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Personal Tax

Income tax changes

The main changes to the income tax rates for 2008/09 were announced in the 2007 Budget and these have now been confirmed - after a fashion!

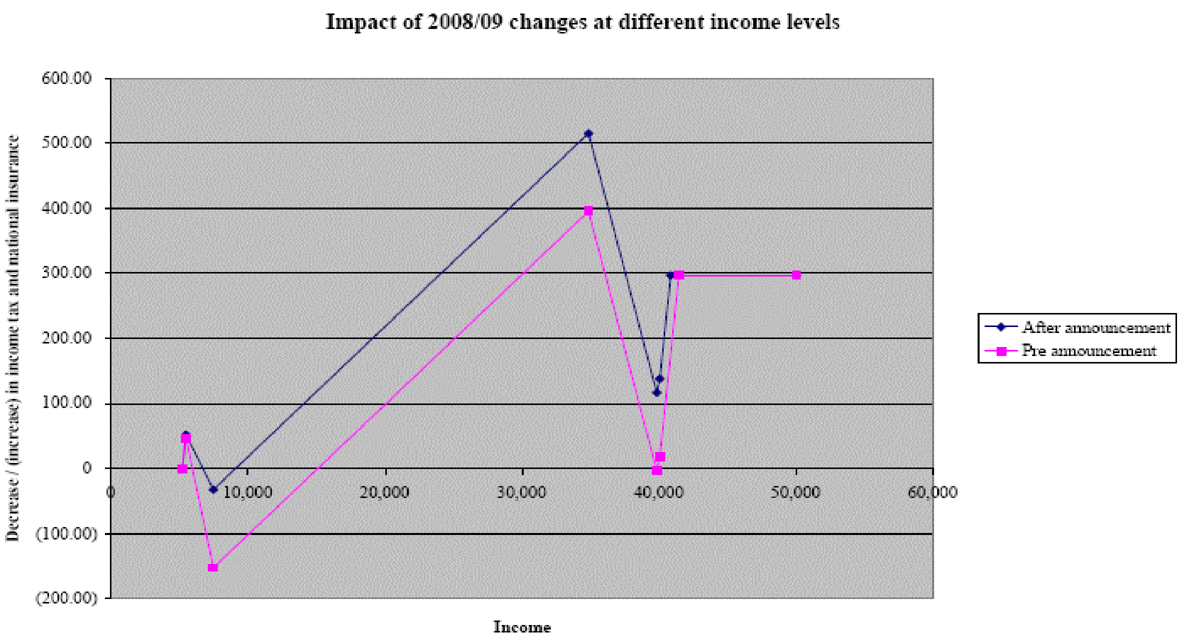
The basic rate of income tax is reduced from 22% to 20% from 6 April 2008 and the 10% starting rate of income tax (the famous '10p tax' that has dominated the media of late) has been abolished. The higher rate tax rate remains at 40%.

A new 10% starting rate of tax is introduced for savings income only (largely bank and building society interest). However, where non-savings income exceeds £2,320 in the tax year, none of the individuals' income will be chargeable at the 10% rate. If an individual’s taxable non-savings income is above this limit then the 10% savings rate will not be applicable. There are no changes to the 10% dividend ordinary rate or the 32.5% dividend upper rate.

History

When the changes to the income tax rates were announced in March 2007, it was noted by the tax profession that ironically the headline grabbing basic rate tax cut would cause hardship for those on lower incomes who were proportionately hit by the removal of the 10% starting band. In particular those who had income above the personal allowance up to around £17,000 would be left worse off, particularly if they failed to qualify for tax credits because they did not meet the qualifying criteria eg no children to qualify for Child Tax Credit or those who work insufficient hours to get working tax credit.

The political fall-out did not arrive until 2008 when voters began to write to MPs to complain. A revolt by backbenchers led to the Chancellor having to announce an embarrassing 'u-turn'.
In May 2008 the thresholds were revised. The personal allowance for those aged under 65 increased by £600 for 2008/09 to £6,035. The basic rate band was reduced by £1,200 to £34,800. There have been no announcements concerning national insurance which means that the income tax personal allowance and the national insurance primary threshold will not be aligned in 2008/09.
The impact of the changes is illustrated on the following graph:



The Chancellor said this change will mean that 22 million people on low and middle incomes will gain an additional £120 this year – this figure being the estimated average loss from the Budget 2007 'package' which included the changes to the 10% rate. 4.2 million households will receive as much or more than they originally lost, and the remaining 1.1 million households will see their loss at least halved. Some 600,000 people will be taken out of tax altogether.

Increasing the personal allowance has the advantage of being simple, capable of being backdated to April 2008 and relatively easy to deliver quickly. However, it is an expensive measure which will cost £2.7 billion. This is because it is not targeted, and benefits many people who had not lost out from the tax rate changes in the first place.

Also, because the measure is based on the average loss, a large number of people will not be fully compensated, and they will be the taxpayers on the lowest incomes. For example those with pay packets between £5,435 and £6,035 will receive less than the full £120.

We are expecting information shortly on when employers will have to implement this changes. The message in May to employers from HMRC was do not implement these changes until notified.

This is also not the end of the story either. The cost of correcting the '10p tax rate' situation has cost the Exchequer a massive sum but it only relates to this year.

The Pre Budget Report in the autumn should include information on what the Chancellor will do to compensate for future years.

Non-payable tax credit

In a move to correct an anomaly in the legislation, the non-payable tax credit will now be taken into account on dividends received from non-UK resident companies. This will apply for UK resident and domiciled individuals from 6 April 2008 and will reduce the effective rate of tax from 32.5% to 25%.

Article by Francesca Lagerberg

Lecture P486 (6.08 Minutes)

Developments in employee subsistence

Employment Income Manual para EIM05200

If subsistence is paid at a scale rate, which is calculated to do no more than reimburse the expenditure incurred by the employee on allowable expenses, that is not in itself regarded as a round sum allowance. Accordingly, on application the employer can be authorised to make such payments gross.

That treatment can indeed apply to any employee expenses where it is often difficult to obtain receipts and the item is widely incurred in broadly similar amounts.

Scale rate expenses and sampling exercises

Paras EIM05210, EIM05215 and *EIM0522*0 published in February 2008 refer to a sampling exercise to determine the amount that employees are spending on allowable subsistence whilst away from home on a business journey (in addition of course to the tax free incidental overnight expenses up to £5 per night in the UK under Section 240 ITEPA2003).

The following points arise from this:

1. HMRC does not accept that allowable expenses include the cost of a packed lunch prepared at home from items purchased as part of the employee's ordinary domestic shopping arrangements, or other food brought from home. They then say that the cost of sandwiches etc. bought on the way to a temporary workplace can be included.

2. HMRC officers considering an application for a dispensation for scale rate subsistence need to be satisfied that the proposed scale rate payments are set at a level which broadly represent the amount that their employees are actually spending on allowable subsistence expenses. Employers should therefore be prepared to provide HMRC with evidence of the amount that their employees are spending. Such evidence should ideally be in the form of receipts but other evidence, such as an employee's contemporaneous record of expenses incurred, should also be considered.
3. HMRC accept that it will be impractical for some employers to obtain evidence of expenditure incurred by every one of their mobile employees. Where that is the case, they will accept evidence in the form of a sampling exercise based on the expenses incurred
    - by a **random** sample
    - of 10% of the eligible employees
    - for a period of one month
4. Employers will have to be able to satisfy HMRC that their 10% sample really is a random one – for example, every 10th name from an alphabetical list of the employees concerned. HMRC will accept the evidence produced by such a random sampling exercise as the basis for agreeing the amount of the employer's scale rate subsistence payment.
5. HMRC accepts that it may not be possible for an employer to ensure that all the selected employees keep their receipts (or produce a contemporaneous record of their expenses) for the whole of the sampling period. There will be cases where the employer obtains responses from less than 100% of the chosen employees, and others where the expenditure is not 100% vouched. A sample which is less than 100% complete may nevertheless contain sufficient information to be statistically valid. HMRC should not automatically reject the evidence of a sampling exercise which falls **slightly** short of "10% for a month". It says that this is an area where judgement is needed and that they have to decide whether the evidence produced is sufficient to support a scale rate subsistence payment of a particular amount, having regard to:
    - the number of eligible employees
    - the size of the 10% sample and
    - the amount of evidence actually produced
6. For the avoidance of doubt, HMRC state that is not necessary for all eligible employees to keep evidence of their expenses for a month. Evidence need only be kept by the 10% of employees who are randomly selected to take part in the sampling exercise.
7. If a dispensation is given following a sampling exercise of the kind described above, no further sampling exercise will be necessary – and the dispensation will remain in force - whilst circumstances remain unchanged.
8. Dispensations which were issued before this sampling guidance was published are not affected and remain in force. However, the sampling guidance should be followed, where appropriate, if such an employer
    - applies for a new dispensation, or
    - wishes to increase the amounts payable under the existing dispensation by more than the rate of inflation.

Scale rates for accommodation and subsistence payments to employees travelling outside the UK

HMRC has published benchmark scale rates that employers can use, without the need for employees to produce expenses receipts (although of course the employer may require them). The rate tables are in *para EIM05290* with guidance also supplied.

The main points are:

1. The scale rates are in addition to the incidental overnight expenses that can be reimbursed under Section 240 ITEPA2003 of up to £10 per night overseas.

2. They only apply overseas and are not compulsory, so that larger actual reimbursements could be made or the employer could negotiate a larger scale rate if appropriate.
3. If the employee stays as a guest of a private individual/colleague and does not pay for accommodation or meals, the employer may reimburse 10% of the subsistence only rate to cover (for example) a gift to the host.

Examples from para EIM05280

1. *An employee on a business trip to Switzerland arrives in Geneva at 15.00 on Monday and books into a hotel in the city. He checks out after breakfast on Thursday and leaves on the 09.00 flight. The employer may reimburse the employee as follows:*

2 x 24 hour rate (15.00 Monday to 15.00 Wednesday)	*708 Swiss francs*
Wednesday night (room rate)	*203 ,, ,,*
10 hour rate (15.00 Wednesday to 09.00 Thursday)	*114 ,, ,,*
Total	*1025 Swiss francs*

Note that payment for the 18 hour period from 15.00 on Wednesday to 09.00 on Thursday is limited to the room rate (203 Swiss Francs) plus the 10 hour rate (14 Swiss Francs).

Alternatively, if the employer pays for the hotel direct, or chooses to reimburse the employee's actual (room only) accommodation expenses, they may use the benchmark rates to pay tax/NIC free subsistence expenses as follows:

2 x subsistence only rate (15.00 Monday to 15.00 Wednesday)	*302 Swiss francs*
10 hour rate (15.00 Wednesday to 09.00 Thursday	*114 ,, ,,*
Total	*416 Swiss francs*

2. *An employee spends a day in Belgium on business, arriving in Brussels at 09.00 and leaving at 20.00. The employer may reimburse subsistence expenses at the Brussels rate for over 10 hours = €61.*

   If the employee had left Brussels between 14.00 and 19.00, reimbursement would have been limited to the over 5 hour rate = €26.

3. *An employee makes a business trip to Madrid, where she stays for 2 nights as the guest of a friend. Meals are provided free of charge, except for 2 lunches which the employee has to buy while she is in the city on business. The employer may reimburse:*

   2 x 10% of Madrid subsistence only rate (€92) = €19

   The employer may also reimburse the actual cost of the two lunches that the employee had to pay for.

HMRC's own subsistence rates

It has been reported that the subsistence rates shown overleaf are the maximum rates agreed for HMRC staff:

		£
NIGHT SUBSISTENCE		
1. Overnight stay	Central London	100
	Belfast, Bristol, Leeds	85
	Elsewhere	75
2. Evening meal (due in addition to 1.)		20
3. Personal expenses allowance		5
4. Overnight stay with friends /relatives		25
DAY SUBSISTENCE	Over 5 hours	6.50
	Over 10 hours	14
NIGHT WORK OR SLEEPING IN OFFICES ON CALL OR STANDBY AFTER A DAY'S WORK		7.60
SLEEPING IN OFFICE AFTER WORKING LATE		10.90

Other issues include:

- Item 4 above is paid instead of 1 and 2, but still attracts 3 (which is effectively the normal incidental expenses exemption).
- Receipts must be provided for claims under 1, where the claim is limited to the amount actually paid up to the maximum stated. Receipts under the other heads are apparently not required although HMRC say that receipts must be kept for all claimed expenditure over £10.
- HMRC negotiated its own dispensation under the above policy, with its own tax office.
- It has also been reported that drivers can not only claim 5p per mile per passenger on a business trip, as indeed can any employee, but so can each passenger even if they do not pay anything towards the cost of the trip.

Article by Gerry Hart

Lecture P487 (12.35 Minutes)

Gift Aid

The Government are keen to continue the success of the Gift Aid scheme and so they have announced a number of wide-ranging measures to make it easier for both donors and charities to take advantage of the relief. These include the launch of a user-friendly web information service, the provision of small charity training programmes and the development of a Gift Aid toolkit containing standard forms, guidance and marketing materials.

One of the few downsides of a reduction in the basic rate of income tax is that charities relying on Gift Aid donations for the bulk of their income are worse off because their repayable tax credit drops to 20% of the gross gift as compared with the previous 22%. However, it has been decided that Gift Aid refunds will be received by charities for the next three years at a transitional rate of 22%, made up of the new 20% basic rate of income tax from HMRC and an additional 2% from the Treasury (Cl 50 and Sch 19 FB 2008). This special relief will have effect for qualifying Gift Aid donations made between 6 April 2008 and 5 April 2011 (inclusive).

Hitherto, where a net charitable donation of £100 was made by a higher rate individual, the tax effects were as follows:

(i) the charity was able to recover a tax refund of 22/78 x £100 = £28; and

(ii) the individual received higher rate relief on his gift of (40 – 22)% x £128 = £23.

Thus a gift with a net cost of £77 in the donor's hands was worth £128 to the recipient charity.

The reduction in the basic rate of income tax for 2008/09 means that the gross amount of the donation is 100/80 x £100 = £125 and so the charity is prima facie only able to recover £25. Under this new arrangement, the charity can claim an additional £3 from HMRC – this is the 2% which would otherwise have been lost. Thus charities will continue to receive the same amount of money as they would have done before, but charitable donations will be more attractive for wealthy taxpayers given that their higher rate relief will now be worth (40 – 20)% x £125 = £25.

Article by Robert Jamieson

Lecture P488 (5.44 Minutes)

ESC A11 (split year treatment) and Part 7 ITEPA 2003

Recent discussions have suggested that there is some uncertainty over the current HMRC views on ESC A11 and its application to Part 7 ITEPA.

This ESC is likely to be replaced by legislation at some point, partly because a review of extra-statutory concessions is in progress, but also because the Government announced during debates on the Finance Bill its willingness to consider the possibility of a statutory residence test.

However, to cover the period while the ESC remains in place, a clarification is set out below, which is intended to give certainty during the period before a new legislative basis is introduced.

*HMRC views on **ESC A11** and its application to Part 7 ITEPA*

The split year treatment applied by the concession to other (non-ERS) earnings means that for example, an employee who comes to the UK for a secondment beginning on 1 June would be regarded as not UK-resident and therefore not taxable in the UK on his or her general earnings from the same employment for the period from 6 April to 31 May of that tax year.

There is some uncertainty over whether HMRC has historically regarded the concession as applying to Part 7. This issue has recently become more significant, since the remittance basis legislation introduced by FB 2008 has potentially widened the scope of the ESC.

Year of arrival

While the view of HMRC has always been that the ESC does not apply to income falling within Part 7 in the year of arrival, it appears that some employers, taxpayers and their advisers may not have been aware of this. So for open years, and until a statutory basis is introduced, HMRC will accept that ESC A11 applies to such income in the year of arrival. See, however, the comments on section 62 and Chapter 3C charges in the paragraph headed "Other Charges" below.

Earlier years which are settled will not be reopened, whether ESC A11 has been applied to ERS gains or not.

HMRC reserves the right to depart from this position in cases of avoidance.

Year of departure

It has been set out in guidance that ESC A11 does not apply in the year of departure where a charge under chapter 3C applies. It may have been less clear that the ESC was not available where charges arise under other parts of the legislation Part 7.

Therefore, as for the year of arrival, for open years and until a statutory basis is introduced, HMRC will accept that ESC A11 applies in the year of departure except in the case of a charge under Chapter 3C in the year of departure where the position will continue to be that ESC A11 is not available.

Earlier years which are settled will not be reopened, whether ESC A11 has been applied to ERS gains or not.

HMRC reserves the right to depart from this position in cases of avoidance.

Other charges

It should also be noted that, where a right to acquire securities has been obtained prior to 6 April 2008 in the non-resident part of the year of arrival in the UK and that right is not “money's worth” (ie not a legal option in the context of *Abbot v Philbin*) there will be a charge to tax when securities are acquired pursuant to that right. Both pre and post 2008 the charge to tax on acquisition will arise by virtue of ITEPA 2003 s 62. Alternatively, if the right does constitute money's worth on grant, a charge to tax may arise under ITEPA 2003, Part 7, Chapter 3C to the extent that the original right is in respect of UK duties. See HMRC's guidance in the Employment Related Securities Manual at ERSM70410.

Further guidance on all these issues will be published in the Employment Related Securities Manual as soon as possible.

Individual leaving the UK see *Simon's Direct Tax Service* E6.122

HMRC Notice 7 July 2008

Understanding changes to personal allowance and basic rate tax band

The Chancellor's announced increase to the 2008–09 Personal Allowance comes into effect from 7 September and will be backdated to 6 April. This guidance tells employees when, whether and how the changes will affect them. As a result of the changes, many employees will see their tax code change in September. This guidance advises how these changes will affect payroll.

Understanding the changes to the Personal Allowance and basic rate tax band in September 2008

The Chancellor announced that the basic Personal Allowance for the 2008–09 tax year will increase by £600 from £5,435 to £6,035. At the same time the basic rate tax band (the amount of taxable income you can earn before paying higher rate tax) will reduce from £36,000 to £34,800.

This guidance tells you when, whether and how the changes will affect you.

– When and how the changes will take effect.

– How the changes will affect your pay and tax.

– How the changes will affect your tax code.

– If you are a student and get tax-free pay.

– If you are a higher rate taxpayer.

– If you are 65 or over – further guidance.

– Effect on other tax allowances and National Insurance.

– Effect on attachment/arrestment earnings orders.

When and how the changes will take effect

IF YOU ARE UNDER 65, OR ARE 65 OR OVER BUT ONLY QUALIFY FOR THE BASIC PERSONAL ALLOWANCE

If you are an employee or receive a personal or company pension the changes will be reflected in wages and pension payments from September 2008. The allowances will be backdated to the start of the tax year (6 April).

If you pay tax through Self Assessment, the new allowances will be taken into account in your Self Assessment tax calculation and tax bill for 2008–09.

IF YOU ARE 65 OR OVER AND QUALIFY FOR THE HIGHER AGE-RELATED PERSONAL ALLOWANCE

If you qualify for the higher age-related allowances your tax allowances will not change. Your higher age-related allowances were raised at the start of the tax year and you are already getting the benefit of these. For more information read the later section, If you are aged 65 and over – further guidance.

How the changes will affect your pay and tax

IF YOU PAY TAX AT THE BASIC RATE OF 20%

The changes take effect from the first pay day on or after 7 September and equate to a tax saving of approximately £120 over the course of the tax year. If your September pay day is on or after 7 September, you will pay up to £60 less tax that month. If you are paid monthly and your September pay day is before 7 September, you will pay up to £70 less tax in October. How much your tax reduces will depend on how much you have paid already – and in some cases you might get a repayment as part of your pay.

After this if you are paid monthly you will pay up to £10 a month less tax and if you are paid weekly you will pay up to £2·30 less tax. (The actual figures will depend on your income.)

IF YOU PAY TAX AT THE HIGHER RATE OF 40%

The changes will only benefit basic rate taxpayers. To find out more read the later section If you are a higher rate taxpayer.

HOW THE CHANGES WILL AFFECT YOUR TAX CODE

Your employer or pension provider will adjust your tax code based on the information that we send them.

– All tax codes that end in L will increase by 60.

– Codes P, V, Y, BR, D0 or NT will stay the same.

– Other codes may change, but this will depend on your particular circumstances and we will also write to you about this.

To find out more read the relevant section below.

IF YOUR TAX CODE ENDS WITH A LETTER “L”

If your tax code ends with an L then broadly speaking the number in the tax code multiplied by 10 is the amount of tax-free pay you are entitled to for the year.

We will tell your employer that they can automatically increase your tax code by 60 – giving you the extra £600 of allowances announced by the Chancellor. For example the tax code 543L (showing the current Personal Allowance of £5,435) would change to 603L, taking your new Personal Allowance to £6,035. We will not write to you separately about your new tax code unless something else changes which doesn't relate to the Personal Allowance adjustment.

If you have asked us to set some of your allowance against another job or pension, we will add the extra personal allowance to the tax code for what our records show is the main one.

IF YOUR TAX CODE STARTS WITH A LETTER “K”

You will have a K code if your overall untaxed income is greater than your tax allowances (the tax-free Personal Allowance and any other allowances to which you are entitled). Broadly speaking, the K code number multiplied by 10 indicates how much must be added to your taxable income to make sure you pay the right tax overall.

If you currently get the basic Personal Allowance (as opposed to the higher age-related Personal Allowance) your K code number will reduce as a result of the changes (which means you'll pay less tax) – and it's even possible that you will no longer need a K code. Either way, we will write to you and your employer with a new code and your pay will be adjusted from September/October as described earlier.

IF YOUR TAX CODE ENDS WITH A LETTER “T”

If your code ends with a T, it usually means that it's been adjusted to take account of changes that will need to be reviewed again before or at end of the year.

Where possible we will use the change to the basic Personal Allowance to make adjustments to help get you off the T code as early as possible. We will send you and your employer details of any change needed, and your pay will be adjusted from September/October as described earlier.

IF YOUR TAX CODE ENDS WITH LETTERS P, V OR Y

These codes relate to age-related tax allowances and will in this instance stay the same because you are already receiving the benefit of the increased age-related Personal Allowance which came into effect in April.

IF YOU HAVE BR, D0 OR NT TAX CODE

These tax codes are used where you have more than one job and/or pension. Therefore BR, D0 or NT tax codes will not change.

IF YOUR CODE IS OPERATED ON THE “SPECIAL BASIS”

Your PAYE Coding Notice (usually sent to you at the start of the tax year, but also at other times – to tell you which tax code you are on) may state that your tax code is operated on the “special basis”. This means we tell your employer or pension provider to ignore previous earnings and tax paid this tax year when working out your tax. You will be on a special basis code either because we are waiting for missing information about your previous tax and pay or because there has been a change which could lead to an underpayment of tax by the end of the tax year.

In this case you'll get the benefit of the £10 a month or £2.30 a week reduction from September 2008 but we will not know if you'll get the reduction backdated to April until we have the information we need about your previous tax and pay or until we have reviewed your total tax liability after 5 April 2009.

We will review all of these tax codes at the time we apply the new Personal Allowance rate and, where possible move you back onto a normal tax code (which means that you will get your Personal Allowance backdated then if applicable). If you need to stay on the special basis code following the review you will still get the benefit of the £10 tax reduction from September 2008 to April 2009. We'll then check your actual tax position for the whole year.

IF YOUR TAX CODE NEEDS TO BE CHANGED BEFORE 7 SEPTEMBER FOR ANOTHER REASON

We will continue changing individual tax codes where necessary before 7 September (based on individual changes of circumstance) and using the current Personal Allowance of £5,435. If your tax code changes during this time it will then change again in September when the revised Personal Allowance of £6,035 starts to apply.

IF YOU ARE STUDENT AND GET TAX-FREE PAY

If you are a student working solely in the holidays and you have already signed a form P38(S) for 2008–09 to get paid tax-free and your total earnings for the year go above £5,435 but will stay below £6,035 you must contact your employer and complete another P38(S) or equivalent record.

If your earnings go above £6,035 you'll need to pay tax through your employer's PAYE (Pay As You Earn) system. In this case you'll get the benefit of the new Personal Allowance through your tax code.

IF YOU ARE A HIGHER RATE TAXPAYER

The changes announced by the Chancellor are designed to benefit basic rate taxpayers only. Higher rate taxpayers will not be affected at all. This is because while the basic Personal Allowance has been increased by £600, the threshold at which you start to pay higher rate tax has been reduced by £600 – achieved through a £1,200 reduction to the basic rate tax band.

ILLUSTRATION—

You currently pay higher rate tax on income above £41,435. This is called the “higher rate threshold” and is the combination of the current basic Personal Allowance (£5,435) and the current basic rate band (£36,000).

After the changes the basic Personal Allowance will increase by £600 to £6,035 but the basic rate tax band will reduce to £34,800. When added together these last two make the new higher rate threshold £40,835 – which is £600 lower than it was previously.

WORKED EXAMPLE FOR HIGHER RATE TAX PAYER FOLLOWING THE CHANGES TO THE BASIC PERSONAL ALLOWANCE AND BASIC RATE TAX BAND

Current Rates

Gross Taxable Pay £55,000

Less Personal Allowance £5,435

Taxable £49,565

20% on £36,000 = £7,200

40% on £13,565 = £5,426

Total tax due = £12,626

Rates from 7 September

Gross Taxable Pay £55,000

Less Personal Allowance £6,035

Taxable £48,965

20% on £34,800 = £6,960

40% on £14,165 = £5,666

Total tax due = £12,626

If you are aged 65 and over – further guidance

There are no changes to the full (age-related) Personal Allowance of £9,030 for an individual aged 65 to 74 and £9,180 for individuals aged 75 and over. So an individual with a tax code ending in V, Y or P will not get a new code number.

(The full age-related Personal Allowance amount is only available if your income is below £21,800. If your income is more than this, your allowances are gradually reduced down to the level of the basic Personal Allowance. In this case you will have a tax code ending in L or T. See above for what may happen if you have one of these tax codes. As described earlier, if your level of income means you only get the basic Personal Allowance then you will get the new rate of £6,035.)

Effect on other tax allowances and National Insurance

BLIND PERSON'S ALLOWANCE, MARRIED COUPLE'S ALLOWANCE AND INCOME LIMIT FOR AGE-RELATED ALLOWANCES

These allowances are unaffected by the changes.

NATIONAL INSURANCE CONTRIBUTIONS

National Insurance rates and thresholds remain the same.

EFFECT ON ATTACHMENT/ARRESTMENT EARNINGS ORDERS

Most people will pay less tax because of the changes. As a result you will have more earnings for your attachment/arrestment. This in turn may mean that you'll have more deducted for the attachment/arrestment. The effect will depend on your individual circumstances and the type of attachment/arrestment.

However, if you already pay the full amount due for child support or maintenance each payday the change will not affect your attachment/arrestment deductions.

CHANGES TO EMPLOYEE PERSONAL ALLOWANCE AND BASIC RATE TAX BAND IN SEPTEMBER 2008

Following the Chancellor's announcement, the basic Personal Allowance for the 2008–09 tax year is increasing by £600 from £5,435 to £6,035 and the basic rate limit is reducing from £36,000 to £34,800.

As a result, many employees will see their tax code change in September. This guidance tells you how these changes will affect your payroll.

– How are employee tax codes changing?

– When to apply the new tax codes.

– Updated tools, tables and guidance.

– Taking on a new employee on or after 7 September.

– Student employees receiving tax-free pay.

– The effect of the changes on employees' pay.

– If you need to refund tax to an employee.

– Getting ready—what to do now.

HOW ARE EMPLOYEE TAX CODES CHANGING?

The table below summarises the changes you'll need to make to your employees' tax codes. You must update codes with an L suffix without waiting for an individual P6 notice from us. You should leave other codes unchanged unless you we send you a P6.

Type of tax code	*Action*
L suffix	Add 60 to the existing tax code number. For example, old tax code 543L becomes 603L.
T suffix	Only change the tax code when we send you a P6 notice.
P, V or Y suffix	Do not change these tax codes unless we send you a P6 notice.
A or H suffix	These are no longer used so contact your HMRC office immediately if you have any of these tax codes.
NT, BR or D0	Do not change these tax codes unless we send you a P6 notice.
K prefix	Only change the tax code when we send you a P6 notice.

Details of these changes will also be included in a revised form P7X(2008)(2). This will be available online – there'll be a link to it from this page when it's released – and on a revised Employer CD-ROM that we'll send to you in August.

If we need to send you an individual P6 notice to update an employee's tax code, it will be dated 24 August and after that date no further tax code notices will be sent until 14 September.

If you get your tax codes online, these tax code notices will be available to download or view through our Data Provisioning Service (DPS) over three days from 24 August. If you are an agent, the seven-day window to view these codes will also start from the date we make them available.

WHEN TO APPLY THE NEW TAX CODES

The new tax codes must be applied on the first payday on or after 7 September 2008.

If you use payroll software, it must be up to date to apply these changes. Make sure that you have received an update from your software provider before 7 September which incorporates these changes.

If you operate your payroll before you get an opportunity to apply the new tax code notices please reassure your employees that they will see the benefit of their increased allowance in October.

UPDATED TOOLS, TABLES AND GUIDANCE

We are updating all the relevant tools, tables and guidance to make sure you have all the information you need to operate your payroll after the tax code changes take place.

As and when these updates are released they will be available on our website, and there will be links to them from this page. The updates will also be included on the revised Employer CD-ROM 2008 (August) Edition that we'll be sending you in August.

If you had initially asked us to send you paper versions of any of these publications, then we'll send you updates in the same format. You can also order paper versions from our Employer Orderline from 13 August.

The changes we are making include—

– an updated P11 Calculator, available only on the revised Employer CD-ROM 2008 (August);

– an updated PAYE Tax Calculator;

– a new edition of Employer Helpbook E12(2008)(3) “PAYE and NICs rates and limits for 2008–09” (for use on or after 7 September 2008);

– an update to Employer Helpbook P49 “Paying your employees for the first time”;

– an update to Employer Helpbook E13 “Day-to-day payroll”;

– new Taxable Pay Tables (September 2008); and

– revised form P38(S)(2008)(2).

Note that Tax Tables A are not being changed, so you can continue to use the existing version.

When their replacements become available, you must destroy—

– any earlier versions of the Employer Helpbook E12;

– Taxable Pay Tables (May 2008); and

– any unused stock of form P38(S)(2008).

TAKING ON A NEW EMPLOYEE ON OR AFTER 7 SEPTEMBER

To decide which tax code you must use for a new employee who starts work for you on or after 7 September, you will need to follow the instructions in the updated version of Employer Helpbook E13, “Day-to-day payroll”, as follows—

FOR NEW EMPLOYEES WITH A P45

Use the guidance at step 3 on page 23 of the updated PDF version of E13.

If you are using a printed version of the E13, follow the instructions in the E13 September supplement we have sent to you.

FOR NEW EMPLOYEES WITHOUT A P45

Use the guidance on pages 25 and 26 of the updated PDF version of E13.

If you are using a printed version of the E13, you must use both the instructions on pages 25 and 26 of the original helpbook and also the updated instructions for page 26 contained in the E13 September supplement.

STUDENT EMPLOYEES RECEIVING TAX-FREE PAY

A new form P38(S)(2008)(2) is being introduced for use on or after 7 September which reflects the increased Personal Allowance of £6,035.

If you have students who have already declared on a form P38(S) that their earnings for the year will not exceed £5,435, these declarations can remain in place until the end of the tax year, unless following the introduction of the increased Personal Allowance it becomes apparent that a student's income will exceed £5,435 but will not exceed £6,035. In these cases, a P38(S)(2008)(2) or equivalent record must be completed.

THE EFFECT OF THE CHANGES ON EMPLOYEES' PAY

Employees paid on a monthly basis will receive around £60 extra in September followed by an additional £10 a month until the end of the tax year.

Employees paid weekly should see an increase in their pay for the week starting 7 September of around £53, followed by an extra £2.30 each week for the remainder of the tax year.

For employees who have paid less than £60 tax by the end of August this year, the September increase in pay will match the tax they've paid to date.

EMPLOYEES ON A WEEK 1 OR MONTH 1 CODE

Employees on a Week 1 or Month 1 code will get an increase of £2.30 per week or £10 per month from September. But they will not be able get the full increase backdated to April until they are back on a cumulative code or until after the end of the tax year when we review their total liability.

EMPLOYEES PAYING HIGHER RATE TAX

The changes announced by the Chancellor are designed to benefit basic rate taxpayers only. Higher rate taxpayers will still pay the same amount of tax overall as previously. This is because the increase in the Personal Allowance is being offset by a reduction in the threshold at which higher rate tax is payable.

IF YOU NEED TO REFUND TAX TO AN EMPLOYEE

Most employees will receive the benefit of the increased Personal Allowance by paying less tax from September. But you may have employees who will be entitled to a refund of tax paid earlier in the year.

Making this kind of refund does not cost you anything. The usual process is for you to deduct the amount you need to refund from your next payment to us of PAYE tax, NICs, CIS or student loan deductions.

If you do not have sufficient deductions to cover the amount you are refunding, you can apply to us for advance funding to make up the difference. We will send this to you as a cheque. Use the link below for more information.

Remember that if you have no PAYE payments to make to us in any tax month or quarter, you must tell us. This lets us know that we don't need to issue a payment reminder.

Tell us that you have no PAYE payment to make

GETTING READY—WHAT TO DO NOW

You should take the following steps to ensure you are prepared for your first payday on or after 7 September—

– Make sure that for every employee you have a P11 Deductions Working Sheet or equivalent record (see page 4 of Employer Helpbook E13).

– Before 7 September apply any tax code changes dated 23 August or earlier.

– If you use the CD-ROM P11 Calculator, load the latest version when we send it to you in August (for instructions, see the article "Employer CD-ROM 2008 Revised (August) Edition" in Employer Bulletin 30 which we'll send you at the same time).

– Prepare to apply new tax codes dated 24 August in line with the instructions in the sections above. Do not operate these codes before 7 September.

– Calculate whether you will need advance funding to make tax refunds to any of your employees.

Personal allowance—general see *Simon's Direct Tax Service* E2.111

Rates of tax see *Simon's Direct Tax Service* E1.102

HMRC Notice 17 July 2008

Lewis v Revenue and Customs Commissioners SpC 690

The appellant was employed by the Revenue from 1997 and commuted from her home in Warwickshire to various offices in the Midlands. In 2000 the Revenue advertised positions for International Specialists working in the International Division in London and the job advertisement stated that there would be "the opportunity to adopt an alternative working pattern including working from a remote location 2 to 3 days a week". The Revenue offered that opportunity because there were concerns that the Division was not receiving applications from the most able staff and they wanted to open up the opportunity to a wider group, including those outside London, and hoped to attract more female and ethnic minority staff. The appellant applied for the post because of the alternative working pattern. Her application was successful and, before she took up the post, she agreed with her line manager that she could work at two different locations, viz her home and the London offices. However, there was no requirement to have an alternative working pattern and not all staff recruited at the time were offered it. The appellant took up the post on 5 June 2000 and the Revenue provided IT equipment and office furniture for her home office. Thereafter the appellant applied for a deduction for her travelling expenses between her home and the London office under TA 1988 s 198 in respect of the tax years 2000–01, 2001–02 and 2002–03 and ITEPA 2003 s 338 in respect of the tax year 2003–04. The Revenue disallowed the deductions and the appellant appealed. For the years up to 2002–03, TA 1988 s 198(1) provided for the deduction of (a) "qualifying travelling expenses" and (b) any amount (other than qualifying travelling expenses) expended wholly, exclusively and necessarily in the performance of the duties of the office or employment. Section 198(1A)(b) provided that "qualifying travelling expenses" were expenses of travelling which (i) were attributable to the necessary attendance at any place of the holder of the office or employment in the performance of the duties of the office or employment, and (ii) were not expenses of "ordinary commuting" or "private travel". It was agreed between the parties there was no difference in meaning between the relevant provisions in TA 1988 and ITEPA 2003. The appellant contended—(1) because the Revenue considered that there was shortage of qualified applications they had offered alternative working pattern jobs, which meant that whoever was appointed on those terms had two places of work and therefore was necessarily obliged to incur travelling expenses between the two; (2) the Revenue could secure her services only by offering an alternative working pattern job; she would not have accepted a traditional International Specialist job based in London; and her job was different from that of other International Specialists based in London; (3) the office at home was a fully-functioning office and the travel was between two offices and not from her home; and (4) the job in question was that of alternative working pattern International Specialist, with the consequence that every holder of that job would have two workplaces, and therefore travel between them was necessary in the performance of the duties. The Revenue submitted—(1) the fact that the appellant's home was also a workplace did not prevent it from being a home—the travel between her home and London was ordinary commuting; (2) the travel was not necessarily incurred because it arose from the appellant's personal circumstances of choosing to live. There was no objective requirement that the duties of the employment necessarily had to be performed in any location other than the London offices and when travelling she was travelling to her work and not on her work; and (3) the job in question was that of an International Specialist generally and the duties were based in London. The fact that the appellant (and a few others) were permitted to work from home for part of their time was an exception made on account of her personal circumstances which had nothing to do with the duties of the job.

In determining whether the amounts were necessarily expended on travelling in the performance of the duties of the office or employment, the Special Commissioner considered that the travelling expenses had to be necessarily incurred by every holder of the office or employment in the performance of their duties. Whether the expenses were necessary was determined not by reference to the circumstances of the particular individual who held the office or employment but by the office or employment itself. In the present case the job in question was that of International Specialist generally of which the appellant was one. It was artificial to say that there was a separate job of alternative working pattern International Specialist; the alternative working pattern was merely an option that the employee might, in the words of the advertisement, have “the opportunity to adopt” with the agreement of the employer. The alternative working pattern was peripheral to the employment. For travelling expenses to be allowable the cost had to be necessarily expended in the performance of the duties. On the facts there was nothing about the duties that required them to be performed at the appellant's home. To be deductible the appellant would have to show that every holder of the job, which was that of International Specialist and not alternative working pattern International Specialist, would be required to have two workplaces. That would be the case if she could show that the only possible appointees lived outside London and were unable to travel to London every day because of other commitments. The most the appellant could show was that she and some other holders of the job were in that position, which was not sufficient to qualify. Accordingly, the travel expenses were not necessarily incurred in the performance of the appellant's duties.

The Special Commissioner also found that the issue in TA 1998 s 198(1A)(b)(i), whether the expenses were of ordinary commuting, was satisfied as the travel in question was between her home and permanent workplace. The fact that the travel was also between her office at home and London did not prevent it from being her home. The expenses were therefore excluded as being expenses of ordinary commuting. It followed that the appeal would be dismissed; *Kirkwood (Inspector of Taxes) v Evans* [2002] EWHC 30 (Ch), [2002] STC 231 applied.

Appeal dismissed.

Capital Gains Tax

Kellogg Brown & Root Holdings Ltd SpC 693

The appellant company, a UK incorporated and tax resident company, was a wholly-owned subsidiary of H Co, a US based multinational company carrying on engineering and other operations worldwide. At the material time the appellant was a holding company for a number of UK resident subsidiaries within the H Co group including, within the insurance division, HICUK and HUAL ("the H companies"). In addition the appellant was a direct wholly-owned subsidiary of HHI, a company which had several different classes of stock held by H Co and some of its subsidiaries were parent companies of the different divisions within the H Co group. In 1995 H Co decided to spin off its global insurance division into a new US parent company of the insurance division, HIG (which was a subsidiary of HHI), and to transfer the shares in the H companies to a newly incorporated and UK tax resident company, HHUKL, which was to be a subsidiary of HIG. The spin-off was governed by a distribution agreement dated 10 October 1995 between H Co and HIG under which H Co distributed to its shareholders the shares in HIG and pursuant to a sale agreement HHL (a second-tier subsidiary of H Co) sold the shares in H companies to HHUKL (a first-tier subsidiary of HIG). The distribution agreement was conditional and a no constraint clause provided that the satisfaction of the conditions did not create an obligation on H Co to effect the distribution or limit that company's rights to terminate the agreement and abandon the distribution. The sale agreement was conditional on "the distribution … being effected pursuant to the distribution agreement". The distribution was effected at the latest by 8.30am Houston time on 23 January 1996, the stock certificates having been put in the United States mail addressed to the stockholders prior to 8.30am on that day. In its company tax return, the appellant sought to set off the capital loss of £14,867,445 arising on the sale of the H companies against chargeable gains of £14,867,445 in its accounting period ended 31 December 2000. HMRC amended the return disallowing its claim on the basis that the appellant and HIG were "connected persons" within TCGA 1992 s 18(3) when the distribution agreement and the sale agreement were made. The appellant appealed contending (1) s 28 determined that the disposal under the sale agreement took place when the agreement became unconditional, ie when the distribution was effected at 8.30am on 23 January 1996, and at that time the shares in HIG had been distributed to the shareholders of the H Co and that company no longer had any interest in the shares of HIG; (2) the sale agreement could not be read as if it were conditional on the distribution agreement becoming unconditional. That was not what it said, and the no constraint clause made it clear that there was no obligation on the H Co to make the distribution on the satisfaction of the conditions. The sequence of events was made clear by the agreements; (3) the shareholders of H Co and HIG did not satisfy the conditions for connection in TCGA 1992 s 286(5)(b)—if a group of 2 or more persons has control of each company"—because they were not a group and nor did they have control of either party within the meaning of TA 1988 s 416. The word group had to be given an ordinary, sensible and realistic meaning, such as *The Shorter Oxford English Dictionary* definition; and (4) even if the shareholders constituted a group, they did not have control of the company and HHUKL within s 416 because they had no interest in the share capital of those subsidiaries or rights entitling them to participate in their assets on a winding-up. They were not able to exercise direct or indirect control over the affairs of those companies. Persons who did not individually have control could only have control "together" within s 416(3) if there was some agreement or agreements for them to aggregate their votes so that they can collectively exercise indirect control over the company's affairs. Sections 416(2) and (3) looked at the real world situation and were not deeming provisions. Section 416(6) contained attribution provisions that could be applied only to a single person who alone (or together with his associates) had control of that company as it used "person" in the singular in contrast to the reference to persons in sub-s (3). Even if the shareholders in H Co and HIG were such a group having control of the H Co and HIG they did not have control of HHL and HHUKL within s 416(2) because they did not have direct or indirect control over the affairs of the appellant and HHUKL. HMRC submitted—(1) the purpose of the connected persons rules was the presumption that connected persons might not make a bargain at arm's length. That should be tested at the time of making the agreement when the price was fixed even though the agreement was conditional. TCGA 1992 s 28 determined only when the disposal took place; TCGA 1992 s

18 was concerned with a completely different issue, that of the relationship between the parties to the agreement; (2) even if s 28 did determine the time of connection, the sale agreement became unconditional when the conditions in the distribution agreement were satisfied; (3) even if the sale agreement was construed in accordance with its terms the distribution and the sale of the shares in HICUK took effect at the same time as part of the same overall commercial transaction, and one should not artificially dissect those transactions separated only a scintilla of time; (4) in relation to connection by TCGA 1992 s 286(5)(b), the only connection necessary for there to be a group was the ownership of the shares in the same company. That interpretation was in accordance with the scheme of the legislation, that two companies owned to a significant extent by the same people should be treated as connected because the relationship gave rise to potential for avoidance by creating artificial losses; (5) in relation to control there was no suggestion that the common group of shareholders did not own more than 50% of the share capital of both H Co and HIG. The group should be treated as being the person for TCGA 1992 s 416 by virtue of s 416(3) and also constituted the group having control for s 286. The common group of shareholders either had indirect control of HHUKL and the appellant, or the rights of H Co and HIG to control their subsidiaries could be attributed tot he common group of shareholders by s 416(6).

The Special Commissioner considered that TCGA 1992 s 28 determined both the time of the disposal and the time when there was a connection. The words “is connected” in s 18 made it clear that both disposal and the definition of the connected persons must be applied at the same time. Section 28 specified the time of the disposal and it would be odd if the time at which the persons were connected had to be determined at a different time without the section making that clear.

The Special Commissioner found that there was no obligation on H Co to make the distribution before they actually did so. It made commercial sense for the sale agreement to be conditional on the distribution being effected otherwise it would be possible that the sale agreement took effect but the distribution did not. The parties had made it clear that they intended the distribution to take effect before the sale of shares. Reading the reference to the distribution being effected to mean the distribution agreement becoming unconditional would be contrary to the expressed intention of the parties.

The Special Commissioner considered that control for the purposes of TCGA 1992 s 286 meant control at general meetings of the company. Shareholders in a UK company could never exercise control over the company's affairs in the sense of the business of the company; the most they could do was to remove the directors. In any case s 416(2) went on to say that, without prejudice to the generality of those preceding words, a person should be taken to have control of a company “if he possesses or is entitled to acquire—(a) the greater part of the share capital …”. Therefore one person having the greater part of the share capital of a company had control over the company. The word “together” in s 416(3) did not impose any additional requirement that there was an agreement between them so that they could collectively exercise control before one could aggregate their votes; it was the natural word to use to total their rights, here their shareholdings. Therefore two or more persons together (ie in total) having the greater part of the share capital of a company have control over the company. It is not necessary to ask whether they exercise, or are able to exercise, control over the company's affairs. And by s 416(6) one could attribute to those two or more persons all the rights and powers of any company of which they have control so that one could attribute to them the parent company's right to control its subsidiaries. Therefore the shareholders holding the greater part of the share capital of H Co controlled the Appellant, its 100% sub-subsidiary; and the shareholders holding the greater part of the share capital of HIG control HHUKL, its 100% subsidiary. Furthermore, the reference to group in s 286(5) did not import any additional requirement of commonality of purpose. It was the natural word to denote a collection of people who had a common relation, rather than purpose, of being shareholders in a company in accordance with the dictionary definition. On the facts a collection of shareholders who owned the greater part of the share capital of both companies on 23 January 1996 could be identified. It followed that the collection (or “group”) of shareholders holding the greater part of the share capital of H Co and of HIG were a group of persons consisting of the same persons having control of each company, and by s 416(6) also having control of the appellant and of HHUKL. Therefore the appellant and HHUKL were connected with each other. Accordingly the appellant was connected with HHUKL at the time of the share sale by virtue of s 286(5)(b) with the result that the capital loss of £14,867,445 was not available against the appellant's other chargeable gains. It followed that the appeal would be dismissed.

Appeal dismissed.

Shares note for Northern Rock investors

HMRC have published a note setting out their understanding of the consequences of the transfer of Northern Rock plc into temporary public ownership.

The information is in relation to the capital gains tax position of former shareholders in the bank, and the income tax and CGT position of those who held shares and share options under employee share schemes.
With regard to CGT, HMRC consider the entire loss to the shareholder of his or her shares under the transfer order to be an occasion of disposal under of TCGA 1992, s 24(1).

The time of the disposal will be 22 February 2008, the date the transfer order came into force, which falls in the tax year 2007-2008.

As no consideration was received for the shares, the disposal on 22 February will normally give rise to a loss in respect of any allowable costs of acquisition.

Where the disposal includes 'free' shares received by the same holder when Northern Rock demutualised in 1997, those shares will not have any cost for capital gains purposes.

Further information on the tax treatment of free shares is contained in Inland Revenue Tax Bulletin 34.
Losses can be set against chargeable gains in the usual way.

Any payment under the compensation scheme order will be chargeable to capital gains tax under s 22(1)(a) as a capital sum derived from the recipient's former shareholding.

The charge will arise in the tax year in which the compensation is received. Where a former shareholder has not claimed a capital loss under s 24(1), any allowable costs incurred in acquiring the shares may be deducted from the compensation in arriving at the gain.

Employees with a savings contract under the save as you earn may choose to continue paying monthly contributions into their savings scheme.

When the three-year or five-year contract expires, they can receive their savings with a tax-free bonus. They will no longer have an opportunity to exercise an option and buy shares at the end of the contract.

As a separate matter, if any compensation is received from the Government for extinguishing of rights to receive shares, the compensation is likely to be the receipt of a benefit in connection with the SAYE options, so the amount of the benefit will count as employment income under ITEPA 2003, s 77 in the tax year in which the compensation is received.

Any shares held in a share incentive plan were transferred into public ownership on 22 February under the transfer order. A loss will arise for CGT purposes, as explained above.

Any compensation received from the Government will be chargeable to capital gains tax for the tax year in which it is received.

It will no longer be possible to exercise any options acquired under a company share option plan and receive shares in Northern Rock.

If any compensation is received from the Government for extinguishing of rights to receive shares, this compensation is likely to be the receipt of a benefit in connection with the CSOP options, so the amount of the benefit will count as employment income under ITEPA 2003, s 477 in the tax year in which the compensation is received.

Turning to restricted shares within ITEPA, Chapter 2, as no consideration was received when shares were taken into public ownership on 22 February 2008, there is no 'chargeable event' under s 427(3) and therefore no charge to income tax in 2007-08.

As no consideration was received for the shares, for capital gains purposes the disposal on 22 February will normally give rise to a loss in respect of any allowable costs of acquisition.

Any compensation received from the Government in connection with employment-related securities is likely to be the receipt of a benefit in connection with those employment-related securities.

The amount of the benefit, to be determined on the facts of each case, will count as employment income under s 447 in the tax year in which the compensation is received.

Since Northern Rock shares were not tradeable immediately before they were disposed of in February 2008, HMRC consider they are not readily convertible assets under s 702(1)(a).

Furthermore, they would have been 'corporation tax deductible' under FA 2003, Sch 23 and are therefore not treated as readily convertible assets by ITEPA 2003, s 702(5A). Therefore, PAYE will not be operable and the employment income should be returned by the employee via the self assessment process.

In related news, for circumstances in which an individual died in the period 22 February 2007 to 21 February 2008 (inclusive) while owning shares in Northern Rock, and the shares were subsequently taken into temporary public ownership before they were either sold by the personal representatives or transferred to the person(s) entitled under the deceased’s will or intestacy, the shares will be treated as if they had been cancelled as at 22 February 2008, for the purposes only of IHTA 1984, s 186A.

Provided the other conditions of s 186A are met, a claim to relief under those provisions may be made by the appropriate person.

Inheritance Tax and Trusts

Trusts and the Finance Bill 2008

Income of beneficiaries under settlor-interested trusts

The income of a settlor-interested trust is treated as the settlor's income on an arising basis.

In non-settlor interested discretionary trusts, where income payments are made to beneficiaries, the income constitutes a new source and so is taxed on the beneficiary. The tax paid by the trustees is available to the beneficiaries in the form of a fully refundable tax credit.

With a settlor-interested trust, an income payment to a beneficiary is still a new source of income which is taxable in the beneficiary's hands. However, the tax paid by the trustees of such trusts continues to be treated as having been paid on behalf of the settlor – see (a) above. Because the settlor will already have been taxed on the whole of the trust income, charging the beneficiary to tax on top of this would result in a form of double taxation.

S685A ITTOIA 2005, which was inserted by FA 2006, provides that income paid by the trustees of a settlor-interested trust to non-settlor beneficiaries comes with a non-repayable notional tax credit equal to the higher rate of tax (currently 40%) which covers the whole of the tax liability on that income.

Unfortunately, under the ordering rules, income from a trust was charged *before* savings and dividend income. The result was that a non-settlor beneficiary of a settlor-interested trust who also had savings and/or dividend income could find that his non-trust income was then pushed into the higher rate bracket so that more tax was due overall.

Cl 64 FB 2008 amends this unintended consequence of the FA 2006 modification so that income from a settlor-interested trust is treated under S1012 ITA 2007 as representing the highest part of the individual's total income rather than the lowest. This correction is backdated to 6 April 2006 so as to ensure that those affected will not be disadvantaged by the original omission of this measure.

Transitional serial interests (TSIs)

Sch 20 FA 2006 amended the IHT rules for interest in possession trusts. It included a transitional period from 22 March 2006 to 5 April 2008 (inclusive) to enable trustees to reorganise trusts set up before 22 March 2006 without being subject to the new regime.

Two changes have been made to this part of the IHT code:

(i) The transitional period has been extended by an extra six months so that it now comes to an end on 5 October 2008 (Cl 135 FB 2008). This gives the trustees more time in which to replace an existing interest in possession with a new one (known as a TSI).

(ii) In September 2007, a controversial view was expressed by HMRC concerning TSIs. They suggested that, where a pre-22 March 2006 life interest comes to an end and is replaced on or before 5 April 2008 (as it then was) by another life interest in favour of the same life tenant, S53(2A) IHTA 1984 required this event to be treated as an immediately chargeable transfer. This view was not thought to be correct and the matter has now been dealt with by repealing S53(2A) IHTA 1984 and replacing it with a new provision which makes it clear that there is no chargeable transfer in these circumstances (Cl 134 FB 2008).

Article by Robert Jamieson

Lecture P489 (11.31 Minutes)

McKelvey (personal representative of McKelvey, deceased) SpC 694

The deceased, who never married and had no children, owned two properties as investments. She lived with her blind and frail mother as her carer providing for her daily needs. The deceased was diagnosed with terminal cancer and in March and May 2003 she transferred the two houses, jointly valued at £169,000, to her mother by way of gift. Following the deceased's death on 14 March 2005 the mother refused to countenance paid care or her admission into residential care, and other family members temporarily undertook her care but her condition deteriorated and she died on 3 February 2007. HMRC issued a notice of determination charging inheritance tax to the effect that the gifts of the houses to the mother were chargeable transfers by virtue of IHTA 1984 s 3A(4). The deceased's executor appealed contending that the deceased had transferred the two properties to her mother in order to provide her with the financial resources to pay for her future care, either in her own home or if it became necessary, in a care home, and that accordingly they were exempt transfers within IHTA 1984 s 11(3) and thus excluded from the effect of IHTA 1984 s 3A. The fact that, as a result of the mother's refusal to accept paid care, none of the deceased's gifts had been drawn on was immaterial—the only consideration for the purposes of s 11(3) was the donor's intention when the gift was made. The reasonableness of the provision, both in principle and in amount, could only be considered when the gift was made since it was not open to the donor thereafter to monitor the use of the assets. Moreover, it was the donor's assessment of what was reasonable which should be considered—the test was not wholly objective. HMRC accepted that gifts of the kind made by the deceased were in principle capable of falling with IHTA 1984 s 11(3) as being intended for the care, rather than the maintenance, of the beneficiary. However, s 11 taken as a whole supposed that there was an immediate or imminent need for the gift and that it, or the proceeds of sale, would be used for the qualifying purpose within a fairly short period—mere contingent need was not enough. Section 3A itself imported a retrospective element since sub-s (5) made it clear that one did not consider whether tax was payable until the transferor had died. Thus it was permissible to taken into account events between the making of the gifts and that death.

The Special Commissioner considered that the reasonableness of IHTA 1984 s 11 had to be considered in the light of the circumstances as they were reasonably believed to be at the time the gift became effective, in the instant case in March and May 2003, and not as they later turned out to be. The only retrospective element to s 3A, if indeed it truly was a retrospective element, was that by virtue of sub-s (4) a potentially exempt transfer became an exempt transfer if the donor survived for seven years and a chargeable transfer if he did not. Section 11 excluded a gift from the description of “transfer of value”, to which alone s 3A was directed, if any one of the conditions it prescribed was met—thus if s 11 was engaged, the gift was not a “transfer of value” and s 3A did not apply to it at all. Therefore, the proviso to s 3A(1) and s 11 could be read only upon the assumption that the characteristics of the gift had to be considered, and a consequent determination made whether s 3A applied, at the time the gift became effective. However, in determining what was reasonable, it was not only the deceased's view of what was reasonable. Section 11 focused on “reasonable provision” which suggested an objective standard. On the facts it was reasonable to conclude that, when the gifts were made, the mother would require paid care in the near future. There was, in practical terms, little realistic alternative to paid care and accordingly the deceased's decision to make the gifts for the purpose of paying for her mother's future care was based on reasonable grounds.

In determining the amount of reasonable provision the Special Commissioner considered that it was appropriate to adopt the approach taken in personal injury cases—in particular taking a multiplier and a multiplicand to arrive at a basic amount and then adjusting it. In the present case the multiplier should be 5·5, upon the footing that the deceased would have been capable of providing care for a little longer, and the multiplicand should be £21,000, the quoted cost of care in the mother's own home in 2003, leading to a basic sum of £115,500. In addition, £25,000 should be added to cover the contingency of the mother's admission to a nursing home. Therefore reasonable provision at the time the transfers were made amounted in all to £140,500. It followed that £140,500 represented reasonable provision for her case and fell within IHTA 1984 s 11, while the remainder was to be regarded, in the light of the deceased's death within seven years, as a chargeable transfer falling within s 3A. The appeal would be allowed in part.

Appeal allowed in part.

Administration

New era for tax enquiries

There have been plenty of recent developments in the tax investigations field, some of them promising but others worrying. For example, the use by HMRC of the less aggressive term of *compliance checks* countered somewhat by greater powers being given to HMRC.

Reducing the burden of audits and inspections

This promise was followed up in the Budget 2008 press releases where it was stated that the aim is to ensure that compliant taxpayers will incur less burden; those who do not understand or who make mistakes will be supported to make it easier for them to comply in the future; and those who deliberately do not comply will be targeted quickly with an intervention designed to change their behaviour. This is intended to be achieved as follows:

– Better targeting, by making better use of third party information and of information collected during normal processing activities. Clearly, it will be even more important to disclose any aspects of your client's business that do not conform to any likely business model held by HMRC – perhaps by including a brief business profile. Under this heading HMRC plans to have a strategic analysis system in place by 2010/11.

– Reviewing the design of the intervention process with a view to extending the range of intervention options available, so as to create a set that are better targeted, less intrusive, and less costly to businesses and HMRC. In the meantime, if a client is selected for an enquiry it may well be possible to find out straightaway exactly what HMRC's apparent concerns are.

– Carrying out interventions as quickly and efficiently as possible, involving (a) the use of HMRC officers trained in direct, indirect and employer compliance, who can carry out single interventions; and (b) use of clear communications from the start, to reduce time spent on the enquiry. Both these ideas are being trialled, and in the meantime a reference to them could be used to your advantage whenever an enquiry drags on.

New approach to compliance checks

This follows the ignominy of the *interventions pilot* in 2006 (cost £1.06 million; yield £664,000; over 90% of interventions yielded nil tax), and the 2007/08 *openness and early dialogue test* which may or may not have been regarded as a success.

It is planned to be legislated for in 2009 (via powers granted to HMRC in Schedules 36 & 37 FB2008) and basically involves the following:

1. Use of flexible compliance checking regime, proportionate to risks and taxpayer behaviour
2. Common approach to information gathering powers, record-keeping requirements and time limits, taking a "whole taxpayer" view
3. Focus on highest risk taxpayers
4. Increased coverage of taxpayers who simply make mistakes, or fail to take reasonable care, and need guidance to get things right in future
5. Shorter and flexible checks on a wider range of risks and non-compliant taxpayers.

Current investigation timetable

HMRC published these results in Budget 2008 for the average elapsed time for their business compliance checks (excluding LBO or SCI cases).

They also stated that it takes them an average of 86 days to obtain a reply to their first information request in a SA enquiry.

Type of check	Average elapsed months
Corporation tax -full	23.8
Corporation tax – aspect	16.5
Income tax – full	18.3
Income tax – aspect	14.5
Employer compliance	11
VAT	2.7

Is the new era good news?

Summary of the points to take on board:

1. The even greater need to explain any unusual business statistics in terms of pattern of expenditure claimed, ideally by including a brief business profile in the tax return. The tax office receiving the figures is likely to be miles away so the officer will not have any understanding of the local business environment which may be a factor when the officer analyses the results.
2. If a tax return is selected for enquiry, push for an explanation of exactly what HMRC are apparently unhappy about.
3. Educate clients to ensure they are not regarded as high-risk under the new era and spell out to them the advantages of not being high-risk; in particular that they will not have to face mandatory visits to their premises.
4. Is there any role left to play for random enquiries?

The likely new legislation on HMRC powers

The existing powers in Sections 19A to 20 TMA1970 for income tax and CGT will be replaced. Subject to consultation the likely changes for all taxes will cover:

- Exercise of information powers on a pre-return basis (as a means of tackling issues before a return is due). The potential problem here is that records will not always have been fully written-up until after the end of the accounting period.
- Checking the position of someone who has not been issued with a tax return. Currently they may issue *Tax review form 810(T)* but that does not have to be completed.
- Power to require taxpayers to produce non-business records, whether or not a tax return is issued. This is planned to have no right of appeal, on the grounds that it relates to statutory records which must be kept by law.
- Power to see a taxpayer's non-statutory records. These could include appointment diaries, board meeting minutes, correspondence, schedules and photographs.
- Power to require the creation of a document, such as an annotated schedule, provided *"the information is potentially relevant to establishing a tax position and the request is reasonable"*. There would be a right to appeal against such a notice.
- Right to inspect business premises and assets provided the inspection is reasonably required in order to check a person's tax position. HMRC's slant on this clearly controversial proposal is that *"the ability to see the business can give the officer a better commercial perspective and a more complete picture of the records, assets and business activities. This can reduce the time taken and avoid the asking of what turn out to be unnecessary questions. The ability of fiscal authorities to see business records, assets and premises is the norm throughout OECD countries. Of 30 countries surveyed, 25 provide access to business premises"*

HMRC state that any new legislation will specify that the time and date of the visit should be convenient to the taxpayer, although an unannounced visit is planned to be possible in exceptional circumstances, and as an example they refer to businesses which use electronic cash registers.

Article by Gerry Hart

Lecture P490 (10.33 Minutes)

HMRC Powers

HMRC is pushing ahead with a review of all its existing powers. This covers enquiries, investigations, penalties and all forms of checking tax returns. The review will last a few more years but we have some further details in what will soon be the Finance Act 2008.

Incorrect returns

The Finance Act 2007 included a new framework for assessing penalties on incorrect returns covering all the major taxes eg income and corporation tax and VAT. This new regime takes effect for returns filed after April 2009. This will see penalties imposed based on taxpayer behaviour and the key to reducing penalties for errors will depend on whether they took 'reasonable care'.

This is best shown in the table below:

Reason for penalty	Penalty	Possible min. reduced penalty for unprompted disclosure	Possible min. reduced penalty for prompted disclosure
Careless action	30%	0%	15%
Deliberate but not concealed	70%	20%	35%
Deliberate and concealed	100%	30%	50%
Error in HMRC assessment	30%	0%	15%

Notes to table:

1 the careless action penalty is subject to suspension for a maximum of 2 years where HMRC think that compliance with a condition of suspension would help the taxpayer avoid further penalties for careless inaccuracy

2 there can be a special reduction of any of above penalties where HMRC considers there are special circumstances, not linked to ability to pay

The March 2008 Budget extended this framework to almost all other taxes bar tax credits. The Finance Bill 2008 includes provisions to bring in the same type of regime for penalties for inheritance tax, environmental taxes, stamp duties and excise duties. This will affect returns filed on or after April 2010.

Compliance checks

The new terminology for HMRC to check that businesses and individuals are paying the famous 'right amount of tax' is 'compliance checks'. For income tax, corporation tax, capital gains tax, VAT and PAYE new rules will apply from 1 April 2009. This will include more stringent record keeping requirements and a power to look at those records in 'real time'. There will also be a power to visit business premises but not people's homes. There will be a lot of concern about how this will all work in practice.

After much pressure, the Government did amend the original proposals so that an information power to visit a business premise will now require (in most circumstances) 7 days notice rather than the 24 hours first put forward. Only an 'authorised officer' can undertake the visit and there will be a Code of Conduct.

In addition there will be new powers relating to the ability to search goods and baggage at airports and other places of transit. Primarily this will allow Customs to open and unpack containers rather than insisting this is undertaken by the proprietor of the goods.

Tax debt

Changes are also being made to the way HMRC manage tax debt. For example, by the autumn of 2008 it will be accepting payment by credit card. Other changes include giving HMRC the ability to offset repayments against tax liabilities and greater debt enforcement powers.

Tribunal reform

The Ministry of Justice is overseeing major changes to the way tribunals operate in the UK. The Tribunals, Courts and Enforcement Act 2007 brought in the idea of a new first-tier tribunal which will see the end of the General and Special Commissioners as we know them, from 2009. The Finance Bill 2008 includes a power to introduce secondary legislation to change the way appeals against HMRC are handled in light of those changes.

Concessions after *Wilkinson*

A few years ago the House of Lords decision in Wilkinson [2006] STC 270 raised concerns about whether HMRC was able to make extra-statutory concessions. The upshot has been that there have been no significant concessions since that case and a fear from HMRC of changing existing ones. The Budget confirmed that after taking legal advice, HMRC believes its existing concessions are within its 'collection and management' discretion and therefore should survive. It is intending to legislate a significant proportion of them by Treasury Order and will do this via a power introduced in the Finance Bill 2008.

We will also be seeing discussions begin on the introduction of a new Taxpayer's Charter. Such a document existed in the 1980's and then gradually fell into disuse before being removed. The intention is for it to set out taxpayer rights and obligations. A Charter will bring the UK into line with most other developed countries. An initial consultation paper has been issued and can be found on www.hmrc.gov.uk.

Article by Francesca Lagerberg

Lecture B490 (9.03 Minutes)

Revenue and Customs Commissioners v Khawaja

The taxpayer was the controlling director of a company which ran a restaurant from which he received remuneration. He submitted tax returns for the years 1993/4 to 1998/9 in which he declared the amounts he had received by way of remuneration, benefits in kind and rental income. The Commissioners considered that he had under-declared his income and raised their own assessments, estimating the amounts they believed he had received. Following a High Court challenge to those assessments, the Commissioners served a notice claiming penalties under TMA 1970 s 95(1)(a) for—“negligently submitting incorrect returns ... for the years [referred to above]”. The taxpayer appealed to the General Commissioners who found, inter alia, that the taxpayer had not been shown to have negligently understated income in respect of remuneration for the years in question. In so finding, the General Commissioners applied the criminal standard of proof of beyond reasonable doubt. The Commissioners appealed by way of case stated.

The principal issue that fell to be determined was whether the general Commissioners had erred in applying the criminal standard of proof.

The appeal would be allowed.

Proceedings such as those in issue in the instant case were undoubtedly civil. There was nothing criminal about them. That therefore gave a starting point of a presumed civil standard of proof. There was no reason to depart from that starting position.

They were in complete distinction to parallel proceedings which could be brought for fraudulent tax evasion, and they covered ground (negligence) which could not sensibly be the subject of criminal proceedings in such cases. Although the word "penalty" was used, that was far from determinative. The penalties were first raised by a notice issued by the Commissioners. There were only ever proceedings if that notice was challenged by the taxpayer. That was not a criminal-type procedure. That was plainly a procedure allied to a civil recovery procedure. Having regard to the penalties scheme under the Value Added Tax legislation, and the recommendations which had been the precursor to the institution of that regime, it was clear that the civil standard of proof applied to the penalty schemes under that regime and that it had been assumed that the same standard applied under the penalty regime in respect of income tax.

In those circumstances, the General Commissioners had applied the wrong standard of proof in determining the taxpayer's appeal.

Accordingly, the matter would be remitted for further hearing.

Standard of proof in tax appeals

In *Revenue and Customs Commissioners v Khawaja*, HMRC issued a penalty notice under TMA 1970 s 95(1)(a) on the basis that the taxpayer had negligently submitted returns.

The taxpayer appealed the penalty notice to the General Commissioners who, applying the criminal burden of proof, that of beyond all reasonable doubt, decided that he had not been shown to have negligently understated part of his income for the years in question and reduced the penalties.

HMRC appealed the decision on the grounds that the Commissioners should have applied the civil burden of proof in determining the taxpayer's appeal, ie the balance of probabilities.

Allowing HMRC's appeal, the High Court held that proceedings relating to penalties for negligence were civil in nature and therefore required proof only to the civil standard. The case was referred back to the Commissioners for consideration on the basis of the correct standard of proof.

Sch 36 'marks end of SA as we know it'

New HMRC powers proposed in the Finance Bill could lead to 'the end of self assessment and the enquiry window as we know it', barrister Keith M Gordon has warned.

Schedule 36 will allow the Revenue to request information from a taxpayer before he or she has submitted a return, claimed Mr Gordon, who added that new powers will allow the taxman to demand data not only during an enquiry window but also later, if there is suspicion of a loss of tax.

'In other words,' he said, 'HMRC need not be on the verge of a discovery. They might already know about the underpayment, or they may have simply failed to act during the enquiry window on the information in the return.

'There need to be no insufficient disclosure, or no fraudulent or negligent behaviour,' Keith told guests at the annual Wyman Debate held by the ICAEW Tax Faculty.

He then went on to argue that the Finance Bill proposes to give HMRC 'more powers than the police' in terms of being able to enter premises.

The constabulary only have the power of entry if they hold a warrant or have a suspect under arrest for a serious offence, noted Keith, who was junior counsel for the victors during the Arctic Systems case in the House of Lords.

However, para 12 of schedule 36 allows HMRC to inspect premises without notice if the occupier has agreed or if an authorised officer wishes to carry out – or has authorised – and inspection. When prior notice is issued, it need not be in writing.

A taxpayer has no right of appeal against any such inspection, Keith added, saying that if HMRC ‘really want to stitch up the taxpayer’ they could tell the first-tier tribunal that they believe premises are used by the taxpayer in connection with a business.

They would then receive authorisation for an inspection, turn up when the taxpayer is not present and have only to leave a copy of the notice in a prominent place, or give it to the person who *appears* to be in charge.

He went on: ‘If the taxpayer turns up and finds the officers raiding the property, it might not be unreasonable for the taxpayer to try to assert his or her legal rights. Actually, the taxpayer does not have any such legal rights’.

Simon Norris, head of HMRC’s powers review team, insisted that schedule 36 of the Finance Bill includes 37 identifiable safeguards for taxpayers, including the right of a business to refuse a search by visiting tax inspectors.

Meanwhile, the Treasury’s Mark Neale, MD of the department’s budget, tax and welfare directorate, argued that it was in the interests of HMRC to use ‘consistent and transparent’ powers that are ‘exercised reasonably and within the framework of government safeguards, and not used ‘in an arbitrary or unreasonable way’.

Business Tax

Appropriation of trading stock

The 'long established rule' mentioned in BN19 is the rule that arose from the 1955 decision in *Sharkey v Wernher* 36 TC 275.

In brief, Lady Zia Wernher had a stud farm that was taxed as a trade and a horse-racing activity that was treated as a hobby. When she transferred some horses from the stud farm business to the horse-racing hobby, the House of Lords held that she should bring into her accounts the amount that those horses would have been sold for on the open market, had she sold them as the stock in trade of the stud farm.

The legislation

What does the new legislation actually say? Put simply, it 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'. It includes 'all land or other property'. Specifically excluded are:

- materials used in the manufacture, preparation or construction of any such thing,
- any services performed in the ordinary course of the trade, or
- any article produced, or any material used, in the performance of any such services.

So 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.

For income tax, these provisions are inserted as ITTOIA 2005, ss 172A to 172E. For corporation tax, they appear to be left as FA 2008, Sch 15 but will presumably be incorporated into the corporation tax rewrite.

It is clear that the intention is to ensure that non-trading transactions involving trading stock are to be treated as occurring at market value, whatever price (if any) is actually paid.

Why now?

The reason we were given in BN19 for enacting this decision more than 50 years after the decision in *Sharkey v Wernher* is the doubt caused by FA 1998, s 42. This tells us that the starting point for determining business profits is the accounts figure, subject to 'any adjustment required or authorised by law in computing profits for those purposes' (s 42(1)). But it was not clear whether the judicial decision in *Sharkey v Wernher* amounted to an 'adjustment required or authorised by law'. So the new legislation is intended to put the matter beyond doubt.

One might ask why this measure had been brought forward now, after it had been rejected for inclusion in the rewrite project when ITTOIA was enacted. In the debate on Sch 15, the minister, Kitty Ussher, explained:

'The hon gentleman [Mark Hoban, MP for Fareham] asked why we abandoned our plans to legislate on the market value principle as part of the tax law rewrite project in 2000. We intended to do so, but some respondents felt that as the rule was not previously contained in law, to include it in a law rewrite was inappropriate. That is a grey area, but we thought it best to err on the side of caution, so the relevant provisions are excluded from the tax law rewrite bill. However, including such a thing in the Finance Bill enables us to debate the matter properly and get the issues on record. I hope that we have achieved that.'

Other observers have suggested that the decision in *HMRC v William Grant/Small v Mars UK Ltd* [2007] STC 680 was another driver for these new rules. In those joined cases, the House of Lords reasserted the primacy of correct accounts as the starting point for determining taxable profits.

Furthermore, correct accounts did not require appropriations into or out of trading stock to be dealt with at market value.

Unfortunately, as we shall see, a proper debate was not really achieved and the legislation as enacted leaves plenty to argue about in the future.

Restriction to trading stock

The first question is why the provision is restricted only to trading stock and work in progress. *Sharkey v Wernher* concerned trading stock, as we have seen. But 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. So, if a chocolatier buys sugar for use in making chocolates, and takes a couple of bags of sugar home for personal use, why is that to be treated differently from the situation where he takes home a batch of chocolate for his wife?

The sugar is clearly a raw material and excluded from the definition of trading stock, it being material used in the manufacture or preparation of trading stock. But the chocolates are trading stock by virtue of being the goods that a chocolatier sells in the normal course of his trade, so their expropriation from stock would require an adjustment under this new legislation. Certainly, this was the view taken when I was training as an inspector: raw materials were treated as trading stock in this context.

By analogy with *Sharkey v Wernher*, this would be as if the adjustment is made if mature horses are taken into the racing stables but not if the transfer is of immature foals which are too young to race.

What is market value?

This problem area has been discussed in previous articles. But it is worth highlighting again. In a Readers' forum reply ('Variable value'), *Taxation*, 2 November 2006, page 127, a restaurateur asked about adjustments in respect of a bottle of wine taken from stock to drink at home. HMRC were apparently contending that the market value adjustment should be on the basis of the list price on the wine list. Keith Gordon agreed that a better answer would be the retail price at a supermarket or local wine store (that is, if *Sharkey v Wernher* was still good law in the first place). In other words, market value can only be applied to the item concerned and not to the wider context of the trade carried on in these circumstances. To use the words of the new legislation, one would expect the open market to be one where you buy wine *per se*, not a market restricted to restaurant wine lists.

A recent article by 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. Many of us see this as an area ripe for major disputes in the future. In this context, I am reminded that the new approach heralded by the Varney Report is that all new legislation is to be accompanied by detailed guidance from HMRC. I look forward to seeing the guidance for these rules.

Trade discontinuing

I have previously expressed some concern about the interaction between this new legislation and the provisions for the disposal of trading stock on cessation of trade. I think, on reflection, my concerns may be unfounded.

Although the interaction is not made explicit in the legislation, TA 1988, s 100 and ITA 2007, s 173 are both headed 'Valuation of trading stock at discontinuance'. Similarly, by an amendment in this year's Finance Bill, Chapter 12 of ITA is entitled 'Trade profits: valuation of stock and work in progress on cessation of trade'. Although the titles and headers are not strictly part of the legislation, it is nevertheless reasonable to infer that the intention of Parliament is for the new rules to apply to a continuing trade and for the existing rules to apply for valuation on cessation, unaffected by the new provisions. Even if the legislation is not explicit, it seems likely that the courts would interpret the interactions this way.

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.

Broad view

Statement of Practice A32 was also mentioned in both Keith Gordon's 1 May 2008 article and in the parliamentary debate. It specifically states that inspectors should 'take a reasonably broad view' of the *Sharkey v Wernher* principle. Also, the 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. In any case, the explicit nature of the new provisions are such that it may be difficult for HMRC officers to 'take a reasonably broad view', as no discretion is apparently permitted.

In debate, Kitty Ussher confirmed that the statement of practice would no longer be needed and would be removed once the new rules were in place. But she also said:

'The Statement of Practice A32, as it is properly called, is part of HMRC's published guidance. That sets out how HMRC applies the market value rule in *Sharkey v Wernher* in practice. Once the rule is legislated in the Bill, as we propose to do today, there will be no need for a separate statement of practice, but there will be no practical effect on businesses, which will continue to operate the rule in the same way as they have always done.'

Does this help? Most commentators seem to believe that the statement of practice is a form of extra-statutory concession, 'the guidance softened or provided exemptions to the status quo' (from the Commons debate). If this is so, then its loss leaves businesses exposed to tax charges that they would not have previously suffered. If the minister is correct, the statement of practice is HMRC's view of the extent of the *Sharkey v Wernher* principle, so that the enactment of that principle should not lead to any change in interpretation or of HMRC practice. Only time will tell, but many of us suspect that the new legislation will be applied in ways that *Sharkey v Wernher* never was.

Practical measures

Keith Gordon (in his 2003 article) postulated a trader who buys 101 articles at the cash and carry, 100 for the shop and one for personal use. As a trainee inspector, this was one of the scenarios I was taught to challenge under *Sharkey v Wernher* principles. Sometimes it might just be simpler to separate business and personal purchases, even if all that means is to pay for them separately.

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 saying that the invoice relates to 101 items, of which 100 are for the business, so that the actual financial book entry only refers to the 100 items of stock. If the entire invoice is entered, with a reversal for the single item for personal use, an over-zealous inspector might contend that the book entry put all 101 items into stock and that the reversal was an appropriation for personal use.

In many cases stock is indeed taken from the business for personal use, so it is important to keep detailed records of what was taken and what the selling price was. 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.

Complicating matters

What ever else it does, this new legislation is likely to make the operation of the UK's tax code that bit more difficult. Apart from the unanswered questions raised in this article, I suspect that more issues will come to light as people start to operate the new regime.

The sad thing is that it could all have been avoided so easily by proper consultation. Time and again we have said we will engage with HMRC and the Treasury to help draw up new legislation. Frequently this happens. But all too often there is inadequate or no consultation, as here, and the result is confusion.

I hope that the minister was right, when she said that the new legislation 'is simply a translation from guidance into legislation'. Will HMRC follow her lead?

Article by Peter Miller writing in Taxation

Lecture B486 (11.56 Minutes)

Employment status

The best and the worst place to start with employment status is the case law. It is the best place because that is where the battle ground is in this area. Developments in how HMRC interpret status pretty much all derive from case law. It is paradoxically also the worst place to start as there are so many cases, often contradictory or so peculiar to their own facts that it is hard to derive any hard rules.

The other difficulty is that the usefulness of the case can depend very much on whether it is an employment law case eg usually an individual arguing that they are employed to get rights like unfair dismissal or a tax case, where the individual is likely to be contending they are self employed to avoid a higher tax charge. The two bodies of case law do not necessarily follow each other and the sympathy of the court can be swayed by the plight or otherwise of the individual in front of them.

Nevertheless, there are a number of cases that do stand out and are frequently referred to in any new case in this area. All emphasis below is my own.

First up is a case that is now over 40 years old but is still regularly quoted. In Ready Mixed *Concrete v Minister of Pensions and National Insurance* (1967) 2 QB 497, the Judge (MacKenna) said that 'a contract of service [ie employment] exists if these three conditions are fulfilled:

i the servant agrees, that in consideration of a wage or other remuneration, he will provide his own work and skill in the performance of some service for his master

ii he agrees, expressly or impliedly, that in the performance of that service he will be subject to the other's **control** in a sufficient degree to make that other master

iii the other provisions of the contract are **consistent** with its being a contract of service.'

Despite the rather outdated master/servant terminology, these three tests are still used in cases today. The first test has, however, moved on more than the other two and is more commonly referred to today as **'mutuality of obligation'.**

Another key case is *Market Investigations Limited v Minister for Social Security* [1969] 2 QB 173. Here Mr Justice Cooke contended that the fundamental test to be applied was whether a person was in business **on his own account**. This is arguably akin to the consistency test in Ready Mixed Concrete (rule iii above) but possibly is clearer about the need for a person who is self employed to show they are free of the shackles of employment.

This test was considered in *Hall v Lorimer* (1993) 66 TC 349 (the case that brought the job of a vision mixer to public notice). Lord Justice Nolan said in this case:

'In order to decide whether a person carries on business on his own account it is necessary to consider many different aspects of that person's work activity. This is not a mechanical exercise of running through items on a check list to see whether they are present in, or absent from, a given situation. The object of the exercise is to paint a picture from the accumulation of detail. The overall effect can only be appreciated by standing back from the detailed picture which has been painted, by viewing it from a distance and making an informal, considered qualitative appreciation of the whole … Not all details are of equal weight … The details may also vary in importance from one situation to another.'

More recent cases like *Lee Ting Sang v Chung Chi-Keung* 2 AC 374 have explored this term and there is a good summary in the recent Special Commissioners decision in *Dragonfly Consulting Ltd* SpC 655 of the types of issue that may be relevant:

i does the taxpayer provide his or her own equipment

ii does the taxpayer hire his or her own helpers

iii what degree of financial risk does the taxpayer bare and what opportunity for profit does the taxpayer have

iv what degree of responsibility for investment and management does the taxpayer have?

v is the taxpayer part and parcel of his or her 'employer's' organisation (see *Hall v Lorimer*)

vi the **degree** of control to which the taxpayer is subject (rather than the mere existence of a right of `control') vii termination provisions – termination on notice may be a pointer towards employment in some cases (it was found to be so in *Morren v Swinton* (1965) 1 WLR 576 but found to be neutral in *McManus v Griffiths* 1997 70 TC 218)

viii the intention of the parties.

Substitution

Substitution once appeared the holy grail in employment status disputes. It became a central part of many decisions and looked as though it could be the knock-out blow to prove that someone was self employed. The issue was first raised effectively in *Express Echo Publications v Tanton* 1999 IRLR 367 by Mr Justice Gibson. He said:

'It is in my judgment established … that where … a person who works for another is not required to perform his services personally, then as a matter of law the relationship … is not that of employee and employer.'

This was not the first discussion of substitution of course. In *Ready Mixed Concrete* Mr Justice MacKenna said that freedom to do a job either by one's own hands or by another's is inconsistent with employment 'though a limited or occasioned power of delegation may not be.'

The potential knock-out blow that substitution could provide in a status dispute led many contracts to include a substitution clause as a matter of course. The difficulty was that many of these clauses were either poorly drafted or did not fit the real facts of the situation.

Mr Justice Park in *Usetech*, for example, was faced with a relatively weak substitution clause. He noted that whether a relationship is one of employment depends upon all the circumstances and the relative weight of a number of potentially conflicting indicia. In particular he said:

'The presence of a substitution clause is a indicium which points towards self-employment and, if the clause is as far reaching as the one in Tanton it may be determinative by itself.'

This appears to leave us in the situation that if there is a substitution clause which is capable of being given effect to (it does not have to have been used but must be able to be used) and it is such that the arrangement cannot properly be treated as a contract for personal service, then this ends the matter. If the substitution clause is not that strong it becomes just one of the issues to be considered as part of the overall picture.

Control

Control was one of Mr Justice MacKenna's key tests. He talked of a 'sufficient degree' of control. The Court of Appeal in *Montgomery* (paragraph 23) also pointed to this test and said:

'mutuality of obligation and the requirement of control are the irreducible minimum for the existence of a contract of employment.'

The concept of control was much clearer when there was a master/servant element to an employment. In a more sophisticated world the difficulty is what level of control is sufficient to satisfy this test.

In *Dragonfly Consulting* the Special Commissioners summed up this dilemma as follows:

'I accept that there must be something in the contract which can reasonably be called a right for the employer to control the employee. But such a right need not be a right to control every aspect of what is done: what is done, how it is done, when and where it is done; instead a restricted right may be adequate.'

Reverting back to *Ready Mixed Concrete*, Mr Justice MacKenna accepted that in many cases the employer or controlling management have no more than a general idea of how the work is done are no inclination to interfere, but 'some sufficient framework of control most surely exist' (paragraph 19), and at paragraph 23 indicated that tribunals should exercise appropriate latitude in determining the question of control.

What is the control is exercised through an independent agent? In *Dragonfly Cons*ulting the Special Commissioner argued that 'a company can only exercise control through the agency of real people and when considering whether or not the company has exercised control it matters not whether those people are agents because they are employees or agents because a specific power has been delegated to them'.

Employment Status Indicator (ESI)

In order to find one's way through the maze of cases, HMRC has developed an electronic tool called the Employment Status Indicator or ESI. It can be accessed on http://www.hmrc.gov.uk/calcs/esi.htm . By inputting data via the tool, you get an indication of an individual's or a group's employment status.

HMRC has published the following information:

'We have recently published some additional guidance which explains that customers can rely on the ESI as giving a binding decision provided they keep certain documentation. The documentation includes the ESI print out and the contract with the worker.'

The updated guidance can be accessed through the ESI. Once you have entered the ESI go to the link ‘ ESI Application’. Then go to the link ‘information about employment status’. The updated guidance can be found under the heading ‘Employers obligations(workers employment status)’.

Article by Francesca Lagerberg

Lecture B487 (10.59 Minutes)

Aumchareon (trading as Bangkok Thai Restaurant) SpC 691

The appellant, a sole trader, owned a Thai restaurant between 1 May 2002 and 30 September 2003. The Revenue opened an enquiry into his self-assessment returns for 2002–03 and 2003–04. The Revenue observed the restaurant and made test purchases which were not found on a subsequent search of the records. An officer made an analysis of the records and using a business economics model calculated the expected takings. She calculated the food to drink ratio for June 2002, September 2002 and March 2003 to demonstrate that drinks (excluding tea and coffee) amounted to 25 percent of the takings and that therefore expected sales were of £152,000 compared to the declared sales of £132,000. On 22 December 2005 the officer made two jeopardy amendments to the self-assessments for 2002–03 and 2003–04 and thereafter issued closure notices for the two years. Those figures were put to the appellant who made no comment on them. He subsequently appealed and the proceedings were transferred from the General Commissioners. The officer revised the figures and also discovered that the takings for September 2002 had not been included in the declared figures. She calculated the tax for 2002–03 as £8,900 and for the following year as £5,800. The appellant did not appear at the hearing and his previous adviser did not know his whereabouts, although it was believed that the appellant had returned to an unknown address in Thailand. In those circumstances the Special Commissioner made a direction under the Special Commissioners (Jurisdiction and Procedure) Regulations 1994, SI 1994/1811, reg 28 dispensing with the requirement to serve documents relating to the appeal on him.

The Special Commissioner found that the Revenue's figures had been carefully calculated and put to the appellant. The burden of proof was on the appellant to displace them and he had done nothing to do so. Accordingly, the appeals against the jeopardy amendments to his self-assessments for 2002–04 inclusive would be dismissed.

Appeal dismissed.

Corporation Tax

Updated position on associated companies

This of course can result in far less than £300,000 of profits enjoying the 21% rate. The concerted attack by HMRC in cases where the existence of an associated company may not be known or anticipated (the prime example involves an LLP used for a film scheme) seemed to be on the verge of collapse as HMRC said that they were keen to remove the anomaly whereby companies can be treated as associated when there is very little real, or no, commercial connection between them. They said that ideally they would like to get back to the original intention of the legislation which was to counteract the fragmentation of a business in order to maximise entitlement to the small companies' rate of corporation tax.

Consultation

HMRC published a consultation document on changes to the capital allowances regime which at paragraphs 2.15 and 2.19 envisaged a return to the 1973 anti-fragmentation regime in relation to the proposed new £50,000 Annual Investment Allowance. These capital allowances proposals have been 'informed' by current HMRC thinking on how to get the small company tax rate regime back to its original intent.

Proposals

HMRC then came up with three proposals for reform:

1. Amend Sections 416 and 417 TA1988 (definitions of associated companies and control) so as to require some commercial interdependence between companies for them to be treated as associated;
2. Amend Section 13 (small companies' relief) so as to disapply Section 416 and make the anti fragmentation aim explicit; or
3. Replace the existing rules by a TAAR aimed at counteracting the fragmentation of a business to take advantage of the small companies' rate of CT.

HMRC has looked in the past at option one, amending Sections 416 and 417, but did not pursue it because of the considerable number of cross references to these sections throughout the taxing statutes and the very significant amount of work that would be needed to ensure that any change had no more than the desired effect. So the two main options looked like the second and third.

What happened?

In the event all that happened is that Clause 32 FB 2008 states that from 1 April 2008 the rights and powers held by business partners are only attributed when relevant tax planning arrangements have at any time had effect in respect of the taxpayer company. That covers arrangements which involve the shareholder or director and the partner, and secure a tax advantage because of greater small companies relief.

No business carried on

There are some circumstances where an associated company can be ignored on the grounds that it did not carry on a business at any time in the accounting period concerned. Case law helps here – particularly *Jowett v O'Neill and Brennan 1998 STC482* which is referred to in *para CTM03590* of the *Company Tax Manual.* Specifically, where a company only has bank deposit interest as an income source, and there is no active management of the monies invested, and there is no evidence of the situation being contrived to avoid tax, the company is not carrying on a business.

That position is backed up by a case in the High Court where they upheld the Commissioner's decision that no business was carried on by a company which ceased trading and then let its old trading premises to an unconnected tenant. The rent was its sole source of income and it was held that it was not carrying on a business as it had no active participation in the letting - *CRC v Salaried Persons Postal Loans Ltd 7/4/06.*

It should be appreciated that a subsidiary only receiving interest will suffer corporation tax at 28% itself as it is a close investment holding company.

Article by Gerry Hart

Lecture B488 (8.31 Minutes)

Barkers of Malton Ltd v Revenue and Customs Commissioners SpC 689

HG, a garage business, carried out its trade at a large premises in York ("the site"). A property company (E), of which P was the director, wanted to buy the site for residential redevelopment, but not the business. There were three possible options for separating the business from the site—(a) selling the business to the existing management. A private investor was prepared to acquire the controlling share of the business in order to assist. However, he subsequently withdrew at the eleventh hour; (b) selling the business to the B group, which owned other local car dealerships, and was prepared to consider buying HG's business if E secured the freehold of the site; and (c) the closure of the business, which P stated in evidence was not really a viable option. On 28 October 1994 E agreed that it would purchase the entire share capital of HG, subject to contract. On 12 January 1995 E wrote to HG informing them that it wished to vary the agreement for sale, namely that the business assets and liabilities of HG must be transferred to HY, a newly formed subsidiary, prior to completion of the share purchase which was to take place the following day. The letter did not mention that HG would continue to trade as the undisclosed agent of HY. The following day, 13 January 1995, the companies involved held various board meetings at the premises with a view to concluding the various purchases. The broad sequence of events was as follows—(i) at 9am HG resolved with effect from start of business of that day to transfer ownership of the business, trading assets and trading liabilities (exclusive of the freehold property and related borrowings) to its new subsidiary, HY; (ii) at 9.01am HY acknowledged same and it was resolved that HG should continue the trade as the undisclosed agent of HY; (iii) at 9.30am E resolved to purchase the entire issued share capital of HG, which owned HY carrying on the trade from the site; (iv) at 9.30am HG acknowledged same, new share certificates were issued and a resolution was passed to appoint new directors; (v) at 10am HG resolved to sell for £2 the entire share capital of HY to B with immediate effect; (vi) at 10am B resolved to purchase same; (vii) at 10.01am HY acknowledged that the entire share capital of HY had been acquired by B from HG and new share certificates were issued; (viii) at 10.30am HY resolved to sell its trade together with all trading assets and liabilities to the appellant company with immediate effect; and (ix) at 10.30am the appellant resolved to acquire the assets and liabilities of HY and its trade as a car dealer and repairer with immediate effect. It was also resolved that HG should continue to run the trade as undisclosed agent on the appellant's behalf. Throughout the 90 minute duration of those meetings, the garage business carried on as usual, but no transactions were completed during the 90 minutes when HY owned the business assets. Thereafter the appellant claimed relief under TA 1988 s 343 on the trading losses incurred by HG on the transfer of the trade from HY to it. The sole issue arose as to whether HY carried on the trade which was originally owned and carried on by HG between 9–10.30am on 13 January 1995. The appellant submitted that—(1) TA 1988 s 343 did not require the trading to take any particular form or to be of specific duration—it mattered not whether HY carried on the trading for one minute or several years; (2) at the outset of the negotiations there was still a range of options on the table for the potential destination of the HG business; (3) the creation of the agency relationship, which was normal commercial practice, did away with the need for HY to put its business straightaway on a more formal footing, which was why it did not open bank accounts for the trade or take steps to change stationary or the staff contracts of employment; (4) that the garage employees continued with their jobs as usual that day—someone was responsible for carrying out that trade and that someone had to be HY because at the material time it owned the garage business; and (5) the structure and sequence of the transactions were set up for valid commercial reasons; not to set up a tax advantage. The Revenue contended that—(1) TA 1988 s 343 required HY to carry on the trade of HG, in the sense that the trade was carried on in a way which could result in profits or losses being realised so as to be recognised for tax purposes; (2) the mere ownership of business assets did not constitute carrying on the trade; during the period in question HY did nothing. It did not incur any expenditure and receipts, no transactions were entered into by HY and it was highly unlikely that HY would be liable to third parties during that period; and (3) whilst there was no prior agreement by HG to sell HY to the appellant when HY was under its ownership, on the facts the sale to the appellant was the most likely outcome. The management buy out had been ruled out and P in his evidence had indicated that the closure of the business was not a viable option. The reality was the parties expected that the business would be sold onto the appellant. In those circumstances the parties were not contemplating that HY would carry on the trade for the short period pending the conclusion of the various transactions.

The Special Commissioner considered that the mere ownership of the trade could not constitute carrying on the trade for the purposes of TA 1988 s 343. On the facts the appellant had not proved on the balance of probabilities the existence of the agency arrangements as its contention was too general and did not carry weight in determining whether HY resolved at 9.01am that HG should continue the trade as the undisclosed agent of HY. There was insufficient evidence that the said agency arrangement was made. From the appellant's perspective the existence of that agency was critical as it explained why HY assumed no formal trappings of carrying on a trade. However, equally as important was the apparent uncertainty surrounding the sale of the trade to the appellant which minimised adverse inferences about the shortness of the period that HY purported to trade by raising the possibility that it would have to trade for a longer period if the sale fell through. The appellant had failed to prove those two critical areas. In those circumstances the mere fact that the employees continued with their jobs was insufficient on its own to establish that HY carried on the trade. Therefore, the appellant had failed to show on the balance of probabilities that HY carried on the trade during that 90-minute period. That conclusion was given force when examined against the whole evidence. The short duration of the ownership of the trade by HY together with the absence of any negotiations about the terms of its acquisition by B added to the sense of inevitability of the eventual sale to the appellant and generated a perception that the parties did not expect HY to carry on the trade for so short a time period. In addition, there was no evidence of any trading activity undertaken by HY. It incurred no expenditure and no receipts, and did not enter into transactions during the 90-minute period. Having regard to all the circumstances HY did not carry on the garage trade acquired from HG. HY did not carry on the trade of the garage business within the meaning of TA 1988 s 343 and the appellant was not entitled to the benefit of the trading losses accrued by HG. The appeal would therefore be dismissed in principle.

Appeal dismissed.

Controlled foreign company

In *Vodafone 2 v Revenue and Customs Commissioners*, the taxpayer company had a wholly owned subsidiary (VIL) which was incorporated in Luxembourg. The taxpayer's tax return for the relevant period did not include any entry for the profits of VIL. The then Revenue issued a notice of enquiry into the taxpayer's return. The taxpayer appealed, on grounds that the imposition of tax for the profits of the subsidiary under the controlled foreign companies (CFCs) legislation (principally TA 1988 ss 747, 748), was contrary to the freedom of establishment (art 43 EC), and/or the free movement of capital (art 56 EC).

Allowing the taxpayer's appeal, the High Court held that TA 1988 s 748(3) could not be construed as compliant with art 43. The CFC legislation had to be disapplied so that no charge could be imposed thereunder on a company such as the taxpayer.

Dividends received by non-resident company

In *Japan Post and others v Revenue and Customs Commissioners*, the claimants were non-UK resident companies, recognised as an arm of the Japanese Government and thus had no liability to UK tax. In the relevant periods, the claimants received dividends from UK companies. Under TA 1988 s 232 they were entitled to a tax credit in respect of the dividends, although they had not received a tax credit from the then Revenue in respect of all those dividends. The issue was whether TA 1988 s 824 entitled the claimants to a repayment supplement, recognising that the claimants effectively had overpaid an amount of tax where they had not yet received the tax credit due.

Refusing the claim, the High Court ruled that s 824 did not extend to companies which paid no UK tax and so the claimants had no entitlement to receive a repayment supplement.

Double taxation and corporation tax rate

The rules for giving double taxation relief on foreign income have not been altered to reflect the reduction in the corporation tax rate. HMRC have stated they will address the problem in Finance Bill 2009, with provisions backdated to 1 April 2008 to ensure that no income faces double taxation. In the meantime, HMRC will use their statutory discretion to give the necessary double taxation relief.

Mixer cap and changes in corporation tax rate

In her speech announcing the third reading of the Finance Bill, the Financial Secretary said—

"Owing to an unintended oversight, the rules for giving double taxation relief on foreign income did not get altered to reflect the reduction in the corporation tax rate. If that were uncorrected, some companies could face double taxation on a small part of a number of dividends received during this financial year. This technical matter obviously needs to be rectified, and HM Revenue & Customs (HMRC) will discuss the solution with business representatives to find the best possible fix. We will then address the problem in next year's Finance Bill, with provisions backdated to 1 April 2008 to ensure that no income faces double taxation. In the meantime, HMRC will use its statutory discretion to give the necessary double taxation relief."

This note gives some further detail about the problem that the Financial Secretary described and the process for coming to a solution.

HMRC will work with the Confederation of British Industry (CBI) and others to identify the most appropriate solution, consistent with the elimination of double taxation of dividend income and will publish draft clauses for comment.

In the coming year very little corporation tax liability will actually arise from dividends paid in the year, but companies will need to make quarterly instalment payments and possibly final corporation tax payments before any change to the law can take effect in next year's Finance Act. For this period HMRC will not deny foreign tax credit because of this mismatch.

Further details are given in question and answer format below. If you have any questions, please contact Andrew Page.

Double Taxation Relief (DTR) on dividends – questions and answers

How is dividend income taxed when a company's accounting period straddles a change in the corporation tax rate?

Dividend income is taxed in the same way as all other income. It is apportioned between the two financial years in proportion to the number of days falling in each year, in accordance with section 8 ICTA 1988. Section 834(4) clarifies that the apportionment must be on a time basis.

The effect is to tax all income of an accounting period at the average rate applicable for the whole period, including any dividend income. See HMRC guidance at CTM01405 for further detail.

For example, if a company has an accounting period to 31 December 2008, income of the period is apportioned between the 2008 and 2009 financial years in the proportion to the number of days of the period falling in each financial year. This produces a combined average rate applicable to all income of approximately 28.5 per cent.

How is the rate used in the "mixer cap" in section 799(1)(b) defined?

The mixer cap applies by reference to the statutory corporation tax rate on the day that the dividend is paid (see section 799(1A)). This cap limits the amount of tax that may be taken into account as underlying tax in relation to the dividend for the purpose of relieving double taxation.

What is the effect of this mismatch?

If a dividend is taxed at a rate that is higher than the mixer cap rate, the foreign tax credit will be capped at an amount lower than the corporation tax arising on the dividend, so a proportion of the dividend will be taxable without relief.

Can the difference be covered by Eligible Unrelieved Foreign Tax (EUFT)?

Not if the underlying rate of foreign tax on the dividend exceeds 28 per cent before the application of the mixer cap. The excess foreign tax up to a maximum of 45 per cent will give rise to EUFT and a dividend that has given rise to EUFT cannot also claim EUFT.

What will the solution be?

The Financial Secretary has given assurance that double taxation relief will not be restricted by reason of this unintended mismatch. HMRC will discuss exactly how the problem should be solved with business representatives, but in the meantime HMRC will work on the assumption that the mixer cap applies by reference to the rate of tax actually applying to the dividend, not the statutory rate and will give relief accordingly.

Can companies rely on this assurance?

Yes. This announcement represents a binding commitment by HMRC to exercise its managerial discretion to give double taxation relief in line with the Minister's statement.

Value Added Tax

VAT Disbursements: technical note

This article reviews the subject of when a charge to a customer can be treated as an "outside the scope" disbursement for VAT purposes, and looks at recent case law on the subject – the Tribunals have over the last year raised serious questions about HMRC's policy on a particular application of these rules, being the recharging of MOT test fees by a garage to a customer.

Background

The "rules" on disbursements are set out in Notice 700. The following extracts give the general principles and then HMRC's policy on MOT test fees.

Introduction and conditions for VAT disbursements

It is the practice in some trades and professions for some or all of the costs incidental to a supply, such as travelling expenses, to be described as disbursements and shown or charged separately on the invoice issued to the client. In many cases, these items do not qualify to be treated as disbursements for VAT purposes.

If...	Then...
these costs have been incurred by suppliers in the course of making their own supply to their clients	they must be included in the value of those supplies when VAT is calculated.

However,

If...	Then...
you merely pay amounts to third parties as the agent of your client and debit your client with the precise amounts paid out	you may be able to treat them as disbursements for VAT purposes and exclude these amounts when you calculate any VAT due on your main supply to your client.

You may treat a payment to a third party as a disbursement for VAT purposes if all the following conditions are met—

- you acted as the agent of your client when you paid the third party;
- your client actually received and used the goods or services provided by the third party (this condition usually prevents the agent's own travelling and subsistence expenses, telephone bills, postage, and other costs being treated as disbursements for VAT purposes);
- your client was responsible for paying the third party (examples include estate duty and stamp duty payable by your client on a contract to be made by the client);
- your client authorised you to make the payment on their behalf;
- your client knew that the goods or services you paid for would be provided by a third party;
- your outlay will be separately itemised when you invoice your client;
- you recover only the exact amount which you paid to the third party; and
- the goods or services, which you paid for, are clearly additional to the supplies which you make to your client on your own account.

All these conditions must be satisfied before you can treat a payment as a disbursement for VAT purposes.

Generally, it is only advantageous to treat a payment as a disbursement for VAT purposes where no VAT is chargeable on the supply by the third party, or where your client is not entitled to reclaim it as input tax.

If you treat a payment for a standard-rated supply as a disbursement for VAT purposes, you may not reclaim input tax on the supply because it has not been made to you. Your client may also be prevented from doing so because the client does not hold a valid VAT invoice.

Evidence for VAT disbursements

If...	Then...
you treat a payment as a disbursement for VAT purposes	you must keep evidence (such as an order form or a copy invoice) to enable you to show that you were entitled to exclude the payment from the value of your own supply to your principal. You must also be able to show that you did not reclaim input tax on the supply by the third party.

This example illustrates the invoicing procedure—

A registered person supplies standard-rated services to a client for a basic fee of £80. In addition, the supplier incurs £20 expenses which are passed on to the client, but which do not qualify for treatment as disbursements for VAT purposes. The supplier also pays £50 on behalf of the client in circumstances which qualify that payment to be treated as a disbursement.

The supplier must issue a VAT invoice to the client, showing—

Services	£80.00
Expenses	£20.00
Value for VAT	£100.00
17.5 per cent VAT	£17.50
Disbursements	£50.00
Total	£167.50

Examples of supplies which cannot be treated as VAT disbursements

The following are examples of supplies which might, for accounting purposes, be charged or itemised separately, but which cannot be treated as disbursements for VAT purposes—

Example 1— A solicitor pays a fee to a bank for the transfer of funds telegraphically or electronically to, or from, the solicitor's own business or client account.

VAT treatment—The solicitor cannot treat the bank's fee as a disbursement for VAT purposes. The service for which the charge is made is supplied by the bank to the solicitor rather than to the client. Although the bank's supply may be exempt from VAT, the fee when re-charged, even though at cost, is part of the value of the solicitor's own supply of legal services to the client and VAT is due on the full amount.

Example 2— A solicitor pays a fee for a personal search of official records such as a Land Registry, in order to extract information needed to advise a client.

VAT treatment—The solicitor cannot treat the search fee as a disbursement for VAT purposes. The fee is charged for the supply of access to the official record and it is the solicitor, rather than the client, who receives that supply. The solicitor uses the information in order to give advice to the client and the recovery of this outlay represents part of the overall value of the solicitor's supply. The solicitor must account for output tax on the full value of the supply.

Note—Where a solicitor pays a fee for a postal search, this may be treated as a disbursement since the solicitor merely obtains a document on behalf of the client. The client will normally need to use the document for their own purposes, such as to obtain a loan.

Example 3— A consultant is instructed by the client to fly to Scotland to perform some work.

VAT treatment—The consultant cannot treat the air fare as a disbursement for VAT purposes. The supply by the airline is a supply to the consultant, not to the client. The recovery of outlay by the consultant represents part of the overall value of the consultant's supply of services to the client. The consultant must account for output tax on the full value of this supply.

Example 4— A private function is held at a restaurant. The customer pays for the food, drink and other facilities provided, and also agrees to meet the costs of any overtime payments to the staff.

VAT treatment—The restaurant cannot treat the overtime payments as disbursements for VAT purposes. The supply by the staff is made to the restaurant, not to the customer. The staff costs are part of the value of the supply by the restaurant and VAT is due on the full amount.

Example 5— A manufacturer makes a separate charge to a customer for royalty or licence fees, which were incurred in making a supply to the customer.

VAT treatment—The manufacturer cannot treat the royalty or licence fees as disbursements for VAT purposes. The recovery of these fees is part of the manufacturer's costs in making the supply to the customer. The manufacturer must account for output tax on the full value of the supply, including the royalty or licence fees.

MOT test charges

This paragraph deals with the VAT treatment of MOT test charges. In particular, it explains the conditions which must be met if the MOT test fee charged by a test centre to an unapproved garage and recharged to the latter's customer is to be treated as a disbursement.

If you are a test centre

Then...	Provided that...
the fee you charge for carrying out an MOT test may be treated as outside the scope of VAT	it does not exceed the statutory maximum fee. Any discount you give to an unapproved garage should be treated as a normal trade discount (and does not represent consideration for any supply to you by the garage).

If you are an unapproved garage

And...	Then...
provided you show the exact amount charged by the test centre separately on the invoice to your customer, and meet the other conditions of paragraph 25.1.1	you may treat this element as a disbursement and outside the scope of VAT. Any amount you charge your customer over and above the amount charged to you by the test centre, is consideration for your own service of arranging the test on behalf of your customer and is taxable at the standard rate.
you choose not to treat the amount charged to you by the test centre as a disbursement, or you do not satisfy all the conditions set out in paragraph 25.1.1	you must account for VAT on the full invoice amount.

Recent cases

Solicitor's costs: A solicitor failed to account for VAT on a number of categories of costs which were charged on to clients, including telegraphic transfers, copies of Land Registry documents, and fees for land and bankruptcy searches.

The Tribunal agreed with HMRC that these costs were his own, and charging them on to clients should be liable to VAT. It commented that HMRC will allow by concession local authority search fees to be treated as disbursements where the exact cost is charged on to clients, but this solicitor did not do so. The full amount was therefore liable to VAT.

The solicitor failed to provide any convincing arguments to support a contention that only the "profit element" should be subject to VAT, or a contention that the assessment was excessive in its computation of the VAT due. The appeal was dismissed.

VAT Tribunal (20,330): *David John Curtis*

MOT tests

First case – Scotland, 2007

A trader had an unusual and unexpected success in respect of the recharging of MOT test fees to customers. The HMRC policy has been as follows, and has normally been accepted by traders and the Tribunal for over 10 years:

- MOT test fees are outside the scope of VAT;
- if a garage subcontracts the work and passes on the exact cost of the test to the customer, it can be treated as a disbursement and no VAT is added (an extra, VATable charge can be levied for arranging the fee);
- if a charge is passed on which is higher than the cost of the fee to the garage, it cannot be treated as a disbursement and the whole charge is subject to VAT.

The Scottish Tribunal nevertheless found that £35 of a £44 on-charge should be treated as a disbursement, contrary to Notice 700 section 25.1.1 and several decisions of the English Tribunal. The chairman remarked that none of these have binding authority, and the VAT notice fails to pay sufficient regard to the statutory monopoly of approved MOT testing stations on the charging of MOT fees. The customer was aware of the subcontracting (because the garage was not a licensed testing station – it could not legally make the supply), even though the details were not itemised on the invoice, and the supply of the test for £35 was clearly not part of the garage's own turnover.

VAT Tribunal (20,100): *G A Duncan (t/a Duncan Motor Services)*

Second case – England, 2007

Following the above decision in Scotland, another trader succeeded in arguing that he should only treat the "profit" from recharging the cost of MOT tests to customers as his turnover. HMRC argued that this could only be permitted if he itemised the exact amount charged to him by the testing station on his invoice to the customer, and showed the "profit" element as a separate charge.

In this case the Tribunal commented that it was clear that the trader (who represented himself) did not understand the law relating to agency or disbursement at any point – while carrying out the transactions concerned, before or after the hearing. However, he had been advised to display a notice in his premises explaining to customers that MOT tests were arranged as agent, and this was enough – in the view of the Tribunal – to make him legally into an agent. The various arguments put forward by HMRC's counsel about "secret profits" and contractual arrangements were dismissed.

The Tribunal commented on the following paragraph from Business Brief 21/96, which sets out HMRC's policy and on which HMRC sought to rely:

"*Any amount charged by an unapproved garage to its customer over and above the amount charged by the test centre is consideration for its own service of arranging the test as agent of the customer and is taxable at the standard rate. Where the unapproved garage shows the exact amount charged by the test centre separately on the invoice to the customer, and meets the other conditions of para 10.8 of the VAT Guide, it may treat this element as a disbursement and also outside the scope of VAT.*"

This was described as "extremely confusing at best, or otherwise just wrong".

There was also criticism of the Customs officer who had ruled that the full amount was chargeable. She was asked to comment on revised invoices which the garage owner had introduced in an attempt to satisfy Customs, describing the charge as "MOT – exempt: £36; sub-cont[ract] £9". She said these were "fine", which the chairman described as "a stunning remark". The description on the invoice was what HMRC appeared to rely on entirely, and this description was completely wrong: if the garage owner was "sub-contracting" the work (rather than arranging it as agent) then the whole amount should indeed be chargeable.

In conclusion, this case involved a detailed analysis of the contractual arrangements involved in providing MOT tests and a severe criticism of HMRC's policy and the officer's understanding of the law underlying that policy. It did not necessarily agree with the *Duncan* case (the chairman said that the facts were important and the facts may have been different), but it suggests that HMRC should reconsider Business Brief 21/96 and how it is applied.

VAT Tribunal (20,269): *Martin Peter Jamieson (T/A Martin Jamieson Motor Repairs)*

Third case – same chairman, 2007

Another taxpayer won a case contending that the amounts paid by customers for MOT tests should be treated as disbursements even if they did not meet the strict conditions laid down in HMRC policy (as set out in Business Brief 21/96). The Tribunal chairman was asked to set out his understanding of the law for HMRC to take away and consider. As it was the same chairman that decided the *Jamieson* case, this did not necessarily represent a significant body of opinion disagreeing with HMRC, but it showed that HMRC were keen to understand why they were losing the case.

The problem was that the garage, for commercial reasons, adopted an arrangement that was different from that described in BB 21/96. That supposes:

- the unapproved garage will pay a reduced fee to the approved MOT testing station, say £36 (free of VAT as a payment for an MOT test);
- the unapproved garage will itemise on its invoice to the customer the MOT fee of £36 and the "discount" or "arrangement charge" of £8, and output tax will be charged at the VAT fraction of £8.

Instead, this garage:

- paid the testing station the full £44 for the test, and showed the full £44 on its invoices to its customers;
- charged the testing station a fee for arranging the test and ferrying the car to and from it (in fact rather higher than the normal discount, but no more than was necessary to cover the costs of the ferrying service, given the distance between the garages).

HMRC argued that the effect of these apparently separate transactions was a single transaction in which the "ferrying charge" was actually a discount; having recharacterised the two transactions in this way, it would not be possible to treat the MOT fee as a disbursement because the actual amount paid was not itemised on the invoice to the customer.

The garage owner, representing herself, explained that there really were two separate transactions. She had charged the customer the exact amount paid for the test to the approved garage, and believed that she had done what BB 21/96 required.

While the dispute was in progress, the person responsible for ferrying cars died, and a different, closer testing station started to be used. The arrangements were changed to match HMRC's understanding of BB 21/96. The garage owner said that this had caused confusion and some loss of business: some customers thought that the garage was making an unjustified profit in the disclosed discount, and some thought that they could obtain their MOT test more cheaply by going direct to the testing station.

The Tribunal held that there was no justification in treating the two transactions as one. Although there was no written agreement establishing the delivery charge, it was clear that something was done for the payment that was invoiced and paid by the testing station to the garage. The only justification that the HMRC officers appeared to have was the following statement in BB 21/96: "*The discount given by a test centre to an unapproved garage will be treated as a normal trade discount and will no longer be seen as consideration for a taxable supply by the unapproved garage either to the test centre or its customer.*" The chairman noted that this dealt with the proper treatment of a discount, but it did not require a genuine arrangement of the type seen here to be recharacterised as such a discount.

Having decided that the two transactions were separate, the Tribunal had to consider whether the test was arranged as agent for the customer, in which case the £44 recharged could be treated as a disbursement. Although this was not straightforward, given that it was unlikely that either party would understand the legal theory of agency, the Tribunal was satisfied that this was an agency arrangement. As he observed in *Jamieson*, the Tribunal chairman commented that HMRC's approach ought to be based on an understanding of agency law, but appeared to concentrate only on what appeared on the invoices.

The chairman suggested some possible wording for signs that could be displayed in garages to establish the agency relationship beyond doubt. These wordings covered both the "HMRC preferred" discount approach and the "two transactions" approach favoured by the garage in this case.

VAT Tribunal (20,567): *KJ Lower & Mrs SJ Lower*

Fourth case – different chairman, 2008

Now another Tribunal has come out even more strongly against HMRC's policy on garages passing on MOT testing fees to their customers. The argument was much the same as in the earlier cases, but here the trader did not display a sign indicating that tests would be carried out by someone else. HMRC argued that failure to disclose the discounted fee paid to the tester meant that the garage could not be acting as an agent.

Dr Avery Jones extended the earlier decisions by looking at the 6th Directive (art.79 in the renumbered version). He held that the Directive did not require the separate identification of the recharged amount to make it a disbursement. He also held that there was no requirement of the domestic law to require such identification – the statement in the VAT Notice was "advice not law".

The decision concludes with the following criticism, which surely must lead to a reaction from HMRC:

If we may add a postscript agreeing with the Tribunals in Jamieson *and* Lower and Lower *that Customs' guidance is completely unhelpful to people like the Appellant who was doing his best to comply with the law while running a vehicle repair business. We are grateful to Mr Ruck Keene for his detailed analysis of the law of agency, most of which the Appellant not surprisingly said went over his head, but garages are not interested in understanding fine points of law, and nor should they be required to do so. There is a need for Customs to issue some revised guidance in this area setting out clearly to the public and their officers how garages should avoid the trap of being treated as a principal. The guidance currently given to officers (V1-37 Control Notes para 3.1.2) saying that 'If the business is an unapproved garage, they will normally have to "sub-contract" MOTs to an approved test centre' the disbursement route is available on satisfaction of various conditions depends on the quotation marks round "sub-contract" to give it the exact opposite meaning.*

VAT Tribunal (20,627): *Carl John William Denton t/a Denton Auto Repairs*

Article by Mike Thexton

Lecture B489 (20.31 Minutes)

Zero-rating—potato products

In *Proctor & Gamble UK v Revenue and Customs Commissioners*, HMRC issued a decision letter determining that the taxpayer's product, "Regular Pringles", a savoury snack, was standard-rated for the purposes of VAT on the basis that it fell within the exception to zero-rating found in VATA 1994 Sch 8 Group 1 item 5. The principal question related to whether the taxpayer's product fell within excepted item 5 as being "similar products made from the potato, or from potato flour, or from potato starch,".

Allowing the taxpayer's appeal, the High Court held that Regular Pringles were not products within excepted item 5 (see *De Voil Indirect Tax Service* **V4.226**).

Fiscale eenheid Koninklijke Ahold NV v Staatssecretaris van Financiën

Facts and issues

The claimant calculated and declared VAT on sales in the supermarkets in the Netherlands operated under its aegis on the basis of the total amount per till receipt or "shopping basket". The amount of each till receipt was rounded up or down to the nearest cent (up if the third decimal place in the euro amount was 5 or more, otherwise down), and VAT was determined on the total of the amounts so arrived at. However, in two supermarkets, the claimant made a different calculation for its own purposes—it rounded the selling price of each item, rather than each till receipt, and in every case rounded down. It further calculated that the VAT liability arrived at on that basis in the period at issue was some €1,400 less than the amount actually declared and paid, and applied for reimbursement of that amount, which was refused. In the course of the proceedings brought by the claimant challenging that refusal, the Hoge Raad der Nederlanden sought from the European Court of Justice a preliminary ruling on the questions (1) whether rounding of VAT amounts was governed solely by national law or was a matter for Community law, and (2) if the latter, whether Community law required the member states to permit rounding down per article.

Article 11(A) of Sixth Council Directive 77/388/EEC (as amended by Council Directive 91/680/EEC) ("the Sixth Directive") provides—

"The taxable amount shall be—(a) … everything which constitutes the consideration … obtained by the supplier from the purchaser …"

Article 22 provides—

"… (3)(a) Every taxable person shall issue an invoice … (b) The invoice shall state clearly the price exclusive of tax and the corresponding tax at each rate as well as any exemptions … (4) … (b) The return shall set out all the information needed to calculate the tax that has become chargeable … including, where appropriate, … the total value of the transactions relative to such tax … (5) Every taxable person shall pay the net amount of the value added tax when submitting the regular return …."

Decision

(1) Neither the Sixth Directive nor First Council Directive 67/227/EEC contained a specific rule as to rounding of VAT amounts. While articles 11(A)(1)(a), 22(3)(b) and 22(5) of the Sixth Directive were capable of referring by implication to rounded amounts of VAT, they did not lay down any express rule as to the manner in which it was to be carried out. In interpreting VAT provisions, account was to be taken of objectives as well as wording. It was clear from Second Council Directive 67/228/EEC that the objective of the turnover tax was to achieve equal conditions of taxation for the same supply in all Member States, and the objectives of the relevant provisions of the Sixth Directive were the following—article 11(A)(1)(a) – to guarantee uniformity of the taxable amount; article 22(3)(b) – in relation to the particulars which had to appear on invoices, to ensure that the internal market functioned properly; articles 22(4) and (5) – to ensure that the tax authority had available to it all the information required in order to calculate and collect the exact amount of tax payable. It could not be inferred from the objectives of those provisions, any more than from their wording, that a specific method of rounding had been laid down by Community law. The matter was therefore one for each of the Member States, which, in establishing or accepting a particular method of rounding, had to observe the principles underpinning the common system of VAT, and particularly those of fiscal neutrality and proportionality. The answer to the first question was therefore that in the absence of specific Community legislation, it was for Member States to decide on the rules and methods of rounding amounts of VAT, those States being bound, when making that decision, to observe the principles underpinning the common system of VAT, in particular those of fiscal neutrality and proportionality.

(2) In the light of the answer to question (1), question (2) was to be taken as asking whether only one method of rounding, namely, rounding down per item, was capable of satisfying the principles of fiscal neutrality and proportionality. The principle of fiscal neutrality, as applied in the circumstances, required that taxable persons not be treated differently, with regard to the

method of rounding applied in the calculation of VAT, in respect of similar services which were in competition with each other (see *Solleveld v Staatssecretaris van Financiën (Joined Cases C-443 and 444/04)* [2007] STC 61, [2006] ECR I-3617, para 35 and the case law there cited), and that the amount of VAT to be collected by the tax authority correspond exactly to the amount of VAT declared on the invoice and paid by the final consumer to the taxable person (see *Elida Gibbs Ltd v Customs and Excise Comrs (Case C-317/94)* [1996] STC 1387, [1996] ECR I-5339, para 24). That did not entail any obligatory particular method of rounding, so long as the correspondence between the amount of VAT to be collected by the tax authority and the amount declared on the invoice and paid by the final consumer was ensured. As to proportionality, VAT was "a general tax on consumption exactly proportional to the price of goods and services"— article 2, first paragraph, of the First Directive. That principle required that any rounding be carried out in such a way that the rounded amount corresponded as closely as possible with the amount of VAT arising from application of the rates in force. Since it was clear from inter alia the illustrative calculations provided in the observations submitted to the court that several methods of calculation could satisfy that requirement, no obligatory use of any one particular method of rounding could be inferred from the principle of proportionality, either. The answer to the second question was therefore that Community law, as it stood at present, entailed no specific obligation for Member States to permit taxable persons to round down per item the amount of VAT.

VAT—Amendment to the Exemption for Fund Management Services

Budget Notice 74 – VAT—Amendment to the Exemption for Fund Management announced changes to the VAT exemption for fund management services and that draft legislation and guidance would be published in April.

After this announcement, we discussed various aspects of the changes with business representatives and, following this, now publish drafts of the legislation, Explanatory Memorandum and guidance.

– Exemption for the management of "special investment funds" – Guidance

– Draft Statutory Instrument and Explanatory Memorandum

Exemption for the management of "special investment funds"

Article 135(1)(g) of the Principal VAT Directive exempts "the management of special investment funds as defined by Member States".

Until 30 September 2008, UK law (Items 9 and 10, Group 5, Schedule 9 to the VAT Act 1994) defined the following funds for the purposes of the exemption—

– Authorised unit trust schemes (AUTS)

– Open-ended investment companies (OEICs)

– Trust-based schemes (TBS)

AUTS and OEICs are UK open-ended collective investment schemes, regulated by the Financial Services Authority (FSA) as authorised investment funds (AIFs). TBS are single property schemes and none have been authorised in recent years. The category is now largely redundant and has been deleted from the VAT exemption with effect from 1 October 2008.

Further changes from 1 October 2008 have followed the ECJ judgment in JP Morgan Fleming Claverhouse Trust plc [2008] STC 1180 ("Claverhouse" case C-363/05) which ruled on the interpretation of the term "special investment funds as defined by Member States".

The key points in this judgment are—

1. the term "special investment funds" is capable of including closed-ended investment funds, such as investment trust companies (ITCs);

2. Member States have a discretion to define "special investment funds" for the VAT exemption but, in doing so, must pay due regard to—

a. the purpose of the exemption;

b. the principle of fiscal neutrality.

According to the Court, the purpose of the exemption is to facilitate investment in securities for investors through investment undertakings. In particular, this requires that there is VAT neutrality between the choice of direct investment in securities and investment through collective investment undertakings. Furthermore, there must be equality of treatment of funds which are similar to, and in competition with, funds falling within the scope of the exemption such as those covered by the UCITS Directive (this sets out common EU rules for the regulation of "Undertakings for Collective Investment in Transferable Securities")

Collective investment undertakings (CIU)

As the name suggests, CIU are in the business of collective investment ie they pool and invest capital raised from the public and do so for a fee or "management charge". It is this management charge that is the subject of the VAT exemption. CIU may be constituted in various legal forms eg under statute as companies (such as OEICs), under trust law (such as AUTS) or by contract (the French fonds communs de placement "FCP" is an example). Common to all of these is that investors hold shares or units in the CIU, but the CIU may be open-ended or closed-ended.

Open-ended means that the CIU has variable capital. The number of shares in issue continually changes as new shares are issued to new investors and shares are cancelled when investors decide to cash them in. The shares are regularly valued (often daily) as being the net asset value (NAV) in the fund, divided by the number of shares in issue.

Closed-ended means that the CIU has fixed capital. Following an initial issue of shares, the number of shares in issue remains fixed (subject to further one-off issues). Unlike an open-ended CIU, there is no requirement to redeem shares from investors who wish to cash them in. Rather, the shares are traded on a stock exchange so that investors can buy and sell them at the market rate. This market rate may be higher or lower than the corresponding NAV, in which case the shares are said to be trading at a premium or discount to the NAV.

VAT exemption for the management of open-ended collective investment schemes

Item 9 and the Notes to Group 5 (amended from 1 October 2008) set out the open-ended funds to which the exemption applies. In summary these are collective investment schemes which are—

– All UK-established AUTS and OEICs; or

– Recognised overseas schemes

The UCITS Directive provides a framework for the common regulation of open-ended CIU within the European Economic Area (EEA). The case-law has made it clear that CIU complying with the UCITS Directive are "special investment funds" for the VAT exemption. The relevant UK regulations refer to Collective Investment Schemes (CIS) and this term applies to UK AUTS and OEICs. Most of these are UCITS compliant, but there are also "retail non-UCITS" (such as funds of alternative investment funds "FAIFs") and "non-retail" (qualified investor schemes or "QIS").

Recognised overseas schemes fall into three basic categories—

– Collective investment schemes established elsewhere in the EEA, which are authorised as UCITS-compliant in their own Member State and where notification has been given to the FSA of the intention to market the units to UK investors. This category will also cover schemes established in Gibraltar.

– Collective investment schemes established in Guernsey, Jersey, the Isle of Man and Bermuda, which have similar regulation to UK CIS and have been recognised by the FSA so that their units can be marketed to UK investors.

– Collective investment schemes established elsewhere, which have similar regulation to UK CIS and have been given an individual recognition order by the FSA so that their units can be marketed to UK investors.

Umbrellas and sub-funds

Many larger CIU are "umbrellas" whereby the assets are separated into distinct "sub-funds". It is important to note that, for the purposes of the legislation, each sub-fund is treated as a collective investment scheme in its own right. By way of example, a SICAV (a form of OEIC) established in Luxembourg is an umbrella with, say, 30 sub-funds. If it is intended that shares in 5 of the sub-funds are to be sold to UK investors, notification must be given to the FSA. Amongst other things, this notice must contain the name of the SICAV and of each of the sub-funds to be marketed to UK investors. In this case, only the 5 sub-funds are recognised overseas collective investment schemes for the VAT exemption. Recognised overseas schemes (including details of the relevant sub-funds) are included in the FSA register, accessible via the Financial Services Authority website.

VAT exemption for the management of closed-ended collective investment undertakings

Item 10 and the Notes to Group 5 (amended from 1 October 2008) set out the meaning of "closed-ended collective investment undertaking" for the VAT exemption. In arriving at this definition, account has been taken of criteria similar to those for the open-ended funds in item 9. This includes a comparable (albeit under different regimes) level of regulation, and the market for investment by the general public in the UK. If the CIU satisfies the conditions in the definition, it will qualify for the exemption regardless of where it is established. Taking these conditions in turn—

The sole object is the investment of capital raised from the public, wholly or mainly in securities. The assets are managed on the principle of spreading investment risk.

There is some consistency between these conditions and the definition which currently applies to open-ended CIU in the UCITS Directive. This, too, refers to the sole object being investment of capital raised from the public and the investment restrictions in that Directive ensure that investment risk is spread across eg a range of securities. In interpreting "sole objective", no regard should be had to secondary investment aims – for example investing in particular markets or in "ethical" investments. Rather this means that the CIU must not carry on any activity other than that of collective investment. "Wholly or mainly" means that at least 50 percent of the assets consist of securities which, as elsewhere in the VAT exemptions, includes equity and debt securities as well as other financial instruments eg financial derivatives.

All of the ordinary shares (or equivalent) are included in the UK Official List

By listing, the CIU must comply with rules made by the FSA in its capacity as UK Listing Authority.

All of the ordinary shares (or equivalent) are admitted to trading on a regulated market in the UK

EU-wide minimum standards of regulation apply to those CIU whose shares are traded on a regulated market. These concern the detail to be provided to investors in the CIU prospectus and other disclosure requirements. Currently, the only regulated markets in the UK are the main London Stock Exchange (LSE), the PLUS trading platform for listed securities and SWX Europe (formerly Virt-x, a London exchange for certain Swiss companies). Other markets operated by the LSE, eg AIM are not regulated markets.

In practical terms, most CIU which are investment trust companies (ITCs) or venture capital trusts (VCTs) meet these conditions. Real estate investment trusts (REITS) are unlikely to meet the condition for investment "wholly or mainly in securities".

Meaning of "management"

As noted above, the VAT exemption concerns the management charge or fee which is normally deducted from the assets in the CIU periodically. In most cases, the manager is required by regulation to be a separate entity – for example the authorised corporate director (ACD) of an OEIC or the operator of an AUTS. Following the judgment in *Abbey National (C-169/04)*, it is clear that the term management refers to the activities of administering the CIU as well as investment management activities. This is particularly relevant when considering the liability of services delegated by eg the ACD to a third party. In this case, investment management services provided by a third party (usually under a mandate) are also exempt as part and parcel of the management of the fund.

Similarly, if a third party is delegated to carry out a package of administrative services which overall has the distinct characteristic of a single supply of fund management services, this too will be exempt. However, some services will not have such a characteristic – for example, the services of a solicitor may be required to draft, or assist in drafting, legal documents which are essential to the operation of certain CIU (eg a trust deed or prospectus). Such services have the characteristic of legal services and so cannot fall to be treated as fund management.

There is more potential for delegated administrative services to be seen as characteristic of fund management with open-ended CIU than with closed-ended CIU. This is because the activities which make up the administration of open-ended CIU are more extensive and are prescribed in their regulation. Also, a key feature of open-ended CIU is the requirement for regular valuations of the units. Services which consist of this are peculiar to and so characteristic of the management of such funds.

Input Tax

Input tax incurred on costs which are used exclusively to make exempt supplies is not deductible. Similarly, input tax attributed to exempt supplies under a partial exemption method is not deductible. Unlike other exempt financial services, there is no entitlement to deduct input tax in respect of fund management services when the customer of those services is established outside the EU.