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Personal Tax

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.

Lecture P482 (4.29 Minutes)

Tips and the National Minimum Wage

On 13 June 2008 the EAT ruled in HM Revenue & Customs' favour by supporting current National Minimum Wage legislation relating to tips, in the case of Annabel's restaurant and night club. The decision is good news for the UK's restaurant and bar workers.

This means that employers have to pay their staff at least the National Minimum Wage regardless of any tips, gratuities, service or cover charges, so long as the tips are not paid directly through the employer's payroll.

HMRC argued that payment via a 'tronc' (an independent tips distribution scheme) does not count towards the National Minimum Wage.

The Judge determined that where restaurant or bar service charges are paid by the customer to the employer, but are then paid into a 'troncmaster's' bank account for distribution in accordance with a 'tronc' scheme agreed between the troncmaster and employees, the sums so distributed to employees are not 'paid by the employer' for the purposes of being included in any National Minimum Wage calculation.

Denise Gaston of HM Revenue & Customs said—

'Our priority is to ensure that all workers are paid at least the National Minimum Wage. We are very pleased that the court has recognised HMRC's commitment to ensuring that tips are correctly and fairly distributed to the people who earn them. This is good news for bar and restaurant workers across the UK.'

A spokesperson for the Department for Business said—

'It is essential that all UK workers receive the pay they are entitled to and that everyone earns at least the National Minimum Wage. Equally, it's important that tipping is fair and we are already examining what options are available to help ensure transparency.'

HMRC vigorously enforces the minimum wage across all employment sectors including the catering and hospitality industry. Anyone who thinks they are not being paid National Minimum Wage rates should contact the confidential NMW Helpline on 0845 6000 678 and we will ensure the law is complied with.

The taxpayer has already indicated their intention to appeal the decision.

Tax credits and directors

Directors of small companies claiming tax credits can run into various problems if they have paid themselves a low salary plus dividends. However, one trap for the unwary is the interaction between two unrelated pieces of legislation – tax credit entitlement rules and the national minimum wage rules.

In order to benefit from the basic element (and therefore any other elements) of working tax credit, a claimant must be engaged in qualifying remunerative work. Ignoring the self employed, the original definition of employed read:

"employed ... means employed under a contract of service, and includes the holding of an office, the emoluments of which are chargeable to Schedule E ..."

(Reg 2. The Working Tax Credit (Entitlement and Maximum Rate) Regulations 2002 (SI 2002/2005)).

Therefore the definition includes those formally employed, and directors as office holders.

However, the Working Tax Credit (Entitlement and Maximum Rate) (Amendment) Regulations 2003 (SI 2003/701) amended this definition with effect from 6 April 2003. Regulation 2 is amended to read:

"employed ... means employed under a contract of service or apprenticeship where the earnings under the contract are chargeable to income tax as employment income under ..."

The removal of the term 'and includes the holding of an office' means that directors will not qualify as office holders alone, and thus would need to be employed under a contract of service in order to qualify. Many directors do not choose to enter into a contact of employment with their companies, as this permits some flexibility over their pay.

When the national minimum wage legislation came into force, there was concern about the implications for directors of small companies who were drawing a minimal salary. The professional bodies sought, and obtained reassurance for directors of small companies from the then Inland Revenue (as the enforcement body) as follows.

If a director draws a salary from a company in return for his or her services, even in cases where he or she is the sole worker in a company, it is not necessary to pay him/herself minimum wage unless the director is also an employee of the company. Under normal circumstances directors would not be regarded as de facto employees unless the individual director has sought to obtain the benefits that employment law could provide for him or her, by entering into a specific contract of employment with his or her company. Thus it is only necessary for a director to draw minimum wage when he or she has taken the step of entering into a contract of employment. Otherwise, any payment for services would be made to him or her as office holder, rather than a worker, and there is no minimum rate of pay.

So the interaction of these two pieces of legislation is quite clear. In order to claim working tax credit (including the childcare element) the director of a small company should enter into a formal contract of employment with his or her company, and therefore should draw national minimum wage for the hours worked. Otherwise a claim to WTC will fail, unless the claimant's partner is working for the necessary number of hours per week. Claimants of child tax credit are unaffected, as there is no necessity for the claimant to be working in order to claim. In these cases, the taper threshold is increased, with the main CTC award not tapered until the income reaches £15,575 in the current tax year.

The practical implications are, therefore, to prevent a claim to the childcare element of WTC when either partner (or the sole claimant) is a director of a company and not drawing minimum wage, as childcare requires that both claimants satisfy the test of 'working' for a minimum number of hours per week. Otherwise, the impact will only be noticeable when claimants have very low joint income (below the £15,575 threshold) and had been hoping to benefit from WTC in addition to the maximum CTC that they will secure; this will also affect those claimants who do not have children and were seeking to claim WTC only. Once again, however, if one of the claimants in a couple satisfies the 'working' test, there will be no loss of tax credits.

Example

Peter and his wife Lily are directors and shareholders of Black Limited, which they formed several years ago when they started up their business. Peter works for around 35 hours per week and Lily works for around 20 hours, trying to fit her work schedule around their twin sons, who are at school. The children have after school care twice a week to allow Lily to work later, and this costs £75 per week. Although the costs are greater in the school holidays, this is ignored for the purpose of this example.

Lily and Peter would be hoping to claim tax credits as follows :

	£
Working Tax Credit – basic amount	1,800
Couple	1,770
30 hours	735
Child tax credit two children	4,170
WTC childcare element (80% of actual costs)	3,120
Total available award (ignoring family element)	**£11,595**

In the current year, the couple's income is quite low, as the company has not been profitable, so it has not been possible to draw dividends. The salaries paid to the couple are £5,000 each – total £10,000.

The net award would therefore be :

	£
Gross award	11,595
Less taper: (10,000 – 6,420) x 39%	(1,396)
Net award (ignoring family element)	**£10,199**

However, the couple do not qualify, as their directorships do not meet the definition of working, so their gross award is reduced to:

Child tax credit two children	£3,120

In terms of taper, the income of £10,000 is below the 'CTC only' taper threshold of £15,575, so there is no taper. However, the net award has reduced by £7,079.

Article by Rebecca Benneyworth writing in Taxline.

Foreign homes in corporates?

In some countries it will be beneficial (or compulsory) for UK owners to hold their foreign homes via a corporate. This vehicle will have it's own issues from a UK tax perspective.

Benefit in kind

Following the case of *R v Allen,* it was established that a "deemed director" could also be held liable for UK tax on the same basis as an actual director.

A deemed director, sometimes referred to as a "shadow director", is defined in the taxes acts at Section 67 ITEPA 2003 as including "any person in accordance with whose directions or instructions the directors of the company (as defined above) are accustomed to act". This definition was further enhanced by the *Secretary of State for Trade and Industry v Deverall* case which, in broad terms established that a shadow director can include anyone on whose advice or guidance the actual directors are accustomed to act but it does exclude advice given in a professional capacity.

The combination of the Allen case and Deverall cases had a particular impact on, typically, non-UK domiciled individuals who commonly owned their main UK home via an offshore company, ultimately owned by an offshore trust for inheritance tax purposes. Often, in this situation, the occupying individual would have influence over any actual directors making the individual a deemed director of the offshore company. They were therefore potentially liable to UK tax under the living accommodation benefit provisions, now contained in Part 3, Chapter 5 ITEPA 2003.

Part 3, Chapter 5 ITEPA 2003 charges apply simply on the basis that accommodation is "provided" for an employee. The question therefore arises as to whether these provisions would also apply to property overseas (whether or not that property was owned by an overseas company). If so, it would apply to holiday homes owned by entities which are treated as opaque by HMRC (see Tax Bulletin 50 of December 2000 and Tax Bulletin 83 of June 2006).

The position was clarified on Budget Day 2007 when Budget Note 50 confirmed that legislation would be included in Finance Act 2008 which would ensure that individuals who have bought or will buy a home abroad via a company will not face a benefit in kind charge. The Finance Bill 2008 conditions which are to be met are:

- The individual must own part or all of the shares in the company.
- The company has been the holding company of the property since the property was acquired or the individual acquired the company.
- The company needs to hold a legal interest in the property (under local law), the property should be the only or main asset and any other activities should only be incidental to the ownership of the property interest.

The benefit in kind can still apply where:

- The overseas company has other assets (perhaps other properties) and only one is used by the individuals for personal use
- The company has other activities (for example development activities)
- The property was acquired by the company from a connected company at undervalue.
- If expenditure on the property is incurred by a connected company.
- If borrowings are outstanding from a connected company, unless at a commercial rate, or it results in the individual being subject to a loan benefit in kind.
- If there is a tax or national insurance avoidance motive.

A connected company is a company connected with the individual, his family or employer or any company connected with such a company.

The charging mechanism when applying the benefit in kind provisions for overseas properties is explained at EIM11440 and EIM11441. Broadly, the basis of the charge is the market rental value of the property for the period it is available.

Anti-avoidance

Any rental income received by an overseas entity which owns the property may be caught under the provisions of Chapter 2 Part 13 of ITA 2007. This would mean that where, in the case of an overseas company which owns an overseas property, and which receives rental income, the profits of that company could be taxed on the individual who funded the company originally. This is likely to apply where the foreign company is merely an investment company but it may be possible to argue where there are a number of properties, let as a trade via an overseas company, that the defences available under Section 736 to 742 ITA 2007 apply. This defence should be available where the overseas company is a development company.

Capital gains tax

Where the property is owned via an overseas company, the provisions of Section 13 TCGA 1992 are likely to apply. This attributes the capital gain to the participators in the company (the shareholders) and means that the gain arising within the company becomes chargeable on the individuals resident in the UK.

From 6 April 2008, the attribution also applies to individuals who are not domiciled in the UK, although it does not apply where the company is a trading company. This latter exclusion is unlikely to apply in the case where property is available for personal use or the business is regarded as an investment business. It should be noted that unlike the income tax anti-avoidance provisions, there is no motive test for Section 13 TCGA 1992 and this applies irrespective of whether the arrangements are commercial and not for the avoidance of tax.

Inheritance tax

Most jurisdictions will charge local inheritance tax on the death of the owners of any real property located in that jurisdiction. It should also be noted that many jurisdictions do not have a full inter-spouse exemption and so where the property is left to the surviving spouse there may still be local inheritance tax payable.

Some jurisdictions have forced heirship rules (France for example) and owning shares rather than real estate can bypass these rules. Local advice must however be sought.

Summarised from Lexis Nexis Overseas Property Conference, March 2008

Lecture P481 (18.36 Minutes)

Statutory residence test 'a possibility'

A statutory residence test has become a possibility after Jane Kennedy, Financial Secretary to the Treasury, agreed to consider the idea in the Public Bill Committee debating the 2008 Finance Bill.

Up to now, the Government's line had been that after all the recent changes to residence and domicile, it was not going to do anything else for the remainder of this Parliament.

However, the various professional bodies have presented the case for a statutory residence test.

Francesca Lagerberg of Grant Thornton and chairman of the technical committee of the Tax Faculty of the ICAEW said such a test would provide certainty, as under the current regime, proving non-residence can be very difficult as recent cases, e.g. Gaines Cooper, Shepherd, and Grace, have shown.

After hearing the arguments for a statutory residence test, Ms Kennedy agreed that there was an opportunity to introduce the test and she would like to hear views as to what form it should take, etc.

Ms Lagerberg said that this 'is really good news' - although she noted that, at this stage, Ms Kennedy had not committed to introducing the test, but was just agreeing to discuss it.

Taxation of small pensions

Pension from an insurance company or a pension scheme run by your former employer, however large or small, should be paid under Pay As You Earn (PAYE).

The vast majority of pensioners are already paid in this way, but some are still being paid under old arrangements which were agreed between pension providers and the Inland Revenue predecessor to HM Revenue and Customs (HMRC).

HMRC will be bringing any untaxed pensions into tax from the current tax year (2008–09).

Pensions started since April 2007

HMRC have already asked Pension Providers to make sure that all new pensions which have started since 6 April 2007 are taxed correctly, and also to send them details of all pensions which began before that date and which are being paid tax-free under an old arrangement.

Pensions which started before 6 April 2007

For such pensions where no tax was being deducted, from April 2009 the pension provider will send HMRC details so that they can check to see if it can continue to be paid tax-free. Taxpayers need take no further action at present.

Who is affected?

Pensioners will **not** be affected if any of the following apply—

- They are receiving a pension or pensions and you already complete a self-assessment tax return every year.
- Their pension or pensions are already being paid under PAYE and taxed.
- If they are 65 or over but not yet 75 and their estimated taxable income for the year from 6 April 2008 to 5 April 2009 from all sources, including state retirement and other pensions, is less than £9,030.
- If they are 75 or over and their estimated taxable income for the year from 6 April 2008 to 5 April 2009 from all sources including state retirement and other pensions, is less than £9,180.
- If they are under 65 and their estimated taxable income for the year from 6 April 2008 to 5 April 2009 from all sources, including any state retirement pension (if they are female) and other pensions, is less than £6,035.

Pensioners may be affected if—

- they receive a pension which is not being taxed, the untaxed pension is not included in the tax code applied to their main source of income or their estimated taxable income exceeds the relevant limit set out above

What will happen if tax is due?

HMRC will contact anyone who needs to be pay tax on their pension in a Pay as You Earn (PAYE) coding notice (P2) which they will send out once they have received and reviewed the pension details received.

For most people this should mean that their pension will be taxed from 2009–10 onwards and any underpayment of tax for 2008–09 will normally be collected in 2010–11 through PAYE month by month.

HMRC will not normally ask anyone to pay any tax which should have been paid on a pension before April 2008.

Enterprise management incentive

A brief overview

Tax advantaged share options with a market value of up to £120,000 can be granted to qualifying employees of qualifying companies. There is an overall total share value of £3 million under EMI options for all employees and the shares must be in an independent trading company with gross assets of less than £30 million. So the typical larger owner managed business (OMB) client is attracted by this scheme to aid retention and recruitment by way of incentivising key employees.

The grant of the option is tax free and normally there are no tax or National Insurance contributions to pay when the employee exercises the option.

On sale, under the pre-5 April 2008 rules, any capital gains tax charge was reduced by taper relief with a holding period effective from the option grant day, not the exercise date, so it was generally the case that full business asset taper relief applied giving an effective tax rate of 10% for higher rate employees.

Entrepreneurs' relief

The Finance Bill 2008 abolishes taper relief, and a flat rate capital gains tax charge of 18% now applies to all disposals except where entrepreneurs' relief may be available.

If the appropriate conditions are met, entrepreneurs' relief will apply giving an effective tax rate of 10% on the first £1 million of gains.

However, for the majority of EMI schemes, it is unlikely that the conditions will be met:

- Most schemes would not grant an employee more than 5% of the shares/voting rights of the company.
- It is not that common for shares to be issued with the important voting rights necessary to qualify.
- The shares have to be held for one year from exercise. The employees will need to fund the exercise for a full year before a sale can take place if entrepreneurs' relief is to be in point.
- Where an employee leaves an employer whilst holding exercised option shares, relief would be denied as the working employee or director rule would not be satisfied for a whole year leading up to sale.

Benefits of EMIs going forward

Many employees in EMI schemes receive only a relatively small number of shares and will not be worse off because their capital gain will fall within their annual exemption (currently £9,600) or the disposal could be split over two tax years if larger. There may also be a possibility of transferring exercised shares to a spouse or civil partner to use his or her annual capital gains tax exemption — scheme rules may prevent this and would need to be looked at carefully.

Even in the event that the gain is above the annual exemption, or exemptions if spread over two years or sold via a spouse, the tax rate is only 18% on that excess of capital gain.

For those fortunate enough to acquire shares in excess of the 5% requirement, provided they hold the shares for one year following exercise and all the conditions continue to be satisfied they will be able to take advantage of the entrepreneurs' relief 10% tax rate on any gain (up to £1 million lifetime allowance) in excess of their capital gains tax annual exemption.

From a practical point of view, the employee would need to be in a position to fund the purchase of the shares and hold them for a full year. This would involve investment of a large sum in the employing company and may be a difficulty for the employee concerned.

Unapproved schemes

By contrast, if the employee concerned had been granted unapproved options he would have paid tax and National Insurance contributions.

Additionally, he would have had to pay the employer's NIC liability at 12.8% if a joint election had been made, although he would have received tax relief on that additional cost in his capital gains tax computation which would be calculated in the usual way on disposal of the shares.

I think employees will see the continuing tax and National Insurance contributions benefits of EMI shares over unapproved schemes and, although the tax charge is now some 8% higher, I believe that most employees would still be incentivised by the offer of such shares in their employing company.

The employing company's position

For a company to qualify, they must:

- be independent (the company must not be controlled by another company);
- be trading in the UK (more than 50%);
- not have gross assets in excess of £30 million (this is measured at the time the option is granted and applies to the consolidated assets of the group where there is more than one company);
- have fewer than 250 employees (at the date of grant); and
- not undertake certain excluded activities (e.g. dealing in shares, property development, provision of legal or accountancy services, shipbuilding, coal and steel production, etc.).

A valuable relief

Assuming that the qualification conditions are met, there is a valuable relief available to companies. This statutory deduction is the difference between the market value of the shares at the time of the exercise and the amount paid by the employee. These deductions under FA 2003, Sch 23 are given for the period in which the employee acquires the beneficial ownership of qualifying shares.

The way that the relief is given depends on the business carried on by the employing company.

- For trades and rental businesses, the relief is allowed as a deduction in computing the profits taxable under ITTOIA 2005, s 5 and s 268.
- For a business carried on by an investment company, the relief is treated as disbursed as management expenses under TA 1988, s 75.
- For a life assurance business carried on by an insurance company, the relief is included among the amounts the company may treat as part of its management expenses under TA 1988, s 76.

Benefits for the company

Whilst valuable, the tax deduction is only one of a range of 'benefits' for the employing company.

The company can choose who exactly benefits under the scheme, subject to the material interest barrier of 30%, thereby incentivising those employees who are key to the business and whom the employer needs to retain to develop the company for the future.

Employee motivation

Additionally, to motivate employees the options can be performance linked and employers will use these schemes to set objectives for employees congruent with the business plan. The company is also able to set the exercise price and the option period giving them control over the value of the benefit to the employee.

From an articlein Taxation by Penny Bates

Internationally Mobile Executives - Remittance basis of taxation

This article describes the proposed new regime as it is currently expected to apply to employment income for employees resident but not ordinarily resident in the UK. In the modern style, the new rules came into effect on 6 April 2008 with the legislation still in draft form (in Finance Bill 2008) and with some revisions expected before Royal Assent.

Previously

Previously, employees who were resident but not ordinarily resident in the UK were subject to UK income tax on earnings (defined in ITEPA 2003, s 62) for work done in the UK wherever these were paid but were able to not pay income tax on earnings for work done abroad, provided this income was paid outside the UK and not remitted to the UK (ITEPA 2003, s 26). The attribution of earnings between UK and foreign duties was made on the basis of days actually worked in the period in accordance with the ratio UK:overseas workdays. HMRC's practice (promulgated in SP 5/84) was to assume that in a particular tax year remittances were made firstly from income in respect of duties performed in the UK; only once remittances exceeded this amount were overseas earnings considered to be remitted to the UK.

Proposals

Under the proposals, the remittance basis of taxation is now normally only available where a claim is made by the individual on his or her tax return under the proposed new ITA 2007, s 809B. Claimants will forgo their personal allowance if their unremitted overseas income and gains in the year exceed £2,000. The now-famous £30,000 annual charge for claiming the remittance basis will not be applicable to many resident but not ordinarily resident employees, as few such short-term visitors will have been resident in the UK in seven out the previous nine tax years.

What is a remittance?

There has been an attempt at making a single definition for all types of income and gains, with the basic rules in ITA 2007, s 809K and expanded rules and anti-avoidance provisions in ss 809L to 809R. This laudable attempt at consistency is immediately undermined by some of the exemptions in ss 809S to 809Y, as explained later in this article.

The main part of the definition of a remittance to the United Kingdom is that 'money or other property is bought to, or received or used in, the UK by or for the benefit of a relevant person' or 'any service is provided in the UK'. There are two key concepts here which it is worth contrasting with the previous law.

Firstly, the definition of relevant person broadly includes the individual, close family members and certain companies or settlements with which they are connected. This addresses the alienation loophole described in Grimm v Newman, whereby funds given to a spouse outside the UK and subsequently brought to the UK by that spouse could not be said to be remitted to the UK by the taxpayer. It is worth noting that HMRC acknowledges that changes to the current draft of the definition of relevant person and its use in the legislation will be needed to ensure the rules prevent avoidance without interfering with genuine commercial arrangements, as far as is practicable.

Secondly, 'other property' was not formerly included in the definition of remittance for non-employment income, so bringing to the UK, for example, cars purchased out of foreign investment income would not have caused a tax charge unless they were subsequently converted into money, such as by sale. Much of the draft legislation on exemptions from the definition of remittance is aimed at making this broad definition practical, by excluding in certain circumstances clothing, footwear, jewellery and watches for personal use, and works of art and collectors' pieces. Unfortunately, while the exemption for works of art and collectors' pieces applies no matter what sort of income or gain was used to purchase them, the exemption for clothing etc only applies if they are derived from foreign investment income, not if they are derived from capital gains or earnings. This preservation of a distinction in treatment between types of income and gains is, for many, unwelcome, raising as it does the prospect of inspectors demanding wardrobe inventories as part of their enquiries into employees' tax returns.

Remittance of mixed funds

Where funds have been remitted to the UK from an overseas bank account, draft s 809P deems the order of remittance of any particular mixed funda s follows:

(a) employment income not included in (b) or (c) below and not subject to a foreign tax;

(b) earnings for overseas workdays not subject to a foreign tax;

(c) amounts counted as employment income under the employment-related securities rules in ITEPA 2003, Part 7 (for example, income on exercise of share options) that is attributable to overseas workdays and is not subject to a foreign tax;

(d) foreign investment income not subject to a foreign tax;

(e) foreign chargeable gains not subject to a foreign tax;

(f) employment income subject to a foreign tax;

(g) foreign investment income subject to a foreign tax;

(h) foreign chargeable gains subject to a foreign tax; and

(i) other income or capital.

A remittance is allocated in the order specified above first to amounts that have arisen in the current tax year, then to amounts that arose in the tax year before that, and so on. HMRC is expecting this draft section to be amended before the Finance Bill becomes law.

Defining (a) above as, broadly, earnings for work done in the UK continues one aspect of HMRC's SP5/84 treatment. However, the requirement to assess each and every remittance separately, based on the contents of the mixed fund at that moment in time, rather than on all of the funds in that account in the year, is effectively a reversal of the approach in SP5/84.

Example

For example, Teri is a resident but not ordinarily resident employee earning £60,000 per year at a rate of £5,000 per month paid into a foreign bank account, who has 25% overseas workdays, such that £15,000 of her earnings could be excluded from tax if not remitted to the UK.

For the first nine months of the tax year she remits all her income to the UK immediately on receipt but she keeps all £15,000 of her last three months' income outside the UK. For the sake of simplicity, PAYE and other payroll deductions are ignored in this example. Under SP 5/84 the amount of income from UK workdays in the whole year (£45,000) is compared to the amount remitted to the UK (£45,000) and, as the latter does not exceed the former, the £15,000 attributable to overseas workdays is not treated as remitted to the UK and is not taxed.

Under the proposed new rules nine separate reviews must be undertaken, one for each remittance of the monthly salary, and nine separate assessments made of what sort of income is being remitted to the UK. If Teri were using her foreign bank account's debit card for all of her spending in the UK, she might easily be making ten separate remittances per week just by paying for meals. This would be 520 remittances a year and mean 520 separate reviews of what sort of funds have been remitted. This seems to be a quite disproportionate amount of work to expect a taxpayer (or tax return preparer) to undertake, and it is to be regretted that HMRC seems to be discarding the more sensible approach of SP5/84.

In addition, it is unclear from the proposed legislation whether HMRC expects taxpayers to assess the workdays apportionment of each payment of income separately. For example, should the apportionment of the April salary be based just on workdays in April, or should the apportionment be based on all the workdays in the year? HMRC is consulting widely on the mixed funds section and it is to be hoped that, when finalised, the process will be simpler and more practical.

From an article in Tax Journal by Carol Stubbings

Present for Miss Jones?

Over the past few months, many privately owned companies and businesses have changed hands in order that 'Mr Company Owner' could capture the benefits of 10% tax on the capital gains he has realised. Many may have made significant payments to their personal secretaries, long suffering servants, and other unsung heroes.

What is their tax position?

Is the payment 'earnings' ('general earnings') under ITEPA 2003, s 62? This is a very broad based definition and will catch everything that we would commonly think of as earnings. Furthermore, tax cases have demonstrated that earnings are not just remuneration or reward for services past, present or future. They also include payments that are received by virtue of the employment relationship itself.

Section 62 is not restricted to payments such as salaries, wages and tips in return for the performance of services. HMRC will always look at s 62 as the first charging section for payments to employees and the courts have decided many cases over the years.

What is a reward for services?

While regular payments are likely to come from the employment and be taxable under s 62, an element of doubt can arise when the payment is a one-off. We need to look at the facts of each payment to decide if there is a tax liability.

A voluntary payment, e.g. a taxi driver's tip, is taxable as earnings if it is from employment. Although it comes from the generosity of the payer, this does not prevent it being taxable (Calvert v Wainwright 27 TC 475).

Who makes the payment?

A payment may be earnings within s 62, even if it is paid by somebody other than the employer. What matters is that the payment is made because the recipient holds the employment, or as a reward for services provided in the employment, and not for any personal reasons.

Payments will be taxable under s 62 if they are received in respect of an office or employment notwithstanding that there is no enforceable right to receive the payments, or that they may be said by the payer to be made by way of gift. Payments made, however, not by virtue of the office or employment, but by way of testimonial or in recognition of the personal qualities of the recipient, will not be taxable. Whether they are received in respect of an office or employment is primarily a question of fact having regard to all the circumstances.

Not always taxable

Even if the taxpayer does hold an office or employment, he will not be taxable if the gift was made to him solely as an expression of gratitude or a testimonial for what he had done.

Dream team

Finally, let us consider payments to Bobby Moore and Geoff Hurst, team members of the 1966 World Cup winning England team.

In Moore v Griffiths 48 TC 338 payments from the Football Association (FA) were considered. Bobby Moore was captain of the team. In June 1966 the FA resolved to pay a bonus of £22,000 to the members of the team in the event of their winning the cup, but the team was unaware of this until after it had won. In August 1966 Moore received £1,000 with a letter of congratulations and thanks from the FA, the 22 members of the World Cup squad having requested that the £22,000 should be divided equally between them. The judge concluded that the payment had the quality of a testimonial or accolade rather than remuneration.

The following factors pointed to that conclusion.

- The payment had no foreseeable element of recurrence.
- There was no expectation of reward.
- The payment was not made or even announced by the FA until after it had already dispensed with the services of Mr Moore.
- The action of the FA was applause for that victory and as a mark of its esteem rather than as a reward for services rendered by employees.
- The terms of the letter from the FA indicated that the payment was intended to mark its pride in a great achievement rather than to remunerate the meritorious execution of the employee's services'.
- Each member of the team, regardless of the number of times that he played or whether he was a player or a reserve, received precisely the same sum of £1,000. The sum therefore was not in any way linked with the quantum of any services rendered. Accordingly, the circumstances in which this payment was made, considered as a whole, led away from the conclusion that the payment was of the nature of a reward for services rendered.

Objective factors

Objective factors that would lead to a conclusion of an employment character would include evidence of:

- a right under an express or implied employment contract;
- an advance promise to entice a different level of employment service; or
- a custom or regular practice of such receipt in a particular type of employment relationship

The following situations would be cumulative evidence that a gratuitous payment was other than by virtue of the employment relationship:

- no tax deduction by the payer;
- evidence of a personal relationship, e.g. Miss Jones (the secretary) attending family weddings, drinks occasions, organising birthday cards etc.;
- the isolated nature of the payment: once might be unexpected, even twice, but thereafter there may well be an expectation that would suggest an informal employment relationship; or
- the occasion being an exceptional event (such as the sale of the family business which tends to only happen once).

From an article by John Hodgson

Capital Gains Tax

Entrepreneurs' relief and rent on business property

This article focuses on situations where the decision to charge rent may impact on the outcome of a claim to entitlement to entrepreneurs' relief under the soon-to-be TCGA 1992, ss 169H to 169S, currently found in Finance Bill 2008, Sch 3. Unless noted otherwise, all references below are to the new ss 169H to 169S.

The focus of this article is solely upon the capital gains tax issues. In each of the scenarios explored it is likely that there will be VAT and stamp duty land tax implications of the structure, and consideration needs to be given to property law generally. Where the asset in question is settled property, advisers will need to take trust law issues on board too.

What follows comprises commentary from the standpoint of the entrepreneurs' relief provision in respect of some common scenarios.

John — a sole trader

Entrepreneurs' relief arises to sole traders who make 'qualifying business disposals' within s 169H.

Let us assume that John has been a sole trader for several years trading from Unit B6, a building owned by him. In recent years, John has outsourced the manufacturing side of his business and this has freed up approximately 40% of Unit B6 which he has let on a short lease to a third party.

Say, in January 2009, John decides to retire and sell the business as a going concern. He immediately finds a buyer and the buyer is happy to let the tenant continue in occupation until his lease expires.

On the disposal of the business the following capital gains arise:

Asset	Gain (£)
Goodwill	600,000
Sale of Unit B6	400,000

John has read in the financial pages of his Sunday newspaper that, because the gain amounts to not more than £1 million he will not pay tax of more than 10%. John reports the transaction to his taxation adviser only after the disposal has been made. His adviser starts to consider the issues.

Is there a reduction in relief?

The main question which arises is to what extent may John's gain on the disposal of Unit B6 be reduced by entrepreneurs' relief? Is there a restriction because of the letting of 40% of the building for a period of time?

Section 169H(1), (2) and s 169I(1), (2)(a) and (3) combine to require John to demonstrate that he has disposed of a business (or part of a business) which has been owned by him for a period of at least one year ending with the date of disposal. In so doing, John can demonstrate that he has made a qualifying business disposal, being a material disposal of business assets falling within s 169I. These requirements are clearly met. However, John's adviser is also worried about s 169H(3) which contains a further requirement. It reads as follows.

'But in the case of certain qualifying business disposals, entrepreneurs' relief is given only in respect of disposals of relevant business assets comprised in the qualifying business disposal: see s 169L.'

Broadly speaking, s 169L has effect so that, where the asset disposed of is used in a trade carried on by a sole tradership or a partnership, it is necessary for the assets comprised in the qualifying business disposal referred to above to be 'relevant business assets'.

<u>What is a relevant business asset?</u>

Subject to one important proviso (see below), in the case of a disposal of a sole tradership, a relevant business asset is an asset used for the purpose of a business carried on by the individual (s 169L(3)). There is no requirement in the legislation for the asset to be fully used in the business. It must be in use in the business at the time the business is disposed of and, because this was the case in John's situation, his £400,000 gain on the property disposal is potentially eligible to be reduced by entrepreneurs' relief.

Turning to the proviso in s 169L referred to above, it is provided that certain assets are to be considered as 'excluded assets' and the gains thereon cannot be reduced by entrepreneurs' relief. Section 169L(4) reads as follows:

'The following are excluded assets:

(a) shares and securities; and

(b) assets, other than shares or securities, which are held as investments.'

Clearly, John's interest in the building is neither a share nor a security, but the question is whether the property could be regarded as an investment asset by HMRC. In the author's opinion, an asset purchased by a trader to provide himself with a place from where to carry on business operated as a sole tradership is not to be regarded as an investment asset, whether or not it is subsequently let as described.

Therefore, John's claim to entrepreneurs' relief would not be restricted. If John has made no other disposal attracting relief, he will reduce the aggregate of his capital gains arising on his two relevant business assets by 4/9ths; i.e. from £1 million to £555,555.

<u>Letting an investment asset</u>

Of course, little in tax is that straightforward. Let's now say that John had originally acquired the premises to let it out to third parties. Only subsequently had he installed himself as a part user of the building, occupying say 25% for his sole tradership. Here, entrepreneurs' relief could well be restricted as HMRC could argue that the asset had remained an investment asset throughout and, as such, then assess the full gain (not just 75% of it) as an 'excluded asset' under s 169L(4) (see above). The reality is likely to be that John occupying 60% would be accepted, but if John only occupied 10% he would have to argue his case — with some considerable difficulty. HMRC might perceive his occupation as driven by entrepreneurs' relief planning!
Fred and business cessation

The next scenario also involves a sole trader. In March 2009, Fred, who has owned his business for many years, disposes of the goodwill of his business and ceases to carry on his trade. The goodwill disposal crystallises a capital gain of £400,000 which is reduced by 4/9ths to £222,222. Fred owned the premises from where his former business was operated. He has viewed this asset as his 'pension fund' and he has let it to the new owner of the business at a full market rent.

After two years, the new owner of the business goes bankrupt and Fred regains vacant possession. Thirty months after ceasing to trade, Fred sells the building to a developer realising a capital gain of £1 million. The question is, can Fred claim the balance of his £1 million lifetime entrepreneurs' relief?

The answer here is that s 169I((2)(b) and subsection (4) thereof combine to allow the post-cessation disposal of an asset to, nevertheless, be treated as a material disposal of a business asset. This is so even though the asset has been leased to a third party.

Provided the post-cessation asset disposal takes place not more than three years after the business ceases (and the chargeable asset was in use in the business when the business was disposed of), entrepreneurs' relief can be claimed. Use during the post cessation of business period (maximum three year period) is not a factor taken into account.

In this scenario, Fred's £1 million gain would be taxed as in example 1.

Example 1

	(£)	(£)
Gain on disposal of building		1,000,000
Maximum gain eligible for entrepreneurs' relief (£1 million less previous goodwill gain £400,000)		600,000
Part of gain not eligible to be reduced by relief		400,000
Part of gain eligible for relief	600,000	
Entrepreneurs' relief 4/9ths	266,667	
Taxable at 18%		333,333
Therefore gain as reduced by entrepreneurs' relief is:		733,333
Less: Annual exemption (say)		10,000
Assessable at 18%:		723,333

Associated disposals

The position regarding an associated disposal, i.e. the disposal of assets owned by an individual and provided either (i) for use in a trade of partnership of which he is a member, or (ii) for use by the owner's 'personal company' in its trade, which is provided for in s 169K, is not so generous.

In the case of such use by a partnership or a personal company (broadly, a company where the asset owner is either an employee or officer thereof and owns at least 5% of the ordinary shares and controls at least 5% of the voting rights by virtue of the shares held) there is a restriction to be made when calculating the availability of entrepreneurs' relief. Put simply, if the asset has been provided in consideration for the payment of rent or other consideration, the relief available is restricted. Where the rent paid is at the level of a full market rent, the relief is reduced to nil. Where the rent paid is less than market rent, the relief is restricted on a 'just and reasonable' basis (s 169P(2)).

Accordingly, if, say, Simon had let a factory to his personal company throughout the period he owned the asset at 50% of the market rent and he makes a capital gain on its disposal (which must, inter alia, be linked to a disposal of his shares in the company in question if it is to be an associated disposal (see s 169K(3)) his entrepreneurs' relief would be restricted as shown in example 2.

Example 2

	(£)	(£)
Say, gain on sale of factory		1,000,000
Less: 50% not eligible for relief		500,000
		500,000
Gain eligible for relief	£500,000	
Less: entrepreneurs' relief (4/9ths)	222,223	
Balance		277,777
Assessable		777,777

The £500,000 balance of Simon's £1 million lifetime limit will be available against the gain arising on the disposal of shares in his personal company with which the property disposal is associated.
Partners and associated disposals

As regards associated disposals involving an asset previously provided by one or more partners in a partnership, there is a particular point to note.

This concerns the precise wording of the rent restriction operating in associated disposal situations. The restriction is found in s 169P(4)(d) and applies where 'for the whole or any part of the period for which the assets which (or interests in which) are disposed of are in use for the purposes of the business, their availability is dependent on the payment of rent'.

The question which arises is what constitutes 'rent'? What is the position if, say, an asset is owned jointly by two partners, A and B, out of a total of six equity partners and under the partnership arrangements there is an agreement that A and B will receive the first tranche of profits, being £50,000, to reflect the level of rent which would be payable for a similar property if the two partners were not making the property available? Does this arrangement constitute the payment of consideration which is to be regarded as rent? At first sight, an unwelcome answer for many partners (possibly putting a smile on the faces of their colleagues) is found in s 169S(5) which defines rent as including 'any form of consideration given for the use of the asset'. From this it would not be unreasonable to say that the profit-sharing arrangements do constitute consideration given for the use of the asset and for the entrepreneurs' relief to be restricted.

However, it is understood that, in most instances HMRC will not take this view, the motive behind the extended meaning of rent is to catch other payments dressed up to be something other than rent.
An iniquitous situation?

As regards associated disposals and the payment of rent, etc. a government minister has indicated (at the Report stage of the Finance Bill) that the Treasury will look again at the iniquitous situation currently found in the provision relating to past rents.

The pre-6 April taper relief provisions do not penalise a taxpayer for letting an asset to his personal company or to a partnership, but those same lettings will restrict entrepreneurs' relief — even if such rents were to cease with effect from 6 April 2008. The legislation requires entrepreneurs' relief to be restricted where at any time during the period of ownership of the asset it was in use in the partnership or the personal company. If the rent were to be waived from 6 April 2008, a restriction in the level of entrepreneurs' relief available will still apply as regards the previous rental payments.

We await developments here.

Trust gains

The next issue concerns the use of trust assets in consideration for the payment of rent by a beneficiary to the trust.

There is a limited form of entrepreneurs' relief available here, but it is important to understand that trusts do not have their own lifetime allowance of entrepreneurs' relief. What is possible — in limited circumstances — is for a beneficiary to effectively surrender part of his £1 million lifetime relief to the trustees.

This is not an article about entrepreneurs' relief and trust gains generally but, briefly, the situations where a trust can benefit from entrepreneurs' relief can be summarised as follows.

- Only 'qualifying beneficiaries' of a trust can surrender relief to the trustees of that trust. Broadly, 'qualifying beneficiaries' are those with an interest in possession rather than discretionary beneficiaries, but see s 169J(3) for full definition.

- The disposal must be either shares in a company which is the qualifying beneficiary's personal company (referred to earlier in this article) or be a 'relevant business asset' — an asset used in a business carried on by the beneficiary in question.

In addition, in the case of an asset disposal by the trustees, it must be shown that:

- throughout a period of at least one year ending on the asset disposal in question the asset was used for the purposes of a business carried on by the qualifying beneficiary (or by a partnership of which he is a member); or

- it was so used throughout a period of one year ending within the three-year period ending on the asset disposal in question; and

- the qualifying beneficiary either ceases to carry on the business in question at the time of the disposal of the asset or has done so not more than three years earlier.

Rent and excluded assets

Therefore, taking on board the limited circumstances outlined above, the question of relevance to this article is what happens if the trustees charge rent or other consideration for the use of the asset in question? The first point to note is that the charging of rent by the trustees for the use of an asset used by the beneficiary's personal company is not an issue because a trust gain arising on such an asset cannot attract relief; while a trust gain arising on shares in a personal company of a qualifying beneficiary may qualify for entrepreneurs' relief, a trust gain on an asset, say trading premises, let to such a company cannot.

The main issue here is whether or not a trust gain arising on the disposal of an asset, say trading premises, used in a business carried on by a beneficiary can benefit from entrepreneurs' relief where it has been the subject of a rent charge. On the face of the legislation summarised above, the charging of rent is not a factor to be taken into account.

However, there is one more condition not highlighted above. It is arguable that all trust assets, if they are to be eligible for relief, must be 'relevant business assets' as defined in s 169L(2), (3). This being so, the trustees must be able to show that the asset is not an excluded asset within s 169L(4); in particular, not an investment asset. How can such assets held by trustees not be investment assets — irrespective of whether the trustees charge rent?

Clarification please

In summary, the issue as regards trustees charging a qualifying beneficiary rent is solely one of whether all trust assets are held as investment assets and cannot therefore by their very nature benefit from any entrepreneurs' relief.

If this were to be the case, it would clearly fly in the face of the purpose of the provision and it is to be hoped that after the Finance Act 2008 has received Royal Assent, the position will be clarified. If partners receiving a prior share of partnership profits are not to be treated as receiving disguised rent as described earlier, trustees who hold assets should enjoy similar 'helpful' interpretation of the statute.

Kevin Slevin writing in Taxation, May 2008

STOP PRESS

On 25 June 2008 the Government tabled a Finance Bill amendment to entrepreneurs' relief relating to associated disposals.

Initially, under the rules for entrepreneurs' relief, assets owned by an individual would not have qualified in full for the relief if he or she had let them to his personal company.

The amendment assuages this problem so that assets that are used that way before 6 April 2008 (but not after that date) will qualify for entrepreneurs' relief.

Restrictions on assets owned by the individual but let to unrelated third parties are not affected.

Lecture P483 (16.15 Minutes)

Planning for future disposals under entrepreneurs relief

Apart from the matters discussed in earlier sessions, there are a number of other points which indicate that tax planning under entrepreneurs' relief will, if anything, contain more pitfalls than those which arose in connection with the previous regime.

Using the family

Where a client is married, the easiest way to 'stretch' the new relief is to ensure that both spouses qualify, whenever possible. If a husband who owns 50% of a family company – his brother is the only other shareholder – gives half of his shares to his wife, each party will be entitled to claim entrepreneurs' relief if the company is taken over, say, 18 months later. This assumes that, in addition to her 25% shareholding, the wife has been a director or employee of the company for at least the last 12 months. Similarly, where children are involved, a pre-sale gift of the requisite number of shares to a son or daughter accompanied by a holdover claim under S165 TCGA 1992 should enable a larger amount of entrepreneurs' relief to be claimed in total.

Earn-outs straddling 6 April 2008

Where a sale has already been concluded with an earn-out which is satisfied in loan notes, the normal deferral rule in S138A TCGA 1992 will apply. In broad terms, this has two effects:

(i) there is no initial CGT charge on the value of the earn-out right; and

(ii) the gains relating to the earn-out loan notes will only be taxed when they are cashed in.

Given that the loan note redemptions will now fall to be taxed under the post-5 April 2008 flat rate rules, the vendor should consider whether it will be advantageous to make a S138A(2A) TCGA 1992 election to disapply the deferral provisions. By making this election, he becomes taxable on a *Marren v Ingles (1980)* basis so that the initial value of the earn-out right is charged as part of the sale consideration for his shares. Thus the vendor will effectively have shifted more of his overall gain on the transaction into the favourable pre-6 April 2008 regime. In the case of a sale which took place in 2006/07, this opt-out election must be made no later than 31 January 2009. If it took place in 2007/08, the critical date is 31 January 2010.

Property letting

Consider, for example, a client who owns commercial property which he has let to an unconnected business. In the past, his property ownership would have been eligible for business asset taper (provided that the tenant was a trading operation), but there is no entrepreneurs' relief for disposals of such assets in 2008/09 and later years. Property investments of this sort are now less attractive from a taxation point of view. Accordingly, investors may, in future, increasingly turn to furnished holiday lettings, the gains on which *will* qualify for the new relief.

Enterprise management incentive (EMI) share options

A serious loser in the revised CGT stakes is an employee who holds EMI share options. Although the maximum value of shares in respect of which EMI options can be granted has been increased from £100,000 to £120,000 for grants made on or after 6 April 2008, such arrangements have been dealt an unmistakable body-blow by the abolition of taper relief. Because taper on EMI shares accrued from the date of grant rather than the date of exercise, it was possible for employees to exercise their options (having waited for two or more years to see how their company was performing) and then sell their shares on the following day with the benefit of immediate 75% business asset taper. This is no longer possible – indeed, entrepreneurs' relief will only start to accrue once the employee has acquired his shares which will now have to be held for at least 12

months before the relief can be claimed. In addition, the employee has to meet the various 5% tests in the legislation, but it is probable that many will be unable to do so. As one commentator has pointed out:

'One can only wonder if this is an intended effect, since it surely discourages the entrepreneurialism and support of small enterprises which the Government have historically been at pains to promote.'

Piecemeal sales

A client who is planning to sell his shares piecemeal will need to retain a minimum 5% stake in order to be eligible to claim entrepreneurs' relief on the remaining shares in the future.

Sale-driven incorporations

Sole traders who incorporate their business prior to a sale will have to wait at least 12 months before going ahead with the disposal of their shares. Alternatively, if they incorporate using S162 TCGA 1992, they can always make a disapplication election under S162A TCGA 1992.

Article by Robert Jamieson

Lecture P484 (19.09 Minutes)

British CGT lawsuit in Spain

As British holidaymakers head to Spain this summer in their thousands, many more are expected to be battling to reclaim millions of pounds from the country's tax authorities.

Around 300 Britons have begun their attempt to reclaim capital gains tax, after being overcharged by 20% following the sale of properties in Spain between June 2004 and December 2006, and many more complainants are forecast to come forward.

Currency exchange broker HiFX, which is working to publicise the case, estimates that around 4,500 people could soon be making claims at an average amount per person of £19,300, making a total of more than £86 million.

The case against the overcharge was sparked when British non-residents were charged Spanish non-residents' income tax rate of 35% on capital gains, compared to the rate of 15% paid by Spanish nationals.

In January this year, the European Commission judged that this contravened EC Treaty rules on discrimination and therefore was unduly charged by the Spanish government – which as a result is facing a class action lawsuit.

Many plaintiffs are expected to also demand missing interest at a compound rate of 6%, meaning payouts could be on average of 26% larger than first predicted.

HiFX director Mark Bodega said: 'We have always said it would be extremely difficult to put an actual figure on the number of people affected by this tax issue and how much they would be able to reclaim.

'This is largely because the Spanish government will not reveal this information.

'However, the sums that people are coming forward to reclaim are much larger than anticipated [and] we anticipate there are… still a lot of people who need to come forward to reclaim what is rightfully theirs.'

Share sales by individuals

Finance Bill 2008 brings in a fundamental reform to capital gains tax rules with effect from 6 April 2008. The reform is not only to 'simplify' CGT for individuals, trusts and personal representatives (so note that companies are unaffected) but also to raise revenue for the Exchequer.

At the heart of this 'simplification' is removal of the potential complexity of indexation allowance and taper relief and to introduce a flat rate of CGT of 18% on all assets. This aim for 'simplification' was impaired slightly, but nevertheless welcomed, by the late announcement of the introduction of a 10% rate on the disposal of certain business assets, called 'entrepreneurs' relief'.

On the disposal of shares on or after 6 April 2008, the new regime can be summarised as follows:

- Only UK resident or ordinarily resident individuals are subject to capital gains tax.
- The gain is calculated by deducting the base cost of the shares from the disposal proceeds. The base cost will generally be the sum paid for the shares, incidental expenses on their purchase and sale, including stamp duty.
- The base cost is NOT increased by indexation allowance.
- Automatic rebasing of shares held on 31 March 1982 to their market value on that date (with 'halving relief' abolished).
- No taper relief.
- A flat rate of CGT of 18%
- Entrepreneurs' relief available on certain qualifying disposals of business assets reducing the effective CGT rate to 10%.
- The gain can be relieved by any brought forward or same year capital losses.
- Individuals are also entitled an annual exemption of £9,600 (for 2008/09).

Entrepreneurs' relief

In the 2007 Pre-Budget Report the introduction of the 18% flat rate was announced by the Government as the closing of a loophole in the CGT regime; abused, it was perceived, by the private equity market. However, it was argued by the CBI, amongst many other representatives of the business community, that the original proposals were poorly targeted and affected all taxpayers including any long-term holder of business assets such as shareholders in family trading companies, and employees in company share schemes. But at the same time, shareholders in investment companies and those with portfolio holdings would potentially benefit. Taper relief for these holdings only reduced the CGT rate to a minimum of 24% of the indexed gain.

It was perhaps no surprise therefore that an amendment to the original proposals was made in respect of the sale of certain business assets. These rules on 'entrepreneurs' relief' were announced on 24 January 2008, but it was not until 28 February 2008 that HMRC finally released draft legislation and a page of 'frequently asked questions' on the subject.

The new entrepreneurs' relief is intended to meet the concerns of those taxpayers who were perceived to be unfairly targeted by the original reforms.

Put simply, the relief works by allowing the first £1 million of gains made on qualifying business disposals in a taxpayer's lifetime to be charged to CGT at an effective rate of 10% (being 5/9ths of the 18% rate).

Example

Sarah sells her trading business and realises gains of £450,000 (before entrepreneurs' relief)

Gain	450,000
Less relief (4/9 of £450,000)	(200,000)
Chargeable gain (before annual exemption)	£250,000

Types of disposal

New section 169H introduces the three types of disposal that qualify:

1. a material disposal of business assets
2. a disposal of trust business assets, and
3. a disposal associated with a relevant material disposal.

A business is defined as anything which is a trade, profession, or vocation and is conducted on a commercial basis and with a view to the realisation of profits.

Material disposal of business assets

1. the disposal of the whole or part of a business: meaning an individual disposing of a business carried on alone or in partnership which the individual has owned throughout the 12 months ending with the date of disposal

   Example

   Fred has owned his quarrying business since April 2000. He sold the business as a going concern in May 2008 and made a gain of £500,000. As he has owned the business for over a year and sold the whole business the disposal would qualify for entrepreneurs' relief.

Where part of a business is being sold the old retirement relief case of McGreggor v Adcock should be referred to for the courts likely views. That case concerned the disposal of a 5 acre field out of 20 or so acres and was ineligible for retirement relief. The answer to FAQ 5 seems to confirm HMRC's interpretation of the new rules where an asset is disposed of in isolation.

2. the disposal of (or interests in) one or more assets in use, at the time at which a business ceases to be carried on, for the purposes of the business: meaning an individual disposing of assets of a business in (1) above within three years of the cessation of that business

3. the disposal of one or more assets consisting of (or interests in) shares in or securities of a company - meaning that throughout the year ending with the date of disposal:

   a. the company is the individual's personal company – in other words, the seller owns at least 5% of the ordinary shares giving him at least 5% of the voting rights, and

   b. the company is a trading company or the holding company of a trading group, and

   c. the individual is an officer or employee of the company or one or more of the companies that are members of the group.

   This is called 'Condition A' in the section 169I.

   - or meaning that within the three years immediately preceding the disposal, the company ceased to be either a trading company or a member of a trading group but satisfied 'Condition A' throughout the year preceding cessation ('Condition B').

     Example

     Barney has owned all of the shares in Rubble Limited since 1995. The company ceased trading as a result of Barney's ill health in June 2008. In December 2008 the company was liquidated resulting in a capital gain of £1.2 million. As the disposal is within 3 years of the cessation of the trade which was carried on for at least one year immediately prior to cessation the first £1 million gain would qualify for entrepreneurs' relief.

Disposals of trust business assets

Where the assets are shares or securities, and the beneficiary of the trust has an interest in possession in those assets, then entrepreneurs' relief is available to the trustees so long as the beneficiary meets

the conditions for relief as if he were disposing of the shares. Those conditions are throughout a period of one year ending not earlier than three years before the disposal:

- the company is the qualifying beneficiary's personal company
- the company is either a trading company or the holding company of a trading group and
- the beneficiary is an office or employee of the company or of one or more companies which are members of the trading group.

In relation to a disposal of assets used or previously used for the purposes of a business (including that of a partnership), then those assets must have been used by the beneficiary throughout a period of one year ending not earlier than three years before the disposal, and the beneficiary must have ceased carrying on the business on its disposal or within three years earlier

Associated disposals

Entrepreneurs' relief may also be available for disposals associated with relevant material disposals – new section 169K. Three conditions must be met:

- The material disposal is either the disposal of the whole or part of the individual's interest in the assets of a partnership or the disposal of shares in or securities of a company.
- The individual concerned is making the disposal as part of his 'withdrawal from participation' in the business carried on by the partnership or by the company.
- Throughout the year ending with the earlier of the disposal and the cessation of the business, the assets disposed of are in use for the purposes of the business.

The relief may therefore be available in the situation where an individual disposes of a property that is used by the business from which he is withdrawing his participation in.

However, relief is restricted to a 'just and reasonable' amount taking into account:

- the relative lengths of periods of business and non-business use,
- the part of the asset used for business purposes
- the length of period that the individual was involved in carrying on of the business, and
- if the asset is property on which the individual receives rent, the extent to which the rent paid is less than the full market rent for the assets.

Contrast this with the rules for taper relief where business asset taper was unaffected by charging of rent.

Example

Wilma, is the controlling shareholder and director of her own fashion retail company. She has been renting premises that she owns personally to her company at full market rent throughout the 5 year period of ownership. The disposal of the premises at the same time of the shares would not qualify as an associated disposal.

If Wilma stopped charging rent to her company for the last year of ownership, one fifth of the gain would now be eligible for entrepreneurs' relief.

Meaning of 'trading company' and 'trading group'

One of the conditions that a disposal of shares or securities in a company is a material disposal is that the company is a trading company or the holding company of a trading group throughout the period of one year ending with the date of disposal.

A new provision is introduced in new section 165A to define 'holding company', trading company' and trading group'.

A 'holding company is a company that has one or more 51% subsidiaries (section 838 ICTA 1988).

A 'trading company' is a company carrying on trading activities whose activities do not include to a substantial extent, activities other than trading activities. 'Trading activities' broadly means activities carried on by the company in the course of, or for the purposes of, a trade carried on by it.

A 'trading group' is a group of companies, whose members' activities, taken together, do not include to a 'substantial' extent activities other than trading activities. The activities of the members of a group are treated as one business and intra-group activities are disregarded for these purposes.

A 'group of companies': company plus effective 51% subsidiaries (may include non-resident companies).

These definitions are common to the substantial shareholdings exemption and CGT entrepreneurs' relief.

Amount of relief

The amount of relief that can be claimed is aggregated 'relevant gains' less aggregated 'relevant losses' in the tax year reduced by 4/9ths.

'Relevant gains' means gains on the disposal of a qualifying business disposal of shares or securities of a company and gains on the disposal of any 'relevant business assets' comprised in any other qualifying business disposal. 'Relevant losses' has a similar meaning with regard to respective losses. 'Relevant business assets' is defined as, broadly speaking, the assets used for the purpose of the business other than shares, securities and assets held as investments.

If the amount of net gains, plus net gains from 'earlier relevant qualifying business disposals', exceeds £1m, then the reducing fraction is applied only to the net gains which fall below £1m.

Claims for entrepreneurs' relief

New section 169M confirms that the relief must be claimed and the claim must be made on or before the first anniversary of the 31 January following the tax year in which the disposal is made.

The form of consideration

Receiving cash for shares should have straight forward CGT consequences, with a CGT computation being prepared in the normal way.

The date of the sale will normally be the date of exchange of contracts unless the contract is conditional whereupon the disposal date will be the date on which that condition (which must be a condition precedent) is satisfied. Determining the date of sale would affect the calculation of taper relief (none after 5 April 2008); and the tax year in which the disposal takes place. Conditional contracts can be used to defer the disposal point past 5 April into a new tax year and therefore postpone the CGT by twelve months.

Apart from cash, there are a number of common ways in which a share sale will be structured, often dependent on the form of consideration that the vendor wishes to receive.

These notes consider

- Paper for paper exchanges
- Acquisition for loan loans
- Acquisitions involving deferred consideration and earn outs

From an article by Bob Trunchion

Lecture B481 (12.10 Minutes)

Paper for paper exchanges

'No disposal' rule

The capital gains legislation provides an important and automatic relief where there is an exchange of securities in one company for those in another company in a typical takeover situation.

No chargeable disposal arises and instead the new securities issued (shares or debentures) are treated as 'standing in the shoes' of the old shares and take on the same base cost and deemed to have been acquired when the old shares were acquired.

Such a "paper for paper" transaction does not amount to a chargeable disposal provided either:

- the acquiring company B obtains more than 25% of the ordinary share capital of the target company A; or

- there is a general offer which, if accepted, would give the acquiring company B control of target company A; or
- where as a consequence of the exchange of securities, the acquiring company B holds the greater part of the voting power of target company A.

This section applies sections 127 to 131 (share reorganisations) with the necessary adaptations as if company A and company B were the same company and the exchange were a reorganisation of its share capital.

Example

Andy has owned 100% of the shares in his trading company Pandy Manufacturing Ltd since 1998 when he subscribed £100 for 100 £1 ordinary shares. In July 2008 he received a takeover offer from Looby Loo plc, a listed company. The offer was valued at £1,000,000 and comprised 250,000 ordinary shares in Looby Loo plc, valued at £4 a share and represents about a 1% interest in the acquiring company.

As the rules in s135 TCGA 1992 apply to the takeover there would be no disposal when Andy exchanges his old shares for the new shares in Looby Loo plc. The new shares would be deemed to have a base cost of £100 the original cost of the old shares.

When the new shares are sold (following a s135 reorganisation), the chargeable gain will be taxed under the new CGT regime and therefore any taper relief accrued on the old shares falls away.

Disapplication of the 'no disposal' rule

It is possible of course that the exchange, etc. could qualify for entrepreneurs' relief but by the time the new shares are disposed of, the conditions for relief are not met.

The entrepreneurs' relief rules allow for a claim to be made so as to ignore the normal rule that there was 'no disposal' and instead to treat the gain as subject to a claim under entrepreneurs' relief.

The claim must be made on or before the first anniversary of 31 January following the end of the tax year in which the reorganisation takes place.

Example

Continuing the previous example, as Andy's shareholding in Looby Loo plc will not qualify for entrepreneurs' relief (being less than 5%) there would be relief on the ultimate disposal of the new shares. He would be advised to make an election to disapply s135 and take advantage of entrepreneurs' relief against the £1 million gain at the time of the takeover. The new shares would then have a capital gains base cost of £1 million for subsequent disposal.

His gain would therefore be:

Proceeds	*1,000,000*
Less cost / IA	*(100)*
Gain	*999,900*
Less:	
Entrepreneurs' relief (4/9 x £999,900)	*(444,400)*
Gain	*£555,500*
CGT @ 18%	*£99,990*

Note that the capital gains tax, near enough £100,000 would be payable by 31 January following the year of disposal, and there may not be funds available to pay the tax liability as the transaction is merely a paper for paper exchange.

Advance clearance

The section has effect subject to section 137(1) which specifies that the exchange of securities must be for bona fide commercial reasons and not part of a scheme or arrangements of which the main purpose or one of the main purposes, is avoidance of tax. However, persons holding 5% or less of any class of shares or debentures as a result of the exchange are not in any case denied relief by section 137.

Although not absolutely necessary the legislation provides the comfort of an advance clearance procedure that the conditions of section 137(1) are met.

The case of a Mr Snell recently considered the tests of section 137(1). Mr Snell sold his shares in his family company in December 1996. Consideration for the shares was £7.3m of which £6.6m was in loan stock. Before redeeming his loan stock. Mr Snell moved abroad and became non-resident for tax purposes. He redeemed the loan stock in July 1997 and claimed that under s136 he rolled over the gain in December 1996 and the gain crystallised when he was not resident and not liable to CGT.

In terms of whether the transaction was carried out for bona fide commercial reasons, both the Special Commissioners and the High Court accepted that it was necessary to only look the transaction effected (the exchange of shares) If that exchange was for bone fide commercial reasons, which they agreed it was, it was not necessary to consider why Mr Snell had chosen to take loan stock rather than cash or shares.

But on the tax avoidance test, the judge considered, first, whether there was a scheme or arrangement and, second, whether the purpose was tax avoidance. On the first point, the judge concluded that there was a scheme or arrangement (a 'plan of action' or 'combination of events') linking Mr Snell becoming non-resident with the acceptance of loan notes and their redemption when non-resident. On the second, he found that on the basis of the evidence, the only purpose of the scheme was to avoid tax.

From an article by Bob Trunchion

Lecture B482 (9.31Minutes)

Acquisition for loan notes

Shares received under a paper for paper exchange can be relatively illiquid and it may be preferable therefore for individual shareholders to receive debentures or loan notes. Two advantages, assuming certain conditions are met, are:

- deferring the liability to chargeable gains, and
- phasing the disposal over more than one tax year in order to utilise several years worth of annual exemption (£9,600 for 2008/09) and

It was also the case that under the CGT regime prior to 6 April 2008, the opportunity to acquire could extend the period for taper relief. However, following the withdrawal of taper relief, that advantage disappears but there still remains an important distinction to be made in receiving loan notes whether to receive then as qualifying corporate bonds (QCBs) or non-qualifying corporate bonds (non-QCBs).

QCBs and non-QCBs

Loan notes can be divided between QCBs and those which are not (non-QCBs). A QCB is exempt from CGT for an individual and therefore the 'roll-over' rules in section 135 do not apply to QCBs.

Instead, where QCBs are issued in satisfaction of the proceeds on sale of shares, the gain crystallises at the date of sale and is held over (or 'frozen') pending the redemption of the note.

Until 5 April 2008, the decision to take QCBs or non-QCBs had been driven mainly by whether the taxpayer needed to extend their relevant holding period for taper relief purposes. No further taper relief would have accrued when a gain crystallised on shares exchanged for QCBs but would have done so if exchanged for non-QCBs. Non-QCBs therefore proved a favoured option if the owner had not yet held the shares for at least two years.

From 6 April 2008, no taper relief is available in calculating the taxable gain on the sale or redemption of a QCB or a non-QCB, whether or not the shares were disposed of before 6 April 2008.

QCBs

As noted above, where a paper-for-paper exchange involves the acquisition of QCBs the rules in section 116 TCGA 1992 apply for a gain to be calculated on the exchange into QCBs but for the charge on that gain to be held over until the QCBs are redeemed or sold.

For the purposes of entrepreneurs' relief, section 169R deems the exchange into QCBs to be a disposal and if the disposal meets the relevant conditions for relief then the gain held over is reduced accordingly.

Example

In the example above involving the takeover of Pandy Ltd by Looby Loo plc, if the consideration had instead have been £1 million worth of Looby Loo plc sterling debentures then Andy would be treated as having made a gain of £1 million. However the gain would be deferred until the debentures are disposed of or redeemed. Again Andy would not qualify for entrepreneurs' relief on redemption of the Looby Loo plc debentures and thus would again be advised to disapply s135 and elect for entrepreneurs' relief at the time of the takeover.

Transitional rules for QCBs

Where there was an exchange of shares for QCBs before 6 April 2008 but the charge on the gain is deferred under section 116 until on or after that date, the transitional rules in the Finance Bill provide that entrepreneurs' relief may be claimed in respect of the chargeable gain. This is on condition that the disposal of the old asset would have qualified for entrepreneurs' relief at the time of the exchange.

The relief is only available to the individual who exchanged the shares. If that person has since transferred the QCBs to a spouse or civil partner, then the relief is not available.

Example

Noddy has owned 100% of the share capital of Toytown Ltd, a trading company since 1982 when he subscribed £100 for 100 £1 shares. The company was taken over by Big Ears plc in March 2007 for £5 million, and Noddy received £3 million cash and £2 million QCB loan notes in Big Ears plc redeemable in March 2009.

The gain on the cash element £3 million (less £60) in March 2007 would have attracted business asset taper, reducing the gain chargeable to £750,000, with CGT payable of approximately £300,000.

The £2 million gain (less £40) attributable to the QCB loan notes would be deferred until the loan notes are redeemed in March 2009. Although the disposal appears to have qualified for business asset taper, its abolition with effect from 6 April 2008 means that the deferred gain £2 million will come into charge in March 2009 and taxed according to the rules that apply at that date. In the absence of entrepreneurs' relief the CGT liability would be 18%, £360,000.

However, as Noddy would have qualified for entrepreneurs' relief had the disposal taken place in March 2007 (5% held for a year, employee, and trading company) then the relief can be claimed against his March 2009 gain

Gain on 2007 loan QCBs	*2,000,000*
Less relief (4/9 of £1,000,000)	*(444,444)*
Chargeable gain (before annual exemption)	*£1,555,555*
CGT liability @ 18%	*£280,000 (or £1m @10% and the next £1m @ 18%)*

Non-QCBs

For non-QCB holders, the chargeable gain is held over from the sale of shares but, again, no taper relief will be given on that gain.

Entrepreneurs' relief would only be available on the redemption of the loan notes if the conditions for entrepreneurs' relief are met at the time of redemption. Relief will therefore depend on his holding in ordinary shares in the company and whether he is an employee of officer of that company.

Terms of the loan note

The decision for shareholders in future will be whether they wish to 'lock-in' the chargeable gain at the time of exchange for loan notes irrespective of the value of the loan notes on disposal (the QCB route), or to defer the gain but accept that the chargeable gain will be based on the value at disposal (the non-QCB route).

Structuring a loan note

A QCB is defined in section 117 as a security, the debt on which has at all times represented a normal commercial loan and which is expressed in sterling and in respect of which no provision is made for conversion into, or redemption in, a currency other than sterling.

A non-QCB would therefore need to include one or more of the following provisions:

- a right to subscribe for further loan notes,
- provision for a right to redeem, or expressing the notes, in a foreign currency,
- a right to convert into shares, or
- a right to interest which is dependent on the results of the business.

Period to redemption

Where redeemable loan stock is used, HMRC will normally not allow relief if it is redeemable within a period of less than six months of the transaction, as they take the view that it is tantamount to being cash (i.e. a post-dated cheque).

From an article by Bob Truncheon

Lecture B483 (7.11 Minutes)

Deferred consideration and earn-outs

An individual seller may be forced to take deferred consideration. This is probably because the buyer has insufficient funds at the time to pay the purchase price in cash or because it is in buyer's interest to make part of the valuation of the business contingent on future profitability.

Ascertainable consideration

Ascertainable consideration at the time of sale is brought into charge immediately whether payment is deferred on not. For example, completion accounts prepared shortly after completion may determine the price paid for the shares at completion.

If any part of the consideration is subsequently known to be irrecoverable, a tax repayment may be claimed.

Unascertainable consideration

Part or all of the deferred consideration may also be unascertainable. Earn-outs, for example, may be payable in cash or in paper, and are determined by reference to the performance of the business for a specific period after the acquisition.

In the case of Marren v Ingles, a right to receive deferred consideration was held to be a separate asset for CGT purposes. As a consequence, where a shareholder receives securities through an earn out provision on a take over, whilst there will be a CGT disposal on the ultimate disposal of the new shares obtained through the earn out there could be two earlier occasions of charge:

1. on the acquisition of the earn out right as part of the consideration for the original shares and
2. when the earn out right is disposed of in exchange for new shares.

Deferral of gain

Section 138A TCGA 1992 has the purpose of treating the exchange of shares for the right to an earn out, to be satisfied in the form of shares and/or loan notes, as a paper for paper exchange and thus facilitating the section 135 'no disposal' rule to operate.

The right to an earn out, to be satisfied in paper, is treated as a 'security' for CGT purposes in the form of a non-QCB but only where:

- the earn out right is to be satisfied by the issue of shares or debentures in the take over company;
- it is consideration for the transfer by the vendor of shares or debentures in the old company; and
- the value or quantity of new shares is unascertainable (probably hinging on the attainment of profit targets the in Newco etc).

When the earn out right is satisfied through the issue of new shares or non-QCB loan notes, this is treated under section 138A as a conversion of the deemed non-QCB security and therefore the no disposal rule under section 127 is applied. The gain on the original shares is therefore deferred further to the time of the ultimate disposal of the new shares or loan notes.

If the deemed non-QCB is 'exchanged' for the issue of QCBs, section 116 disapplies section 127 and section 116(10) operates to crystallise a gain and holds over the gain to redemption of the QCBs.

Entrepreneurs' relief on deferred gains

Under the old taper relief provisions, section 138A was particularly helpful as the 'roll over' into a non-QCB meant that the taper relief holding period on the original securities could continue to accrue usually resulting in vendors obtaining full business asset taper relief. This had the advantage over a right to an earn out in cash which ranked only for non-business taper. Consequently, vendors were often advised to structure their earn-out agreement so that they were satisfied in the form of short-dated (interest bearing) loan notes.

From 6 April 2008, taper relief is of course no longer relevant and therefore the question arises of whether entrepreneurs' relief is available

QCB earn-out

Section 169R deems that the issue of QCBs in satisfaction of an earn out right as a disposal and, if the individual is eligible for entrepreneurs' relief at the time of the disposal, then the gain that becomes chargeable and held over under section 116(10) is reduced by 4/9ths accordingly.

It must be a material disposal of business assets to qualify for entrepreneurs' relief and therefore the conditions in section 169I – hold 5% of the ordinary shares in a trading company and is a officer or employee – must all be met throughout the year to disposal. However, in most cases, the seller is unlikely to meet these conditions (particular the shareholding condition) at the time of the earn out!

A further consideration is to opt to be taxed on the receipt of the earn out right under the Marren v Ingles principle. This can be achieved by disapplying section 138A by electing under section 138A(2A). The election must be made on or before the first anniversary of 31 January following the tax year in which the original share sale is made. The election brings the gain on the receipt of the earn out right into charge which may be reduced if entrepreneurs relief is available at that time.

The effect is essentially the same as disapplying the no disposal rule under section 169Q. In fact, it would appear that instead of electing out of section 138A, an individual could elect under section 169Q to disapply section 127 (for disposals on or after 6 April 2008) with the same result. The election under section 169Q has the same 22 month deadline as section 138(2A).

Example

Mary subscribed £100 for the entire share capital of Mungo Ltd in 1990. On 30 June 2008, Mary sold Mungo Ltd to Midge Ltd for:

- *£300,000 in cash to be paid on completion and*
- *a deferred earn out based on certain profit targets over two years to be satisfied in the form of (QCB) loan notes in Midge Ltd.*

The maximum earn out is £1m and the right to receive it is valued on the takeover at £600k. The loan notes received in satisfaction of the earn out are worth £700k and are received in June 2010. Mary redeems the notes six months later in December 2010.

June 2008 -Cash

		£
Consideration		*300,000*
Less:		
Apportioned base cost	*£100 x 300k/(300k+600k)*	*(33)*
Gain		*299,967*
Less: entrepreneurs' relief	*4/9 x 299,967*	*(133,319)*
Chargeable gain		*166,648*
Less annual exemption		*(9,600)*
Taxable gain		*157,048*
CGT liability @ 18%		*£28,269*

Section 138A applies to defer the gain on the earn out.

December 2010 – Earn out

		£
Earn out proceeds		*700,000*
Less:		
Residual base cost	*£100 less £33*	*(67)*
Gain		*699,933*
Less: entrepreneurs' relief	*(not eligible)*	*-*
Chargeable gain		*699,933*
Less annual exemption (say)		*(10,500)*
Taxable gain		*689,433*
CGT liability @ 18%		*£124,098*

Total CGT liability of £153,367

If Mary elects out of section 138A treatment (by 31 January 2011), the whole consideration is taxed under the Marren v Ingles principles:

June 2008 –Cash plus value of earn out right

		£
Consideration (cash)		*300,000*
Value of earn out right		*600,000*
		900,000
Less:		
Base cost		*(100)*
Gain		*899,900*
Less: entrepreneurs' relief	*4/9 x 899,900*	*(399,956)*
Chargeable gain		*499,944*
Less annual exemption		*(9,600)*
Taxable gain		*490,344*
CGT liability @ 18%		*£88,262*

December 2010 – Earn out

		£
Earn out proceeds		*700,000*
Less:		
Base cost of right		*(600,000)*
Gain		*100,000*
Less: entrepreneurs' relief	*(not eligible)*	*-*
Chargeable gain		*100,000*
Less annual exemption (say)		*(10,500)*
Taxable gain		*89,500*
CGT liability @ 18%		*£16,110*

Total CGT liability of £104,372. This is almost £50,000 lower than if section 138A were not disapplied. However the decision must also take into account the cost of funding the earlier payment of tax, in this case about £60,000, and (although not a concern in this example) the difficulty of electing out of section 138A before the actual earn outs are known

Shares and/or non-QCB earn-out

Entrepreneurs' relief on the sale of new shares or redemption of non-QCBs issued to the seller will be available if the conditions in section 169I are met in the year prior to the disposal. As one of these conditions requires a holding of 5% of the ordinary shares in the company, it would perhaps be unusual in most takeovers if the relief could be claimed.

As referred to above, the seller could opt to be taxed on the receipt of the earn out right under the Marren v Ingles principle by electing to disapply section 138A and claiming entrepreneurs' relief on the gain (assuming the conditions for relief are met).

An election under section 169Q provides a further mechanism to disapply the no disposal rule in section 127 and claim relief on the disposal of the original shares

For completeness, it is worth adding that a section 169Q election cannot disapply the non-disposal on conversion of the earn out right (a deemed non-QCB under section 138A) to shares or non-QCBs. This is because section 169Q is only applicable on the 'non-disposal' of shares.

Loss carry back

Section 279A TCGA 1992 is another valuable provision where an earn out is received in cash. If a loss arises on the ultimate earn out, S279A provides a carry back of that loss against the gains arising on the receipt of the earn out right. Note that S279A is not available where S138A applies.

Example

Ernie Wright sold his shares in his trading company to a competitor on 1 June 2006. The terms of the deal were that Ernie received £500,000 cash immediately plus further cash in two years time dependant upon the future profits of the business. The amount of the future cash was determined by a formula that would provide an amount ranging from nil to £2 million in cash.

The net present value of the right to the future consideration was agreed with shares valuation division at £500,000 and consequently Ernie would be charged to capital gains tax on £1 million consideration (£500,000 cash now plus the value of the earn-out right).

The right to the future consideration (a chose in action) is treated as a new asset acquired at the time of the deal.

Let us assume that the amount that Ernie receives in 2008 under the earn–out formula is only £200,000. This would mean that Ernie realises a capital loss of £300,000 on the new asset acquired. S279B enables the loss to be set against the earlier gain.

However, this still leaves a decision to be made in the case of share sales as to whether to take the deferred consideration or take loan notes (QCBs or non-QCBs.

Stamp duty

Clearly, if an amount of consideration is unascertainable at the time of transaction, there would be difficulty, without specific rules, to calculate the correct amount of stamp duty payable. This would be where consideration is calculated by reference to future events such as future profits.

The 'contingency principle' therefore intervenes to provide certainty. The rules operate as follows:

- where a stated amount may increase or decrease, stamp duty is payable on the stated amount
- where a minimum amount is stated but no maximum, stamp duty is payable on the minimum amount
- where a maximum amount is stated, stamp duty is payable on the maximum amount.

Consideration for shares which is wholly unascertainable is not chargeable. However, this may be challenged by Stamp Office who may wish to refer to the market value of the shares at completion in assessing the duty (following the decision in).

Ascertainable consideration

Treatment is different for consideration that is undetermined but ascertainable at the time of completion. For example where the consideration is to be ascertained by reference to the completion accounts prepared perhaps several months later. In that case, stamp duty is assessed on the amount of consideration subsequently ascertained.

To avoid interest and penalties, the buyer should submit stock transfer forms for stamping within 30 days and should also make a payment on account by reference to the estimated amount. The Stamp Office will hold the forms pending confirmation of the amount of consideration and duty payable (the so-called 'wait and see' procedure). Alternatively, Stamp Office may allow provisional stamping of the stock transfer forms so that the share register can be updated. Stamp Office will require an undertaking in writing from the person submitting the transfers that they will be resubmitted when the consideration has been ascertained and pay (or receive a repayment of) any additional stamp duty and any interest.

Employment related securities

Where the seller of a business was also a director or employee of the business and/or becomes a director or employee of the acquirer there is risk that if not properly structured all or part of the earn out may be taxed as employment income if received by virtue of the individual's employment.

Where an earn-out operates entirely to cover further proceeds of sale, with no element of remuneration, then Income Tax and NICs should not be payable. But where an earn-out includes an element that passes value to a prospective employee of the acquiring company as reward for services over a performance period, then that remuneration element could be within the charge to Income Tax and NICs.

HMRC's Employment Related Securities manual confirms that when an earn out takes the form of a right to acquire securities at some time in the future subject to conditions, it will, for the purposes of Chapter 5 ITEPA 2003, be a 'securities option'. However, where the purchaser of a company has the choice of paying the earn-out in cash or securities, then it will not be a securities option.

The manual goes on to say that employees in receipt of such securities options may continue to work for the business or cease their employment. Employees who continue to work for the business will have acquired a securities option from their prospective employer and the legislation deems this to be 'by reason of employment'. But it also stresses that employees who cease to work at the time the business is sold may also be deemed to have acquired their option 'by reason of employment'

Assuming Chapter 5 applies for both categories there will be a potential liability to Income Tax and NIC on the receipt of the earn-out securities. However, where it can be shown that the earn-out is further consideration for the disposal of securities rather than value obtained by reason of employment, the value of securities exchanged for the earn-out will be taken to be equal to the value of the securities acquired under the earn-out itself. There will then be no liability to Income Tax arising.

The Revenue's manual offers further guidance by highlighting the following key indicators in determining whether an earn-out is further sale consideration rather than remuneration are:

a) The sale agreement demonstrates that the earn-out is part of the valuable consideration given for the securities in the old company
b) The value received from the earn-out reflects the value of the securities given up.
c) Where the vendor continues to be employed in the business, the earn-out is not compensation for the vendor not being fully remunerated for continuing employment with the company.
d) Where the vendor continues to be employed, the earn-out is not conditional on future employment, beyond a reasonable requirement to stay to protect the value of the business being sold.
e) Where the vendor continues to be employed, there are no personal performance targets incorporated in the earn-out.
f) Non-employees /former employees receive the earn-out on same terms as employees remaining.

The following factors may also be relevant:

g) Negotiations between the seller and buyer as to the level of the earn out in relation to the value of the consideration given for securities in the old company.
h) Any clearance that might have been obtained under Section 138 and Section 707 demonstrating the bona fide nature of the transactions, and the level of the earn-out linked to profitability or other key performance indicators of the business.
i) Evidence that future bonuses were reclassified or commuted into purchase consideration would indicate that the earn-out was, at least partly, remuneration rather than consideration for the disposal of securities.

Where the earn-out is partly deferred consideration for the old securities and partly a reward for services or inducement to continue working for the business, then an apportionment of the value will need to be undertaken on a just and reasonable basis.

This guidance is only applicable to the computation of earnings under Chapters 2, 3 or 5 Part 7 ITEPA 2003.

From an article by Bob Trunchion

Lecture B484 (15.26 Minutes)

Inheritance Tax and Trusts

IHT and CGT valuations and S274 TCGA 1992

The general rule in S274 TCGA 1992 is that, if the value of an asset on a person's death is agreed for IHT purposes, that value must also apply in a future CGT context (ie. when the legatee comes to sell the item in question). This provision works well in practice, given that, in the normal course of events, the IHT event precedes the CGT one.

Where the asset does not need to be valued at the time of death (eg. because it is eligible for 100% business property relief or because it passes to a spouse), a later disposal by the legatee necessitates a formal CGT base cost valuation.

However, following the introduction of the transferable nil rate band rules, a potential problem has arisen. This can best be illustrated by an example.

<u>Illustration</u>

Mr Ewart died on 1 August 2002 (when the nil rate band was £250,000), leaving his entire estate on a discretionary trust for the benefit of his wife.

Mr Ewart's legacy included some private company shares which the trustees sold in 2007. HMRC subsequently agreed that the market value of these shares as at 1 August 2002 was £48,000 – they had not been valued at the time of Mr Ewart's death.

When Mrs Ewart died on 1 July 2009, it was necessary to establish whether her personal representatives could make a claim to increase her nil rate band of £325,000. This would only be the case if the chargeable transfer on Mr Ewart's death was less than £250,000 (because he would not then have utilised the full amount of his nil rate band). Normally, this would involve a formal IHT valuation of all his assets and, if the shares were valued at a different figure from the £48,000 which was agreed following the sale in 2007, this would require a reopening and recomputation of the trustees' earlier CGT liability.

A new provision, which is found in Para 8 Sch 4 FB 2008 and which takes effect for values ascertained on or after 6 April 2008 (see Para 9(4) Sch 4 FB 2008), ensures that the previously determined CGT base cost is not displaced. This seems like a sensible modification to prevent unnecessary administrative confusion.

Lecture P485 (5.38 Minutes)

Draft guidance on transfer of IHT nil rate band

Draft guidance on transfers of unused nil rate bands has just been published by HMRC ahead of its incorporation into its Inheritance Tax manual.

The ability to transfer nil rate band (TNRB) between the estates of husband and wife or civil partners was introduced in the FA08. The legislation relating to the transfer of unused nil rate band is contained within IHTA84/S8A-C.

The effect of TNRB is that when a surviving spouse or civil partner dies, the nil rate band available at their death will be increased by the proportion of the nil rate band that was not used on the death of their spouse or civil partner.

TNRB is available where the death of the surviving spouse or civil partner occurs on or after 9th October 2007.
For spouses, the first death can have occurred at any time before or after that date and the relief therefore applies where the first death occurred under IHT, Capital Transfer Tax or Estate Duty and there was unused nil rate band.

For civil partnerships the first death must have occurred on or after 5 December 2005, the date the Civil Partnership Act became law in the United Kingdom. While it was possible to enter into a civil partnership in other countries prior to this date, the Act states that where a relationship was recognised under overseas law before the UK Act came into force, the parties to the relationship are to be treated as having formed a civil partnership recognised in the UK on the date the Act came into force.

Link to HMRC:http://www.hmrc.gov.uk/cto/iht/transfer-unusednil.htm

BPR and transfer of assets

The Special Commissioners decided in the case of Trustees of the Nelson Dance Family Settlement v Revenue & Customs [2008] SpC 682 that the transfer of land used in a business into trust (without the transfer of the business itself) would qualify for 100% business property relief (BPR). This decision is relevant to sole traders and might be of particular interest to farmers considering transferring land into trust but continuing to carry on the business.

The decision concerned whether for business property relief to be available under s 104, IHTA 1984 there has to be:

- A transfer of value which has resulted in a reduction in the value of 'relevant business property' (as defined by s 105, IHTA 1984) in the transferor's estate, regardless of whether an actual transfer of the 'relevant business property' takes place (the taxpayer's argument).
- Or, a transfer of value that is a transfer of property that meets the definition of 'relevant business property' contained in s 105, IHTA 1984 (HMRC's argument).

Some commentators may query the decision on the basis that it would seem reasonable to conclude that unless you transfer a business or an interest in a business, you will not have transferred relevant business property and the relief would not be available.

However, from a policy viewpoint, the decision is consistent with the 50% relief available for assets held outside of a partnership or company – why should a sole trader not benefit from relief for assets transferred? Furthermore, s 104, IHTA 1984 only requires the value transferred to be 'attributable' to the value of the relevant business property.

It is not known whether the decision will be appealed. Even if upheld, its application is limited to sole traders.

Lindsey Wicks, Grant Thornton UK LLP writing in Taxline, July 2008

Administration

New penalties regime brief published

HMRC have published a brief about the new penalty regime. In it, they refer to the learning package which they have published on their website.

The Revenue describes the key points of the new penalties as follows:

- The new penalties are one of the first pieces of cross-cutting legislation designed to make the tax system simpler and more consistent.
- If taxpayers take reasonable care to get their tax right, HMRC will not penalise them, even if they make a mistake.
- If they do not take reasonable care, errors will be penalised and the penalties will be higher if the error is deliberate.
- Telling HMRC about errors, especially if this is unprompted, can substantially reduce any penalty due.

The new penalties are for errors on returns and documents initially for income tax, VAT, PAYE and National Insurance contributions paid by employers, capital gains tax, corporation tax and the construction industry scheme.

For these taxes, it applies to returns or other documents for tax periods starting on or after 1 April 2008 that are due to be filed on or after 1 April 2009. The relevant legislation is FA 2007, Sch 24.
In addition to the learning module, HMRC explain that their web page for new penalties, has frequently asked questions, a leaflet, and technical guidance, which are updated.

SA returns: Stalemate over service company question?

The vexing issue of "the service company question" apparently remains unresolved, three months into the tax year.

Accountingweb.co.uk's readers flagged up the fact that guidance to the question on page TR4 of the 2008 SA tax return was far from clear, back in March. In the following month, the Institute of Chartered Accountants in England and Wales (ICAEW) and Chartered Institute of Taxation (CIOT) decided to seek clarification from HMRC as to the purpose for the question and as to which sorts of business are the intended targets.

The ICAEW said that "it is unhappy with the way that this question and accompanying guidance have been worded."

"This is proving more difficult to resolve than the similar question on this year's Form P35 and on which we gave advice earlier in April, because the taxpayer is required to quantify the 'Total amount of any income included anywhere on this Tax Return, derived from the provision of your services through a service company.'

It adds that it will be meeting with HMRC shortly and further guidance is expected.

AccountingWeb

Self-assessment enquiry and amendment windows—practical examples for agents

This guidance provides you with scenarios to show how the new legislation on SA enquiry windows and amendments might apply in practice. A selection of scenarios for enquiry windows and amendment windows in a variety of circumstances, including—

- paper and online filing
- late submissions of returns
- returns that are amended.

Situation	*Enquiry window ends*	*Amendment window ends*	*Explanation*	*Legislation 2007/08 = Year 1 2008/09 = Year 2*
1 Paper return filed 30/09/08	30/10/09	31/01/10	Paper return filed before filing date of 31/10/08.	TMA 1970 s 81D(a)
			Enquiry window ends 12 months from the date the return is delivered.	TMA 1970 s 9A(2)(a)
			Amendment window ends 12 months after 31 January in Year 2	TMA 1970 s 9ZA (2)–(3)(a)
2 Online return filed 29/11/08	29/11/09	31/01/10	Online return filed before filing date of 31/01/2009.	TMA 1970 s 8 1D(b)
			Enquiry window is 12 months from the date the return is delivered.	TMA 1970 s 9A(2)(a)
			Amendment window ends 12 months from 31 January in Year 2	TMA 1970 s 9ZA (2)–(3)(a)
3 Paper return filed 5/12/08. All tax due paid 29/01/09	31/01/10	31/01/10	Paper return filed after filing date.	TMA 1970 s 81D(a)
			Enquiry window is up to, and including, the quarter day following the first anniversary of the date the return filed.	TMA 1970 s 9A(2)(b)
			Penalty of £100 incurred for late filing, capped at nil as all outstanding tax paid by 31/01/2009.	TMA 1970 s 93(1) TMA 1970 s 93(2) TMA 1970 s 93(7)
			NB If an enquiry subsequently increases the tax due, the conditions for capping the penalty will no longer be met and the penalty will be reinstated as £100 or the amount of tax unpaid at 31/01/2009, whichever is lower	
			Amendment window ends 12 months after 31 January in Year 2	TMA 1970 s 9ZA (2)–(3)(a)
4 Return filed online 29/11/08. Amended by taxpayer 7/09/09	29/11/09	31/01/10	Return filed online by filing date. Enquiry window is 12 months from the date of filing. Taxpayer amends return within the time limit allowed.	TMA 1970 s 81D(b)
			Enquiry window for main return ends 29/11/2009.	TMA 1970 s 9A(2)(a)
			Amendment window for main return ends 12 months after 31 January in Year 2.	TMA 1970 s 9ZA (2)–(3)(a)

			Enquiry window for amendment extends to 31/10/10 (but the enquiry can only cover content of the amendment if it is opened after 29/11/09).	TMA 1970 s 9A (2)(c) TMA 1970 s 9A(5)(a), (b)
5 Notice to File issued 1/09/08. Paper Return Filed on 25/11/08	25/11/09	31/01/10	Return filed on paper before the filing date (which, as notice to file issued between 31 July and 31 October, is three months from the date of the notice for paper returns ie 30/11/08. Had the taxpayer chosen to file online, the filing date remains 31/01/09).	TMA 1970 s 81F(a)
			Enquiry window closes 12 months from the date the return is delivered.	TMA 1970 s 9A(2)(a)
			Because the notice was given before 31 October for the purposes of amendment only the filing date remains 31/01/2009 irrespective of the method of filing. The amendment window ends 12 months after this filing date.	TMA 1970 s 9 ZA(2), (3)(a)
6 Notice to File issued 15/11/08. Return filed online 10/02/09	10/02/10	14/02/10	Return filed online before filing date (which, as the notice to file was issued after 31 October in year 2 is three months from the date of the notice to file. Enquiry window closes 12 months from the date the return is delivered. Amendment window is 12 months after the last day of the period of three months beginning with the date of the notice.	TMA 1970 s 8(1G) TMA 1970 s 9A(2)(a) TMA 1970 s 9 ZA(2), (3)(b)

HMRC Guidance Notes

Treasury loosens HMRC powers

Widespread fears that HMRC were to be granted restrictive new privileges have been allayed.

Increased powers of inspection that were expected to be introduced in this year's Finance Bill have been relaxed to suggest a less forceful approach by the Revenue.

The new entitlements were mooted to provide the department with the authority to enter and search business premises with, potentially, as little as 24 hours notice.

However, following debate in Parliament, they will now be subject to limits and conditions, and the altered bill will introduce at least a seven days' notice period.

The original draft of the bill contained rules that would have allowed inspectors to enter and inspect any business premises. This was amended to only premises used by the person whose liability is being checked (with the exception of locations used in connection with the taxable supply of goods).

In addition, the inspection powers are now limited so that inspectors may not enter or inspect any part of premises used solely as a dwelling.

Grant Thornton welcomed the changes, remarking that businesses will have breathed a collective sigh of relief at hearing the news.

The financial adviser's national tax office head, Francesca Lagerberg, welcomed 'improvements here to safeguard taxpayers' rights that the original draft had neglected'.

She went on to stress that is ‘essential that any new power for HMRC has a matching safeguard and is only used in limited and appropriate circumstances. No one wants to see any possibility of “fishing expeditions”' into taxpayers' affairs’.

Extending the notice window to seven days, said Mrs Lagerberg, ‘will enable businesses to be better prepared for visits, which can be very stressful. In particular, small-to-medium-sized businesses will benefit greatly, as many lack the resources to comply promptly [with] an HMRC inspection'.

However, Fran then noted that other new rules – unchanged from the original draft of the Finance Bill – will allow for a shorter notice period, or no notice at all, to apply where it is agreed with the occupier, or where it is approved by an authorised officer of HMRC.

She remarked that the finalised powers are still fairly stringent in areas, but added that it was pleasing ‘that the Treasury saw sense in the more significant points being made by interested parties when amending HMRC's powers and that there is guidance’.

Taxation, 25 June 2008

Business Tax

Duality of purpose

I have rather belatedly got around to reading s 34, Income Tax (Trading and Other Income) Act 2005 and find to my surprise that this provides a statutory override to the duality of purpose rule. Section 34 provides the general rule previously found in s 74, ICTA 1988 that a tax deduction is only permitted for an expense incurred wholly and exclusively for the purpose of the trade.

We all know from our mother's knee how restrictive these words are – and that the existence of a duality of purpose disqualifies the entire expenditure from relief. One only has to think of Vodafone Cellular Ltd v Shaw 69 TC 376 to see how strictly HMRC applies the test. In this case, the company incurred expenditure relating to a trade of a subsidiary. The payment was disallowed by HMRC on the basis that the purpose of the payment was not only to benefit its own trade but also that of its subsidiary. It would have been an allowable deduction in respect of either trade, but because it was for the benefit of both, no part of the expenditure was allowed. This was HMRC's argument and they succeeded in the High Court; fortunately the Court of Appeal saw sense and allowed relief.

Nevertheless, it is common HMRC practice generally to allow an apportionment of expenditure between trading and non-trading purposes, providing an apportionment can reasonably be made, and this general practice has now been enshrined in the legislation. Section 34(2) says that:

if an expense is incurred for more than one purpose, this section does not prohibit a deduction for any identifiable part or identifiable proportion of the expense which is incurred wholly and exclusively for the purposes of the trade.

However, it should be noted that this does not go so far as allowing a reasonable proportion of an expense; relief is only allowed for an identifiable part or proportion of the expenditure.

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

Incorporation under the new regime

The changes to capital gains tax that apply from 6 April 2008 are wide ranging and have implications for a number of common tax planning areas. These new rules introduced a CGT standard rate of 18 per cent — less than half that applying for higher rate income tax. A further change is the introduction of entrepreneurs' relief as an additional relief allowing an individual to realise gains on business assets over a lifetime of up to £1m and secure an effective CGT rate of 10 per cent on those gains.

One area of common tax planning is the incorporation of a business — whether into a private limited company or into a limited liability partnership (LLP). This article considers the implications of the new CGT rules in terms of incorporation.

This article considers:

- structuring as a limited company or an LLP;
- the interaction of entrepreneurs' relief with incorporation reliefs;
- the ownership of a property outside of a company;
- the treatment of goodwill; and
- maximising entitlement to entrepreneurs' relief.

All statutory references are to TCGA 1992 unless otherwise stated, and the references to ss 169H–169S are to the new provisions — as they stand at the time of writing — to be inserted by clause 7 and Sch 3 of the Finance Bill 2008. Schedule 3 was agreed without amendment by the public committee on the Finance Bill on 13 May.

Limited company or LLP?

The new entrepreneurs' relief encourages structuring new ventures as LLPs because the qualifying conditions for shareholders in owner-managed companies are far more restrictive than for partnerships. For limited companies, it is necessary for the individual to have both 5 per cent of the ordinary shares and 5 per cent of the votes in the company as well as being an officer or employee of the company in order to qualify for the new relief. There is no such minimum percentage for a partner, and nor is it necessary to have an active interest in the same way. The result is that LLPs are more attractive for those with percentage shareholdings of less than 5 per cent or for passive investors.

A further incentive derives from the impact of the new CGT regime on enterprise management incentives (EMI). For new start ventures, it will be possible for employees holding EMI options to achieve a tax rate of 18 per cent but it is now more difficult to achieve an effective rate of 10 per cent. The only way this can be achieved is if the employee holds options over 5 per cent or more of the ordinary shares and exercises these more than 12 months before the sale of the company. This is likely to apply to only a minority of EMI cases.

By contrast, if the new venture is set up as an LLP then it will be much easier to introduce employees as partners with restrictions dealt with through the partnership agreement. It will be possible to reward them without being caught by the normal employment-related securities restrictions in ITEPA 2003 and for such individuals to benefit from entrepreneurs' relief even on very small percentage interests in the partnership.

Therefore, for new business ventures, it will be essential that the adviser fully considers potential structuring by means of an LLP rather than through the use of a limited company. The LLP approach may also enable a gain to be sheltered by means of roll-over relief. However, the enterprise investment scheme (EIS) — with its potentially valuable deferral relief — is only available if a corporate structure is used.

Given that an LLP has the same degree of limited liability protection as a limited company, and that the income tax advantages of incorporating have now reduced or disappeared, then incorporating a business into an LLP now appears to be much more attractive from a CGT perspective and in terms of the tax payable on a sale.

Interaction of entrepreneurs' relief with incorporation reliefs

There are a number of possible approaches to incorporation and reliefs that can apply. TCGA 1992 s 162 relief applies (although the taxpayer now has the option of electing to disapply it) where a transfer of the entire assets of a business is made to a company in exchange for the issue of shares. The chargeable gains arising on the transfer of assets are rolled over and subtracted from the cost of the shares. The alternative is to use the standard hold-over relief under s 165 and this is the most common method.

It is therefore necessary to consider how the new entrepreneurs' relief interacts with these reliefs, especially as there is currently some uncertainty in this area. This is because, whilst entrepreneurs' relief is based upon the retirement relief legislation, the wording has been modified in a number of places with possible implications for interaction with s 162 and s 165 as well as other reliefs, including s 152 (roll over relief) and Sch 5B (EIS deferral relief).

New s 169N sets out the method of calculation of entrepreneurs' relief by reference to the £1m lifetime limit and the reduction of the gain by 4/9ths. These computational provisions are set out in s 169N(1)–(3). Sub-section 4 provides that the amount remaining after the reduction by 4/9ths '… is to be treated for the purposes of this Act as a chargeable gain accruing at the time of the disposal …'

This seems to specify that in considering other reliefs that may apply by reference to a chargeable gain, then that gain is an amount after the claim for entrepreneurs' relief. However s 169N(1) applies entrepreneurs' relief to 'relevant gains and losses'. These are defined in s 169N(5) and s 169N(6) and whilst the drafting is not entirely clear, s 169N(5)(a) — dealing with a disposal of shares — states that relevant gains are to be '… computed in accordance with the provisions of this Act fixing the amount of chargeable gains'.

HMRC has stated during consultation on the Finance Bill that this gives priority to other reliefs over entrepreneurs' relief. However, this seems something of a generalisation because the reference in this sub-section is to the gain being computed in accordance with the rules of the Act rather than by reference to the making of any specific claims.

HMRC has confirmed that entrepreneurs' relief does take precedence over EIS deferral relief under Sch 5B, as that relief is not a computational provision and only seeks to defer a chargeable gain.

As far as s 152 is concerned, this works by reference to the reinvestment of the consideration rather than by reference to the chargeable gain. As such, it clearly takes precedence over entrepreneurs' relief as the gain is reduced by means of the approach to the computation. In the same way, s 162 is an automatic relief (subject to the taxpayer's election to disapply it) and is also a computational provision in terms of arriving at the gain. As such, it must apply before s 169N is considered.

However, HMRC also maintains that s 165 is a computational provision that takes priority over a claim for entrepreneurs' relief. This does not seem to be borne out by reference to the mechanics of the section as a relief under s 165 works by reducing the market value that would otherwise apply by the amount of the chargeable gain. As such, it is structured around the chargeable gain in a similar way to Sch 5B although the mechanics are not the same.

Further, s 165(4)(a) states that the chargeable gain to be held-over is the amount that would have arisen 'apart from the section' which seems to give priority to other provisions in the Act. This is reinforced somewhat by s 165(6) which specifically makes reference to giving priority to retirement relief but it does not seem that that provision has been replicated into entrepreneurs' relief. As such, there would seem to be a very good argument that entrepreneurs' relief takes priority over s 165, and the example below is based on this assessment.

The order of priorities of relief is important when structuring the investment. Traditionally, incorporation into a private limited company has been structured either under s 162 or s 165 with the latter being the most common because of the additional flexibility to leave proceeds outstanding on loan account. This can enable the extraction of profits in a very tax-efficient manner. However, it is also possible to structure an incorporation under s 162 such that not all of the consideration is satisfied in the form of shares and with a capital gain arising on the amount of the cash or loan account balance consideration.

The ability to structure arrangements such that an immediate gain arises does enable advantage to be taken of entrepreneurs' relief. This could be particularly beneficial if the incorporation is combined with succession planning such that it is sensible to use up some of the lifetime limit of the older generation on incorporation. Whilst this would give rise to an immediate tax liability, it would enable future profits to be withdrawn in a very tax-efficient manner. Regardless of the precise order of set off, this is best achieved by transferring goodwill for a sum in excess of its base cost — perhaps with a partial claim under s 165.

Example

John and Peggy incorporate their business under s 165 with a value of goodwill of £200,000 left outstanding on loan account. They claim entrepreneurs' relief and the CGT payable is as follows:

	£
Gain (there is no base cost)	200,000
Less entrepreneurs' relief	
4/9ths	88,889
	111,111
Less annual exemption x 2	19,200
	91,911
CGT at 18 per cent	£16,544

This is still a very tax-efficient way of extracting monies from a business.

Property retained in personal ownership

It is common on an incorporation for property to be retained in personal ownership, and as a result one of the most difficult aspects of the new entrepreneurs' relief rules is in respect of associated disposals. This concept is taken from the retirement relief legislation and deals with the position where assets are owned outside of a company or partnership. Historically, this would tend to be a property although it could also be an intangible asset such as goodwill or intellectual property rights.

As with retirement relief, entrepreneurs' relief is extended to the gain on the associated disposal of the asset outside of the company or partnership as long as that disposal takes place with the disposal of the shares in the company or of the partnership interest. This is an important distinction and a major change from the taper relief legislation.

Section 169K provides that there is a disposal associated with a relevant material disposal if three conditions are met.

(a) an individual makes a material disposal of business assets which is a disposal of the individual's interests in the assets of a partnership or of the shares or securities, or interests therein, of a company. It should be noted that this relief is not available to trustees and does not extend to disposals associated with a material disposal of a sole trader;

(b) the individual makes the disposal as part of his withdrawal from participation in the business carried on by the partnership or company; and

(c) throughout the period of one year ending with the earlier of the material disposal of the business assets and the cessation of the partnership or company's business, the assets concerned are used for the purposes of the business.

Condition (b) refers to the associated disposal being 'part of the withdrawal of the individual from participation in the business carried on by the partnership or by the company'. It is not entirely clear what this relates to and it seems to be a retirement requirement which will be the subject of HMRC guidance and the facts of the situation in each case.

The amount of entrepreneurs' relief available on a disposal associated with a relevant material disposal is restricted on a just and reasonable basis by s 169P where:

1. the asset is used for the business during only part of the individual's ownership period;

2. only part of the asset is so used;

3. the individual is concerned in the carrying on of the business for only part of the period for which the asset is used for the purposes of the business; or

4. during some part of the period when the asset is used for the purposes of the business its availability is dependent on the payment of rent.

Rent is defined in s 169S as including any form of consideration given for the use of an asset. This is a potential barrier to incorporation where an asset owned outside of a company is let to the company for a commercial rent or royalty as it will prevent entrepreneurs' relief from subsequently applying. The Treasury's explanatory notes on the Bill refer to the payment of rent turning the asset into an 'investment'. There has been much lobbying on this point, but at the time of writing there had been no concessions by the Government on this issue. However, further guidance by HMRC was promised by Jane Kennedy in the 13 May debate and it will potentially be concessionary.

Where a business is incorporated, then it is common practice to retain a property in personal ownership, both to avoid SDLT and as a means of extracting income tax-efficiently. However, if this is done on an incorporation, then the property should be provided rent-free if there is a likelihood that the business will be sold. The potential SDLT liability may be able to be avoided if incorporation is into an LLP as there is an exemption if the qualifying conditions are met. As such, this again favours the LLP as it will no longer be as beneficial to retain properties personally outside a limited company.

Maximising entitlement to entrepreneurs' relief

There are a number of different factors to consider in the context of maximising future entrepreneurs' relief entitlement including for example protecting the lifetime limit; ensuring that the relief is available on an arm's length sale; and maximising the number of shareholders qualifying for entrepreneurs' relief.

In order to protect the relief it will be important to take advantage of CGT exemptions and deferral reliefs on incorporation. As far as maximising the number of qualifying shareholders is concerned, in order to qualify for the relief as a shareholder it is necessary for the company to qualify as the shareholder's personal company within s 169S(3). To achieve this, the shareholder must be an officer or employee of the company and hold both at least 5 per cent of the ordinary shares and at least 5 per cent of the votes. In view of this, careful consideration is needed in the drafting of the memorandum and articles of association and any shareholders' agreement.

Where a trust is involved which holds shares in a company, then particular care is required to ensure that there is a qualifying life tenant (see s 169J).

Treatment of goodwill

As already mentioned, a common strategy on the incorporation of a limited company has been to transfer the goodwill to the company in exchange for a loan account and so suffer a maximum effective tax rate on the extraction of these monies of 10 per cent. This is often in combination with a s 165 hold-over relief claim to restrict the value used in respect of a sale at an undervalue.

However, it is not just a matter of the value used for the goodwill but rather whether or not there is transferable goodwill in the first place. Where the goodwill is personal to the individual concerned, then HMRC's view is that it cannot be transferred to the company. Equally, HMRC will often argue that the goodwill is part of the property, such as in the case of a pub or a hotel and so inseparable from that asset.

HMRC sets out the potential tax implications of a transfer of goodwill where CGT treatment does not apply in HMRC Tax Bulletin 76 (April 2005). This is an area that needs careful consideration as part of planning any incorporation.

Use of the EIS

A different approach to incorporation is to make a gain on the cessation of an unincorporated business and then set up a new company qualifying for CGT deferral relief under the EIS. This could be attractive where there are gains to shelter arising from non-business assets and, as explained above, enables advantage to be taken of entrepreneurs' relief as part of the incorporation process. It may also work well if there is a new investor being introduced as part of the incorporation of the business. Therefore, depending on HMRC's view on the interaction between entrepreneurs' relief and s 165 hold-over, then this may become a more favoured planning strategy in relevant cases.

Conclusion

There are a number of structuring issues that arise from the CGT reforms and it is important to reassess established planning strategies to make sure that they are still appropriate. The abolition of business asset taper relief means that incorporation strategies and asset ownership arrangements are likely to change and there are a number of knock-on implications which this article has sought to highlight.

John Endacott BSc(Econ) FCA CTA (Fellow) writing in Tolleys Practical Tax, 20 June 2008

Is it appropriate to appropriate trading stock?

Clause 34 and Sch 15 to the Finance Bill sets out legislation intended 'to put on a statutory basis the rule from the case Sharkey v Wernher which has effect where goods are appropriated into or from trading stock other than by way of trade. In such circumstances, the profits of the trade for tax purposes should be adjusted to replace the cost of the stock or the actual proceeds with their market value'.

The legislation

The legislation says that any appropriations of assets into trading stock or *vice versa*, or any disposals or acquisitions of trading stock 'otherwise than in the course of trade' are to be brought into account at the price it 'would have realised if sold in the open market at the time' of the transaction. If transactions 'otherwise than in the course of trade' are subject to transfer pricing legislation, the latter takes priority.

Trading stock is defined as anything 'which is sold in the ordinary course of trade, or which would be so sold if it were mature or its manufacture, preparation or construction were complete'.

The new rules apply only to the disposition of trading stock and work in progress and **not** to the provision of services or to the disposition or raw materials or consumables.

Restriction to trading stock

The first question is why the provision is restricted only to trading stock and work in progress. In the context of a manufacturing trade, it is hard to see why raw materials acquired for the purposes of the trade should not be treated in the same way.

What is market value?

In his latest article, Keith Gordon refers to a shopkeeper who sells fresh bread. If he takes an unsold loaf out of the shop at the end of the day, what is the market value? It might be the price he gave it first thing that morning, and one might expect the average HMRC officer to contend for that price. It might be the discounted price for which the loaf could be sold towards the end of the day. Or it might be nothing, if the unsold bread was normally just thrown away. This point would apply to all perishable goods and my early experience was that many small traders would take old stock home for personal use rather than throw it away. On that basis, there should be no tax adjustment under either *Sharkey v Wernher* or the new legislation.

So far, we have not seen any HMRC guidance on how the issues of market value will be resolved.

Capital gains issues

TCGA 1992, s 161(1) provides that an appropriation of a capital asset into trading stock crystallises the chargeable gain, as if the asset had been disposed of on the open market at that time. Section 161(3), however, allows an election whereby no gain arises under s 161(1) and the asset becomes trading stock at market value less the accrued gain (which effectively brings the asset into stock at cost plus indexation). Section 173 extends the rule for groups of companies, to allow a transferee trading company to elect that a capital asset transferred from another group company be brought into trading stock at market value less the accrued gain.

The new provisions do not mention these capital gains rules at all. When amendments were proposed, to ensure that s 161(3) elections would take priority, Kitty Ussher said:

'The amendments seek to clarify how the market value rules introduced by clause 34 and Sch 15 intend to interact with similar rules for capital gains tax. They appear to be based on a concern that the legislation will override and affect the capital gains rules set out in TCGA 1992, ss 161 and 173. I am sure that the hon gentleman will be relieved to know that that concern is unfounded. The schedule will have absolutely no impact on the operation of the capital gains legislation, and ss 161 and 173 … will continue to apply in the same way as they do currently. Had our intention been to override those sections …, we would have explicitly amended or repealed them. We have not done so because that is not our intention.'

This is all very well as a clear statement of intent (or of non-intent), but is it sufficient? On the one hand we have the new legislation telling a trader that the appropriation of assets into stock must be treated as having been acquired at market value, for tax purposes. On the other hand, we have a rule that says the value to be brought into the trading accounts is market value less the chargeable gain on the asset. In addition, we have a clear statement from the sponsoring minister that the new rules are absolutely not intended to have any impact on the capital gains rules.

Consider what might happen in practice. An antiques dealer has a desk that he bought some years ago for £1,000. It is now worth £2,500 and he wants to sell it in his shop. As the trader is an individual, no indexation is due, so the inherent gain is £1,500. If he makes a s 161(3) election, the effect is to override s 161(1), so that there is no capital gain. The market value of the desk for the purposes of computing trading profits is reduced to £1,000.

But ITTOIA 2005, new s 172C tells us that the asset must come into trading stock at market value on the date of appropriation, i.e. £2,500. If we take this as a given, and the trader sells the desk for market value, then the trading profit is nil and the capital gain has also fallen out of account. One might suggest that TCGA 1992, s 161(3) should override ITTOIA 2005, new s 172C (or its corporation tax equivalent), but s 161(3) is arguably not an income tax provision and, in any case, income tax provisions usually have precedence over capital gains provisions.

Sharkey v Wernher rule does not apply

The Shrkey v Wernher principle is stated not to apply in three specific circumstances:

a) 'services rendered to the trader personally or to his household …

b) 'the value of meals provided for the proprietors of hotels, boarding houses, restaurants, etc. and members of their families …

c) 'expenditure incurred by a trader on the construction of an asset which is to be used as a fixed asset in the trade.'

At least one and maybe two of these are potentially caught by the new legislation.

In the context of the new rules, (a) is clearly outside the scope as services are excluded from the scope; (c) which might apply, for example, where a construction trader builds his own office block, might not be caught if one takes the view that a self-built asset does not constitute an appropriation from stock. But (b) looks like it will be clearly caught by the new legislation.

Practical measures

In terms of record keeping, I suggest that it is important only to put the business stock through the books. This might require a note on invocies saying that the invoice relates to x items, of

which y are for the business, so that the actual financial book entry only refers to the y items of stock.

As an inspector, I found that most small traders would happily admit to taking stock but usually they had no idea how much. If you keep a comprehensive record of what you take, it will be much easier to make any adjustments required and much harder for HMRC to impeach the records of the business in this respect.

If stock that is reaching its sell by date is taken, record that too, along with any records you might have of the selling price of that stock over its last few days on the shelf. That way, you might be able to avoid a tax adjustment completely or even claim a loss on the basis that the selling price of old stock would have been less than cost.

This is an area where some HMRC guidance would be helpful. But it is also the area where traders can, with careful record keeping, help themselves to avoid problems with HMRC.

From an articlein Taxation by Pete Miller

Corporation Tax

Section 419(5), ICTA 1988 and upstream loans

Section 419 charges tax on close company loans to participators, where the loan is outside the company's ordinary business. Under s 419(1) tax is payable by the company as if it were corporation tax at a rate of 25% of the amount of the loan or advance (due nine months and one day from the end of the accounting period).

Section 419(4) provides that where the loan or advance subject to tax under s 419(1) is repaid, released or written off, then a claim for relief from the tax can be made. The claim must be made within six years of the end of the financial year in which the repayment, release or write off occurs. If the repayment, release or writing off is made on or after the day on which the tax becomes payable, then relief under s 419(4) cannot be given until nine months from the end of the accounting period in which the repayment, release or writing off occurred (s 419(4A)). For companies going into liquidation it may be relevant to consider that s 419(4A) specifies that relief can only be given in an accounting period (see also CTM61610).

Section 419(5) provides that where a company makes a loan which does not give rise to a charge under s 419(1) (for example because the loan is made to a non-participator), and another person then makes a payment, transfers property or satisfies a liability of a participator, then unless the amount lent or advanced to the participator is included as income of the participator, the loan from the company is treated as being made directly to the participator and subject to the 25% tax.

This situation could apply in a typical MBO where the target company lends to a new company (formed to acquire target), and consideration is then advanced by the new company to the shareholders of target. Strategies to ensure this charge does not arise where the loan funds are used to make advances to a participator (such as share sale proceeds) include:

i) ensuring the participator is removed from the share register before the company enters into the loan agreement (signature of stock transfer forms is not sufficient), and the position is not prejudiced by the individuals remaining participators through holding shares or loan notes; or

ii) ensuring the loan is cleared within nine months of the year end of the company making the loan (for example by way of dividend); or

iii) ensuring that the loan is not made by target in the first place, but is obtained from an unconnected third party (for example a bank) which may seek a guarantee from the target company before making the loan. (Consideration has not been given to transfer pricing in this suggestion, though there may be circumstances where this could be relevant.)

We understand from a recent discussion with HMRC that they are targeting this area, particularly where the taxpayer exiting from a company paid no more than 10% tax and the level of reserves would have permitted a dividend payment, notwithstanding the fact that a clearance has been obtained under s 707, ICTA 1988 and s 701, ITA 2007.

Chris Lallemand, National Tax Consultant, Smith & Williamson Limited writing in Taxline

ACT claims under mistake of law

In *Europcar UK Ltd and others v Revenue and Customs Commissioners*, the 19 claimants were included in the 2001 group litigation order concerning advance corporation tax suffered by companies with non-UK parents (the ACT GLO). The claims concerned the limitation period in respect of claims for restitution on the basis of a mistake in law. The issues included whether the claimants had made valid claims in mistake before 8 September 2003 and, if not, what effect FA 2004 s 320 had on claims brought before 8 September but amended after 20 November 2003 to add a claim in mistake.

The High Court ruled that claim forms had to set out the material facts relied upon and the causes of action to which they related. However, read in the context of the ACT GLO, the individual claims (excepting claim 5) would be valid claims in mistake prior to 8 September 2003.

The fifth defendant had made amendments which amounted to adding a new claim and would be caught by s 320.

Landlords' energy-saving allowance

The Energy-Saving Items (Corporation Tax) Regulations, SI 2008/1520 come into force on 7 July 2008, and have effect in respect of expenditure incurred on or after 8 July 2008. The Regulations specify energy-saving items in respect of which expenditure may be deducted by residential landlords who pay corporation tax when calculating the profits of their property business.

The Finance Act 2007, Section 17(2) (Corporation Tax Deduction for Expenditure on Energy-Saving Items) (Appointed Day) Order, SI 2008/1521 appoints 8 July 2008 as the day on or after which FA 2007 s 17(1) shall have effect. Section 17(1) inserts new ss 31ZA–31ZC into TA 1988 in relation to a corporation tax deduction for expenditure on energy-saving items.

The Treasury also announced, on 16 June 2008, that the scheme had formally received state aid approval from the European Commission.

Associated companies and duty of directors

In *Re Paycheck Services 3 Ltd and other companies Revenue and Customs Commissioners v Holland and another*, the respondents were directors of companies which acted as corporate director and company secretary of various composite companies. Relying on Extra-statutory Concession C9, the respondents contended that the composite companies were not associated companies. On 18 August 2004, the respondents received professional advice that ESC C9 did not apply, the effect being that the profits would be liable to corporation tax at the full rate.

The composite companies continued to pay dividends, which HMRC contended would not leave sufficient funds to pay the increased corporation tax.

Questions were whether—

1 the respondents were de facto directors of the composite companies;

2 they had acted in breach of their duties; and

3 Companies Act 1985 s 727 would apply (relief for honest and reasonable conduct).

The High Court ruled that the first respondent was a de facto director. Dividends paid after 18 August were unlawful and the first respondent was liable for these. Section 727 did not relieve the first respondent from liability as regards the continued payments after 18 August.

Corporation tax relief for employment related securities under FA 2003, Sch 23

Basic rules

The basic rules may be summarised as follows.

- Where an employee acquires shares or an option to buy shares in a qualifying company, a corporation tax deduction may be claimed.
- The shares must be fully paid non-redeemable ordinary shares and must either be listed on a recognised stock exchange, in a company which is not controlled by another company, or in a subsidiary of a company which is listed on a recognised stock exchange.
- The shares must be in the employing company.
- If the company whose shares are the subject of a qualifying share option is taken over, relief will still be available provided the options are replaced with options over shares in a qualifying acquiring company.
- The amount of the relief is the difference between the market value of the shares at the time they are acquired and what, if anything, the employee pays for the shares.
- The relief applies whether the shares are issued by the company or transferred by a shareholder — either way there is no cost to the company.
- The employee must be liable to income tax in respect of the award or on exercise of a share option (subject to an exception where the employee is non-resident, but the duties of the employment are performed in the UK). In the case of share options this does not preclude relief where no charge arises on exercise because the options were granted under an HMRC-approved scheme
- Relief is normally given in the period in which the shares are acquired unless the shares are restricted or convertible and in respect of which the employee may be taxable on the occurrence of later chargeable events, e.g. where the shares may be subject to forfeiture — see below.
- The rules are modified in the case of shares which may be subject to forfeiture if certain conditions are or are not met. In such circumstances the tax charge on the employee may be deferred until the risk of forfeiture expires. Corporation tax relief is deferred in those circumstances so as to match the time when the employee is taxable on the acquisition.

Private company shares and readily convertible assets

Private company shares are not RCAs provided that no trading arrangements exist or are likely to come into existence and provided that the company qualifies for the corporation tax deduction under Sch 23 (ITEPA 2003, s 702). If the shares are not RCAs, PAYE is not applicable and the acquisition is not NIC-able (though chargeable events arising in connection with the shares may be subject to PAYE/NICs).

Unrestricted shares

The amount of relief in the case of unrestricted shares is the difference between the market value of the shares at the time they are awarded and the consideration given by the employee (Sch 23 para 8).

'Market value' is defined in Sch 23, para 30 by reference to their open market value. The relief thus does not specifically mirror the amount on which the employee is taxable, though it would for most practical purposes. The employee is taxable on any undervalue as general earnings within ITEPA 2003, Part 3, Ch 1 and not as specific employment income within Part 7 (i.e. the earnings related securities (ERS) legislation). While the capital gains tax definition of market value applies for the purposes of Part 7, it does not apply to the charge on general earnings which is based upon the value in 'money's worth'.

Exercised share options

For the company to qualify for corporation tax relief, the employee must be within the charge to income tax under ITEPA 2003, s 476 (Sch 23 para 14). The amount of relief is the difference between the market value of the shares on acquisition and the amount or value of any consideration given by the employee (Sch 23 para 15). If the employee has agreed to meet all or part of the employer's Class 1 NICs on the acquisition, this does not affect the corporation tax deduction.

The rules for shares acquired under options are stated to be subject to the rules relating to restricted and convertible shares (Sch 23 para 11(2), (3)), which can be slightly confusing in the case of restricted shares acquired under options, as two sets of rules then get mixed up.

Restricted shares

In the case of restricted shares, in addition to a potential charge on acquisition, a charge may also arise under ITEPA 2003, s 426 when restrictions are lifted or expire (that is, unless an election has been made under ITEPA 2003, s 431 to be taxed on acquisition based upon the unrestricted market value (UMV) of the shares). The amount(s) and timing of relief under Sch 23 corresponds to the taxation of the employee.

For income tax purposes, the employee must be either subject to tax on the acquisition as general earnings or will be subject to tax under ITEPA 2003, s 426 in respect of later chargeable events (Sch 23 para 20).

Schedule 23 para 20 is stated to apply in place of the requirements of para 7 which thus only applies to unrestricted shares. However, para 20 does *not* apply where restricted shares are acquired under option. This is clear from the wording of para 20(1) which says para 20 only applies in place of para 7 — not para 14. Otherwise no relief would be due because the charge on exercise of share options is under ITEPA 2003, s 476 and therefore the income tax position of the employee would not meet the requirements of para 20. However, Sch 23 paras 21 and 22 *do* apply to restricted shares acquired under option.

The timing of relief is governed by para 22 depending upon the occasion of charge on the employee. Thus, corporation tax relief for any amount chargeable on acquisition is for the accounting period in which the shares are acquired (para 22(3)). Where shares are acquired under option, relief is for the period in which the shares are acquired pursuant to the option (para 22(4)). Relief in respect of a chargeable event under s 426 is given for the period in which the chargeable event occurs (see para 22(6)).

Convertible shares

The amount of relief under Sch 23 in respect of convertible shares also mirrors the charge on the employee (para 22C).

As for restricted shares, the timing of the relief may be on award, on acquisition pursuant to an option or when a chargeable event, e.g. conversion, occurs.

Section 431 election

In the case of restricted shares, if an election is made under ITEPA 2003, s 431, the employee is taxable on the unrestricted market value (UMV) of the shares 'up front'. Where a s 431 election is made, although based upon UMV the charge to tax is still on general earnings within Part 3, Ch 1 and so Sch 23 para 20(2)(a)(i) is met. The timing of the relief is unchanged, i.e. by reference to the date of acquisition. Due to the s 431 election there cannot be any subsequent chargeable events, at least under the restricted securities legislation in Part 7, Ch 2.

EMI options

Provided that the option price is not less than the market value of the shares at the date of grant, no income tax charge arises under s 476 on exercise of the option (ITEPA 2003, s 530).

How much is the corporation tax deduction, given that no tax charge arises on the employee? The corporation tax deduction under Sch 23 will be based upon UMV. Of course, since no income tax charge arises on exercise of the option there is no reason to apply to HMRC Shares & Assets Valuation ('SAV') for a post-transaction valuation check (PTVC) in relation to the employee's tax position. However, my understanding is that in the case of EMI options, SAV will accept a request for a PTVC purely for the purposes of the Sch 23 deduction. The request should be made via the company's tax inspector.

Defining market value

In relation to the exemption under s 530, 'market value' is defined by ITEPA 2003, Sch 5 para 55 by reference to the capital gains tax definition. The market value is thus the open market value, postulating both vendor and purchaser as hypothetical.

Traditionally, the open market value would reflect transfer, etc. restrictions under a company's articles of association, but it would ignore personal restrictions as not being inherent characteristics of the asset for which the hypothetical purchaser bids. However, that is not how HMRC interpret the rules. Form VAL 231 asks for:

'Proposed share value subject to restrictions or risk of forfeiture: actual market value (AMV)'; and

'Proposed share value, without taking those restrictions or risk of forfeiture into account: initial unrestricted market value (IUMV).'

Provided that the option price is not less than AMV, the whole UMV is exempt on exercise. One of the useful things about EMI is that it is possible to request a valuation ruling *prior* to granting the options and it is now SAV's policy to agree both AMV and UMV at that time. However, UMV is relevant only for the purposes of ITEPA 2003, Sch 5 para 5, i.e. the £100,000 limit.

Income tax on EMI options

Where EMI options are granted at a discount from the market value, the discount will be subject to income tax on the exercise of the option. An anomaly arose because ITEPA 2003, s 531 ('Limitation of charge on exercise of option to acquire shares below market value') defines the taxable amount for the purposes of s 476 as the market value of the shares *at the time the option was granted*, less any consideration given for the grant of the option and the option price itself.

In other words, the s 476 gain equals only the amount of the discount, which is fine as far as s 531 is concerned, but since the corporation tax deduction is based upon the amount taxable on the employee that would also limit the deduction to the amount of the discount. In other words, the exempt amount, i.e. the difference between the market value of the shares on exercise and the price paid, was excluded from the equation.

FA 2006 inserted para 21(4A) into Sch 23 which corrects the anomaly with retrospective effect to 1 September 2003 so that the amount which would have counted as employment income under s 476 apart from the EMI code, plus the amount which actually counts as employment income, is eligible for the corporation tax deduction.

For further explanation see: www.hmrc.gov.uk/shareschemes/deductionforshares.htm. One final point is that s 431A only applies of course where no liability to income tax arises on exercise of the option, i.e. where wholly exempt under s 530. Therefore, where a tax charge arises and the exemption is thus qualified under s 531, the s 476 gain will reflect the restricted market value or AMV of the shares on acquisition, unless an actual election is made under s 431. The Sch 23 deduction will obviously be based, subject to para 21(4A), upon the s 476 charge — with or without the election.

Value Added Tax

New penalties for errors in claims for VAT refunds

The UK is introducing a new system of penalties for errors in tax returns, including VAT refund claims.

You could be charged a penalty if you don't take reasonable care to make sure your claim is correct. This guide will help you understand the law and what you can do to avoid a penalty.

Why do we need penalties?
Most people take care to fill in their tax returns and claims correctly. We want to encourage that and help them get it right.

We use penalties to stop people who don't take care from gaining an unfair advantage.

When are penalties charged?
We can charge financial penalties if you make an error in your claim which means you overstate the amount of refund you are due.

The new penalties apply to VAT claims made under the EC 13th Directive (86/560/EEC) by businesses based outside the European Union, for years commencing on or after 1 July 2008.

And they also apply to VAT claims made under the EC 8th Directive made by businesses based in other European Union member States, for years commencing on or after 1 January 2009.

How to take reasonable care
If you take reasonable care to get it right, we will not charge a penalty if you make an error. Some of the ways you can show you took reasonable care are:

- Keeping correctly completed invoices, vouchers and receipts to support your claim and sending these to us with your claim.
- Ensuring that you have, and provide, an up-to-date certificate of status or of business activity.
- Checking what goods and services you can claim VAT on from the UK and, when you don't understand something, seeking advice from us or an agent familiar with UK refund rules and procedures.
- Telling us promptly about any mistake you discover after you send us a claim.

If you don't take reasonable care, we can penalise any errors. The penalties will be higher if the errors are deliberate.

How to reduce a penalty
We can substantially reduce any penalty due if you:

- tell us about any errors before we ask you about them;
- help us work out if you have claimed too much; and
- allow us to check your figures.

What are the penalties?
The penalty is a percentage of the amount that has been overclaimed.

We will calculate the correct amount of money we are refunding you, and will deduct any penalty.

The penalty rate depends on why you made the error. The less serious the reason, the smaller the penalty will be.

No Penalty	Max 30%	Max 70%	Max 100%
Reasonable care	**Careless**	**Deliberate**	**Deliberate & Concealed**
	Min 0%	Min 20%	Min 30%

How will I know if I have to pay a penalty?
We will discuss your claim with you or your agent to work out the correct amount and any penalty that may be due, before we send a penalty notice. That way you can understand what has happened and why we are doing this.

If you don't agree, you can appeal against the penalty.

Where can I get more help?
You can find more information on penalties for errors, including what other UK taxes it applies to, at www.hmrc.gov.uk/about/new-penalties/index.htm.

HM Revenue and Customs Guidance Notes, 01/07/2008
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Company cars—advisory fuel rates from 1 July 2008

These figures give about one month's notice of the changes and apply to all journeys on or after 1 July 2008 until further notice.

We have agreed with employers that we should give them one month's notice of a change in advisory fuel rates so that they can amend their systems in good time to implement the new rates. Accordingly we are announcing these new rates in time for implementation on 1 July. However, the recent fuel price increases which justify these AFR changes have happened very rapidly. In these unusual circumstances we are mindful that an implementation date of 1 July might mean that drivers will be incurring higher fuel prices before the new rates become effective. Consequently, where employers are able to do so, HMRC is content for the new rates to be implemented immediately ie from 1 June.

Engine size	Petrol	Diesel	LPG
1400cc or less	12p	13p	7p
1401cc–2000cc	15p	13p	9p
Over 2000cc	21p	17p	13p

Petrol hybrid cars are treated as petrol cars for this purpose.

These rates are calculated from the fuel prices in the tables below—

Petrol

Engine size (cc)	*Mean MPG*	*Applied MPG*	*Fuel price (per litre)*	*Fuel price (per gallon)*	*Pence per mile*	*AFR*
up to 1400	48.9	44.0	114.8	521.8	11.9	12
1400–2000	39.5	35.6	114.8	521.8	14.7	15
over 2000	27.8	25.0	114.8	521.8	20.9	21

Diesel

Engine size (cc)	*Mean MPG*	*Applied MPG*	*Fuel price (per litre)*	*Fuel price (per gallon)*	*Pence per mile*	*AFR*
up to 2000	50.7	45.7	127.2	578.3	12.7	13
Over 2000	38.2	34.4	127.2	578.3	16.8	17

LPG

Engine size (cc)	*Mean MPG*	*Applied MPG*	*Fuel price (per litre)*	*Fuel price (per gallon)*	*Pence per mile*	*AFR*
up to 1400	39.1	35.2	57.1	259.6	7.4	7
1400–2000	31.6	28.5	57.1	259.6	9.1	9
over 2000	22.2	20.0	57.1	259.6	13.0	13

Notes

– Mean mpg, miles per gallon, from manufacturers information, weighted by annual sales to businesses (Fleet Audits, 2006).

– Applied mpg - adjusted downwards by 10% to take account of real driving conditions and lower fuel economy for older cars.

– For LPG, mpg is assumed to be 20% lower than for petrol due to lower volumetric energy density.

– Department for Business, Enterprise & Regulatory Reform's latest petrol and diesel prices (26 May 2008), LPG from AA website (May 2008).

Will the rate per mile figures change if fuel prices go up or down?

With effect from the January 2008 change, the rates will be reviewed twice a year. Any changes will take effect on 1 January and 1 July but will be published on the HMRC website about one month in advance.

HMRC will also consider changing the rates if fuel prices fluctuate by 5% from the published rates when each review is made and we consider the price change will be sustained.

Employers should make themselves aware of any changes by referring to this page in June and December each year. It is the primary source of information.

VAT

Customs will also accept the figures in the table for VAT purposes though employers will need to retain receipts in line with current legislation.

HMRC Notice 3 June 2008

VAT—partial exemption – launch of consultation

This Revenue and Customs Brief article announces the launch of a consultation on ideas to simplify the VAT partial exemption rules to reduce compliance costs for businesses. The consultation invites comments and suggestions on the three partial exemption areas identified as simplification priorities by businesses—

- standard method
- de minimis rules
- Capital Goods Scheme (CGS)

It also invites comments on possibly combining partial exemption and business/non-business calculations.

Partly exempt businesses and their representatives are encouraged to participate to help cut compliance costs. Further information on partial exemption is available in Public Notice 706 Partial Exemption.

Background

VAT on costs relating to taxable supplies is recoverable, whereas VAT relating to exempt supplies is normally irrecoverable. A business that incurs VAT on costs relating to taxable and exempt supplies is partly exempt and must apply the partial exemption rules to calculate how much VAT it can recover.

There are around 140,000 partly exempt businesses including financial service providers, property companies, educational organisations, charities, gaming operators and undertakers. Around 120,000 of these, mainly smaller-sized businesses, operate the standard method, which is a simple turnover-based calculation set out in law.

Around 100,000 small partly exempt businesses benefit from being able to recover VAT relating to exempt supplies that is deemed insignificant under the de minimis rules. This is meant to relieve small businesses of the burden of restricting VAT relating to exempt supplies.

Some expenditure on capital items, mainly relating to land and buildings, falls within the CGS. This requires businesses to review the extent to which capital items are used in making taxable supplies for a period of up to ten years, making adjustments to previously recovered VAT where necessary. Most large businesses incur expenditure on capital items.

Consultation

The consultation was launched on 19 June with publication of the consultation document on the HMRC website. Businesses and representative bodies are invited to suggest ways to simplify partial exemption and comment on a number of ideas for simplification. Responses from smaller-sized businesses and their representatives that regularly perform partial exemption calculations are particularly encouraged as they are likely to be affected most and have most to contribute. With this in mind, technical and legal content has been kept to a minimum. The consultation will end on 30 September 2008.

Further information

If you have any queries please contact Patrick Wilson on 020 7147 0595 or by email Patrick Wilson – www.hmrc.gov.uk/asplib/mailer/mailer_form.asp?dpt=PATRICK_WILSON.

Weight Watchers (UK) Ltd 2008

Membership of the taxpayer organisation was open to those whose weight exceeded a level identified by reference to certain charts and who wished to reduce it. In January 2005, the taxpayer introduced for its members a weight loss and weight management programme entitled 'Switch', the benefits of which were made available to members at meetings organised by the taxpayer. A person who became a member attended such a meeting and was enrolled, provided with various documents including the Switch handbook and instructed on how to use it. A leaflet was issued to all at the meeting together with other printed matter and an address was made by the leader of the meeting. The newly enrolled member paid £9 for enrolment and £4·95 for that meeting; the existing members paid £4·95 each for the meeting. In March 2005, the Revenue ruled that for the purposes of VAT the components of the Weight Watchers' classes, the classes and the printed matter together formed one supply of a standard-rated weight loss programme. The taxpayer appealed to the VAT and Duties Tribunal. It contended that the events of the meetings gave rise to two separate supplies, namely a zero-rated supply of the printed materials and a standard-rated supply of the other goods and services. It accepted that, on that analysis, the price paid by the member, either £13·95 or £4·95, should be apportioned. The tribunal allowed the appeal and the Revenue appealed to the High Court. The judge drew a distinction between the supplies made in relation to any given member at his or her first meetings and all other supplies to members attending meetings. He did not interfere with the decision of the tribunal that the consideration paid by the new member at his first meeting, namely £13·95, was for separate supplies of services and printed materials. He therefore dismissed the appeal in relation to the transaction involved in that first attendance. In respect of transactions involved in subsequent meetings, however, he held that the consideration of £4·95 was paid for a single standard-rated supply of weight-loss services. The taxpayer appealed in relation to the decision concerning subsequent meetings. The Revenue cross-appealed in relation to the first issue.

The taxpayer's appeal would be dismissed and the Revenue's cross-appeal would be allowed.

In the instant case, given the obvious interrelation of the transactions at the first and subsequent meetings, the tribunal should have considered them in the order in which they occurred and to test the prima facie conclusions in relation to one category against the prima facie conclusions in relation to the other. Applying settled principles, there had been a single supply at meetings of each description in accordance with the original ruling of the Revenue. The typical consumer was or was about to become a member of the taxpayer. The purpose of becoming a member was to obtain the benefit of the Switch programme. One of the cardinal features of that programme for a member entitled to attend meetings was the reinforcing combination of the diets as taught in the handbook and the group therapy to be derived from the meetings. If it was the combination which the meeting member was buying, then it made no sense from an economic point of view to pay (that was, be charged) separately for the meetings and the publications. There was no difference between one meeting and another except in the case of a customer who was enrolling for the first time or enrolling again so as to attend the meeting without paying for missed meetings since the last enrolment. He or she was not a typical consumer but a subset of that class, wand was only paying the higher price in order to obtain or continue to obtain the benefit of the combination. It followed that the events of the first meeting, from the point of view of the enrolling member, were merely a necessary preliminary to obtaining the benefits of the programme as a whole at that and any subsequent meeting that member attended.

Court of Appeal, Civil Division Sir Andrew Morrit C, Hooper and Lloyd LJJ , 25 June 2008

Staff hire concession: technical note

Background

HMRC have announced that the staff hire concession will finally be withdrawn on 1 April 2009. The announcement was made in a Budget Notice, BN 108, that was apparently accidentally omitted from the first set of Budget Notices issued after the Chancellor’s speech – that stopped at BN 107.

The concession has operated as follows since 2004:

VAT: Hire of staff by employment businesses

1. The arrangements described in paragraph 2 below apply from 1 April 1997. They will continue until Customs has completed its review of the impact on employment businesses of the Conduct of Employment Agencies and Employment Businesses Regulations, which were made by the DTI on 17 December 2003. The review will commence 18 months after the relevant DTI regulation comes into effect on 6 July 2004.

2. Where an employment business within the meaning of the Employment Agencies Act 1973 supplies a member of its staff (the employee) to another business which:

a. is responsible for paying the employee's remuneration directly to the employee, and/or

b. discharges the obligations of the employment business to pay to any third party PAYE, NICs, pension contributions and similar payments relating to the employee,

then, to the extent that any such payments as are mentioned in paragraphs (a) and (b) above form the consideration or part of the consideration for the supply of the employee to the other business, they shall be disregarded in determining the value of the supply of the employee.

Customs accept that the condition at point (a) for the payment of the employee's salary by the client directly to him may be discharged by the client having a contract with a payroll company. The payroll company may be owned by, but separate from, the employment business.

Business Brief 02/04

Customs later re-emphasised this position in a further Business Brief (presumably because many people could not believe that the first Brief so comprehensively reversed the position as it had been represented in 1998). Customs summarised the position until they have completed their review as follows:

- The staff hire concession is available only to employment bureaux that hire out their own employees. It allows them to exclude the salary and associated costs from the VAT charge.
- All other employment bureaux that hire out self-employed work-seekers cannot use the staff hire concession. But they can choose whether to act as agents or principals for VAT purposes.
- Employment bureaux that choose to act as agents for VAT purposes account for VAT only on the commission or margin element of their charges to the hirer.
- Employment bureaux that choose to act as principals for VAT purposes account for VAT on the total charges made to the hirer.
- Customs will accept that the VAT invoices issued by the employment bureaux will be acceptable as evidence of the choice made as to the status of the bureaux for VAT purposes.
- Until the Customs review is completed, all new employment bureaux can also take advantage, as appropriate, of any of the above arrangements.

Business Brief 10/04

HMRC explain that the concession is no longer necessary because all employment businesses are now subject to the same regulatory framework that will ensure that similar businesses will have to charge VAT on the same basis. This means that all will be subject to the same disadvantage – it may become more costly for exempt businesses to use an employment bureau, but at least there will not be distortion of competition as a result.

HMRC undertook a consultation on the operation of the concession in 2006. A summary of responses was published on 1 April 2008.

BN 108

HMRC have published a summary of responses to the review which is reproduced below. It is interesting to see the many comments that were made, almost all of them in support of retaining the staff hire concession, and the staunch refusal of HMRC to accept the validity of any of them. The document explains the legal background to the introduction of the concession (to provide a level playing field between different employment businesses) and the way in which the DTI's Conduct of

Business regulations for employment businesses have – in the opinion of HMRC – removed that need. It goes into great detail and the original will be of interest to anyone who deals with employment businesses or businesses which use temporary staff.

Review of the staff hire concession – summary of responses

1. Introduction

At Budget 2008 the Government announced that HM Revenue & Customs (HMRC) would be withdrawing the concessionary arrangements in respect of supplies of temporary workers by employment businesses with effect from 1 April 2009. In Business Brief 06/06 HMRC invited contributions to a review of the arrangements. Affected businesses and other interested parties were asked to comment, where possible with evidence, on: the existing use of the concession and the effect of any withdrawal; the VAT treatment of employment bureaux, dependent on their status; and the impact of certain DTI regulations. This document summarises the contributions that were received during the course of the review and contains HMRC's responses to them.

HMRC received 51 written responses and additionally met a number of trade associations and other interested parties. HMRC is grateful to those who took part in the review and recognises the time, effort and careful thought that went into their comments and contributions. For ease of reference, the contributions and HMRC responses have been categorised under the following headings:

- Responses on conduct of review and factual information
- Legal analysis
- Level playing field/ distortion of competition
- General responses on the application of the SHC

For the avoidance of doubt, where the term staff hire concession (SHC) is used below this refers to the concessionary arrangements set out in Part A of the Statement of Practice in Notice 700/34 *'Staff'* and the further concession set out in Business Brief 10/04. Where there is a need to distinguish between the two concessions this is made clear in the text. Parts B and C of the Statement of Practice, concerning the secondment of staff by businesses other than employment businesses and the placement of disabled workers under the Sheltered Placement Scheme (or any similar scheme), are unaffected by this review.

2. Background to the review

The SHC was introduced on 1 April 1997 as a temporary measure (following the *Reed Personnel Services Ltd High Court case STC 588*) designed to prevent a distortion of competition between those employment bureaux adopting Reed arrangements when supplying self-employed temporary workers, accounting for VAT solely on their 'commission', and those acting as principals and accounting for VAT on the whole of the consideration received.

The concession was originally intended to expire at the end of 1998. HM Customs & Excise (HMCE) announced in Business Brief 20/98 that, in view of new rules planned by the then Department of Trade & Industry (DTI), employment bureaux would in future be acting as principals for VAT purposes and so VAT would then be due on the full amount received from the client (including salary and associated costs). HMCE added that, until the new DTI rules came into effect, the SHC would be temporarily extended. A further announcement was made in Business Brief 13/99 where HMCE re-affirmed its view following the issue of a consultation document by the DTI and said that the SHC would be withdrawn when the DTI regulations came into force.

The DTI Conduct of Employment Agencies and Employment Businesses Regulations 2003 (Conduct Regulations) were introduced in December 2003. The result of the new Conduct Regulations was such that where temporary workers employed by bureaux (whether under a contract of services or a contract for services) were supplied by that bureaux they could only do so as an employment business. Employment agencies were prohibited from paying the workers directly or indirectly.

Shortly after, HMCE announced in Business Brief 02/04 (and by subsequent amendment to Notice 700/34 'Staff') that the SHC would not be disturbed before a review had been conducted. The review would commence 18 months after the Conduct Regulations came into force on 6 July 2004. HMCE also made clear at this time that it would consult with all interested parties. In Business Brief 10/04, HMCE reiterated that no changes would be made to the SHC pending the outcome of its review and further extended the concessionary treatment to employment bureaux who hired out self-

employed workers. Such businesses could choose, evidenced by their sales invoices, to be agents for VAT purposes, even if in reality they might be principals following the introduction of the Conduct Regulations.

Business Brief 06/06 announced the start of the review and invited contributions from all affected business and any other interested parties.

3. Responses on conduct of review and factual information

3.1 Publicity of the Review

Two contributors expressed concern at what they perceived to be low publicity of the review.

HMRC comment HMRC contacted stakeholders that had previously identified themselves as interested in the issue as well as publicly announcing its review on the Internet. A number of trade associations helped to further publicise the review by carrying articles about it and consulting with their members. In view of the number and range of contributors HMRC is content that key stakeholders had the opportunity to contribute to the review. Overall the number of contributions received is in line with the average for tax consultations.

3.2 Why was the review necessary?

A range of comments were received under this heading as follows:

- HMRC had already decided that the Conduct Regulations render the SHC redundant.

- Acknowledgement that the SHC was always intended to be a temporary measure, but that as it has now been in existence for so long it has become part of standard costing arrangements.

- Appreciation that HMRC must consider and react to the Conduct Regulations, but at least some of the status quo should remain for the healthcare sector.

- One professional advisor said the last 18 months since the introduction of the Conduct Regulations had shown that they can co-exist with the SHC without problems or complaint.

- Questioning as to why the SHC was now considered no longer viable, asking if there were legal drivers behind the review and, if so, what these were.

- The SHC and Conduct Regulations are symbiotic; workers' terms are strengthened by the Conduct Regulations, whilst the SHC ensures that the limited recovery sectors do not suffer a VAT burden on wages. There have been no changes in practice or in contracts since the Conduct Regulations came into being so there is no need to change the VAT view.

- Changes to the SHC are unwarranted.

- Unequivocal opinion that the driver for the review is to increase VAT revenue. They countered that the resulting likely employment of fewer temporary workers would lead to a reduction in PAYE/NICs and even that off-shoring would reduce HM Treasury's tax take and off-set any increase in VAT.

- The driver was anti-avoidance, in which case they felt that specific instances should be targeted, not the UK economy as a whole.

HMRC comment HMRC gave a public commitment in 2004 to review the operation of the SHC, after an extended period, following representations made to it, and further committed to consult as widely as possible with all interested parties. The review was launched in June 2006, and HMRC has fully considered all of the contributions it has received. The primary driver for the review was to ensure that the VAT treatment applied to supplies of staff made by employment bureaux was consistent with UK and EU VAT law. The original introduction of the SHC was to provide equal treatment between employment businesses and employment agencies. The normal VAT rules no longer act to distort competition, since all those operating on a similar commercial basis, and in line with the Conduct Regulations, will now be treated as principals for VAT purposes. It is recognised that the SHC helps those who benefit from it pay less tax but this is inconsistent with normal VAT rules and EU commitments. Although not the main driver, HMRC has acknowledged (in the Impact Assessment that was published on 12 March 2008) that withdrawal of the SHC will also neutralise certain tax avoidance schemes that have emerged over recent years.

3.3 General comments on the use of temporary workers

- In contrast with the rest of the EU, where the market is more restricted by legislation and thus dominated by large bureaux, employment bureaux in the UK are mostly small and medium-sized enterprises.

- The flexibility of the UK labour market was stressed. Temporary workers form an important part of the UK workforce and it would be impossible to operate as efficiently and effectively without them. A National Audit Office report of 10 July 2006 was cited.

- The SHC enables businesses to maintain an efficient headcount, while retaining the flexibility to take on temporary staff to meet short or medium terms needs.

- The use of temporary staff is widespread, and helps with: holiday cover, maternity/paternity leave, sick leave, seasonal peaks and troughs, unusual events, new product launches, one-off projects, training, non-core hours telephone answering, the filling of short-term skills gaps. It enables businesses to react quickly to changes in demand. Three contributors said that a flexible workforce facilitates their sector needs to be extremely adaptable.

- The SHC assists certain businesses to meet regulated staffing hours (e.g. in care homes) or qualified staff to child ratios in crèches.

- A number of FTSE100 companies use temporary staff before taking them on full-time. It is seen as beneficial to hirers that they can terminate relationships with temporary workers at short notice without any of the restraints of employment protection law.

- That the use of temporary staff assists cost and efficiency savings and helps businesses to concentrate on core activities and product development. One contributor said that outsourcing levels the playing field (with larger competitors) for businesses of their size and allows them to concentrate on core business and the development of new products.

HMRC comment These comments informed HMRC's understanding of the drivers for, and business benefits of, using temporary workers. Most VAT-registered businesses in the UK are able to reclaim, subject to the normal rules, any VAT charged to them on hiring in temporary workers. Partly-exempt businesses and others with limited VAT recovery, such as charities and some parts of the public sector, also hire temporary workers and do currently benefit from the SHC, because it means they are charged less VAT than should be chargeable under the normal rules. However, HMRC has to be consistent with UK and EU VAT law in determining the VAT treatment of supplies made and there is no scope to extend the SHC beyond the date set for its withdrawal.

3.4 Who uses/benefits from the staff hire concession?

From the comments received and other research carried out, HMRC has identified a number of sectors that use temporary workers, but the SHC has the biggest impact on:

- Employment businesses who, as a result of applying the SHC, only charge VAT on their profit margin;

- Their clients, particularly those who cannot recover all of the VAT they incur: the financial services sector (e.g. banking and insurance), private healthcare providers, private care homes, private and voluntary aided schools, higher education establishments (e.g. universities), other partly or fully exempt businesses, charities and some parts of the public sector; and

- Temporary workers.

HMRC comment For the majority of businesses who use temporary workers, the SHC has no significant impact because they can fully reclaim any VAT charged. It is only significant for those hirers who cannot recover VAT in full, because its use means that employment businesses charge them less VAT than they would otherwise have to if the SHC was not available. Accordingly, HMRC received a wide cross section of contributions from the limited recovery sector.

3.5 Who would be affected by any changes and what could the impact be?

The following reflects the comments received regarding the potential impact of any changes, listed by category.

(a) Employment bureaux.

- There are thousands of employment bureaux – no one firm has more than 8% of market share in the UK. If the non-recoverable sector exerted its buying power so bureaux had to bear any increased VAT burden, their profit margins would reduce or, if they could not absorb that, some small bureaux would go out of business. Another responder referred to increased insolvencies in the healthcare sector in view of already tight cost constraints.

- Any withdrawal of the SHC would lead to staffing companies reverting to the '*Reed*' agency model[1]. In contrast, another said that healthcare bureaux would be less likely to become agents because of the Conduct Regulations.

- Changes would increase the administrative burden – contract renegotiations, publicity internally and externally, IT and manual system changes.

- One trade body alluded to legal challenges, including Judicial Review. Withdrawal might fuel a challenge to the concept of a supply of staff. If agency is no longer available because of the Conduct Regulations then this could lead to a fundamental re-examination of the nature of a supply made as a principal i.e. what does a supply of staff mean – is it really a supply of (e.g. exempt nursing) services?

1 The 'Reed' model refers to the judgment in the Reed Personnel Services Ltd High Court case 1995 STC 588, where it was found that Reed was acting as an employment agent.

(b) Non/limited recoverable sectors

- Those with limited VAT recovery, i.e. partly and fully exempt businesses, charities and some parts of the public sector would be affected by any withdrawal of the SHC.

- The availability of the SHC is a significant budgetary consideration and preferred suppliers use the SHC. If the SHC were withdrawn, they would face increased and absolute labour costs and the increase in the amount of VAT they were charged would negatively impact on their growth, competitiveness and flexibility. One body representing a limited recovery sector said that removal of the SHC would impede efficient structuring as it would make the out-sourcing of administrative/Human Resources (HR) functions less attractive.

- Withdrawal of the SHC might result in the use of different business models to minimise irrecoverable VAT, but it was said that business restructuring is done at considerable expense and for the long term and it is not easy to unravel structures that have become embedded to counter adverse tax changes without incurring significant expense.

- Some would apply their buying power to pressure bureaux to find ways to mitigate additional costs, or simply require that bureaux absorb them from existing margins. But others would not be able to pass on the costs to clients, due to competitive nature of their particular industry. One contributor said it would not be possible to pass on the cost to employment bureaux due to existing contracts and couldn't readily bring HR functions back in-house.

- Some businesses would hire fewer temporary workers (figures of 10- 40% were quoted). It was suggested that withdrawal of the SHC might fuel off-shoring – the banking sector in particular may progress offshoring, especially call centres (reversing a recent trend) and costing UK jobs. Securities and investment banking are highly mobile and could easily off-shore. But for some, for example where performance takes place in the UK, off-shoring was not a potential option.

- Healthcare bureaux would be especially affected due to a recent alteration of HMRC policy, characterising supplies by healthcare bureaux as of staff (and standard-rated for VAT purposes) rather than hitherto VAT exempt healthcare. The SHC currently mitigates this by restricting VAT to the margin.

- Charities operating care homes: three charities said their levels of activity would reduce. One said withdrawal of the SHC would impact severely on their ability to offer excellence to their disabled clients.

- Standards of care in small, privately-owned care homes could be compromised if they could not recoup VAT via funding or higher charges.

- Withdrawal of the SHC would result in reduced social housing if extra VAT was incurred. This would impact on services to the low-paid and vulnerable members of the community.

(c) Current employees

- Reducing the use of temporary workers would mean the permanent workforce would have to absorb the workload/work overtime and would result in a less diverse workforce.

(d) Temporary Workers

- Withdrawal of the SHC would probably result in significant reduction in the use of temporary labour, reducing opportunities, for example to make the temporary to permanent migration. It would also create downward pressure on salary levels.

- Eight contributors said it would lead to increased unemployment. Jobs in UK call centres would be lost overseas. Many would potentially be affected – the UK has the most temporary staff anywhere in the EU.

- Any reduction in temporary labour would be detrimental to: – parents with carer responsibilities; – older workers re-entering jobs market after redundancy; – mothers returning to work after maternity or career breaks ; – disabled workers, who find temporary jobs an essential step into employment; – students awaiting courses or taking a 'gap year' i.e. those unable or unwilling to commit to full-time or long-term contracts of employment. One temporary worker simply said that flexible working is a necessity. One industry body commented that over half of all temporary workers chose temping for its flexibility, better pay or to gain valuable work experience.

(e) Members of the public

- Patients/fragile/vulnerable members of society would potentially be affected if additional funding or increased prices were not available. State-funded elderly residents' care would be adversely impacted as funding capped by local authorities/ health trusts. Care services for vulnerable members of society would be more expensive and less accessible. Private individuals who hire carers to look after family/friends would be affected.

- NHS patients. Following a more restrictive interpretation by HMRC with effect from 1/4/06 of heading 52 of the 'Contracted Out Services' on which VAT can be reclaimed, bureaux charges in respect of GPs, locums, pharmacists, physiotherapists and other health professionals are excluded. The SHC reduces the impact but its removal would result in a reduction of funds available for patient care.

- Parents paying for childcare in nurseries/crèches would face increased costs, potentially making it uneconomic for them to continue to work or work part-time.

- Beneficiaries of charities' services would receive reduced services.

- Services to tenants, including investment in new housing, would reduce.

- Consumer debt would increase if costs passed on to them by exempt finance institutions.

- Students' education – budgets are capped so the flexibility afforded by the use of temporary workers, e.g. lecturers, is essential.

HMRC comment The SHC permits bureaux to account for VAT on their profit margin rather than the full value of the supply. This means that they charge VAT on a lower amount, resulting in their customers incurring less VAT as input tax. This is especially significant where their customers are not able to recover the VAT they are charged such as fully or partly exempt businesses or charities. The financial benefit obtained from the existence of the SHC is obvious given that it means that budgets incur a reduced VAT element for those unable to recover it in full. The comments above make clear that the SHC also has 'trickle-down' benefits to employment bureaux and workers because hirers' budgets stretch further. The fact that the concession has now existed for 11 years means that, for some of those who have benefited from it, it is the only VAT treatment they have ever known. For customers with limited VAT recovery, exposure to the normal requirement of VAT being charged on the full value of the supply clearly has consequences. HMRC accepts that there could be consequences not just for hirers, but also for employment bureaux and workers. The estimated revenue yield of £125m a year following the withdrawal of the SHC suggests that the

overall impact on the UK's temporary labour market (which had a turnover of £25bn in 2005-06) will be limited. However, the impact within any particular sector is uncertain, and will depend on (a) the ability of providers to pass on the extra VAT to hirers, (b) the ability of hirers to recover any extra VAT they are charged, and (c) the ability of hirers to pass on any extra irrecoverable VAT in the form of higher charges to their customers.

3.6 Impact on revenue

- Any VAT benefit to HM Government would likely be offset by a loss in PAYE/NI from reduced employment for temporary workers.

- There would be reduced Corporation Tax and the potential for increased Social Security benefit payments.

- There may be attempts to circumvent any perceived VAT increase by VAT avoidance arrangements.

- NHS operators' funding for hospitals (including Independent Sector Treatment Centres/ care homes) would have to be increased to offset increased VAT costs.

HMRC comment HMRC agrees that the withdrawal of the SHC could reduce direct tax revenue, but does not expect any loss of direct tax revenue to offset the gain in VAT revenue. The ability of employment bureaux to pass on increased VAT costs to their customers, and the ability of their customers in turn to pass on increased costs that they cannot recover, will limit the loss of direct tax revenue. Still, to the extent that employment bureaux and their customers absorb an increase in costs, then profits and/or wages will be reduced, lowering direct tax revenue. Also, if withdrawal reduces the overall demand for labour, employment will fall, again lowering direct tax revenue. The 12-month notice of withdrawal should lessen any loss of direct tax revenue. The VAT Disclosure regime will cover many arrangements, and HMRC will proactively engage with any VAT avoidance it encounters.

3.7 Interaction with the Conduct of Employment Agencies and Employment Businesses Regulations 2003 (Conduct Regulations)

- The Conduct Regulations have not resulted in practical changes, and do not change the nature of services received by clients of employment bureaux and should not impact upon VAT. The Conduct Regulations may be relevant, but cannot be determinative, as all the facts are relevant.

- Some said that the Conduct Regulations do not impact on VAT. However, others said that they do and some further questioned whether the SHC is now unlawful/prohibited by law as a result of the Conduct Regulations. Another added that if Regulation 8 of the Conduct Regulations has overall supremacy, then HMRC has arguably incited criminal offences per Business Brief 10/04.

- Specialist advisors cannot agree on the impact on Reed of the Conduct Regulations. Another suggested that one answer could be taking the view that the consideration from which VAT is due could be 'commission' only and not the total charge made by employment business to the hirer.

- The SHC and Conduct Regulations are symbiotic and mutually-beneficial: workers' terms strengthened by the Regs whilst the SHC ensures that the limited recovery sector does not suffer a VAT burden on wages. Regulation 8 of the Conduct Regulations only prohibits agency for contract law purposes – agency for VAT purposes is still possible. The definition of employment in the Employment Agencies Act 1973 is wide. As in the *Reed* case, VAT agency is still the correct outcome.

- The Conduct Regulations do not prevent agency status; they just limit it to bureaux meeting rules on how workers are paid. A firm line should be adopted by HMRC in respect of any 'sham' arrangements put in place to circumvent this.

- The Conduct Regulations have not as yet had a direct effect on how the SHC applies, but it is fair to say that more employment businesses are acting as principals, so more likely to use the SHC.

- The Conduct Regulations have overtaken *Reed*; employment businesses hiring out temporary workers must do so as principals (Regs. 9, 14 and 15 of the Conduct Regulations), although they can act as agents when placing permanent workers. Consequently, the 'Reed option' no longer exists.

- It would be a sad irony that withdrawal of the SHC could in fact undermine the aim of the Conduct Regulations, by putting users off using temporary workers and favouring employees.

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- Confirmation was sought that one part of the tax system forming a particular position is not binding on another.

HMRC comment When it was introduced, the SHC was not in any way connected with or dependent upon any non-VAT related DTI rules. It was intended to allow employment businesses breathing space before having to comply with the normal VAT rules. When it became known that legislation was being proposed by the DTI which might affect the VAT status of employment bureaux it was decided to extend the SHC until the introduction of this legislation. By the time the Conduct Regulations were introduced HM Customs & Excise had agreed that the SHC would be extended for a further 18 months. Customs then committed itself to reviewing the SHC, involving consultation with all interested parties. This review was objective, and fully considered the implications of the introduction of the Conduct Regulations, in the context of the normal application of VAT rules, specifically addressing the correct VAT treatment of supplies of staff. Only on the conclusion of this review was the decision taken to withdraw the SHC. At the time the Conduct Regulations came into force, in 2004, Customs also introduced a further concession (in Business Brief 10/04). This further concession allowed those bureaux hiring out self-employed temporary workers to choose, **for VAT purposes only,** whether to act as agent of principal, even though the Conduct Regulations may have meant that in reality they were acting as principals. HMRC therefore rejects the contention that this concession means that such businesses were in breach of the Conduct Regulations. The concession did not allow such businesses to supply on an agency basis, as at least one contributor has stated; rather it allowed such businesses to account for VAT on the same basis as if it were an agent. As is explained in more detail below, it is HMRC's view that the introduction of the Conduct Regulations has had the effect of levelling the playing field within the recruitment sector, and as a result has removed the original driver for the introduction of the SHC.

4. Legal analysis

HMRC asked for views on the impact of the Conduct Regulations and the VAT treatment of employment bureaux. A number of comments were made which looked at possible legal analyses. These are summarised below, together with HMRC's response.

(a) Agency model

Some contributors have suggested that, notwithstanding the changes brought about by the Conduct Regulations, an employment business can still be seen to operate as an agent for VAT purposes. This is because, it is argued, VAT agency is not effectively prohibited by regulation 8 of the Conduct Regulations, and that Regulation 8 only prohibits *for contract law purposes* a bureau from acting as an employment agency in relation to a particular supply. This is not the same as saying that a bureau is not allowed to regard its supplies as supplies as an employment business for contract/agency law purposes, but as supplies as agent for VAT purposes. The contention continues by citing the *Reed* High Court judgment (*Reed Personnel Services Ltd High Court case STC 588)* to the effect that the principle of supply for VAT purposes is not coterminous with the principle of supply for contract purposes. Thus, it is suggested, any withdrawal of the agency model of supply would require the *Reed* case to be overturned by the Court of Appeal and/or an amendment to the VAT Directive.

HMRC comment It is HMRC's view that the Conduct Regulations draw a distinction between:

- an employment agency, which provides intermediary services, finding employment for workers who will then enter into a contract of employment with the third party hirer; and

- an employment business, which supplies persons employed by it (either under a contract of services or a contract for services) to third parties. Whichever is used, the individual concerned will be 'employed' – either by the bureau or by the third party. By Regulation 8 of the Conduct Regulations, an agency is prohibited from paying the employee's wages – so that if a temporary worker obtains work via an employment agency, that worker will be paid by the employer and not the agency. If a temporary worker is supplied by an employment business, the worker will be paid by the business and not the third party hirer. The Conduct Regulations have an obvious analogy with the structure of VAT where there are only two business models permissible, either:

- that of employer/employee with the employer then making a supply of staff (as a principal) to the third party; or

that of agent intermediating so that the employee is introduced to the prospective employer, in which case the agent supplies intermediary services and the employee becomes employed by the third party. It is HMRC's view that, although the DTI regulations do not dictate the VAT supply position, a business operating as an employment business for the purposes of the DTI Conduct Regulations is a principal for VAT purposes. Further analysis on how the Conduct Regulations impact on the VAT treatment is set out at the Annex.

(b) Nature of supply

Some contributors have suggested that, regardless of whether the contractual arrangements between the three parties involve the bureau acting as principal or agent in relation to the placement of a temporary worker with a client, a supply of staff is not a concept supported in VAT law. They argue that the service provided by the bureau is one of *search and selection,* and that VAT should only be due on the value of the core service, represented by the margin or fee charged to clients and that the collection of any payment for the worker's salary is outside the scope of VAT. It is contended that Articles 9(1) and 10 of the Principal VAT Directive (formerly Articles 4(1) and 4(4) of the Sixth Directive), which exclude: *"employed and other persons from the tax in so far as they are bound to an employer by a contract of employment or by any other legal ties creating the relationship of employer and employee as regards working conditions, remuneration and the employer's liability."* arguably supports this view and it is possible to contend that there is a tripartite arrangement between the parties that creates a relationship between the client and the temporary worker that has similarities with that of an employment relationship even though the worker is either self-employed or an employee of the bureau.

HMRC comment It is necessary to first consider whether, as a matter of principle, the supply of staff is a taxable service for VAT purposes. That involves a review of the basic concept of a supply for tax purposes and in particular a supply of services. The usual starting point is Article 2 of the Principal VAT Directive which provides that a *"supply of services for consideration within the territory of a Member State by a taxable person acting as such"* shall be subject to VAT. That is supplemented by the definition of a supply of services at Article 24(1) by which a *" 'supply of services' shall mean any transaction which does not constitute a supply of goods".* These provisions are implemented into UK law by section 5(2) VATA 1994. A supply includes all forms of supply *"but not anything done otherwise than for a consideration*". And a supply of services is *"anything which is not a supply of goods but is done for a consideration".* It is therefore well established that the concept of a supply of services is very broad indeed. As a matter of principle, whenever a taxable person supplies anything (other than goods) to another person, and receives money in return for so doing, that will be a supply of services for VAT purposes. That is no different when the supply in question is of staff employed by or hired by the taxable person. HMRC's view on the nature of such a supply is clearly spelt out in paragraph 2.1 of Notice 700/34 Staff: *'You make a supply of staff for VAT purposes if you provide to another person, for consideration, the use of an individual who is contractually employed by you or is a director of your company.'* Articles 9(1) and 10 of the Principal VAT Directive have historically been interpreted to mean that an employee's remuneration is only excluded in the context of the arrangement between two parties, i.e. employee and employer. HMRC do not believe that those articles can be construed so as to allow activities which plainly are within economic activity, such as the supply of staff, to benefit by way of analogy from the preferential treatment that would have been accorded if the arrangements had been structured differently, namely as a contract of employment. That would offend basic principles of neutrality and VAT law.

(c) Employment law cases

A number of employment law cases were put forward in support of the view that there is an underlying employment relationship between the temporary worker and the end client (and thus by implication the bureau must be acting as an agent for VAT purposes).

HMRC comment Whether a person is employed or not for the purposes of Article 10 of the Principal VAT Directive must engage Community and VAT law concepts of employment, if the neutrality of the tax is to be respected. This is just a further application of the well-known principle that domestic legal concepts are not determinative for VAT purposes; rather the VAT analysis must proceed on the basis of concepts applied uniformly throughout the European Community. Domestic employment law has particular policy objectives which may colour its application and so, for example, lead to a wider application of the notion of employment (so as to protect persons in work by conferring the status of "employee"). Those policy objectives do not necessarily transfer to the

VAT law concept of "employment" which underpins Article 10. Generally, where an employment tribunal concluded that that an individual is, or is not, a de facto employee, this might help to inform HMRC's view. However, as supported by a number of contributors, HMRC is not bound by the conclusions of an employment tribunal or indeed by any of the ample domestic case law on this subject. HMRC considers that the correct approach to Article 10 (which in HMRC's view is clear in its terms and scope), is to construe it narrowly or strictly. This is because it represents an exception to the general rule that supplies are taxable and so cannot apply beyond its stated limits. So, again, Article 10 should not be construed so as to allow activities which plainly are within economic activity, such as the supply of staff, to benefit by way of analogy from the preferential treatment that would have been accorded if the arrangements had been structured differently, namely as a contract of employment. That would offend basic principles of neutrality and VAT law.

(d) Supply of self-employed temporary workers is not a VAT supply

Some contributors suggested that it is more likely that where a self-employed temporary worker was supplied by an employment business then an underlying employment relationship exists between the worker and the end client – effectively that such a worker operating under a contract for services will invariably be providing their services directly to their client.

HMRC comment This contention seems to rely upon the principle that where the contract does not provide all the answers one has to look at the wider context of the arrangements. HMRC's view has historically been that simply because a temporary worker is self-employed this should not preclude him from being supplied, under a contract for services, through an employment business acting as principal, just as with any other sub-contracted arrangement. Direct tax legislation exists to tax certain individuals as if they were employees, but this does not change the contractual or substantive reality of the arrangements. It therefore remains the case that the tax treatment for supplies provided in this fashion are the same as those in other sectors where sub-contracting is common e.g. construction services. In respect of employment businesses the thing that is being supplied is the staff themselves rather than the underlying services, but the contractual arrangements are very similar.

(e) Valuation argument

This contention also refers to Articles 9(1) and 10 of the Principal VAT Directive and is similar to those stated above, but uses the valuation of supply as the basis for its logic. It is argued that, as client companies (hirers) do not usually enter into formal contracts of employment with the hired staff, they could have sufficient statutory and legal liabilities towards them for those companies to be treated as if ties of the kind mentioned in Art 10 came into effect, so disapplying the term 'independently' for the purposes of Article 9(1). The '*employer's liability*' in Art 10 is not expressly defined but could, it is argued, be interpreted as including such obligations as compliance with health and safety regulations and other legislation applicable to the workplace. Such an interpretation would be entirely without prejudice to whether the temporary worker would have all the rights and obligations which occur under a formal contract of employment. It is then argued that, having established that the individual worker's supplies to the end user would not be within the scope of VAT under Art 9(1), because they would not be supplied 'independently', the question arises as to what is the correct valuation of the supply made by the employment business in these circumstances? Some contributors argued that the value of this supply is properly the fee charged and collected by the business for introducing or arranging the provision of the worker, and not the payment made for the labour cost of the temporary worker who for the purposes of Art 9(1) and Art 10 must be regarded in the same way as a formal employee of the end user, even if he is not under a strict employment contract with that end user. The employment business has supplied someone under an employment contract with itself but who will have legal ties to the end user which put him effectively in the same position or standing as an employee of the end user under Art 9(1) because he cannot provide his services 'independently'. Contributors then cited *Glawe Spiel (ECJ C-38/93)* and *Town and County Factors (ECJ C-498/99),* in posing the question whether the employment business could use the salary and other payments which are made to the account of the employee and keep it for its own. They suggested the answer is that it could not – that money is irrevocably allocated to the employee's account because the remuneration is paid directly to the employee and other obligations such as NICS and PAYE are paid directly to third parties, with the employment business having no interest in or right to those monies under the overall contractual framework.

HMRC comment Art 10 of the Principal VAT Directive represents an exception to the general rule in Art 9(1). It is not elastic and in HMRC's view cannot be construed so as to encompass a

relationship as set out above, i.e. one that falls short of an employment relationship, as one that falls within the scope of Article 10. HMRC considers that *Glawe Spiel* has a very narrow application. Another case referred to in support of this argument by another contributor is *First National Bank of Chicago (ECJ C-172/96),* but the same contributor also accepts that a contrary view is suggested by *Nell Gwynn (HoL 1999 STC 79).*

(f) Amend EC law

A possible solution (i.e. to retain the effect of the concession) would be to seek inclusion of supplies of staff in Annex K of the Sixth Directive (now Annex IV of the Principal VAT Directive), although this proposal was made without any explanation. Another cited Art 12(3) and Annex H (16).

HMRC comment HMRC would not seek such an inclusion. The proposal does however reflect a view that there is no existing vires within EU VAT law either for continuing with the SHC, or for legislating for it within UK VAT law. HMRC received no other proposals along these lines, with most of the contributors suggesting that EU law already provides the necessary vires. Some contributors accepted that the SHC was without foundation in EU law.

5. Level playing field/ distortion of competition

Businesses in other EU Member States tend to employ staff directly. The temporary employment market in the UK is more developed, so any partial or total removal of the SHC would reduce UK flexibility and make the UK less cost-competitive.

There remains a need to level the playing field in the non-recoverable sector – agents still exist despite the Conduct Regulations. Two contributors said that any policy change which creates distortion of competition would be unreasonable.

Direct employment does not generate a VAT liability/is outside the scope of VAT and so there is no economic rationale for treating the engagement of temporary workers in a different manner. Article 4(4) of the Sixth VAT Directive, excluding employed persons' activities, should equally apply to temporary workers.

VAT distorts the labour market in the limited recovery sectors and withdrawal of the SHC would exacerbate this. The ability of the NHS and local authorities to recover VAT, to the extent that they can, is unfair to private healthcare providers.

Circumvention through avoidance would be more feasible for large private sector businesses than the healthcare sector – the NHS being unlikely avoidance bedfellows, so smaller private healthcare bureaux have less scope to avoid. Charities don't have the same buying power as the financial services sector, so there was inequity of treatment.

'NHS P' (characterised as a State in-house employment agency handling temporary staff for NHS Trusts, formed in 2001) which is in direct competition with private bureaux but does not have to charge VAT, by virtue of being part of the NHS. It was asserted that this may already have led to one major competitor going into receivership less than a year ago. The SHC partially evens out what would otherwise be a significant disparity.

There is currently a great deal of confusion in the industry (employment bureaux supplying nurses/care workers to hospitals/care institutions) – are these supplies (connected with the provision of care) exempt or not? Conflicting rulings have allegedly been given by HMRC, causing disparity of treatment – many businesses are exempting their supplies, whereas others are being forced to charge VAT by HMRC. This is causing an obvious commercial distortion.

HMRC comment Although employment agents still exist, there will be a level playing field. This is because the same VAT treatment will now be applied to all businesses operating on the same commercial basis under the Conduct Regulations. By definition fully and partly exempt businesses, charities and some parts of the public sector will always have a limited recovery of VAT whereas fully-taxable customers will not. The existence of the SHC artificially distorts the normal operation of the VAT system by allowing employment businesses (VAT principals) to charge VAT on a lower value – as if they were agents merely earning a commission, when they are not, in fact, agents. This treatment is not in accord with the application of normal VAT rules, and has no basis in UK or EU VAT law. It is entirely understandable that the VAT savings resulting from the SHC are valued by those who benefit from it and the above points they make about the impact of its removal are understood. HMRC's aim is that businesses account for the right amount of tax in line with UK and

EU VAT law, and the basic principles of VAT. HMRC will proactively engage with any VAT avoidance it encounters, and the VAT Disclosure regime covers many such arrangements.

6. General responses on the application of the SHC

(a) VAT policy implications/joined-up policy

- A large proportion of contributors used this review as an opportunity to discuss the health exemption and there was a clear perception that HMRC had changed its view so that some services hitherto viewed as exempt were now seen as standard-rated.

- The read-across between SHC and a perceived reduction in scope of the health exemption in Schedule 9 Group 7 VATA 1994 should be considered and joint meetings between relevant HMRC policy teams and interested parties should take place.

- The current exemption under Schedule 9 Group 7 para. 1 VATA 1994 should be extended from medically qualified to personal care provision.

- Does Item 5 Group 7 Schedule 9 VATA (the provision of a deputy for a person registered in the register of medical practitioners) include doctors in hospitals or similar locations, or is it now HMRC policy that this is a standard-rated supply of staff?' Guidance was sought on the interaction between SHC and supplies falling within health/welfare exemptions.

- Notice 710/2/83 on nurses appears to have been withdrawn, with no announcement. There would seem to be no valid reason for abandoning the long-accepted agent/principal rule in 710/2/83 (i.e. exempt services are being supplied, not standard-rated supplies of staff). There has already been an apparent hardening of policy in HMRC following the Glasgow University Tribunal, with HMRC seemingly taking the view that agency supplies of staff in the medical sector are on the whole not exempt.

- There is currently a great deal of confusion in the industry (employment bureaux supplying nurses/care workers to hospitals/care institutions), asking whether these supplies are exempt or not? Conflicting rulings have allegedly been given by HMRC. Part of the problem lies with notice 700/34 *Staff*, which they believe does not sit very well with VAT case law, case law and tribunals that have preceded and followed its issue.

- Nursing agencies merit special treatment – by law or established practice they exercise a high degree of "direction" over the workers and are therefore supplying exempt services rather than "staff".

- Section 41 VATA should be reconsidered to permit the NHS to recover VAT on supplies made to it of temporary workers. Following a perceived more restrictive interpretation by HMRC with effect from 1/4/06 of heading 52 of 'Contracted Out Services' (COS) on which VAT can be reclaimed, bureaux charges in respect of GPs, locums, pharmacists, physiotherapists and other health professionals are excluded. The SHC reduces the impact but its removal would result in a reduction of funds available for patient care. A specific request was made for a change in policy so that such VAT on these services be recoverable under the COS arrangements.

- There is an overlap with the EU Financial Services consultation – there is already considerable uncertainty surrounding the cost of outsourcing arrangements following the ECJ decision in *Arthur Andersen* (C-472/03). HMRC should lobby the EU to secure exemption for outsourcing in the financial services sector as part of the EU Commission's existing consultation. Withdrawal of the SHC followed by exemption would cause confusion and accounting difficulties.

- HMRC should be sensitive and not cause disruption or confusion in the marketplace, in view of numerous VAT changes in the past to health and outsourced financial/insurance services.

- Withdrawal of the SHC could fuel tax avoidance by larger businesses.

- Input from Other Government Departments should be sought in particular the DBERR (formerly the DTI) and HM Treasury, in respect of the impact on the UK employment market.

- Healthcare bureaux would be especially affected due to recent changes in liability treatment by HMRC in characterising supplies as of staff (standard rated) rather than as healthcare (exempt). The SHC currently mitigates this by restricting VAT to the margin. Relevant policy teams, the highest levels of HMRC management and HM Treasury should recognise this.

Concessions already exist for the catering industry and for supplies of staff between charities in non-business areas, and the justification for a concession in the healthcare sector is second to none.

(b) Joined-up Government (Other Government Departments)

Regulation 8 of the Conduct Regulations could be undermined if, to maintain VAT efficiency, hirers take on the payment of temps – HMRC's actions could thus undermine the DTI's aims. HMRC should agree with the DTI a better way of achieving its aim of protecting temporary workers without disrupting existing VAT arrangements.

Withdrawal would mean funding, intended to provide services to the public, would be diverted and paid from one part of the public purse (Department of Health) to another (HM Treasury).

Withdrawal of the SHC would negatively impact upon the UK's reputation for flexible labour markets. One pointed out that 3 out of 4 characteristics of HM Treasury's labour market flexibility model (from a 2003 Treasury report regarding European Monetary Union) would be adversely affected: wage flexibility, working time flexibility and responsiveness of labour market to shocks. Withdrawal would be a contradiction of the Government's objective of achieving flexibility and efficiency in the temporary workforce and protecting temporary workers.

The DTI Under Secretary of State's 2003 speech on the draft Conduct Regulations promoted a flexible labour market was referred to. Also, in its opposition to the EU draft Agency Workers' Directive, the Government has emphasised the benefits to the UK economy of the flexible labour market.

Withdrawal of the SHC could lead to the bankruptcy of smaller operations – contrary to care in the community and another said that it would go against Government policy of promoting care for individuals in their own homes.

Withdrawal of the SHC would undermine the Government's Reform Programme for the Public Sector, since it would negatively impact on independent providers, as they would have to charge VAT in full.

Reference was made to the Chancellor's speech of October 2005 'Global Europe: full employment Europe' where he said '…This calls for greater flexibility in … labour markets and ensuring fairness that expand opportunity and choice, provide security for the vulnerable …'.

Withdrawal of the SHC would impede HM Treasury's stated goal of promoting the UK's financial services sector.

Withdrawal of the SHC would undermine the Government's commitment to full employment and high productivity.

Withdrawal of the SHC would undermine the DTI's aim of increasing employment of disadvantaged groups (single parents and over 50s) – target 10 of PSA target 10 – Maximising Potential in the Workplace.

Withdrawal of the SHC would be against the Government's policy of working in partnership with charities – withdrawal of the SHC would make it harder for charities to compete.

(c) Continuance/Withdrawal of SHC

Twenty one contributors clearly and directly opposed any withdrawal of the SHC and with very few exceptions (see next paragraph) the comments of all others were against any withdrawal of the SHC. One even said that, if change was necessary, it was the DTI's Conduct Regulations that should be brought into line with VAT. Two contributors said that retention of the SHC is justified in the healthcare sector for economic and social reasons, and that new provisions would be needed to protect charities/care homes/public sector from any VAT changes. Another added that the exemption for supplies of staff should be extended.

In stark contrast, one contributor said that there is no justification for the continuance of the SHC. One accountant said HMRC must remove the concession in Business Brief 10/04 due to employment law and actual and potential abuse of the concession.

Agency arrangements should remain in place and another that withdrawal of the agency model would require Reed to be overturned by the Court of Appeal and/or amendment of the Sixth Directive.

- There should be future certainty, incorporating a prescribed period when SHC will be available.
- It would be unreasonable to make any changes in view of other policy changes in respect of healthcare and financial/insurance services. Also, withdrawal of the SHC followed potentially by new EU exemption for outsourced services would cause confusion and accounting difficulties.
- If HMRC wishes to make changes, it should undertake a wide consultation to ascertain employment costs.
- In the event that the SHC is withdrawn, there should be a transitional period of at least one year; existing contracts should be grandfathered; and there has to be a level playing field i.e. the SHC should not be withdrawn if *Reed* arrangements continue to be accepted.

(d) Timing of any changes

- HMRC should await the outcome of the EU financial services review.
- 'Adequate' lead-in time would be needed, another said 9 months and a further contributor said at least one year. Another body suggested that, to help identify abuse and revenue involved, HMRC could require disclosure of use of SHC, for example over a one year period, subject to de-minimis amounts. This would permit a clearer picture of use of the SHC to be formed.
- 'NHS P', an in-house employment agency handling temporary staff for NHS Trusts formed in 2001, is in direct competition with private bureaux but does not have to charge VAT, by virtue of being part of the NHS. This is due to change in 2007/8, when it will have to apply the same VAT treatment as the private sector – implicitly saying that any withdrawal of the SHC should be 2007/8 for health bureaux.

HMRC comment The withdrawal of the staff hire concession has no direct impact on any other concessionary arrangements. The scope of this review was not extended to include a review of other concessions or VAT treatments. However, all relevant information has been shared with the appropriate policy teams that are responsible for these other VAT treatments for their further consideration. As far as nursing agencies are concerned, supplies made as principals of nursing staff to hospitals and care homes are treated as VAT-exempt supplies of healthcare services and therefore not subject to VAT. This is a concession that has been in place since 1983. The catering staff wages concession has been in place since the introduction of VAT, and allows catering contractors to treat the wages of their own staff as a disbursement where they are employed solely to serve a specific client. Thus, VAT is only charged on the management fee. It provides relief for supplying banks, schools, hospitals etc. HMRC approached this review without having taken any decisions on its future. HMRC consulted extensively with HM Treasury during its review, and also liaised with DBERR. However, the overriding driver was that the outcome of the review had to be compatible with UK and EU VAT law. It should also be noted that this concession has always been publicised as temporary or timelimited in some way. In HMRC's view, the introduction of the Conduct Regulations has had the effect of levelling the playing field within the recruitment sector, and as a result has removed the original driver for the introduction of the SHC. The popularity of the SHC is understandable as is the desire expressed by the majority of contributors that it (or something similar) should continue to be available. VAT is based upon EU VAT law (the Principal VAT Directive – formerly known as the Sixth VAT Directive) and UK domestic provisions must be compatible with it. Having considered the matter, and taken advice, HMRC concludes that the SHC is incompatible with EU law. HMRC is also aware that the SHC is being used for tax avoidance purposes, and although principally it is the incompatibility of the SHC with EU law which has led to the conclusion that it must be withdrawn, this avoidance has been taken into account. The SHC confers favourable treatment upon those who use it, and the overwhelming majority of contributors favour its retention. However the SHC was introduced as a temporary measure and whilst this has been extended HMRC believe that there is no technical or legal justification for its continuation. As indicated earlier in this document, the sectoral impacts of withdrawing the SHC are uncertain, although the overall impact on the UK temporary labour market is likely to be limited. Finally, this review and the above comments only relate to Part A of the Statement of Practice contained in HMRC Notice 700/34 *'Staff,* and the extension of the concession contained in Business Brief 10/04. Parts B and C of the Statement of Practice, concerning the secondment of staff by businesses other than employment businesses and the placement of disabled workers under the Sheltered Placement Scheme (or any similar scheme), are unaffected by this review. HMRC has considered the timing of any withdrawal and taken legal advice, the result of which is that the SHC (both the original staff hire concession and the further concession set out in Business Brief 10/04) will be withdrawn in respect of supplies made on or after

1 April 2009. This will give those affected by the change in VAT treatment time to plan for its withdrawal. HMRC is also prepared to discuss the implications of withdrawal further with those sectors that have been affected.

Annex – Impact of Conduct Regulations on VAT treatment

In 2003 the DTI introduced the Conduct of Employment Agencies and Employment Businesses Regulations. The regulations came into force on 6 July 2004.

The key regulation for VAT purposes is Regulation 8: *"Restriction on paying work-seeker's remuneration 8 – (1) Subject to paragraph (2), an agency* shall not, in respect of a workseeker whom the agency has introduced or supplied to a hirer – (a) pay to; (b) make arrangements for the payment to; or (c) introduce or refer the hirer to any person with whom the agency is connected with a view to that person paying to, or making arrangements for the payment to, the work-seeker, his remuneration arising from the employment with the hirer."*

*Under the Employment Agencies Act 1973, an agency is defined as the business of providing services (whether by the provision of information or otherwise) for the purpose of finding workers employment with employers or of supplying employers with workers for employment by them. By contrast, an employment business is defined as the business of supplying people in the employment of the person carrying on the business, to act for, and under the control of, other people in any capacity.

Alongside the Conduct Regulations, the DTI published guidance in association with the Recruitment and Employment Confederation and Equity. This guidance provides the following explanation on the policy background to Regulation 8:

Regulation 8: – Restrictions on paying work-seekers' remuneration Regulation 8 is designed to prevent agencies from directly or indirectly paying work-seekers on behalf of the hirer to whom the work-seeker has been introduced.

Regulation 8(1) provides that an employment agency (as opposed to an employment business), which has provided a hirer with a work-seeker, may not pay or make arrangements to pay that work-seeker either directly or via any person connected with it. The purpose of this regulation is to prohibit employment agencies supplying temporary workers. This used to be particularly popular when supplying temporary workers to hirers who could not reclaim their VAT such as hospitals, schools and in some cases individuals (such as the supply of temporary care workers into people's own homes) and the financial sector. In these cases it was common for an employment agency to introduce the work-seeker to the hirer on a temporary basis so that the work-seeker had a contract directly with the hirer rather than the employment agency. The employment agency would nevertheless settle the payroll on behalf of the hirer. The work-seeker's services did not, therefore, form part of the employment agency's service to the hirer. Therefore, when the employment agency charged the hirer, it only charged VAT on its margin, thereby significantly reducing its VAT charge to hirers who could not reclaim it. The Government however disliked this route because it was unclear from the work-seeker's point of view which party was responsible in law for paying him/her and for other employer related obligations.

Regulation 8 therefore seeks to ensure that, where a recruitment company is supplying temporary workers, it only ever supplies those temporary workers as an employment business. In other words it must engage the work-seekers that it supplies to hirers for temporary assignments either under a contract of employment or a contract for services. It will also be responsible for their pay and any statutory benefits such as holiday pay. It will therefore be the workers' principal employer and the services of the worker will form part of its service to the hirer. VAT will be chargeable on the full amount of its charges to the hirer i.e. the salary element as well as its margin and employer's National Insurance contributions.

Regulation 8 is further underpinned by Regulation 9, which sets out strict rules on how bureaux hold themselves out:

"Restriction on agencies and employment businesses purporting to act on a different basis.

9. – (1) Neither an agency nor an employment business may, in relation to the introduction of a work-seeker to a hirer, purport to the work-seeker to be acting as an agency and purport to the hirer to be acting as an employment business.

(2) Neither an agency nor an employment business may, in relation to the introduction or supply of a work-seeker to a hirer, purport to the work-seeker to be acting as an employment business and purport to the hirer to be acting as an agency."

The DTI's guidance gives the following policy background to regulation 9:

Regulation 9: – Restriction on agencies and employment businesses purporting to act on a different basis Regulation 9(1) and (2) provides that neither an employment agency nor an employment business, shall, when introducing or supplying a work-seeker to a hirer, claim to be acting as an employment agency to the work-seeker and at the same time acting as an employment business to the hirer or vice versa. In other words this regulation prevents firms from claiming to be operating on one basis to the work-seeker, while advising the hirer that they are operating on another basis. This provision will not prevent the employment agency or employment business from operating as both an agency and an employment business in respect of either a hirer or work-seeker, i.e. looking for permanent candidates and supplying temporary workers at the same time for the same client or offering temporary work to a work-seeker, while at the same time looking for suitable permanent positions for them. However, it should provide them with terms in respect of each and set out the capacity in which it is acting very clearly in relation to the services being provided.

Also, Regulation 12 prohibits employment business from withholding payment to work-seekers on certain grounds e.g. on the basis that the employment business has not received payment from the hirer. The Conduct Regulations therefore establish that only employment businesses can pay temporary workers, directly or indirectly. Taken together with the definition of an employment business, and the fact that bureaux have to be consistent in how they contract with temporary workers and clients, it is HMRC's view that there is no scope to suggest that an employment business is merely acting as an agent and paying the workers on behalf of the client. In HMRC's view an employment business is acting as a principal for VAT purposes. Thus, for all supplies made by employment bureaux operating on the same commercial basis, the same VAT treatment will now be applied.

Lecture B485 (15.03 Minutes)