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Personal Tax

Personal tax allowance up by £600

Alistair Darling has addressed the controversy sparked by the abolition of the 10p tax band.

The Chancellor recently announced in the Commons that the personal income tax allowance will be raised by £600, to £6,035, for the 2008-2009 financial year.

This one-off measure, brought forward from the autumn's Pre-Budget Report and expected to cost £2.7 billion, is an effort to compensate low-income and middle-income households that lost out in this year's Budget by an average of £120 each.

Mr Darling said that 22 million people adversely affected by the end of the starting rate of tax ‘will gain an additional £120’, while 4.2 million households ‘will receive as much - or more than - they originally lost, and the remaining 1.1 million households ‘will see their loss at least halved’.

‘In other words’, he added, ‘80% of households are fully compensated, with the remaining 20% compensated by at least half – and, in addition, 600,000 people on low incomes will be taken out of tax altogether’.

The increased personal allowance will apply to all income for this tax year and will be backdated to 6 April 2008.

‘As a result, from September, basic rate taxpayers will see a one-off increase in their monthly income of £60 and then an increase of £10 per month for the rest of the financial year,’ the Chancellor announced.

He then addressed the matter of higher rate taxpayers by saying he would reduce by £600 the threshold at which an individual begins to pay at the top rate of income tax.

In his statement to ministers, Mr Darling said he had considered other ways to settle the row over the abolition of the 10p band, including a one-off rebate or compensatory payment, or changes to the tax credit system.

However, he added that further study led him to believe that a rebate scheme would be ‘complex and expensive to administer [and would] take time to set up, [while] changes to the eligibility for tax credits could not be introduced this year’.

A rise in the personal allowance, claimed the Chancellor, was the 'fairest and most effective' solution.

Higher rate change 'clarified'

The threshold at which an individual begins to pay at the top rate of income tax is to be reduced by £1,200 - not the £600 stated by the Chancellor in his announcement to the Commons.

Alistair Darling Chancellor said that, in order to leaver higher rate taxpayers unaffected by the £600 increase in personal allowances, he was ‘therefore reducing the threshold at which an individual starts to pay tax at the higher rate by £600’.

However, following questions from *Taxation* editor Mike Truman, the Treasury ‘clarified’ the Chancellor’s statement. Mike noted that a £600 reduction in the threshold would leave higher rate taxpayers £120 better off, just as basic rate taxpayers will be.

The department responded by saying that there had been a ‘misunderstanding of terminology’, and that the threshold was actually being reduced by £1200.

‘It seems very surprising that, in a statement as important as this, the Treasury cannot get their terminology right,’ said Mike. He then pointed out that the increase in the basic rate of tax will benefit the very people who also did well from the reduction of the basic rate to 20%: basic rate taxpayers on incomes above £18,000 or so.

Practical impact of the increase in the personal allowance

The Chancellor's statement said that, in order to prevent higher-rate taxpayers from benefiting at all from the increased allowances, he intended to reduce 'the higher-rate threshold' by £600. My immediate reaction on hearing this was that if the higher-rate threshold for taxable income was reduced from £36,000 to £35,400, then all that this did was to remove the additional benefit that higher-rate taxpayers get from any increase in allowances; it still left them £120 a year better off. I had a long conversation with a Treasury press officer about the figures, he went off to get an answer, coming back 15 minutes later with the reply that it was the threshold at which gross income gave rise to a higher-rate liability that was being reduced by £600. Since personal allowances had already been increased by £600, the basic rate band had to fall by £1,200 to £34,800 in order to compensate.

I have, however, since found one important time recently where the higher-rate threshold was used to refer to gross income — last year's announcement that the then Chancellor intended over a period of two years to align the 'higher-rate threshold' with the upper earnings limit (UEL). Since the UEL is based on gross income, it follows that the term 'higher-rate threshold' was for gross income too.

Further apart

The reason that this use of the term was not picked up last year is that it made no difference whether you looked at gross or net income; because the starting point for tax was more or less the same as the starting point for paying NI, an increase in the 'threshold' calculated on the Government's interpretation was just the same as an increase in the band. Now of course it is not, because the Chancellor chose to increase the personal allowance without also increasing the threshold for the zero rate of NI. This means that there are now three figures to bear in mind at the bottom end of earnings:

- NI lower earnings limit, £4,680;
- NI 0% threshold, £5,460 -and
- new income tax personal allowance, £6,035.

At the top end, the two year alignment referred to above was meant to be at a significantly increased level for NI; the higher rate tax limit was intended to increase by inflation while the NI upper earnings limit caught up with it in two stages, thus ensuring that no-one taxed at higher rates lost out year on year (strange that no such attention was paid to the lower paid).

The need to reduce the basic rate band by £1,200 has significantly altered the picture. The upper earnings limit at £40,040 is now closer to the point at which higher-rate tax is due, gross income of £40,835. So, whereas we previously had the NI and income tax limits aligned as best they could be at the bottom of the pay scale but £1,400 apart at the top, they are now out by £600 at the bottom and £800 at the top. That doesn't look like progress to me.

When to argue

If MPs wanted changes they should have been pressing for them prior to the Budget — in fact ideally prior to the Pre-Budget Report. If they had done so, it might have been possible to make a virtue out of necessity, and perhaps align at both top and bottom of the NI scale, with the increase for the higher paid paying for the decrease for the lower paid.

However, if the MPs had pressed for changes earlier, and the Government had accepted that it had to do something, it could probably have put together a better package anyway. One possibility would have been to increase personal allowances by £1,200 instead of £600, align the UEL and 'higher-rate threshold' at, say, £40,250, just leaving the anomaly of the lower threshold to be resolved over the next year or two, and then (crucially) to only reduce the basic rate by 1% instead of 2%. That would have cost less than the £2.7 billion extra (in fact it might not have cost much at all, since some of the increases in tax credits would not have been necessary), and from my initial calculations I don't think it would have created any losers compared to 2007–08.

Still losers

By contrast, the worst aspect of the new proposals is that there are still losers, mostly at very low levels of income. According to the Chancellor's statement, there are still 1.1 million people who lose out. However, there are 600,000 who are taken out of tax altogether by this measure.

Bearing in mind the original calculation that some five million people lost out because of the changes, the broad arithmetic is that the bottom 10% of those five million do well out of the latest changes, because they will pay no tax at all now as their income is less than £6,035 a year. There is then another group, possibly of around the same size, with incomes between £6,035 and £6,635. They will pay tax, but not as much as they would under the 10% band before the £600 personal allowance increase.

But the next 20%, earning between £6,635 and £12,800, will still lose out . Of course, some of these will already have been compensated, in part or in full, by increases in tax credits, which are more likely to apply to those lower down the income scale. However, a childless couple each earning around £8,000 part time, who lose out the most under the new proposals, will not be able to claim working tax credit if working for fewer than 30 hours a week each. Their loss of £110 a year each is about a 1.5% reduction in post-tax income compared to what they would have had if the 10% band had been maintained.

The future

And all this is expressed as being a one year package only, with a more comprehensive and lasting system to be explained in the PBR and introduced from April 2009. Potentially, therefore, personal allowances could be reduced again next year. It is hard, however, to see how this can make significant changes without creating more losers. It is not possible at present to effectively use the tax credit system, because that works on the basis of couples and the tax system works on the basis of individuals. Raising the national minimum wage will do nothing for those already on a higher rate but still earning below the £12,800 'worse-off' point.

The Chancellor (and his predecessor) appears to want to use tax credits as a type of negative income tax which can correct problems such as this. However, the only way to do that effectively is to recast the tax system so that couples can opt to submit a joint tax return allowing them to share allowances and tax rates. This could be made mandatory for those claiming tax credits; after all, the tax credit claim has details of joint income in it.

That, however, is a long term idea, and the Chancellor has a short-term problem. How, then, is he going to refocus the package to make it cheaper?

From an article by Mike Truman, Taxation

Lecture P476 (10.34 Minutes)

Dispensation request for scale rate subsistence payments

Subsistence expenses are a common example of expenses which employers choose to reimburse by means of a scale rate payment. The Employment Income manual (EIM) contains guidance about the evidence HMRC may require in support of a dispensation request for scale rate subsistence payments to employees travelling within the UK.

The sampling technique described in the EIM is not usually appropriate for employees who travel outside the UK, because most employers will not have enough internationally mobile employees to enable them to undertake a meaningful sampling exercise.

HMRC has therefore agreed that employers may use the benchmark rates published by the Foreign and Commonwealth Office when paying accommodation and subsistence expenses to employees whose duties require them to travel abroad, without the need for the employees to produce expenses receipts.

Benchmark scale rate expenses payments—accommodation and subsistence expenses payments to employees travelling outside the UK – Tables (April 2008) – www.hmrc.gov.uk/employers/wwsr-april08-revisions.pdf

Accommodation and subsistence payments at or below the published rates will not be liable for Income Tax or National Insurance contributions (NIC) for employees who travel abroad, and employers need not include them on forms P11D. However, if an employer decides to pay less than the published rates its employees are not automatically entitled to tax relief for the shortfall. They can only obtain relief under the employee travel rules (see EIM31800 onwards – www.hmrc.gov.uk/manuals/eimanual/EIM31800.htm) for their actual, vouched expenses, less any

amounts paid by their employer. By "vouched expenses" we mean expenses which are supported by receipts, or some other contemporaneous record of the amounts spent.

These tax/NIC free amounts are in addition to the incidental overnight expenses that employers may reimburse tax/NIC free under ITEPA 2003 s 240 and the corresponding NICs disregard (see EIM02710 – www.hmrc.gov.uk/manuals/eimanual/EIM02710.htm and NIM06015 – www.home.inrev.gov.uk/nimmanual/NIM06015.htm).

Employers are not obliged to use the published rates. It is always open to an employer to reimburse their employees' actual, vouched expenses, or to negotiate a scale rate amount which they believe more accurately reflects their employees' spending patterns. Employers wishing to negotiate such an amount must of course be able provide HMRC with evidence in support of their figures.

P11D tips for employers

To help with the completion of 2007/08 P11Ds and related forms, the April 2008 edition of HMRC's Employer Bulletin gives a list of common errors made last year:

- make sure the entries on your return are clear and legible;
- use a font size that is clear and readable;
- show the employee's NI number, date of birth and gender;
- an electric car (Fuel Type E) does not have CO2 emissions;
- the 'Dates car available from' box should only be completed when the car was first provided in that tax year;
- the 'Date car available to' box should only be completed when the car was withdrawn in that tax year. Do not enter 5 April unless the car was withdrawn from 5 April;
- when completing interest-free and low interest loans details the 'Dates loan was made' box should only be completed when the loan was first provided in that tax year;
- when completing interest-free and low interest loans details 'Dates loan was discharged' box should only be completed when the loan was discharged in that tax year. Do not enter 5 April unless the loan was discharged on 5 April.

You can find further information at www.hmrc.gov.uk/employers/tma-ebik.shtml and in the Expenses and Benefits section of the Employer CD-ROM.

HMRC intends to issue more messages about both filing and payment after the end-of-year filing date and closer to P11D/Class 1A deadlines. It will also publish information as soon as it hears of any issues that arise with completing forms (paper or online) or with HMRC processing. With luck there will not be any need to do so. If you do encounter difficulties with employer EOY filing, please send details to peter.bickley@icaew.com and we will draw them to HMRC's attention.

ICAEW Tax Faculty

The P11d

The P11d should be submitted by 6 July 2008. All employees must be given a copy of the P11d by that date. Employees who leave between 6 April 2008 and 6 July 2008 must be supplied with a copy if they were employed in 2007/08.

Measuring the benefit

Benefits are chargeable to tax if they are either:

(i) specifically charged within the Benefits Code; or

(ii) "employment-related" benefits under s.201 onwards ITEPA 2003.

An employment related benefit is a benefit provided either for an employee, or for a member of the employee's family or household, by reason of the employee's employment.

Under s.204 ITEPA 2003, "the cost of an employment related benefit is the expense incurred in, or in connection with, the provision of that benefit".

Amounts paid by the employee to the employer towards the provision of the benefit can be deducted from the cash equivalent. Therefore if the employee reimburses the employer's full cost, the taxable benefit will be zero.

Every benefit provided by an employer to an employee which has a cash equivalent, must be reported to the Revenue by the employer on the P11D. The employer should complete a form P11D for each employee who has received taxable benefits, and these forms should be submitted to the Revenue no later than 6 July after the end of the tax year.

In the case of certain benefits, it is very difficult to establish exactly what is the cost to the employer of providing the benefit. In such cases special rules exist to calculate the cash equivalent. Special rules are in place for calculating company car and fuel benefits, accommodation benefits, cheap loans and instances where an employer lends an asset to an employee.

Pepper v Hart

The concept of the "cost of providing" a benefit was the subject of a leading tax case heard by the House of Lords in 1993. The case concluded that it was appropriate to look at the marginal cost method.

Lower paid employees

Certain chapters of the Benefits Code do not apply if those benefits are provided to an employee who defined as a lower paid employee and who is not a director of a company. These excluded benefits include company cars and vans, cheap loans, certain share related benefits and certain expenses payments.

A lower paid employee is one earning less than £8,500 in the tax year.

	£	
Cash earnings (including reimbursed expenses)		X
Payments treated as earnings (eg Benefits)	X	
Earnings from intermediaries		X
Less: authorised deductions		(X)
TEST HERE		X

If an employee is a lower paid employee, taxable benefits will still need to be reported to HMRC but this time on a form P9D as opposed to form P11D.

Company car & fuel benefits

One of the most common benefits offered by employers to their employee is the provision of a company car and fuel for private motoring.

If a car is provided to a lower paid employee who is not a director, the benefit is tax free.

For other employees, special rules exist to enable us to calculate the cash equivalent on the provision of a company car. If a car is made available by an employee for the exclusive use of a particular employee, it doesn't matter whether the car is owned by the employer or leased by the employer from a third party, the employee will have a taxable benefit in respect of the private use of the car. The cash equivalent depends on a number of factors.

The starting point in calculating car benefits is the list price of the car when it is first registered (i.e. when brand new). This is not necessarily the same as the price actually paid by the employer for the car.

The cash equivalent also depends on the vehicle's carbon dioxide (CO_2) emissions. Essentially, the lower the emissions, the lower the benefit. This is an attempt by the government to be responsible with regard to the protection of the environment.

Also the benefit depends on whether the car was available for the whole of the year. As is the case with most benefits, if the employee does not have the benefit for the whole of the year, we need to do an apportionment to arrive at the cash equivalent.

List price

The standard benefit proforma is:

		£
List price when new		A
Accessories		B
Less: capital contributions (max £5,000)		(C)
Revised list price (capped at £80,000)	**D**	

If an accessory is added to the car after it was first made available to the employee, we only need to add on the cost to the list price if the accessory cost more than £100. If not, we can ignore it.

Cash Equivalent

The basic cash equivalent is the list price, multiplied by a certain percentage. This percentage will depend on the amount of CO_2 emitted by the car. The minimum charge is 15%, rising to a maximum charge of 35%.

The list price, multiplied by the appropriate percentage gives us the basic cash equivalent.

The benefit is reduced if the car has not been available to the employee for the whole of the tax year.

As is the case for the vast majority of benefits, if the employee is required to make a contribution towards the benefit and actually does so, these contributions reduce the cash equivalent. This is quite common in practice as with many car schemes, employees make monthly contributions to their employer for the use of the car. These reduce the taxable benefit.

Determining the percentage

The next step is to determine the relevant percentage. List price is multiplied by a percentage which depends entirely on the car's recorded CO_2 emissions. The higher the emissions, the higher the percentage.

Carbon dioxide emissions are measured in terms of the grams per kilometre (g/km) of gas emitted from the car.

For 2007/08 there is a "baseline" figure of 140 g/km. This means that all cars emitting CO_2 at a rate of 140 g/km or less will be taxed at the minimum rate of 15%. The baseline is to reduce to 135 g/km in 2008/09.

The relevant percentage will increase by 1 for each additional 5 g/km of CO_2 emitted above 140 for 2006/07. For example, a car with recorded CO_2 emissions of 145 grams per kilometre, will be taxed using a percentage of 16%, and so on.

We take the CO_2 emissions of the car and deduct the baseline figure of 140. We divide the result by 5 and add it to the minimum of 15% to give the relevant percentage. This is then multiplied by the list price of the car to give the basic cash equivalent.

Further points

In reality, CO_2 emissions figures are exact numbers and are not rounded to the nearest whole multiple of 5. For tax purposes, we are allowed to round down to the nearest 5 g/km.

The percentage can never exceed 35%. This rate will therefore apply for all cars with an emissions figure of 240 g/km or above.

There is a 3% supplement for cars which run on diesel – i.e. an additional 3% is added to the relevant percentage. This is because diesel engines are less environmentally friendly than petrol engines. The minimum percentage which can therefore be applied to a diesel vehicle is 18%. The 3% supplement cannot take the relevant percentage above 35%.

Electric cars produce no CO_2 emissions and receive a 6% discount. The percentage to be applied in these cases will therefore be 9%. There are also discounts for cars running on road fuel gas (e.g. liquid petroleum gas or LPG).

From 2008/09, a fixed rate of 10% will apply for cars with CO2 emissions of 120 g/km or less.

More than one car

An employee may have use of two company cars or he may have one car himself and a second car for a member of his family or household.

In this instance, the employee simply has two benefits, each calculated in the same way – i.e. using list price and CO_2 emissions. Note that if a car is made available by an employer for a member of the employee's family, it is the employee who will have the benefit, not the family member.

Pool cars and emergency vehicles

No benefit will arise if the employee has some incidental private use of a pool car. A pool car is essentially a shared vehicle which is mainly used for business purposes.

As long as private use is incidental and the pool car is not normally kept overnight at the employee's residence, no benefit will arise. Many employers have a small fleet of pool cars which are normally kept somewhere on the premises and which are used for business journeys.

There is also no taxable benefit when emergency service vehicles used by fire, police or ambulance workers are taken home when on-call.

Fuel benefits

A separate benefit will arise where private petrol costs are reimbursed. If the employer only pays for fuel for business purposes, no benefit will arise.

If an employee is provided with fuel for private motoring, the taxable benefit is identified by using the formula below:

) x % based on CO_2 emissions

To calculate the appropriate percentage, we use exactly the same rules as above for car benefit purposes.

No fuel benefit will arise if an employee is required to reimburse the whole of the expense incurred by the employer in providing private fuel and actually does so. If the employee only makes a partial reimbursement, this will have no effect and the benefit will be calculated as above. Therefore an employee contribution towards the costs of private fuel will not result in a "pound-for-pound" reduction in the taxable amount as is the case for other benefits.

The fuel benefit will be reduced if private use fuel is not provided to the employee for the whole of the tax year. However, if private fuel is withdrawn but then reinstated in the same tax year, the benefit charge will apply for the whole tax year. So it is not possible to opt in and out of the car fuel benefit, for example during holidays.

Living accommodation

If a house, flat or any property that is owned or rented by the employer is made available for use by an employee, there will be a taxable benefit for the employee as he is occupying a property provided to him by his employer.

The provision of living accommodation is a taxable benefit for all employees even lower paid employees.

The way that the benefit is taxed depends on whether the accommodation is "job related" or "non job related".

"Job related" accommodation

If an employer provides an employee with job related accommodation, there is no benefit arising to the employee on the use of that accommodation.

Job related accommodation is accommodation which is "necessary" for the job or is provided for the "better performance" of the employee's duties. Employees such as publicans or caretakers will live in job related accommodation. Typically these are employees who are normally required by their employers to live on site in order to do their job.

Job related accommodation also covers situations where accommodation is provided "customarily" for the better performance of the job. For example it is customary to provide a vicar with a vicarage in the parish. This would constitute job related accommodation.

A director of a company cannot have his living accommodation classified as "job related" under s.99 unless either:

a) he does not have a "material interest" in the company (>5% of the shares); and either

b) he is employed as a full time working director or the company is non-profit making or is established for charitable purposes.

Finally, if accommodation is provided by the employer because there is a threat to the employee's physical "security", this will also constitute job related accommodation. Certain politicians such as the Chancellor or the Prime Minister live in job related accommodation on Downing Street and do not pay tax on the provision by the government of their living accommodation.

Rented accommodation

The benefit - i.e. the cash equivalent - is the higher of the rents paid by the employer for the use of the property, and the annual value of the property.

The "annual value" of living accommodation is defined as the rent which might reasonably be expected to be obtained on letting the property if the tenant paid all the usual household bills and the landlord met all repair and maintenance costs. The "annual value" will be provided for you in the examination.

We then deduct any employee contributions – i.e. any rents paid by the employee to the employer for the use of the property. This will give us the cash equivalent.

Higher of:	
Rents paid by employer Annual value of property	X
Less: employee contributions	(X)
Taxable benefit	X

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Employer owned accommodation

There are similar rules where the employer owns the accommodation being made available to the employee.

Again, the starting point in calculating the benefit is the annual value. If the accommodation cost the employer less than £75,000, then the benefit is equal to the annual value.

If the house cost the employer more than £75,000, there will be an additional benefit to the employee called the additional yearly rent – this extra benefit will be added to the annual value to give the total benefit.

To calculate the additional yearly rent we start by taking the cost of the accommodation - "cost" means the original cost plus any improvements. From this we deduct £75,000, and multiply the difference by the "ORI" which is HMRC's official interest rate at the start of the tax year.

When calculating the "cost" of the property, only improvements carried out before the beginning of the tax year are taken into account. Improvements undertaken during the year will affect the "cost" used in calculating the benefit for the following year.

If the employee makes a contribution towards the benefit, this can be deducted in arriving at the taxable cash equivalent.

If employee contributions exceed the amount of the benefit, no loss will arise. The result is simply a benefit of zero.

Loans to employees

When a company lends money to an employee, this is likely to give rise to a taxable benefit called a taxable cheap loan. The cash equivalent of the benefit is calculated using HMRC's official rate of interest. If no interest is charged or the interest rate is less than the official rate of interest, the cash equivalent is the difference between the interest that would have been payable at the official rate of interest and any interest which is paid.

There are two ways in which we can calculate the cash equivalent. The first is by using the average method, and the second uses the strict method. The average method is perhaps more commonly used although either the taxpayer or HMRC can insist that the strict method is used instead.

The employee will have no taxable benefit if the aggregate of all loans outstanding throughout the tax year is £5,000 or less. Therefore if the employer makes one loan to the employee and throughout the tax year this loan never exceeds £5,000, the taxable benefit is zero.

This provision is intended to exempt such things as season ticket loans, so for those of you who travel to work on public transport and have an annual travel card obtained via a loan from your employer, as long as the travel card costs £5,000 or less (and you don't have any more loans), you will not have a taxable benefit.

Note here that the £5,000 rule refers to the aggregate of all loans in the year – this is to prevent an employer abusing the rules by offering a series of loans to the same employee, each of just under £5,000.

Average Method

Under the average method we start by taking the loan outstanding at the start of the tax year – i.e. at 6 April – and to this we will add on the loan outstanding as at the end of the tax year – i.e. at the following 5 April. Having added these together, we divide by two to give the average loan outstanding during the year.

If there is no loan outstanding at the start of the tax year – for example the employer makes the loan to the employee part way through the year – we start by using the amount of the loan at the point it was made. Similarly if the loan outstanding at the end of the year is nil – for example if the loan is completely repaid during the year – we add on the amount of the loan at the point it was repaid.

Having arrived at the average loan for the year, we multiply this by HMRC's average official rate of interest (ORI) for the year.

$$\frac{\text{Loan at 6 April} + \text{Loan at 5 April}}{2} \times \text{average ORI for tax year}$$

If the employee is required to make some sort of contribution – i.e. if the employee pays some interest to the employer on the loan – these contributions reduce the cash equivalent.

Strict method

Under the strict method we simply calculate interest on a daily or monthly basis on the exact amounts of the loan outstanding during the tax year.

Use of employer's assets

If an employer lends an asset to one of his employees, this will give rise to a taxable benefit. Note that the employer is allowing the employee to use the asset – ownership of the asset remains with the employer and does not transfer to the employee.

The benefit in this instance is the higher of:

a) the annual value of the use of the asset; or

b) the sums paid by the employer in providing the asset by way of rent or hire charge.

The "annual value" referred to above is 20% of the market value of the asset at the time it was first made available to the employee.

If the employee makes a contribution – i.e. he pays some sort of rent to the employer for the use of the asset – we can deduct this to arrive at the taxable cash equivalent.

If the asset is lent to the employee part way through the year, having calculated the basic cash equivalent, we must then apportion this for the number of months in the year in which the employee had use of the asset.

This rule will often apply in relation to furniture provided by the employer in living accommodation made available to the employee.

Transfer of assets

Because the asset remains the property of the employer, at some point the employee will be required to give it back. If the employee doesn't return the asset to the employer – i.e. the employer allows the employee to keep the asset - there will be a taxable benefit on this transfer.

The benefit will be the higher of:

a) The market value of the asset at the date it was transferred to the employee.

b) The market value of the asset at the date it was originally lent to the employee reduced by any amounts which have been charged to tax in respect of the employee's use of the asset.

HMRC will take whichever is the higher and will tax this figure. Any payments made by the employee to the employer for the transfer of the asset can be deducted.

Transfers of cars or houses

Where an employee has use of a company car and at a later date that car is transferred to the employee, the benefit is the market value of the car at the date of the transfer minus any payments made by the employee for the transfer of the car. The rules regarding amounts previously charged to tax do not apply here.

This arrangement commonly applies as part of a termination agreement. If an employee is made redundant, to soften the blow the employer may allow the ex-employee to keep his company car.

The same rule applies to transfers of houses.

Use of computers – rules from 2006/07

The £500 exemption has been removed with effect from 6 April 2006. However, the exemption continues to be available for employees who had been provided with computer equipment before 6 April 2006. In effect, the exemption is only removed where computer equipment is first made available to the employee on or after 6 April 2006.

Employees who had use of a computer before April 2006 but who later received a replacement under warranty, will still be able to claim the £500 exemption. However if a new computer is provided outside the warranty period, the exemption is not available.

To calculate the annual benefit, we apply the following steps;

If available before 6 April 2006:

1. calculate the benefit using the 20% rule;
2. deduct £500; then
3. deduct the business proportion to calculate the taxable benefit.

If available after 5 April 2006:

1. calculate the benefit using the 20% rule; then
2. deduct the business proportion to calculate the taxable benefit.

HMRC (in their Employment Manual) will accept that no taxable benefit arises where:

- the employer's policy concerning private use of computers is clearly stated to employees, setting out circumstances where occasional private use can be made; and
- a decision of the employer not to recover the costs of employees' private use is a commercial decision as the administrative costs of so doing would exceeds the amounts involved; and
- there are reasonable checks to ensure that the employer's policy is being followed in practice.

Even with the partial removal of the £500 exemption therefore, employers who have a stated policy permitting incidental private use of computer equipment, should not need to disclose taxable benefits on employees' P11Ds.

Company vans

Where an employer allows an employee exclusive use of a company owned van, there will be a taxable benefit. A "van" in this context is a mechanically propelled road vehicle which is a goods vehicle weighing less than 3.5 tonnes.

As a van is not a car, we do not use the company car rules to calculate the benefit.

The van rules have changed with effect from 2007/08.

From 2007/08 a van with unrestricted private use will have a flat rate benefit of £3,000. This charge is apportioned if the van is not available for the whole of the year.

Where the van is "shared" - i.e. concurrently available to more than one employee – the cash equivalent is split between the employees based on the days it was available.

As well as the benefit for the company van, there will be an annual scale charge of £500 where free or subsidised fuel is provided by the employer for private use by the employee.

Before 6 April 2007, if an employee has use of a van, the benefit was a flat £500 per annum if the van was less than 4 years old, or £350 per annum if the van was more than 4 years old.

Mobile phones

If an employer provides an employee with a mobile phone, this is a tax exempt benefit even if the employer is paying for the employee's personal telephone calls.

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The exemption only covers the "provision for an employee.....of a mobile phone". Therefore if an employee has his own mobile phone and the employer reimburses any private calls or standing charges there will be a taxable benefit equal to the cost to the employer of reimbursing such expenses.

The number of mobile phones that can be loaned without giving rise to a benefit is restricted to one per employee.

There is exemption for phones made available to members of the employees family or household.

Mileage allowances

Mileage allowances will be paid when an employee uses his own car for work purposes. When an employer pays a mileage allowance to the employee, he is reimbursing that employee at a fixed amount per mile for using his own car. The mileage allowances rules do not therefore apply to company vehicles.

HMRC wants to make sure that the employee is not making a profit from the mileage allowance paid to him. If there is a profit – i.e. the cost to the employee of using his car is less than the allowance paid – HMRC will tax that profit as employment income.

To work out the profit, HMRC has tax-exempt limits which we need to apply. If allowances are paid above these limits the employee will be making a profit – if allowances are paid below these limits, the employee will be making a loss.

The tax-exempt limits depend on the employee's business mileage in the year. Business mileage does not include travelling from home to work. If an employer reimburses an employee's travel costs from home to work, this will be a fully taxable benefit.

The limits are reproduced below.

Vehicles	*First 10,000 Business miles*	*Additional Business miles*
Cars	40p	25p
Motorcycles	24p	24p
Bicycles	20p	20p

Tax exempt benefits

Here are the most common exempt benefits:

- Employer's contribution to the employee's approved pension scheme.
- Reimbursement of removal expenses up to a maximum amount of £8,000 (s.277 – s.283 ITEPA 2003)
- Employer provided crèche or nursery for employee's children or up to £55 a week for childcare vouchers.
- Provision of "workplace parking" is a tax-exempt benefit
- Subsidised staff canteens as long as the canteen facilities are available to all employees.
- Incidental expenses paid by an employer to employees working away from home are tax exempt up to a daily limit. (£5 per night working in UK and £10 per night working abroad.)
- Costs incurred by the employer in providing full time, day release or block release training
- Christmas party or other similar function for the employees, if costs ≤ £150 per head
- Awards by an employer to an employee from a staff suggestion scheme ≤ £5,000
- Long service awards of up to £50 per year of service if employee had ≥ 20 years service
- Reasonable costs incurred for working at home. (£2 per week without records)
- Eye tests or corrective glasses where employee uses VDU in employment
- Late night taxis etc when the employee is occasionally required to work late (ie after 9 pm)

Lecture B479 (14.39 Minutes)
Lecture B480 (16.42 Minutes)

Use of home as office

Many sole traders, partnerships or small corporates choose to operate from home.

Whatever the chosen trading vehicle, it should be possible to establish a claim for tax relief on part of the home expenses. There is no specific legislation on this, and instead it is a question of applying general principles to create a valid claim. The HMRC manuals make several references to this subject and there is some Case Law. Recently there have been attempts by HMRC to limit the scope for employees but increase it for the self-employed. This is based on new interpretations rather than any statutory changes

Clearly it is easier to establish a claim where a self-employed person uses his home as his business base, with the usual requirement applying of the expense being wholly and exclusively incurred for the purposes of the business. Indeed there is even more scope following what is said in *para BIM47815* of the *Business Income Manual* when it refers to the 1975 case of *Caillebotte v Quinn* as the authority for being able to apportion the use and cost of a home on a time basis and to allow the expenses of the room during the hours in which it is used exclusively for business purposes.

In particular it says there can be a valid claim for apportioned mortgage interest; telecommunications (including the line rental); insurance (including a household policy); repairs and maintenance.

There are several examples given by HMRC of this new approach in para BIM47825 of which Example 6 is the most important

Example 6

Gordon, an architect, dedicates a room solely for use as his office between 9am and 5pm daily. The room contains a workstation, office furniture and storage for his drawings. He uses the room for an average of 4 hours each day, though often this is spread over his working 8 hour day as he has a number of regular site visits to make. In addition it is not uncommon for Gordon to accommodate clients in his office to discuss plans, outside of normal hours.

The room is available for domestic use outside of business hours and his family regularly make use of the room for around 2 hours each evening.

After apportioning costs by reference to the number of rooms in the house, Gordon calculates the room uses £300 of variable costs (electric and oil) and £600 of fixed costs (council tax, mortgage interest, insurance). In apportioning these costs by time Gordon claims £680 in total, made up of 4/6 of variable costs (£200) and 8/10 of fixed costs (£480).

The claim equates to 75% of the total costs attributable to the room (£680/£900), which Gordon views as a more straightforward but equally reasonable basis for future claims, should his circumstances remain unchanged.

In this example it is very relevant that Gordon’s family use the room in the evening. As the room is not exclusively business, full principal private residence relief should be available when Gordon sells his home.

It is also very important that the eight hours of business use are exclusively business. It is this exclusivity that gives the taxpayer access to the wholly and exclusive deduction. For example, a client working on the kitchen table is unlikely to receive any “wholly and exclusive” deductions as the kitchen is presumably never used exclusively for business.

Example 6 would appear to be a reasonable starting point for use of home as office claims.

If we were to make some assumptions for 2007/08 as regards the backing numbers for the fixed costs in example 6 the following might be reasonable:

	£
Mortgage interest (£750 per month)	9,000
Council tax	2,400
Property insurance	600
	12,000
Relating to study (5% of floor area)	600
Business proportion (8 out of 10 hours)	480

It can be seen from these backing numbers that mortgage interest is a key factor in use of home as office claims. In the above example 75% of the £480 claimed relates to mortgage interest (£9,000 x 5% x 8/10 = £360). Consequently if your mortgage is low then your use of home as office claim will be low. If however your mortgage is high then you will have a high use of home as office claim.

The claim will also depend on the square footage of your home office. In smaller properties the study may represent 10% or more of the area of your home.

Indeed if we assume that 8 out of 10 hours is a reasonable usage percentage, the mortgage interest element of a use of home as office claim would be broadly….

Mortgage (at 6%)	5% floor area	10% floor area
	£	£
£100,000	240	480
£200,000	480	960
£300,000	720	1,440
£400,000	960	1,920
£500,000	1,200	2,400

It can be appreciated that clients with higher mortgages on smaller properties would have the makings of a reasonable home office claim.

In any event it is obvious from HMRC guidance that they require a more scientific approach to use of home as office. This may be in the clients favour.

Illustration 1

Tom, an accountant, dedicates a room solely for use as his office between 9am and 5pm daily. The room contains a workstation, office furniture and storage for client files. He uses the room for an average of 4 hours each day, though often this is spread over his working 8 hour day as he has a number of client visits to make. In addition it is not uncommon for Tom to accommodate clients in his office to discuss matters of a confidential nature.

The room is available for domestic use outside of business hours and his family regularly make use of the room for around 2 hours each evening.

Tom lives in central London and he estimates that his study represents approximately 15% of his property square footage. Tom's mortgage is £500,000.

Tom calculates the fixed costs as follows

	£
Mortgage interest (£2,500 per month)	30,000
Council tax	4,000
Property insurance	1,000
	35,000
Relating to study (15% of floor area)	5,250
Business proportion (8 out of 10 hours)	4,200

The apportioned variable costs amount to £550 so Tom has a "Use of Home as Office" claim of £4,750.

On the face of it this seems a high claim but Tom can substantiate all the elements using HMRC example 6 as a basis.

Home office for corporates?

Clients trading through a company can have the same effective treatment but they need to set up a rental agreement between the company and the individual

Rental payments can prove advantageous as the company may deduct the rents in arriving at its corporation tax profit, provided that such rents do not exceed a commercial arm's length amount. It is advisable to put in place a formal rental agreement and have independent rental valuations carried out by a suitably qualified expert on a regular basis. Failure to instigate this may lead to an Inland Revenue challenge on the deductibility of the rents.

It may be easier to keep a note of the rental rates that local serviced offices charge. Serviced offices are very common and rental rates tend to be based on the size of the office space. It should also be noted that the serviced office rental rates are generally inclusive of utilities and insurance so the comparison is reasonable. If your rental charge is in line with local serviced office rentals it should satisfy the market value test.

In order to prevent the loss of Principal Private Residence relief on the ultimate disposal of the home it is advisable to state in the agreement that the facilities are only let to the company for designated hours each week, for example, 9.00am to 5.00pm Monday to Friday.

If Tom (example above) was to trade through a corporate he may choose to set the home office rentals at £4,750 per annum. Assuming this did not exceed market value of the office space then his company would get a deduction for the rental payments.

Tom would need to declare the rent of £4,750 on his self assessment property pages. As he has a source of property income he would get deductions for any costs "wholly and exclusively" incurred for his property business. Effectively the same basis as a self employed person – so the £4,750 as calculated above. The home office rental profit would be £nil.

If Tom were to simply put costs through the company without a formal rental agreement, HMRC may regard the costs as extra salary. In this regard Tom would not receive deductions for mortgage interest etc as these are not wholly, exclusively and necessarily incurred for his employment.

Hence a "non exclusive" rental agreement is key to securing tax deductions for home office costs.

Interaction with buy to let losses?

Where clients have buy to let losses it should be noted that any "profit" the client makes on their use of home as office rent can be offset by any buy to let losses the client has on other UK properties. As long as the charge from individual to corporate is at market value, the home office rent is part of the

client's UK property business. Hence losses on a buy to let are automatically offset against the home office profit.

Illustration 2

Jane, a surveyor, dedicates a room solely for use as her office between 9am and 5pm daily. The room contains a workstation, office furniture and storage for client files. She uses the room for an average of 4 hours each day, though often this is spread over her working 8 hour day as she has a number of client visits to make. In addition it is not uncommon for Jane to accommodate clients in her office to discuss aspects of the project she is working on.

The room is available for domestic use outside of business hours and her family regularly make use of the room for around 2 hours each evening.

Jane lives in the centre of Bath and she estimates that her study represents approximately 10% of her property square footage. Jane's mortgage is £100,000.

Jane trades through a company and estimates that to rent equivalent square footage in the centre of Bath would cost around £6,000 per annum. Jane's company therefore pays her a fully inclusive rental charge of £500 per month.

Jane also has a small buy to let portfolio which makes a loss of £5,500 per annum.

Jane calculates the fixed costs on her home office as follows

	£
Mortgage interest (£500 per month)	6,000
Council tax	2,000
Property insurance	1,000
	9,000
Relating to study (10% of floor area)	900
Business proportion (8 out of 10 hours)	720

The apportioned variable costs amount to £280 so Jane has deductible expenses of £1,000 to set against her property rent of £6,000.

A rental profit of £5,000 is achieved on her "home office". This is then reduced to £nil after offsetting her buy to let loss of £5,500. Excess property losses of £500 are available for carry forward against next year's property income.

Conclusion

In the past "use of home as office" claims may have been fairly arbitrary – say £10 per week.

Going forward it is worth having a note on file of key information in order to ascertain the reasonableness of the claim. The information collated needs to be targeted towards completing the following table:

	£
Mortgage interest	X
Council tax	X
Property insurance	X
	X
Relating to study (?? % of floor area)	X
Business proportion (8 out of 10 hours)	X

We would then need to add the variable elements such as light and heat, telephone etc.

Most claims should be reasonable but there will be a number which are significantly lower (or higher) than what they should be.

Article by Dean Wootten

Lecture P477 (16.50 Minutes)

HMRC issues 'health warning' on booklet IR20

Following criticism that its recent update of booklet IR20: "Residents and non-residents. Liability to tax in the United Kingdom", is most likely to confuse its readers, HMRC has issued a health warning about the publication.

It points out that it now includes as an appendix Revenue & Customs Brief 01/07 which was issued following the recent Gaines-Cooper case, but it does not include reference to the proposals made in the 2008 Budget to change the way days of presence are counted for residence purposes, nor to changes made to the operation of the remittance basis as we are not able to publish such guidance until the 2008 Finance Act has received Royal Assent.

Once the 2008 Finance Act has received Royal Assent, HMRC says that the content of IR20 will be updated again to include any changes which are confirmed to ensure that its guidance is current until the replacement guidance for IR20 is issued.

In the meantime, HMRC says that information about the way the 2008 Budget proposals will affect residence and the remittance basis can be found in its Budget pages and FAQS

Taxation of overseas dividends

Dividends from UK companies received by UK-resident shareholders are free of basic rate tax and are charged at an effective 25% in the hands of a higher rate taxpayer – this arises by reason of a combination of the 10% tax credit and the 32.5% rate on dividends received.

The same rates of tax have applied to dividends from overseas companies, but with a credit only for foreign tax deducted at source (if any). Accordingly, the tax liability for UK-resident individuals on their foreign dividend receipts has been at the rate of 10% or 32.5% less any foreign tax.

With effect from 6 April 2008, a UK-resident individual having a shareholding in an overseas company will now benefit from a 10% tax credit in respect of any dividends received, provided that he owns less than 10% of the company's share capital (Cl 31 and Sch 12 FB 2008). This means that he will obtain the same effective treatment as for his UK dividends. The other previously announced condition, namely that he must receive in total less than £5,000 per annum in dividends from overseas companies, is not being introduced.

There will be a further extension of this regime on 6 April 2009 for individuals who hold 10% or more of an overseas company's share capital. As long as the overseas company is liable to a tax on its profits of a similar nature to corporation tax, it is proposed that these larger shareholders will also be able to benefit from a 10% tax credit on their dividends.

Recent decisions in the ECJ have been the cause of this change.

Article by Robert Jamieson

Childcare costs

Qualifying childcare

The costs of childcare are built into the WTC. This can help a claimant with up to 80% of child care costs up to a maximum of £175 per week for one child and £300 a week for two or more children i.e. max of £300 x 80% = £240 for two or more children.

Prior to 2006/07 it was only 70% of eligible childcare costs.

The child care must be provided by one of the following

- A provider approved under a Ministry of Defence accreditation scheme abroad.
- An approved foster carer. (The care must be for a child who is not a foster carer's foster child.)

In England only

- A childcare provider registered by Ofsted
- Out-of-hours childcare or supervised activity based childcare provided by a school on the school premises or by a local authority or by a childcare provider registered by Ofsted.
- Until 30 September 2007 – childcare or over seven clubs approved by accredited childcare Quality Assurance schemes
- A childcarer approved under the Childcare Approval Scheme providing childcare in the child’s own home or in other domestic premises
- childcare provided in your own home* by a domiciliary worker or nurse from a registered agency.

For qualifying childcare in Wales, Scotland and Northern Ireland please refer to WTC5 on the HMRC website.

All registered or approved childcare providers are given a letter or certificate as evidence of their approval or registration. Some childcare providers must regularly re-apply for approval or registration. If this applies, the letter or certificate issued to them will clearly say when their approval or registration runs out. It is the claimants reponsibility to make sure that the childcare they are using is registered or approved.

Childcare will not be eligible care for help within the Working Tax Credit childcare element if it is provided by

- a relative of a child caring for that child in the child's home even if the relative is registered or approved, or
- a childcarer approved under the Childcare Approval Scheme, who is caring for a child, or children, away from the child, or children's, home and who is only caring for a child, or children, to whom he or she is related.

A relative of the child means a parent, grandparent, aunt, uncle, brother or sister whether by blood, half-blood, marriage or affinity.

Childcare can be claimed until the 1 September following a child’s 15th birthday.

Once you have started paying childcare costs you must make a claim within three months, as HMRC will not backdate any claims beyond three months. As part of the claim, the claimant must include full contact details of the childcare provider (including their registration or approval number) and details of the average weekly childcare costs.

Working out the weekly average

The rules for working out childcare costs depend on how you pay your childcare.

<u>If you pay weekly and pay the same amount each week</u>

Work out the average weekly costs by adding together your weekly costs for the last four weeks and divide the total by four.

Example 1

Jess normally pays her childminder £50 per week. Her average weekly costs are:

$$\frac{(50 + 50 + 50 + 50)}{4} = \frac{\text{£}200}{4} = \text{£}50$$

If you pay weekly and pay different amounts each week

Your weekly costs may vary depending on more or less help being needed in school holidays.

In this instance work out the average weekly costs by adding together your weekly costs for the last 52 weeks and divide the total by 52. If it is less than 52 weeks since you started using childcare, work out what you expect to spend on childcare in the next 52 weeks and divide that by 52.

Example 2

Ellie normally pays her childminder £40 per week. However in the 10 weeks of school holidays she pays £120 per week. Her average weekly costs are:

$$\frac{(10 \text{ x } \text{£}120) + (42 \text{ x } \text{£}40)}{52} = \frac{\text{£}2{,}880}{52} = \text{£}56$$

If you pay monthly and pay the same amount each month

Work out the average weekly costs by multiplying the amount you paid in the last month by 12 and dividing the total by 52.

Example 3

James normally pays his childminder £200 per month. His average weekly costs are:

$$\frac{(\text{£}200 \text{ x } 12)}{52} = \frac{\text{£}2{,}400}{52} = \text{£}47$$

If you pay monthly and pay different amounts each month

Your monthly costs may vary depending on more or less help being needed in school holidays.

In this instance work out the average weekly costs by adding together your monthly costs for the last 12 months and divide the total by 52. If it is less than 12 months since you started using childcare, work out what you expect to spend on childcare in the next 12 months and divide that by 52.

Example 4

Ben normally pays his childminder £200 per month. However in the three months of school holidays he pays £320 per week. His average weekly costs are:

$$\frac{(9 \text{ x } \text{£}200) + (3 \text{ x } \text{£}320)}{52} = \frac{\text{£}2{,}760}{52} = \text{£}54$$

Changes in average weekly cost of childcare

If the average weekly cost of childcare goes up by £10 a week for more than four weeks in a row, the Revenue should be informed within three months to claim the increase required in the credit.

A drop in childcare costs by £10 a week or more for at least four weeks in a row or the cessation of child care costs, are both mandatory changes of circumstances that have to be notified to the Revenue within 1 month or there is a risk of a £300 penalty.

The averaging rules in relation to childcare costs are particularly complex and can require a degree of forecasting that suggests the rules would only suit those blessed with the gift of foresight! HMRC do however provide useful examples on WTC 5.

If you pay the same amounts weekly or monthly

For weekly payers work out what was paid in the previous 4 weeks and divide that by 4. If this varies from your current average by more than £10 (higher or lower) than HMRC must be notified.

For monthly payers, multiply your last monthly payment by 12 and divide the result by 52.

If it is £10 or more higher than the current average then the claimant must tell HMRC as soon as possible. If it is £10 or more lower than the current average, HMRC must be notified within one month.

If you pay different amounts weekly or monthly

In this instance work out the average weekly costs by adding together your anticipated costs for the next 52 weeks or 12 months and divide the total by 52.

If it is £10 or more higher than the current average then the claimant must tell HMRC as soon as possible. If it is £10 or more lower than the current average, HMRC must be notified within one month.

Example 5

Following on from Example 2 above, Ellie starts working shorter hours on 2 June 2008 and needs her childminder to look after her children for fewer hours each week. During term time she now pays £30 per week and in the 10 weeks of the holidays she pays £100 per week.

Her revised average weekly costs are:

$$\frac{(10 \times £100) + (42 \times £30)}{52} = \frac{£2,260}{52} = £44$$

This is more than £10 lower than her previous average of £56 so she must tell HMRC about this change within one month.

Childcare vouchers

An employer can provide his employees with childcare vouchers to the value of up to £55 per week. Such vouchers do not count as income for tax credits and are not liable to income tax or national insurance.

Care must be taken when claiming tax credit childcare to ensure that the amount of childcare claimed is net of the cost covered by such vouchers.

Although this would appear a generous tax free perk, in fact, in most cases, where 39% taper applies the individual will be worse off as most employers will restrict salary by an amount equal to the tax free voucher provided.

It would be fair to say that the primary beneficiaries of childcare vouchers are high rate taxpayers, taxpayers that just receive the family element of tax credits (£545 or less) or taxpayers where the weekly childcare exceeds £175 (one child) or £300 (two or more children).

Article by Dean Wootten

Lecture P478 (12.47 Minutes)

Capital Gains Tax

Transactions in securities

The recent case of Trevor G Lloyd v HMRC SpC 672 is in many ways a classic s 703, ICTA 1988 case of a transaction in securities. It is well known that s 703, ICTA 1988 (now ss 682 onwards, Income Tax Act 2007) is designed to counteract tax advantages from a transaction in securities, the essence being to bring into charge to income tax a receipt which the taxpayer has arranged to be chargeable to capital gains tax (or not chargeable at all). Section 703 is one of the oldest and most celebrated of the anti-avoidance provisions and it comes with a commercial defence – that the transaction was carried out for bona fide commercial reasons and none of them had as their main object, or one of their main objects, to enable tax advantages to be obtained.

In this case, Mr Lloyd sold some shares in a company to another company for cash and sought to pay capital gains tax on the proceeds, after deducting taper relief and retirement relief. There was no doubt that the transaction was a transaction in securities and that there was a tax advantage (ie the amount received was not brought into charge to tax as income) and the only question was whether the bona fide commercial defence could be satisfied. Mr Lloyd put forward various commercial reasons for the transaction but HMRC was able to show that however commercial those objectives were, they were not advanced in any way by this transaction.

The Special Commissioner agreed. End of case, one might think. However, the Special Commissioner had some interesting comments to make. In particular, he said that although the transaction may have been unnecessary the appellant could still believe that it was, or the directors could regard it as, a step in achieving another commercial purpose. Accordingly, he found that the transaction was carried out for bona fide commercial reasons.

This sounds extremely promising because as long as the taxpayer thinks that he is achieving some commercial purpose, that will be enough to get him within the defence. It makes taking professional advice rather difficult because the adviser, perhaps more experienced in this sort of thing, could have put him right – and that knowledge would have ruined his defence.

Unfortunately we cannot get carried away here, because the defence has two limbs: it is not enough for the transaction to be undertaken for bona fide commercial reasons, the obtaining of a tax advantage must not have been one of its objectives. The taxpayer did understand that this transaction enabled him to claim capital gains tax retirement relief. This was clearly a tax advantage and the Special Commissioner decided that it could not be said to be an effect rather than object of the transaction. A nice try, and it so nearly came off.

Peter Vaines of Squire, Sanders & Dempsey writing in Taxline May 2008

Blackburn and another v Revenue and Customs Comrs [2008]

The High Court allowed the taxpayer's appeal against the Special Commissioner's decision ([2007] STC (SCD) 519) that B (the first appellant) was denied enterprise investment scheme relief in respect of shares issued to him by his company (the second appellant) between 1998 and 2000, having received value from the company contrary to TCGA 1992 Sch 5B para 13.

The Special Commissioner considered (a) that although there had been a generalised intention on B's part that money put into the company would be in respect of shares, it was impossible to accept that whenever money was paid B had been informally applying for shares, and (b) that where there had been a delay in writing up the share register after B had put money into the company without a contract, there had been a return of value to him in that his 'technical' debt had been repaid.

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Peter Smith J accept the appellants' analysis, namely that the Special Commissioner ought to have concluded that any monies received by the company had been on account of capital and not loan, given the 'generalised intention' that the Special Commissioner had found. The company could never have become under an obligation to repay the monies but rather would have become under an obligation to issue shares pursuant to the receipt of that money to capital account.

Entrepreneurs' relief and artificial partnerships

Suppose that Mr A buys a factory and sets up a business manufacturing widgets. Some years later Mega Corporation buys the business but does not want the property. Mr A puts the property on the market and finds a buyer three months later.

The sale of the business qualifies for entrepreneurs' relief but the sale of the property does not. This is because new section 169I(3) requires the business to have been owned by Mr A throughout the year ending with the date of disposal of the property and he does not own the business at that date. Suppose Mrs A does a bit of work for the business and Mr A is advised to transfer the business to an LLP owned 99% by himself and 1% by Mrs A and that he does this at least 12 months before he sells the business. Mr A now qualifies for entrepreneurs' relief on his 99% interest as section 169K(4) requires the asset to have been used for the purpose of the business for 12 months prior to the cessation of the partnership business. I do not understand politics but as a layman I would regard it as surprising, if not daft, that a Labour government should force people into adopting tax avoidance devices to obtain a relief to which logically they ought to be entitled.

Jane Kennedy explained to the Finance Bill Committee that –

- "The hon. Member for Runnymede and Weybridge asked why there were differences for sole traders and partnerships. Tax, including the possible availability of Entrepreneurs' relief, will be just one factor that people might want to take into account when deciding the business structure that is right for them. I acknowledge that the tax regime does influence decision making, but it is not the only factor."
- "All the amendments are unnecessary. In constructing schedule 3, we have deliberately focused Entrepreneurs' relief on individuals disposing of all or part of their business. It is the people who have built up a successful business whom we want to reward."
- "The relief is designed to promote and reward substantial investment and involvement in a business."
- "It is not our intention to encourage the creation of artificial partnerships."

In Mr A's case the LLP is dictated solely by tax reasons so such reasons clearly influence his decision making. He has built up a successful business yet the government does not want to reward him by giving him the 10% rate on the disposal of his property unless he resorts to an artificial structure. He made a substantial investment and involvement in his business, yet is not being rewarded to the extent of the increase in value of the property unless he enters into a tax avoidance scheme when he will get the reward. Forming the LLP with Mrs A seems to me to be "the creation of [an] artificial partnership". Whilst it may not be the government's intention to encourage this, the creation of a situation which forces Mr A to resort to such artificiality to obtain his relief is surely the only sensible thing for him to do.

Accordingly none of the above quotations makes any sense to me in the context of the proposed legislation.

Robert Maas, Blackstone Franks writing in AccountingWeb 20 May 2008

Inheritance Tax and Trusts

Investment land

In 1983, a widow inherited some farmland on the death of her husband. She let the land under conacre and agistment agreements to local farmers. She died in 1999, although due to ill health, she had left the farm in 1992, when her son-in-law took over.

The deceased's personal representatives claimed that the farmland was 'relevant business property' within the meaning of IHTA 1984, s 105(1). HMRC disallowed the claim. The representatives appealed.

The Special Commissioner found that the activity of tending the land undertaken by the brother-in-law was a business under s 105(1). The fact that he had to spend some 100 hours a year seriously tending the land tipped the balance in the appellants' favour. However, when determining whether the business was one of holding investments for the purposes of s 105(3), the Commissioner said that the income from it arose mainly from making the land available to others for payment, without the separate provision of any substantial other goods or services. The business was therefore one of holding investments and business property relief did not apply.

The taxpayers' appeal was dismissed.

McCall and others (personal representatives of McClean, deceased) ***(SpC 678)***

Tax-efficient will planning – the options for 2008

In recent years, the opportunities for lifetime IHT planning have been severely restricted by the pre-owned assets legislation and this has been exacerbated by the trust changes brought in by Sch 20 FA 2006.

It is therefore all the more important to ensure that clients have fully tax-efficient wills. Fortunately, the introduction of the transferable nil rate band has made this process rather more straightforward.

There are three main options:

1. Leave everything to the surviving spouse outright so that there is no IHT to pay and, on the death of the survivor, a full additional nil rate band should be available.
2. Leave everything on a life interest trust for the surviving spouse. Because this should rank as an immediate post-death interest trust, there will be the same IHT consequences as in option (i), but the capital will be protected (eg. for the children of the deceased's previous marriage or against nursing home fees). In some cases, it may be appropriate to combine options (i) and (ii) so that part is left outright to the surviving spouse and part on a life interest trust.
3. Leave assets which are likely to appreciate by more than the 0% band (eg. property) on a nil rate band discretionary trust or, with an eye to future 10-year charges, on a number of pilot trusts (see paragraph 2 below). The rest of the deceased's assets will normally be left outright to the surviving spouse.

The position on the death of the surviving spouse (eg. the widow) is quite different. Assume that she has a nil rate band of (currently) £624,000 available and that she wishes to set up long-term trusts. If she establishes a relevant property settlement in her will with £624,000 and leaves any residue to a charity, no IHT will be payable, but, in the future, any 10-year charges on this settlement will only benefit from a single nil rate band. This will be another situation where pilot trust arrangements could be useful.

Article by Robert Jamieson

Lecture P479 (6.42Minutes)

The use of pilot trusts after FA 2006

A pilot trust is a discretionary settlement established with a nominal sum (typically £10) where the settlor intends that substantial assets will be added at a later date. It is important to remember that a trust is not constituted until the trustees have received property which is then held in accordance with its terms. Therefore, it is necessary to ensure that the stated sum is actually handed over and held by the solicitor who set up the trust.

One consequence of the FA 2006 changes is that such trusts are likely to become more widespread, given that they now have an important part to play in tax-efficient will planning.

Three significant points to note about pilot trusts are:

1. The definition of 'related settlements', which is found in S62 IHTA 1984, requires the settlor to be the same in each case and the settlements to commence on the same day. When a will establishes two or more trusts, they will normally be related settlements. This arrangement should generally be avoided since the value of the property in a related settlement affects the rate of any IHT charge on the 'other' settlement – see, for example, S66(4)(c) IHTA 1984 in connection with the calculation of the 10-year anniversary charge.
2. There is an exception to the rule in (i) above: if one of the settlements creates an immediate post-death interest in favour of the testator's surviving spouse, S80 IHTA 1984 provides that the settlement only commences for this purpose on the termination of that spouse's interest in possession. In such a situation, because a surviving spouse is treated as creating the settlement, this may be related with any other trust which the surviving spouse sets up in his or her will, but *not* with any other settlement established by the first spouse to die.
3. It is relatively straightforward to circumvent the problem of related settlements if the settlor ensures that the trusts start on different dates. This is simple to arrange in the case of lifetime settlements, but, if it is desired to set up more than one trust in a will, all the settlements will come into being on the death of the settlor and may therefore be related. This difficulty can be avoided by establishing pilot trusts during the lifetime of the testator to which he then adds property under the terms of his will. Each of the lifetime trusts will of course have a separate commencement date and the additions (because they all take place on the same day) do not give rise to 10-year anniversary complications under S67 IHTA 1984 – see S67(3)(b)(i) IHTA 1984.

Illustration 1

Craig-Harvey, a widower, has three grandchildren. He wishes to leave £900,000 equally to his grandchildren for them to take when they are 25 (all three are currently minors).

If a single trust is set up in Craig-Harvey's will, it will suffer exit and 10-year anniversary charges going forward. A similar result will occur if three separate trusts (one for each grandchild) are set up in the will as a consequence of the related settlement rules.

However, contrast the position if:

- during his lifetime, Craig-Harvey establishes three pilot trusts on different days for each of the grandchildren; and
- in his will, Craig-Harvey then adds £299,990 to each of the trusts.

The IHT position is that none of the three settlements is related and each will benefit from a full nil rate band. In effect, Craig-Harvey has set up three nil rate band discretionary trusts. This is because the 10-year anniversary charge is calculated by taking into account previous chargeable transfers of the settlor in seven years before he set up the trust but ignoring transfers made on the same day – see S66(5)(a) IHTA 1984. It is assumed that there were no such transfers when the first pilot trust was established. When the second pilot trust came into being (usually on the following day), the £10 put into the first pilot trust falls to be considered, but, given the amount settled, this will doubtless have been exempt under S19 IHTA 1984 and so on. There is a comparable routine for exit charges – see, for example, S68 IHTA 1984.

This means that exit charges from each of the trusts will be tax-free for the next 10 years.

Alternatively, in Illustration 1, the settlor could create six trusts, each with an initial value of £150,000 (in order to try and keep within the tax-free bracket any capital growth which rose faster than the value of the nil rate band). One argument against such as arrangement is that the costs of administering this number of trusts could start to outweigh the tax advantages. However, if the settlor subsequently merged the six settlements so as effectively to create a single trust, the rules in S81 IHTA 1984 (property moving between settlements) will treat the trust property as though it was still comprised in the six original settlements for future tax purposes, thus giving the trustees the best of both worlds.

Article by Robert Jamieson

Lecture P480 (15.01 Minutes)

IHT business property relief clearance

It was announced in the Pre-Budget Report 2007, that the non-statutory clearances regime for businesses would be extended from April 2008. A non-statutory clearance is written confirmation of the HMRC view of the application of tax law to a specific transaction or event. Further details on the extended non-statutory clearances service that was implemented on 1 April 2008 can be found in Revenue and Customs Brief 20/08.

Revenue & Customs Brief No 25/08 was published last week explaining how the scheme is to be extended to IHT business property relief.

From 1 May 2008, for a trial period of six months, clearances will be provided to business owners on the availability of inheritance tax business property relief where there is material uncertainty over the interpretation of the law. For inheritance tax legislation older than the last four Finance Acts, there is a further requirement that the uncertainty relates to a commercially significant issue.

HMRC aims to respond to clearance applications within 28 calendar days, though in complex cases this may take longer.

ICAEW Tax Faculty website, 6 May 2008

Administration

Too late

Angus Monro, then chief executive of Matalan, exercised an option to acquire 1.35 million shares in the company at a zero price. Their market value was £3.12 million. He sold 900,000 shares for £7.38 million in May 1999. He declared a £5.27 million gain in his 1999-2000 tax return and paid £2.1 million tax thereon. The gain was computed according to prevailing practice.

In 2003, the Court of Appeal in *Mansworth v Jelley* [2003] STC 53, ruled that that method of computation was wrong in law. The taxpayer had therefore overpaid tax of £846,000.

His accountant sought to amend Mr Monro's tax return and claimed repayment under TMA 1970, s 33(1) (error or mistake). HMRC refused to accept the amended return or the claim, saying that the gain had been computed on practice prevailing at the time (s 33(2A)) and that the year was closed.

The taxpayer brought an action claiming that he a claim in restitution, regardless of prevailing practice. The action failed in the High Court, so the taxpayer appealed.

The question before the Court of Appeal was whether a common law claim for recovery of money paid under a mistake of law could be brought notwithstanding the effect of s 33. HMRC said it would be inconsistent with the statutory scheme under s 33 to permit such a claim. The taxpayer also claimed that his human right to the peaceful enjoyment of property was violated.

The Court of Appeal said that TMA 1970, s 33(2A) was to protect public finances. If repayment claims were not controlled, there was the risk that a huge amount of tax would be repayable as a result of case law, possibly years after it had been spent. Section 33 was more restrictive than common law provisions and to recognise a common law remedy in the circumstances covered by s 33(1) would be inconsistent with that provision. The taxpayer's claim could not therefore be brought.

With respect to the human rights issue, there was no violation of article 1 of the First Protocol. Tax authorities needed to have a wide discretion to determine tax policies in relation to repayment claims.

The taxpayer's appeal was dismissed.

Monro v CRC, Court of Appeal, 9 April 2008

Smith v Revenue and Customs Commissioners SpC 680

The appellant was the chairman and chief executive of the company for ten years between 1991 and 2001. In 1996 the inspector of taxes opened an enquiry into the company accounts from 1991 to 1995 and as part of that enquiry he requested production of the appellant's private bank, building society and credit card statements for the same period.

The information disclosed revealed substantial monetary deposits into the appellant's personal bank account in each tax year recorded as unknown cash or cheques. No further information was supplied.

In July 1999 the inspector applied for orders under TMA 1970 s 20(1) and (3) to obtain all the company's records for the period ended 31 December 1992 and the appellant's remaining private bank and credit card statements. In August 1999 the appellant's accountants informed the inspector that the company's records for the year ended December 1992 had been completely destroyed by a malfunction of the company's sprinkler system whereupon the inspector extended the enquiry to cover the company's accounting periods from December 1996 to December 1998 and made formal requests of the appellant and his accountants for documents covering the new period, which were not provided voluntarily.

In June 2000 the inspector successfully obtained orders under TMA 1970 s 20(1) and (3) requiring the company and the appellant to produce company records for the three years ended 31 December 1998 and personal bank statements from 6 April 1996 to 31 December 1998. In July 2000 the company provided 50 boxes of its records but they did not include the nominal ledgers, stock

sheets, petty cash books and records of factory shop sales; nor did they produce the company's credit card statements for the two years ended 31 December 1997.

However, from his examination of the appellant's business affairs the inspector found that the appellant had failed to account for income tax on two specific sources of income—(i) expenditure totalling £54,251 incurred on the company's credit card in the period 30 December 1997 to 20 December 1998. The inspector concluded that at least £47,500 was spent by the appellant on his own personal needs, and he assessed the value of the purchases under Sch E as employee benefits.

The inspector also assumed that the appellant had used the company credit card for items of personal expenditure in previous years and he invoked the principle of continuity and assessed the appellant for the same employee benefits for the previous three tax years; and (ii) the appellant's bank account for the period 6 April 1991 to 31 December 1998 revealed unexplained monetary deposits of £410,000 which was either cash from the company or undeclared income from an undisclosed taxable source.

An earlier enquiry into a separate company owned by the appellant had revealed similar unexplained monetary deposits in the appellant's bank accounts and in that enquiry the appellant had accepted that the deposits represented receipts by way of trade arising from the sale of wines. The inspector broke down the deposits and allocated them to the particular tax year in which they arose.

On 10 January 2002 the inspector issued assessments against the appellant in respect of the tax years 1992–93–1996–97 and 1998–99 under the discovery provisions of TMA 1970 s 29 on the basis that the appellant did not pay tax on the income derived from the unexplained monetary deposits and his personal expenditure on the company's credit card; and that the loss of tax was attributable to his negligent conduct in that he failed to make personal return of the profits on the unexplained deposits and declare the benefits of the credit card payments.

As the assessments for 1992–93 to 1994–95 were outside the normal six year time limit and the inspector contended that the 20-year time limit under TMA 1970 s 36(1) applied on the ground that the appellant was negligent in failing to make a return of the benefits in kind and of the profits arising from the unexplained deposits, and in consequence of his failure the Crown suffered a loss of tax. The inspector also issued a jeopardy assessment in respect of the tax year 1997–98 under TMA 1970 s 9C. On 8 January 2008 a closure notice under TMA 1970 s 28 for 1997–98 was issued. The appellant appealed but he did not attend the hearing.

The Special Commissioner found that on the facts the inspector was correct to assess the appellant for income tax on both sources of income. In relation to the unexplained deposits totalling £410,000, the information was derived direct from the appellant and his accountants and the appellant had supplied no information concerning the origins of that money, or any evidence to undermine the Revenue's conclusions and the appellant had accepted on a previous enquiry that unexplained monetary deposits represented receipts from a trade. In addition, the credit card transactions to the value of £47,500 constituted taxable benefits of the appellant in the year ended 31 December 1998. The appellant had not declared the expenditure as taxable income or given a satisfactory explanation for the transactions recorded on the company credit card; and there was no evidence that he had repaid the sums to the company or that the sums were credited to a director's loan account. The company, which was controlled by him, failed to produce credit card statements for the years preceding 1998. The inspector was entitled to assume that the appellant had used the company's credit card for items of personal expenditure in previous years and thereby raise the estimated assessments of the tax due on that expenditure. Furthermore, the inspector had exercised his powers reasonably.

The Special Commissioner also found that the conditions of TMA 1970 s 29(1)(a) and (4) were met when the inspector issued the assessments in January 2002. The appellant had not made a substantive challenge to the making of discovery assessments. In addition, he had given no satisfactory explanation for his failure to make returns and the Revenue had accordingly discharged their burden under TMA 1970 s 36.

The Special Commissioner considered that under TMA 1970 s 9C a jeopardy assessment could only be made if an enquiry into the taxpayer's self-assessment return was in progress under TMA 1970 s 9(1)(A). On the facts the conditions for a jeopardy assessment were not met for the tax year 1997–98 as there was no evidence that an enquiry had been started—the enquiries into the appellant's tax returns arose from a formal enquiry into the company's tax affairs. No explanation

was given as to why a jeopardy assessment had been resorted to for 1997–98 rather than a discovery assessment as with the other tax years. However, the fact that the conditions had not been met did not as a matter of course render the assessment for 1997–98 invalid. An assessment was not invalidated simply because it had been made under the wrong statutory provision of TMA 1970. On the facts the appellant had not been misled by the assessment and the amount assessed under the jeopardy assessment was effectively the same amount as recorded in the assessment schedule. Accordingly the assessment was valid despite it being made incorrectly under TMA 1970 s 9C. It followed that the appeal would be dismissed and the assessments upheld.

P35 warning for service companies

HMRC has been criticised for creating confusion with this year's Employers' Annual Return for PAYE, which a major tax services provider claims has been amended to 'target' service companies.

Abbey Tax Protection believes the intention of the P35 form’s first part of guidance question six – ‘Are you a service company’ – has been designed to split employers into two distinct categories: those who employ only the main shareholder or shareholders, and those whose income is earned by its workforce but do not control the company.

The company went on to state the belief that HMRC is ‘keen to target’ people in included in the first category: freelancers and contractors who have the ability to save tax and National Insurance by paying themselves a small salary and large dividends.

‘Despite HMRC’s contentions that they were not going to use the answers to question six to risk-profile individual employers,’ said Abbey Tax, ‘this can be the only sensible reason for having the question in the first place’.

‘HMRC has said that those businesses who have answered the form incorrectly need not amend it but we can be fairly confident that this concession will not apply in the future.’

The tax services provider then voiced its conviction that the Revenue will use the information in gleans via Q6 to start enquiries into service companies.

‘We would not be surprised to find [HMRC] selecting those companies where the shareholders are paying themselves the basic minimum salary, to avoid any tax or NIC, and taking the rest as dividends.’

Abbey Tax consultancy manager Paul Mason said: ‘HMRC have been forced into correcting misleading guidance in its PAYE P35 information to employers.

‘For many employers it’s simply too late: they’ve been confused into providing unnecessary information that HMRC will undoubtedly use to target individuals, particularly in the service industry, for risk-profiling and tax investigations.’

Last month, the Revenue responded to concerns about Q6, admitting that it had caused considerable confusion and apologising for the matter.

Moran v Revenue and Customs Commissioners SpC 681

The appellant, who was a builder, was employed by three companies of which he was a director or a company secretary.

His self-assessment returns for the years ended 5 April 1997, 1998 and 1999 showed employment income from each of the three companies and tax deductions from those earnings. However, no PAYE tax in respect of deductions from the appellant's employment income was sent to the Revenue by any of the three companies between 6 April 1996 and 5 April 1999.

The Revenue considered that each employer had wilfully failed to deduct the tax under PAYE and issued directions under the Income Tax (Employments) Regulations 1993, SI 1993/744, reg 42(3) (now replaced by the Income Tax (Pay As You Earn) Regulations 2003, SI 2003/2682), directing that the unpaid tax be recovered from the appellant, on the basis that he had received employment income knowing that his employers had wilfully failed to deduct tax according to the 1993 Regulations. Thereafter, in order to give effect to the reg 42(3) directions the inspector of taxes issued discovery assessments under TMA 1970 s 29 in the sums of £6,501, £6,509 and £32,800 for

the years ending 5 April 1997, 1998 and 1999 on the ground that the appellant's assessment to tax had become insufficient as a result of the reg 42(3) directions which withdrew the credit for tax deducted declared in his self-assessment returns and that she could not reasonably be expected to believe on the information available to her at the time the enquiry window closed under TMA 1970 s 9A that the appellant's assessment to tax for the years in question would be sufficient.

The appellant appealed against the discovery tax assessments on the basis that he should be given credit for the tax he suffered from his employment with the three companies. He supplied payslips from one of the companies purporting to show deduction of tax by PAYE for the period from 1 April 1997 to 31 March 1998 but he did not supply the documentary evidence, including company payroll records and personal bank statements, requested by the inspector. The appellant did not attend the hearing.

The Special Commissioner found as a fact that no PAYE in respect of deductions from the appellant's employment income had been sent to the Revenue by any of the three companies. In the light of that finding the onus was on the appellant to demonstrate on the balance of probabilities that the said amounts of income tax as declared in his self-assessment returns were deducted from his earnings. However, the appellant had chosen not to attend the hearing or comply with the request for payroll records and personal bank statements. No weight would be placed on the payslips from one of the companies as that information on its own did not demonstrate that tax had been deducted from his earnings. Accordingly the appellant had failed to show on the balance of probabilities that he should be given credit for the tax he alleged was deducted from his employment earnings with the three companies for the years in question. The Revenue had satisfied the requirements of TMA 1970 s 29 and the appeal would be dismissed and the assessments confirmed.

Appeal dismissed.

Lack of evidence

HMRC opened an enquiry into the appellant’s self-assessment tax return for the year 2003-04. The appellant was a self-employed builder and had deducted various costs in reaching his profit. He did not provide any business books requested by HMRC, and did not comply with the TMA 1970, s 19A notice. A £50 penalty was imposed.

HMRC amended his tax return to disallow certain expenses. The appellant did not provide any other information, although he did try, unsuccessfully, to obtain business papers from his previous accountant. He appealed saying that it was for HMRC to prove that their amendments and his accounts were correct.

The Special Commissioner said that no evidence had been submitted from which he could tell if the appellant had been overcharged by the amended assessment.

The taxpayer’s appeal was dismissed.

Walsh (SpC 676)

Countdown to two tier tribunal system launched

A radical shake-up of the tribunals system was recently unveiled by the Government.

Individual tribunal jurisdictions doing similar work will be brought together into a radically simplified two tier tribunals system – consisting of a First Tier and Upper Tribunal that goes live on 3 November 2008.

This new system, headed by Lord Justice Carnwarth as Senior President, will speed up justice, make the process easier for the public to understand and bring together the considerable expertise that exists in each tribunal jurisdiction.

Justice Minister Bridget Prentice said—

“Bringing individual tribunals into a single integrated system is at the heart of the most radical change to the tribunal system in 50 years.

“This truly modern and unified service will help people to find their way around the system and get solutions to their issues more quickly and efficiently.

“Tribunals often form the public's only experience of the legal process and it vital that experience is effective and serves their needs. These reforms will not come at the expense of continuity, specialisation or service to users.”

Following a consultation on implementing the Tribunals Courts and Enforcement (TCE) Act proposals to create five First Tier Tribunal Chambers and three Upper Tribunal Chambers will be taken forward. Two Chambers from the First Tier, the Social Entitlement Chamber and the Health Education & Social Care Chamber will commence on 3 November 2008.

The Employment Tribunal and the Employment Appeal Tribunal will be separate from the First Tier and Upper Tribunal, although there will be close links between them. The Government is currently considering bringing the Asylum and Immigration Tribunal into the unified tribunals structure and is likely to consult on this shortly.

The Upper Tribunal will be a Superior Court of Record that can deal with onward appeals and judicial reviews.

The Tribunals Service, an executive agency within the Ministry of Justice will continue to provide an integrated administration of the new tribunal system. Implementing the TCE Act is an integral part of the Tribunals Service's Transforming Tribunals Programme, which includes the introduction, later this year, of multi-jurisdictional hearing centres in major towns and cities created to provide a range of services to tribunal users.

Uyar and others v Revenue and Customs Comrs SpC 667

The Special Commissioner, J Gordon Reid QC, confirmed notices issued under TMA 1970 s 19A (power to call for documents for purposes of certain enquiries) except in relation to two specific requirements set out in the notices.

The appellants were (i) two business partners and (ii) the partnership itself. The partners appealed under TMA 1970 s 19A(6) contending that the information had already been supplied and that the balance of the information including rental agreements and bank statements was not 'reasonably necessary' in examining their tax returns. The partnership appealed on the ground that the information not supplied was 'not reasonably required' by HMRC.

The Special Commissioner considered that the issue was whether HMRC was entitled to issue the notices in the terms in which they were framed. If HMRC already had possession of a document called for in a notice, that simply meant the taxpayer need do nothing in response. What was important was the precise wording of the notices and the statutory criteria validating their issue. The notices had been served for the purposes of HMRC's enquiry into the returns and it followed that the fact that some information had already been supplied was irrelevant.

Turning to the precise wording of the notices, the Special Commissioner considered that the requirements set out by HMRC were reasonable except that the specific parts of the notices calling for (i) details of 'who maintained the business records', and (ii) in relation to unvouched expenditure, 'evidence … available to support the expenditure claimed', would be set aside and the words deleted. Save to that extent, the Special Commissioner confirmed the notices and dismissed the appeals.

Business Tax

Write-off of small plant or machinery pools

During the consultation process on the concept of the £50,000 annual investment allowance (AIA), a number of respondents suggested that small balances in the main plant or machinery pool should be able to be written off in full. This idea was seen as a simplification measure, given that, following the introduction of the AIA, small historic pools of expenditure were unlikely to grow and that there would be a significant administrative saving if small businesses, in particular, were no longer required to track and write off this expenditure over a number of years.

It has now been decided that, with effect from 1 (or 6) April 2008, businesses should be able to claim a WDA of up to £1,000 where the unrelieved expenditure in their plant or machinery pool is £1,000 or less (S56A CAA 2001 as inserted by Cl 78(3) FB 2008).

Note that the small pool limit of £1,000 is proportionately increased or reduced if the chargeable period is more or less than 12 months in length.

A taxpayer is not forced to take the whole of his entitlement in a chargeable period, if he does not wish to do so. Any remaining balance can always be written off in a later year.

This provision applies to general plant or machinery pools and also to the new 10% special rate pool. However, it will not have effect for expenditure in single asset pools (presumably because they already have rules which can bring them to an end at a specified time, e.g. when the motor car is sold).

Article by Robert Jamieson
Lecture B476 (6.12 Minutes)

Trading stock and Sharkey v Wernher (1955)

With effect from 12 March 2008, businesses which appropriate trading stock for a different purpose (e.g. for private use) will be treated as if they had sold the stock at full market value and the business will therefore be taxed on any resulting profit, notwithstanding the accounting treatment (Cl 34 and Sch 15 FB 2008).

Following long-established case law (*Sharkey v Wernher (1955)*), HMRC have persisted in the view that, regardless of what money may or may not change hands or what value is put on the transaction in an accounting context, the appropriation of trading stock for private or other purposes should be taxed as a market value sale.

However, to date, this has not been made explicit in statute. Indeed, alternative case law has supported a contrary view – see, for example, *Mason v Innes (1967)*. Such was the uncertainty that the recent Tax Law Rewrite in ITTOIA 2005 could not fully expose the point within the parameters of the original legislation.

S42 FA 1998 also complicated the matter by stating that businesses are taxable on their profits computed according to 'generally accepted accounting practice, subject to any adjustment required or authorised by law'. If HMRC's practice in this area is not explicit in law, there is an argument in the taxpayer's favour that FA 1998 overrides the case law position so that any taxable trading profits should be based on accounting profits rather than market value – under generally accepted accounting practice, such transactions should be credited to the accounts either at the cost price of the stock or at the price actually paid on the disposal.

This recent announcement puts the matter beyond debate for appropriations of stock on or after 12 March 2008. The appropriation of stock for a non-trading purpose is a taxable event and market value must be used for the calculation of the trader's taxable profits.

Article by Robert Jamieson

Lecture B477 (7.47 Minutes)

Is there a better way?

When it was announced in the Budget 2008 that the controversial income shifting rules were not to be implemented with effect from 6 April 2008, a collective sigh of relief could be heard across the tax profession.

Any provisions of this nature would, in my view, have been almost impossible to implement and administratively burdensome.

However, the Budget announcement did not say that income shifting was being consigned to the tax dustbin of history. Instead it said that the proposals were being 'deferred' until next April.

Clearly the word 'deferred' can sometimes mean ideas never actually get back on the political agenda and become one of those items where the related paperwork is quietly left to gather dust.

However, as we have seen in recent months, with the residence and domicile changes, long drawn-out consultations can lurch alarmingly back into fashion.

This means that now is exactly the time when it is necessary to start debating the issues that led to the income shifting rules ever being proposed in the first place and, it is to be hoped, lead to a more sensible way forward.

The workshop

To this end, the Tax Faculty of the ICAEW hosted a small business taxation workshop on 21 April. The concept was to move away from the recent debates around family owned companies, husband and wife businesses and the fall-out from the *Jones v Garnett* case.

Instead this workshop looked to broaden the debate. The underlying problems that have led to such knee-jerk legislation as IR35, the non-corporate distribution rate and the income shifting proposals, all stem from the way small businesses are taxed.

The proposition was how could small business taxation be reviewed to seek better solutions that are proportionate and still encourage enterprise.

A range of individuals attended the workshop, some well known and some not, but all of whom could bring their knowledge and experience to bear on the issue.

They were from firms large and small; some were there on behalf of the main tax representative bodies and others worked for HMRC or the Treasury. No one was there to be quoted or to do anything other than debate some of the issues, explore possibilities and share views.

The hard work of organising the workshop and devising the questions was undertaken by Anita Monteith of the Tax Faculty and, on the day, the event was co-chaired by myself (as chairman of the Tax Faculty's technical committee) and Peter Rayney, who chairs the Tax Faculty's SME committee and is a partner at BDO.

Not easy!

So what were the conclusions of this group of people? It will be no surprise to hear that the answer was 'it's just not very easy'!

This is a long-term, difficult area where the ever lurking law of unintended consequences can mean taxpayer behaviour can alter almost overnight if we get the rules wrong. It is only by looking at the big picture issues that we have a chance of reaching a better tax system.

It is also vital that anyone involved in devising policy has an opportunity to hear the range of views before making any decisions. A summary of the discussion follows.

However, a wide range of views were expressed and by necessity only a fraction of the comments can be captured here. On almost all areas there were dissenting voices, which is a clear marker to any Government that this is an issue that can only progress with detailed consultation and listening.

Does size matter?

A key issue is whether the UK should tax businesses the same regardless of their size. Should we have a common starting point and then provide reliefs and variations to accommodate different factors?

Or should we have a different regime for the large and the small enterprise? The consensus was that there was a natural dividing line between owner managed businesses and larger concerns.

There was also much discussion about what was a ‘small’ business and the distinction between the very small or ‘micro’ business of, say, less than ten employees and other enterprises that certainly were not large but perhaps needed slightly less support than the very smallest of businesses.

The majority thought that the smallest enterprise needed most support and encouragement, but with an understanding that not all businesses want to grow. There was strong support for a distinct small business tax regime.

Structural cracks

So what kind of structure or structures should the UK tax system encourage? For smaller businesses often there is little understanding of the corporate boundaries. In other jurisdictions, e.g. the United States, a business owner can opt to be taxed using the personal rather than corporate route. The problem for the UK would be the difficulties of any such transition.

Another option would be to tax all companies as unincorporated until they reached a certain level of profits, with an opt in to a corporate regime for anyone who chose it.

Regulatory burdens

One of the most often quoted phrases about small businesses is that they face a disproportionate burden of regulation. The discussion point was: is this really true and, if so, can changes to taxation help? Pretty much everyone agreed that small businesses are weighed down with regulation.

Taking on one extra employee can be a huge cliff-edge cost issue, but also the small business has to cope with health and safety rules, employment law, pensions and many other regulatory issues that it is not well equipped to handle, due to its limited resources and manpower.

In fact, several people argued that the burdens of administering tax are nothing like as onerous as the hardships caused by other regulatory issues, such as employment law.

Many attendees mentioned that small businesses struggle to cope with endless change and, because tax is altered so regularly, it does cause particular problems.

However, several people thought there was a need for some radical overhaul that would lead to a much smaller array of taxes and a clearer policy for the ones which remain, e.g. by using purposive legislation.

What should the Government tax?

The issue here was whether the Government should tax the generation of profit or the extraction of profit. There was some support for a starting point of tax based purely on the profits generated, with all companies being taxed at the same rate, i.e. not having a small companies rate.

However, it would be a bitter pill for them to bear, if this meant a significant rise in the tax charge on small companies.

It was believed that if such a course was followed, it would be necessary to give incentives for investment. However, there were difficulties around how you define ‘profit’, e.g. the purchase of plant leads to reduced profit, but is that the right starting point?

Some argued for compulsory VAT registration for all businesses and not to have this based on a minimum level of turnover. Others argued for neutrality between employed and the self employed in order to remove status enquiries.

Tax the family or the individual?

Tax credits have taken us to a system that recognises a ‘family unit’ upon which to base a tax credit award. Taxing a family would remove the types of issues that have been raised in the income shifting debate.

However, the majority thought that independent taxation was a core part of our UK tax system and any efforts to erode it would be problematic and offend against taxpayers' rights to keep most aspects of their domestic life private.

Why should an employer, for example, have to ask for intimate details of someone's personal life to determine his tax position? While there was support for attempts to incentivise long-term relationships which would encourage stable families, there was less certainty about how exactly to define the 'family' that tax should support.

One clear traditional family structure no longer exists; many family units now include older dependent relatives as well as young children. Why should one type of unit be encouraged over others?

There were several suggestions that the existing tax credit systems should be abolished and personal allowances increased instead. Taxing the individual was considered by most to be the only sensible way forward.

Investment and earned income

Should the rate of tax on investment and earned income be the same? Several argued that they should, and that differences just led to further complications. Those with longer memories remembered the investment income surcharge of the 1980s.

The elephant in the room

With no National Insurance on dividends, there remains a strong incentive for certain structures to be favoured by business. Time and time again the discussion came back to the difficulties imposed by having an official view that National Insurance is different from a tax and that it works under a different set of rules.

Although politically awkward, the need to address the National Insurance conundrum is key in finding a solution for small business taxation. Many people argued that it was time for a Government to be brave and take on the issue of the contributory principle.

What next?

The workshop did not expect to solve small business taxation issues in one step. However, what it did highlight was the range of ideas and thoughts that need to be considered before any changes are made and that there is a constructive debate to be had.

The Tax Faculty will be issuing its own discussion paper shortly on the matters that it believes need to be debated to revitalise the continuing review of small business taxation.

From an article by Francesca Lagerberg writing in Taxation

Corporation Tax

Update for CT600

With regard to accounting periods ending after 31 March 2008, HMRC say that announcements in the 2008 Budget mean that the company tax return form (CT600) needs updating.

The CT600 Budget Insert (April 2008) gives advice and lists the main changes including those that affect the return form.

The changes to the rates of corporation tax on profits affect the tax calculations of most companies as the main and small companies' rates and marginal small companies' relief fraction used from 1 April 2008 have all changed.

HMRC have planned for Corporation Tax Online services to handle returns using the new rates from 1 June 2008.

Companies affected by these rate changes are advised by HMRC not to use Corporation Tax Online services before then.

If a company needs to deliver a return before then for a period that ends after 31 March 2008 and that return includes calculations based on the new rates, it can still deliver a paper return direct to its HMRC office provided it follows the advice given in the CT600 Budget Insert April 2008.

There are also changes to capital allowances for expenditure after 31 March 2008, including a new annual investment allowance and the introduction of a first-year tax credit.

Claims cannot be made until after the Finance Bill has received Royal Assent and HMRC have planned for both Corporation Tax Online services and paper returns to handle these new capital allowances from October 2008.

Double taxation—profits/losses of permanent establishment

In *Lidl Belgium GmbH & Co KG v Finanzamt Heilbronn (Case C-414/06)*, the claimant, a limited partnership established in Germany, sought to deduct from the amount of its tax base a loss incurred by its permanent establishment in Luxembourg. The deduction was disallowed on grounds that, under the relevant tax convention, profits and losses of the permanent establishment would be subject to tax in Luxembourg. The ECJ was asked to rule whether this was compatible with Article 43 of the EC Treaty (freedom of establishment).

The ECJ ruled that article 43 EC did not preclude a situation in which a company established in a member state could not deduct from its tax base losses relating to a permanent establishment belonging to it and situated in another member state.

Time To Go?

The recent high-profile cases of Shire Pharmaceuticals and UBM Media Group relocating their holding companies from the UK to Ireland have generated a wave of interest. In this article we consider the current state of the UK review of the taxation of foreign profits and set out some of the key issues that multinationals should consider in deciding whether to remain in the UK.

The review of foreign profits

The formal review started with an announcement in Budget 2007, although informal discussions had been taking place for some months before that date. There was general agreement that the current system is too complex and was not helping the UK in its goal of being a competitive place to do business. The controlled foreign companies (CFC) system, introduced in 1984, was not operating effectively from the perspective of HMRC or business and was under increasing

pressure from decisions in Europe — particularly *Cadbury Schweppes* C-196/04, which held that within Europe, CFC rules should only apply to artificial structures.

On 21 June 2007 a 'discussion document' was issued. It was notable that this was not labelled a 'consultation document' — its aim was to outline broad principles for discussion, paving the way for more detailed proposals at a later date. Whilst this was a laudable aim, it has had two main consequences. The first is that there was, perhaps inevitably, a lack of clarity in the initial proposals, which led to widespread concern that the result would be a significant increase in complexity and a fall in UK competitiveness. The second is that the process has dragged on: the initial target implementation date of April 2009 is still achievable but the risk of its being postponed is increasing. Almost a year after the discussion document, we still do not have the consultation document, which has now been promised 'before the summer' (Budget 2008) — which probably means just before Parliament rises on 22 July.

Behind the scenes Treasury and HMRC officials have held a series of meetings with business and professional bodies and appear genuinely to be striving to craft legislation that will be acceptable to all parties. But there is little information in the public domain and uncertainty over the proposals and their implementation date is damaging business confidence. Press speculation about which businesses may be next to leave the UK is hardly helpful to the process.

Compliance burdens

The reasons given by UBM for its decision to relocate its holding company are interesting:

'… the UK tax system imposes tax on all companies in a worldwide group, and consequently UBM has had to manage the interaction between the UK tax system and the tax systems of the multiple countries in which UBM operates. This has given rise to both significant compliance costs and risks of inadvertent tax charges arising.'

In other words, this is not so much about how much tax the UK charges on foreign profits but how much effort a UK multinational has to go through in order to prove that no tax is due. If the UK wants to improve its competitiveness, there are real issues about perceived burdens on business and the attitude of HMRC. Significant efforts have been made since the large business (Varney) review but there is still a need to tell a simple and convincing story, particularly to overseas investors looking for a European holding company location.

Intellectual property

The key policy issue that HM Treasury needs to determine is the extent to which it 'should' tax the overseas profits of UK multinationals. It has gradually become clear that the most difficult area is probably intellectual property (IP). The Government's perception is that IP is developed (and financed) in the UK, then sold offshore at a relatively early stage in its development — when the arm's-length price is uncertain and arguably quite low — with subsequent profits falling outside the UK tax net. An IP Focus group has been formed to discuss this issue in depth, and in particular to try to draw a sensible line between 'active' and 'passive' income from IP.

As Shire has shown, if it appears that the line is going to be drawn too tightly, activity may simply leave the UK altogether.

Why go to Ireland?

Ireland is renowned globally as being one of the premier locations for establishing a headquarter or holding company.

Business and tax laws help to create a positive environment for international holding companies based in Ireland. The Government's fostering of sustainable macroeconomic policies, pro-enterprise environment, and a well-educated young labour force has combined to bring together a good place to do business. This is evident in the increase in foreign direct investment (FDI).

FDI in Ireland now exceeds !30 billion, as compared with !16 million in 1973: on a per capita basis, FDI is higher in Ireland than any other EU Member State. Trade has increased 80-fold, with consequent benefits for the number of people at work and the choice of products available to all consumers, and the Irish economy has been transformed, with over 128,000 people employed in over 1,000 foreign-owned companies based in Ireland. Ireland has dramatically changed in the last 25 years from low-end manufacturing to high-end headquarter location.

Such 'soft' points as geographical location, English-speaking, common law, pro-business environment, excellent transport links (for example, 22 direct flights a day to London Heathrow), excellent schools and universities (Trinity College, for example, is world renowned), along with a good quality of lifestyle contribute to make it an attractive location for executives looking at overseas assignments. The small point that Ireland has some of the best golf courses in the world doesn't go unnoticed either!

Ireland's favourable tax regime

The combination of Ireland's tax polices creates a very good overall fit for many businesses in the structuring of their global operations.

The 12.5% rate of corporation tax is here to stay, doesn't require a tax holiday, rulings or approval by Government. It is a very straightforward and easy to communicate rate of corporation taxation.

There is no CFC, thin capitalisation or transfer pricing legislation in place and there are no indications of any being introduced in the future.

Dividends are taxed at either 12.5% or 25%, with full underlying credit relief, depending on whether the dividend is earned from trading or passive income. With the combination of onshore pooling there is generally no expected additional tax in Ireland. It is expected that full exemption will be introduced in time. There is no dividend withholding tax to EU or tax treaty countries, including dividends paid to companies controlled by these countries. Ireland also has a wide treaty network, including excellent treaties with the key growth jurisdictions of China and India. The Chinese treaty is particularly favourable, due to the very low rate of withholding tax on dividends from China of 5% and also the additional flexibility of offering 5% withholding tax on disposals at China level.

The holding company regime also includes a full exemption on gains on the disposal of subsidiaries, subject to a minimum twelve-month holding period and 5% holding.

There is a 20% tax credit for R& D expenditure, which with the Government's educational policies now focusing expenditure on encouraging more and more graduates to progress to PhD level is providing both the tax incentive and intellectual capability to carry out high-end R&D.

Getting out of the UK

It is important to note that inverting to Ireland does not remove UK activities from the UK tax net (although it may, over time, affect future investment decisions). Both Shire and UBM have undertaken reorganisations resulting in a new Irish-resident company acquiring the old holding company on a share-for-share basis. Subsequently, overseas activities will be sold up to the new holding company, resulting in an Irish-headed group with UK and other non-Irish activities held below it.

The share-for-share exchange will not normally trigger a tax liability for shareholders. The form of the exchange is a reconstruction under Part 26 of the Companies Act 2006, which gives both company law advantages (for example, only requiring 75% consent) as well as stamp duty exemption. However, it is a major corporate transaction, requiring a full circular and Court consent, so is not to be undertaken lightly.

The sale of foreign activities up to the new holding company is assumed to qualify for the substantial shareholding exemption (SSE), although no doubt it will have been a major exercise

to confirm the relevant conditions are satisfied. It is interesting to note that the availability of SSE will, in many cases, enable emigration to be undertaken on a tax-free basis for the company.

The availability of tax credits to individual minority shareholders receiving foreign dividends, effective from 6 April 2008, means that minority shareholders are less likely to be concerned at receiving Irish rather than UK dividends in future (minority shareholder means a person whose shareholding in the company is less than 10% of the company's issued share capital). However, Shire and UBM both announced that they would be giving shareholders the option of receiving dividends from either the Irish company or a UK company.

Finally, it will of course be necessary to ensure that the new holding company is genuinely resident in Ireland and does not fall back into UK residence for tax purposes. In practice, this is likely to be easier for a major quoted company than a private company to achieve, since its Board composition and formal procedures will be well-documented, but there are still risks that HMRC may argue at some time in the future that it is managed and controlled in the UK. The recent case of Smallwood SpC 669 shows that this issue is by no means redundant.

The way forward

Companies whose activities or customers are primarily in the UK are unlikely to want to emigrate — the potential savings need to be weighed against the costs, including any possible reputational issues. But those whose profits arise mainly outside the UK, or whose links to the UK are only historical, should at least consider their position carefully.

Moving a group's base to Ireland — or some other jurisdiction — will be a major corporate transaction and is not to be undertaken lightly. It will also mean setting up real substance in the new location, with at least some key management posts located there.

The UK's new regime may well include an exemption for foreign dividends, which could be more attractive than the Irish credit system, particularly where groups need to repatriate funds in order to fulfil dividend payments to shareholders. However, if this is combined with wide-ranging new CFC rules and an over-complex compliance regime, the UK will slip further down the competitive ladder.

Most groups with a mixture of UK and overseas activities will want to be ready to leave if the new rules are disappointing — but may decide to stay if the UK achieves its goal of remaining 'one of the world's best places to do business' (Alistair Darling, 29 April 2008).

Heather Self and Conor Begley, Grant Thornton writing in Tax Journal 26 May 2008

Value Added Tax

Library lease

As an educational establishment, Newnham made exempt supplies for VAT purposes and was concerned that it would not be credited with the input tax on the goods and services on which it had been charged VAT. Therefore it entered into a scheme whereby it acquired a shelf company. On completion of the library, the college leased it to the company, and assigned to it all the facilities and staff required to operate the library.

The college opted to tax the lease so that it would become a taxable supply, and the college would be entitled to recover all the input tax on the cost of building the library.

The issue was whether the college, as developer, had remained in occupation of the land within the meaning of VATA 1994, Sch 10 para 3A(7). If it had been, the library was exempt land and the grant of the lease was not a taxable supply.

HMRC said that the college had occupied the land, and did not allow the election. The VAT tribunal found for HMRC, but the Court of Appeal ruled that occupation for the purposes of para 3A(7) required more than a right to use land. The fact that the staff were seconded and answered to the company meant that the company, not the college, occupied the library, after the grant of the lease to the company.

The House of Lords ruled that nothing in the arrangements, whether in law or in practice, contradicted the right of exclusive occupation granted to the company by the lease. The college had the right to enjoy the books. The right to enter the premises for the purpose of borrowing them or consulting them was ancillary to that primary right. The college had not therefore occupied the land.

HMRC's appeal was dismissed.

Principal and fellows of Newnham College in the University of Cambridge v CRC, House of Lords,

Recovery of VAT on expenses

Background

This article covers recent developments on two related but distinct issues:

- the split of VAT incurred on expenses between that which is attributable to business activities and therefore potentially recoverable, and that which is attributable to non-business activities and is not recoverable;
- the split of input tax (i.e. the VAT on expenses attributable to business activities) between that which is attributable to taxable supplies and that which is attributable to exempt supplies (i.e. "partial exemption calculations").

The first issue has been touched on in a number of cases over the years, but the recent *Securenta* case is the most comprehensive and authoritative examination of it by the European Court of Justice.

The second issue is frequently considered by the Tribunals and courts both in the UK and at European level, and this article brings together a number of interesting recent developments in this area.

Use for business and non-business

Although the split between business and non-business VAT is not strictly part of partial exemption, it is often carried out at the same time and may be part of the same special method calculation that is used for partial exemption. The ECJ has confirmed the Advocate-General's opinion on the application of the 6th Directive to this apportionment. The UK government made representations to the court in the case, which is useful because this confirms HMRC's policy on how the split should be done. The ECJ appears to agree with the UK government.

The appellant in the case is a German investment company. It raised money and invested it on behalf of investors. The money was raised by the issue of shares and "atypical silent partnerships", and was invested in real estate, securities, financial holdings and investments of all types. It was accepted by all parties that the company had business and non-business activities: its investments in financial holdings in other companies were the "non-economic" type considered by the ECJ not to give rise to a right of input tax deduction in the *Polysar* case. The business activities were both exempt (financial transactions and some property investments) and taxable (other property investments).

The questions referred to the ECJ were:

1. If a taxable person simultaneously engages in a business activity and a non-business activity, is the entitlement to deduct input tax determined according to the proportion of the assessable and taxable transactions, on the one hand, to the assessable and exempt transactions, on the other hand (the applicant's view), or is the deduction of tax allowed only to the extent that the expenditure connected with the issue of shares and silent partnerships is to be attributed to the applicant's economic activity within the meaning of Article 2(1) of Directive 77/388/EEC?

2. If the deduction of tax is allowed only to the extent that the expenditure connected with the issue of shares and silent partnerships is to be attributed to the applicant's economic activity, should the apportionment of the input tax between business activity and non-business activity be carried out according to an "investment formula" or is – as the applicant submits – a "transaction formula", applying Article 17(5) of Directive 77/388/EEC mutatis mutandis, also appropriate?

The "investment formula" was a method suggested by the German government. The "transaction formula" was a method similar to the normal rules of partial exemption, suggested by the taxpayer.

The UK government's submission was that the proportion of the overhead inputs that is linked to or used for the applicant's non-economic activity does not form part of any input tax deduction calculation, because that proportion of the inputs falls outside the system of deduction altogether and should be disregarded entirely (i.e. it is not input tax – in UK terms, it does not fall within s.24(1) VATA 1994, so it does not fall to be apportioned under s.26 and the regulations made in accordance with that section). The government argued that no means of apportionment between business and non-business is not prescribed by the 6th Directive and the manner in which it is done is therefore a matter for the discretion of the Member States.

The Court concluded that some of the costs incurred by the company in raising money from investors were, at least in part, for the performance of non-economic activities, and that could not give rise to the right to deduct. On the other hand, there was nothing in the 6th Directive to say how a business/non-business split should be determined: there are specific rules for partial exemption, but not for this.

The Court accordingly answered the questions as follows:

1. Where a taxpayer simultaneously carries out economic activities, taxed or exempt, and non-economic activities outside the scope of Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment, deduction of the VAT relating to expenditure connected with the issue of shares and atypical silent partnerships is allowed only to the extent that that expenditure is attributable to the taxpayer's economic activity within the meaning of Article 2(1) of that directive.

2. The determination of the methods and criteria for apportioning input VAT between economic and non-economic activities within the meaning of the Sixth Directive is in the discretion of the Member States who, when exercising that discretion, must have regard to the aims and broad logic of that directive and, on that basis, provide for a method of calculation which objectively reflects the part of the input expenditure actually to be attributed, respectively, to those two types of activity.

The Advocate-General's opinion commented specifically that the Member States, in exercising their discretion in this area, should have regard to the principles of fairness and fiscal neutrality.

ECJ (Case C-437/06): *SECURENTA Göttinger Immobilienanlagen und Vermögensmanagement AG als Rechtsnachfolgerin der Göttinger Vermögensanlagen AG v Finanzamt Göttingen*

"Caretaker" method

A company had agreed to a Customs direction to operate an "interim" special method of partial exemption while a "final" method was agreed (following the acquisition of another company by the group). It believed that the interim method would be subject to revision when the final method was agreed, because it submitted a claim for repayment of more input tax from April 2001 – October 2002 in 2006. HMRC argued that the claim was capped.

The company argued that HMRC's direction to use an interim method, communicated by fax on 13 June 2001, created a right to adjust which went back to that date (i.e. the quarter commencing April 2001). It was clear from the history of correspondence that it had been expected at that time that agreement would be reached long before the cap operated, but that had turned out not to be possible. The questions before the Tribunal were therefore:

- whether the fax created a right from which HMRC could not resile;
- whether the cap in reg.29(1A) applied to partial exemption, when reg.99(7) appears to allow HMRC to determine different "longer periods" for adjustment and regs.108 and 109 require adjustment of attribution and recovery over 6-year periods.

The Tribunal dismissed the appeal. The fax of June 2001 was a special method direction (which HMRC had denied), but it was nevertheless subject to the cap. The words of reg.29(1A) were mandatory, and there was no reason to suppose that they did not apply to partial exemption adjustments. Although it had taken an unusually long time to agree the final method, nevertheless it was subject to the normal capping rules.

VAT Tribunal (20,424): *Morgan Stanley (UK) Group*

Bookmakers win

In the *Town and County Factors* case (19,616) the Tribunal held that the cost of satellite television was residual for a bookmaker's shop, because it promoted not only the exempt betting activity but also taxable supplies made in the shop. HMRC published their policy following this decision in Business Brief 17/06: they considered that "racing feeds" would only be residual if the bookmaker added its own content to the standard feed, promoting its taxable supplies. Sky Sports could be regarded as residual as it was less clearly related to betting activity.

A recent case has held that the Business Brief was too restrictive. In the decision it is highlighted that HMRC had accepted the overall decision in the earlier Tribunal but did not agree with some of its reasoning: the Business Brief contradicted some of that reasoning. That Tribunal had held that the satellite feeds acted as general advertising, drawing people into the shops.

The recent Tribunal explicitly held that there was a "direct and immediate link" between the provision of the information screens and the taxable supplies made by the shop (slot machines, or AWP "amusement with prizes", and Fixed Odds Betting Terminals, FOBTs) as well as the exempt supplies of over the counter betting (OTC). As long as the content was relevant to the services being supplied, it did not matter that no content was added by the appellant.

VAT Tribunal (20,283): *Cheshire Racing Ltd*

HMRC have accepted the decision of the Tribunal in the *Cheshire Racing Ltd* case (20,283) that Satellite Information System feeds are residual costs in bookmakers' shops because they have a direct and immediate link to supplies made by gaming machines. This decision disagreed with the restriction placed by HMRC on the effect of the *Town & County Factors* decision (19,616) in Business Brief 17/06 – HMRC interpreted the decision as only allowing residual treatment where the bookmaker added significant content to the SIS feed in order to promote its own taxable supplies.

HMRC acknowledge that bookmakers may wish to make claims for additional input tax recovery following their acceptance of the decision.

R&C Brief 01/08

Professional institute

ESC 3.35 was issued after the *Card Protection Plan* decision suggested that subscriptions to professional associations should be regarded as for a single supply that was likely to be exempt, whereas previously the association would have recovered some input tax (typically in relation to publications that were included within the membership subscription). The concession states:

"*Bodies that are non-profit making and supply a mixture of zero-rated, exempt and/or standard rated benefits to their members in return for their subscriptions, may apportion such subscriptions to reflect the value and VAT liability of those individual benefits, without regard to whether there is one principal benefit.*"

In the case before the Tribunal, HMRC accepted that the concession applied, but there was a dispute over the respective values given to the exempt and taxable elements. The chairman commented that the Tribunal could not consider the application of the concession, which was unsatisfactory for all parties because they wanted the dispute resolved; so he agreed to proceed on the basis that it was agreed between the parties that there was a separate supply of printed matter, and the dispute was about valuation rather than the application of the concession.

The issue was complicated by the fact that in 2001 the Institute had outsourced the production of its journals. It had previously apportioned its input tax based on the costs of production, but it was no longer so obvious what those costs were when it was entitled to a share of the net profit of the independent business that produced the journals. The Institute was entitled under the agreement to 20% of the publisher's profits from the titles.

Both parties put forward arguments based on "opportunity cost":

- the appellant argued that the "cost" to the Institute of producing the publications was the amount of advertising revenue it ceded to the publisher in 2001, less the publisher's retained profit (result: 83.35% taxable activities);
- HMRC argued that the "cost" was 80% of the net profit of the publishing operation, because that was what the appellant no longer received (result: 37.25% taxable activities).

The Tribunal took a step backward and considered the nature of the 2001 agreement. The chairman thought that this should be regarded as a barter arrangement, under which the Institute did things for the publisher and the publisher did things in return. The "cost" of procuring the publications was what the Institute "paid" under the agreement, and in a barter transaction that has to be valued subjectively as the value of what the Institute was prepared to forgo to obtain the benefits of the barter. The argument is long and detailed, and the chairman comes to the conclusion that HMRC's assessment is too high and the taxpayer's claim is also too high: "*Since we did not have before us sufficient evidence of the value of these elements to determine the assessment we adjourn this appeal for the parties to agree the relevant values and in default of agreement to return to the Tribunal.*"

VAT Tribunal (20,609): *Institute of Biomedical Science*

Capital goods used for the business

In the case of *JDL Ltd*, the UK Tribunal and High Court held that the sale of cars that were used by a car dealer as demonstrator vehicles was to be excluded from the "T over T plus E" calculation under reg.101(3)(a) as "the sale of capital goods used in the business". The case concerned a reclaim by the dealer relating to a time when the input tax on demonstrator vehicles was blocked on purchase or appropriation: as a result of the *Italian Republic* decision, it was realised that the sale of such vehicles should then be exempt, and HMRC sought to restrict the resulting output tax reclaims by arguing that some input tax should also be restricted under the rules of partial exemption. Because of the *JDL* decision, there was no restriction. A recent decision of the ECJ suggests that this is not correct in European law.

The case concerned a vehicle leasing company which sought to include the sale of leased vehicles in its partial exemption calculations. The Danish tax authorities took the view that they were capital goods used in the business and ruled that the sale proceeds should be excluded. The Danish courts referred questions to the ECJ.

The Court considered that the purpose of the legislation which excluded the sale of capital goods was to remove distortions from the recovery of input tax. The list of items to be excluded covered transactions of an unusual or one-off nature which would not reflect the ordinary incidence of input tax in the business. The sale of the leased cars was a fundamental and regular part of the lessor's business, and it should therefore not be excluded.

ECJ (Case C-98/07): *Nordania Finans A/S and another v Skatteministeriet*

Article by Mike Thexton

Lecture B478 (16.54 Minutes)

New rules for the option to tax

And so, at last, the new Schedule 10 to the VAT Act is here. It has been a long time in the making. But after last minute delays the Order was duly laid on 22 April, and the new legislation comes into effect on 1 June 2008.

What Of It?

The whole Schedule has been redrafted. Superseded material, mainly about the developer's self-supply — scrapped eleven years ago — has gone. But the substantive changes concern the option to tax. The very basics may remain the same, but the detailed changes are numerous, and will often make a real difference to transactions and to VAT compliance. For those who do not deal with real estate all the time, the moral is probably simple — assume that what you used to know about the option might not be right any more, and check. But for those who do, there is an awful lot to get to grips with.

So what has changed?

Permission To OPT

In some cases, property owners need HMRC's permission for an option to tax. This is intended to prevent manipulation of inputs and outputs either side of the effective date. It currently applies if the owner has made exempt supplies in the property, such as lettings, since 1 August 1989. In some cases permission is available automatically via *Notice 742A*; in other cases it must be specifically applied for.

There are various changes here:

- We will no longer have to worry about exempt supplies all the way back to 1989 — the fixed 1 August 1989 date is replaced by a rolling ten years.
- Where HMRC's formal permission is needed, it will now be possible for the option to take effect from when permission was sought, or from any date thereafter. At the moment, it can only be effective from when permission is given, regardless of how long HMRC take over the application.
- Once formal permission is given, you will be presumed to have opted, and will no longer need actually to notify. If you do not want to opt, you will need to revoke the option under the 'cooling-off' rules, as explained below.
- A refusal of permission will now be appealable to the Tribunal. In practice, however, HMRC do not so much refuse as haggle.
- If you have purported to opt when you should have obtained permission first, HMRC will now be able to set aside the permission rules and treat the option as valid. This is distinctly double-edged — some people have used the 'discovery' that they should have had permission as a means of ditching an inconvenient option to tax.
- The information HMRC claim to need in order to consider applications will now have the force of law.

These changes have a number of implications but the first two, in particular, will help reduce both the burden of the permission rules and the urgency. Notably, there is no immediate change to the conditions for automatic permission in *Notice 742A*, but it is hoped that this will follow by the end of the year.

'Global' Options — Introducing The Real Estate Election

The old Schedule 10 allows taxpayers to opt on specified land, or on land 'of a description specified'. This has allowed people to opt on, for example, 'the properties that we own' or 'all our retail units'. This has its uses, but has also caused problems — it is not always clear what is actually covered, and HMRC saw particular issues with the 20-year revocation rules, due to apply from August next year.

So the facility of opting on a 'description' of property has gone, and owners wanting an option on these lines now have two ways of achieving it.

The first is to opt on a large geographical area — maybe a city or county, maybe the whole UK. This is straightforward and effective. But it does mean that revocation will be difficult, and often impossible.

The second is a new arrangement which, after various working titles, has emerged as a 'real estate election' or 'REE'. This is, in effect, an automatic option on all acquisitions. It allows for revocation property by property. But the downside here may prove to be the compliance requirements. Someone making a REE will have to provide HMRC with detailed lists of their properties — and not just their opted properties. And they will have to provide updates, and schedules showing what has happened since the last list, whenever HMRC ask. No doubt this is a good discipline, but it will be a deterrent.

The REE will not apply to existing properties, but only to new acquisitions, where a 'relevant interest' — an interest in, right over or licence to occupy land — is acquired only after the REE is exercised. For these, the option automatically applies unless you had opted already, you would need HMRC's permission to do so, or you choose to revoke during the 'cooling-off' period, at which we shall look below. But you cannot revoke the REE itself — only HMRC can do that, if you fail to give them information they ask for.

A REE also has implications for past options to tax. It automatically removes any existing option where you do not have, or no longer have, a 'relevant interest'. And if you have an existing option covering more than one property, you can convert it into a series of individual options. This involves giving HMRC a lot more information, but may be useful when it comes to revoking under the 20-year rule.

REEs fall firmly into the 'facilitation' rather than 'simplification' category. They have advantages, saving time on individual notifications and establishing a clear claim to input tax recovery before an option is triggered. For some people, the requirements will be manageable and the benefits worth having. But a REE is not certainly not something to be entered into lightly.

VAT Groups

Where there is a VAT group, it is still the individual members of the group, and not the group itself, that exercises the option. But the 'relevant associate' rules mean that, by and large, the effect is the same as if the whole group had opted.

One trap here is that, at the moment, a company leaving a group can still be bound by another member's option, and this matters if, perhaps coincidentally, it later acquires an interest in the property. The new rules help to deal with this. Someone who has left the VAT group will no longer be treated as a relevant associate if they have no 'relevant interest' in the property or any right to proceeds from it, and they are no longer connected with anyone who does have a relevant interest and who is still bound by the option.

Demolition And Construction

Historically, HMRC have distinguished between land and buildings. If you had just opted on the land, and then built a building, you needed a new option, or had the choice of not opting on it. And if you had opted on a building, and demolished it, the option did not apply to the land. It was never clear that this was right, particularly after the ECJ judgment in *Breitsohl* Case C-400/98, and in fact HMRC now take the view that it was wrong in law, and was merely 'policy'. In any event, the new Schedule 10 changes all this.

The position for the future will be that an option necessarily covers land and any buildings, and that it survives any construction or demolition work. But HMRC still recognise that this limits flexibility, and may mean that some people have opted on the basis of a false prospectus. So to deal with this.

- If you opt on land and then build on it, you will generally be able to exclude the building, and the land within its curtilage, from the option. You will need to notify HMRC, and there are rules about timing.

- If, before 1 June 2008, you opted on a building, you can revoke the option if you later demolish it, provided the notification made it 'clear' that the option was only on the building. This is extra-statutory and need not be notified to HMRC.

Revocation

Originally, the option was completely irrevocable, never to be undone. Changes in 1995 introduced the three month 'cooling-off' period, and provided for revocation after 20 years — the latter only actually kicking in on 1 August 2009.

The new Schedule 10 takes matters further.

It puts more flesh on the 20-year regime, although further changes are likely, especially around the interaction with the Capital Goods Scheme (CGS), so it is premature to go into details here.

And as well as provision, noted above, for options to lapse on making a REE or leaving a VAT group, there is a new six year revocation rule: subject to some anti-avoidance rules about VAT groups, the option will lapse if you have not held an interest in, right over or licence to occupy the property for six years. This is welcome — under current law, there can be problems where property is reacquired, perhaps coincidentally, and no-one realises an option is still in force.

Finally here, the 'cooling-off' rules are extended and liberalised.

The cooling-off period

The current 'cooling-off' rules apply for three months from the effective date of the option. Revocation applies *ab initio*, and requires HMRC's consent. One condition is that no input tax has been recovered under the option — in practice this often limits the three months further.

The new rules increase the three months to six, and in some cases waive the need for HMRC permission. The problem though is with input tax. If you have claimed some input tax, you can still revoke if you repay it. But what is really needed is a specific mechanism for doing so. None has been introduced, so unfortunately the rules end up revolving, rather uncomfortably, around the partial exemption and CGS regulations.

So although HMRC's permission will sometimes not be needed, this will only apply if there is an established mechanism — an annual adjustment, Regulation 108 (clawback), or the CGS — for repaying any input tax. And, for similar reasons, the property must not have been used since the date of the option.

Otherwise, it may still be possible to revoke with HMRC's permission. But there will still be cases where they refuse because, even though you are willing to repay input tax, there is no legal provision under which you can do so.

Dwellings Etc

The option does not generally affect buildings 'intended for use' as dwellings, but there have been problems, and contradictory Tribunal decisions, about what the vendor or landlord needs to be told, and about how far down the supply chain the actual occupational use can be.

The new law distinguishes, essentially, between existing dwellings and buildings intended for conversion to dwellings. This will apply in much the same way to 'relevant residential' uses, but not to 'relevant charitable' properties.

For properties already designed or adapted, and still intended, for residential use, the option is necessarily disapplied. But in conversions cases, the purchaser or tenant will have to issue a certificate, in a prescribed form, in order to disapply it. Normally they will be certifying that they intend either to live in the property themselves, or to convert it to residential use.

Relevant intermediaries

But they can also certify that they are a 'relevant intermediary' — that they intend to sell on to someone else who will convert it, or indeed that there will be a chain of sales through to the person carrying out the conversion. This is only possible if certificates are issued sequentially back up the supply chain, and so only if the entire supply chain is known. So it remains to be seen how feasible it will be in practice.

Timing of certificates

Certificates must be issued before the relevant supply is made. But HMRC have also shown themselves sensitive to the problems of vendors and landlords. At the moment, these can be caught out — and suffer input tax and/or CGS costs — by a purchaser's or tenant's last minute announcement that they intend to convert the property. In future, once the price is fixed, a certificate can only be issued by agreement between the parties. This also effectively replaces the current arrangement, where the parties can sometimes agree that the option will not be disapplied.

This rule will apply not only to residential conversions, but also where the option is disapplied on a development site for a housing association.

Anti-Avoidance Rules

For the moment, there are only minimal changes to the anti-avoidance rules.

The provisions look at who will be occupying the property, and what for. One test is whether use will be 'wholly or mainly' for taxable, or certain other, purposes. 'Mainly' is not defined, and although HMRC have taken it to mean 80% or more, it is doubtful if this could withstand serious challenge. So the new Schedule 10 substitutes 'substantially wholly' for 'mainly' and allows HMRC to elaborate in tertiary legislation. This will, of course, define it as 80% or more.

The other change here concerns ATMs. HMRC consider that a bank etc can be 'in occupation' of a building just by having an ATM in the wall. This has caused problems. The *Newnham College case* [2008] All ER (D) 210 (Apr) might suggest that HMRC are actually wrong about this, but in any event the law will now ensure that the anti-avoidance rules cannot be triggered purely by an ATM.

In Conclusion

There is a lot here to absorb, and this is not the end of the story. Revocation under the 20-year rule will add a further aspect to the option from August next year, and we can anticipate other changes in the meantime.

There will no doubt be some teething problems. Perhaps some features — we might think of relevant intermediaries and REEs — will prove difficult to use in practice. But overall this is a good package. HMRC deserve credit for it, and for how they have engaged with the outside world and taken suggestions on board. This may not yet be a consistent pattern, but if it can set the tone for the future, this is good news indeed.

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