legislation concerning the developer's self supply charge and developmental tenancies (Item 1(b) of Group 1 of Schedule 9 to the VAT Act 1994) and also co-owners of land (section 51A of the VAT Act 1994)

Explanation of these changes

All the Schedule 10 changes are fully explained in Information Sheet 03/08 which includes guidance on each change together with tertiary legislation where appropriate. New forms which will have the force of law will be produced before 1 June, to support and allow the smooth operation of the new rules.

Other changes

At present, a small number of taxpayers, typically large taxpayers, have what has become known as a global option to tax. This option to tax is effectively an option on the whole of the UK, and is typically expressed as follows:

'I opt to tax the whole of the UK' or more commonly 'I opt to tax all the land I currently own and all that I acquire in the future'.

While there is no problem with retaining these global options, HM Revenue & Customs (HMRC) has in some cases, by concession, allowed the cooling off period to apply to each property as it is acquired. Under the normal rules, the cooling off period can only apply to the option to tax itself and so should expire three months after the option was made (this will be extended to six months from 1 June 2008). Because of the introduction of the new real estate election, this concession will be

withdrawn with effect from 31 July 2009. This should allow sufficient time for those with a global option to decide whether to retain it without a cooling-off period in future, or to convert their global option into a new real estate election.

Nicholas Spence 20563

Tribunal Chairman Charles Hellier ***1 February 2008***

Mr Spence was one of two leaseholders of premises in Weymouth. The upper floor was sublet and operated as a bar. The ground floor was licensed to a series of restaurateurs. When Mr Spence took on the lease he purchased assets from the landlord which would enable him to run a restaurant on the ground floor. In the event he did not do so until after the latest licensee had left on 24 December 2004. She had run a Mexican restaurant and on 14 January 2005 Mr Spence himself opened a Mexican restaurant with the same name (this was later changed slightly, following trademark issues with the last licensee). HMRC argued that Mr Spence should have been registered from 25 December 2004 because he had been the recipient of a transfer of a going concern and his predecessor's turnover had exceeded the registration limit.

The Tribunal was concerned that there needed to be a transfer of a business or part of a business, and that transfer had to be capable of being a supply. In this case Mr Spence was in a position to run a restaurant business before he had licensed others to do so and he was in a position to do so when the last licensee had terminated her business. But he was able to run such a business because of the assets he already owned, not because of anything transferred to him by the last licensee. The Tribunal explained its thinking thus—

> "We consider first whether the transaction was such that the appellant could carry on the same business. We find that it was—the transaction left the appellant with the premises and all the physical assets necessary to carry on the restaurant trade. That he was able to reopen as a Mexican-style restaurant was evidence that he could carry on the same trade. His inability to use the very same name for the restaurant [following the trademark disagreement] did not in our view prevent the business from being the same.
>
> "Next we consider what was transferred to the appellant. There was a sale of some crockery; the other physical assets were already his but he was freed from the impediment of the licence. [HMRC] urged on us that the cessation of the licence transferred the enjoyment of the assets to the appellant and that that was the transfer of a business. Whilst we appreciate that in the Sixth Directive "transfer" probably has an independent European meaning and may not be restricted to something which English law would call a transfer, consideration of the purpose of the Directive's provision suggest that it must be something which could be called a supply. And the reversion of a right to enjoyment otherwise than for consideration does not seem to us to be a supply. We therefore incline to the view that there was no transfer of the right to enjoy the premises or the fixtures and chattels.
>
> "Neither does it seem to us that there was any transfer of goodwill. There was no formal such transfer and [the last licensee's] retention and protective action in relation to the trademark did not suggest either an intention to transfer goodwill or that she put herself in a position where she could not compete. The refusal by the appellant to accept [the last licensee's] formal agreement likewise suggests no transfer of goodwill. To the extent that there was goodwill in the location of the premises this was part of those premises—it thus reverted to the appellant at the termination of the tenancy and was not transferred to the appellant …
>
> "Putting these together we do not think that the transfer of the crockery could in those circumstances be said in substance to be the transfer of a business. If it had been then it would have been the transfer of a business as a going concern because the appellant could have carried on the business. But the absence of any real transfer of the heart of the business in the end persuaded us that this was not a transfer of a business as a going concern."

The appeal was allowed but no costs were awarded.

Marks & Spencer plc v Customs and Excise Commissioners (No 2)

Facts and issues

Article 28(2) of Sixth Council Directive 77/338/EEC in its original version provided—

"Reduced rates and exemptions with refund of the tax paid at the preceding stage which are in force on 31 December 1975 … may be maintained until a date which shall be fixed by the Council …"

Article 28(2), in the version resulting from amendment by Council Directive 92/77/EEC, provides—

> "(a) Exemptions with refund of the tax paid at the preceding stage and reduced rates lower than the minimum rate … which were in force on 1 January 1991 and which are in accordance with Community law … may be maintained. …"

VATA 1994 provided, by section 30 and Schedule 8, for zero-rating for inter alia the supply of food, including cakes and biscuits but with the exception of chocolate-covered biscuits. Between 1973 and 1994 the defendant commissioners treated chocolate-covered teacakes marketed by the claimant as coming within that exception and therefore as standard rated, but in 1994 it was acknowledged that that classification was erroneous as the teacakes were in fact cakes, so that the claimant had been paying tax that was not due. The claimant applied for repayment of the tax unduly paid, but the commissioners were only prepared to pay 10% of the amount, on the ground that the claimant had passed on 90% of the VAT in question to its customers. The commissioners relied on VATA 1994 s 80(3), which provided that, on a claim under s 80(1) for repayment of amounts of VAT unduly paid, it was a defence for the commissioners, in a case (at the material time) of "payment traders" (ie taxable persons who, in a given tax period, owed the tax authorities a greater amount of output tax than they were able to offset by way of input tax deduction), that the repayment would unjustly enrich the claimant (the rule did not at the material time apply to "repayment traders", whose situation was the converse of payment traders). In proceedings brought by the claimant, an issue on limitation was referred to the European Court of Justice for preliminary ruling and was dealt with by that court in *Marks & Spencer plc v Customs and Excise Comrs (No 1) (Case C-62/00)* [2002] STC 1036, [2002] ECR I-6325. In the course of the present proceedings, the House of Lords referred to the European Court a further three questions on the unjust enrichment issue, and also, as a prior matter, two questions on whether the situation in the case was one to which Community law applied at all and whether rights were thereby conferred on taxable persons.

Decision

The first question was whether it was possible for a trader to derive directly from Community law the right to be taxed at a zero rate where that rate was the result of provisions of national law. Article 28(2) of the Sixth Directive did not require Member States to require exceptions from the standard rate such as zero-rating, but it merely permitted them, for reasons of alleviating social hardship. The claimant argued that it had a right to have a particular transaction taxed at a zero rate by virtue of article 12(1) of the Sixth Directive, which provided that VAT was in principle payable at the "rate … in force at the time of the chargeable event". However that provision merely determined the temporal point of reference for applying a given rate of VAT, and did not have the effect argued for. It was thus pursuant to national legislation alone that the claimant could claim the exemption with refund of the tax paid at the preceding state.

The second question was whether there was a right, derived from the general principles of Community law, to a refund of VAT paid in error. The maintenance of exemptions or reduced rates of VAT was permissible only in so far as it complied with the principles governing the common system of VAT, including that of fiscal neutrality (*Commission of the European Communities v French Republic (Case C-481/98)* [2001] STC 919, [2001] ECR I-3369, para 21), and consequently those principles applied even to the circumstances provided for in article 28(2) of the Sixth Directive and could be relied on by a taxable person against a national provision which failed to have regard to them. The right to a refund of charges levied in breach of Community law was the consequence and complement of the rights conferred directly on individuals by Community law (see eg Marks & Spencer (No 1), para 30), and that applied also to charges levied in breach of national legislation permitted under article 28(2) of the Sixth Directive.

The third to fifth questions concerned possible restrictions on the right to repayment based on the principles of equal treatment and fiscal neutrality. Community law did not prevent a national legal

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system from disallowing repayment of unduly levied charges where to do so would lead to unjust enrichment of the recipients (*Commission of the European Communities v Italian Republic (Case 104/86)* [1988] ECR 1799, para 6), but in order to comply with Community law, the principle prohibiting unjust enrichment had to be implemented in accordance with principles such as fiscal neutrality and equal treatment. Fiscal neutrality precluded treating similar goods, which were thus in competition with each other, differently for VAT purposes. Those products therefore had to be subject to a uniform rate. A disparity in treatment of taxpayers who were initially in the position of creditors, on the one hand, and debtors, on the other, vis-à-vis the Treasury, was therefore contrary to the principle of fiscal neutrality, in so far as the taxpayers marketed similar goods.

On those and further grounds stated by it the court gave the following replies to the questions referred—

(1) Where, under article 28(2) of the Sixth Directive, both before and after amendment by Directive 92/77, a Member State had maintained in its national legislation an exemption with refund of input tax in respect of certain specified supplies, a trader making such supplies did not have any directly enforceable Community-law right to have those supplies taxed at a zero rate of VAT.

(2) Where, under article 28(2), both before and after amendment, a Member State had maintained in its national legislation an exemption with refund of input tax in respect of certain specified supplies but had mistakenly interpreted its national legislation, with the consequence that certain supplies benefiting from exemption with refund of input tax under its national legislation had been subject to tax at the standard rate, the general principles of Community law, including that of fiscal neutrality, applied so as to give a trader who had made such supplies a right to recover the sums mistakenly charged in respect of them.

(3) Although the principles of equal treatment and fiscal neutrality applied in principle to the instant case, an infringement of those principles was not constituted merely by the fact that a refusal to make repayment was based on the unjust enrichment of the taxable person concerned. By contrast, the principle of fiscal neutrality precluded the concept of unjust enrichment from being applied only to taxable persons such as payment traders and not to taxable persons such as repayment traders, in so far as those taxable persons had marketed similar goods. It was for the national court to determine whether that was the position in the present case. Furthermore, the general principle of equal treatment, the infringement of which could be established, in matters relating to tax, by discrimination affecting traders who were not necessarily in competition with each other but were nevertheless in a similar situation in other respects, precluded discrimination between payment traders and repayment traders, which was not objectively justified.

(4) The answer to question (3) was not affected where there was evidence that a trader who had been refused repayment of VAT which had been wrongly levied had not suffered any financial loss or disadvantage.

(5) It was for the national court itself to draw any conclusions with respect to the past from the infringement of the principle of equal treatment referred to in para (3) above, in accordance with the rules relating to the temporal effects of the national legislation applicable in the main proceedings, in compliance with Community law and, in particular, with the principle of equal treatment and the principle that the court had to ensure that the remedies which it granted were not contrary to Community law.