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Corporation Tax

1.1 Reduction in the main rate of corporation tax

Section 6 sets the main rate of corporation tax for the Financial Year 2009 at 28%. The reduction from 30% with effect from 1 April 2008 was implemented by Finance Act 2007. There are no changes to the limits applying to the full rate, and therefore no changes impacting upon the payment of tax by quarterly instalments by companies liable to full rate on their profits.

1.2 Increase in the small company rate of corporation tax

Section 7 deals with the rate of corporation tax paid by small companies with profits of up to £300,000. This is 21% for the Financial Year 2008. The fraction for the marginal small companies relief purposes is 7/400, which provides a marginal rate of 29.75% on profits between £300,000 and £1.5 million.

The small company rate is due to rise again for the Financial Year 2009. The rates of small company tax and the related marginal rate borne on profits in excess of the £300,000 threshold are :

	Small company rate	Marginal rate
FY starting 1 April 2008	21%	29.75%
FY starting 1 April 2009	22%	29.5%

1.3 Rates of Research and development tax relief

Section 26 of Finance Act 2008 refers us directly to Schedule 8 of the Act. The commencement date for these changes is 1 August 2008, as the relevant commencement order was made on 22 July 2008 as SI 2008/1933. This means that State Aid approval has now been obtained for these changes (where necessary).

1.3.1 SME rate of relief

Para 1 of Schedule 8 changes all references under SME R & D relief from 150% to 175%. It also amends the rate of payable tax credit down from 16% to 14%. This has the following effect :

Pre FA 2008 :

Qualifying spend	100
R & D relief	50
Total deduction / R & D loss	150
Tax credit relief	16%
Tax credit paid	**£24**

Post FA 2008

Qualifying spend	100
R & D relief	75
Total deduction / R & D loss	175
Tax credit relief	14%
Tax credit paid	**£24.50**

So advice about surrendering R & D losses must be carefully considered in view of the depressed rate of relief, compared to the rates of tax payable, at which rates relief would be obtained in the future by

the alternative of carrying forward losses and offsetting them against future profits. The change applies to expenditure incurred on or after the commencement date.

1.3.2 Large company rate

The rate applying to the large company scheme is increased from 1 April 2008 from 25% to 30%. Although part of Section 26 and Schedule 8 this aspect of the changes has a fixed commencement date in para 2(2), as opposed to an uncertain date in para 1(5) which specifies a Treasury Order for commencement.

1.3.3 Vaccine Research relief rate

This is dealt with by para 3 of Schedule 8 and is also subject to the same commencement order, and therefore commence on 1 August 2008. The rate of Vaccine research relief is reduced from 50% to 40%. Because the relief is phrased differently for SME's and large companies, the actual rates quoted are in some cases 40% from 50% and in some cases 140% from 150%, but the practical effect is the same. The change applies to expenditure incurred on or after the commencement date.

1.4 Qualifying expenditure – R & D relief and VRR.

The definition of qualifying expenditure for the SME scheme has been slightly amended by Section 27 so that in respect of staff costs it also includes social security contributions paid by the company in another EEA State or Switzerland, as a parallel to the allowance for employer's NI contributions in the UK.

Qualifying expenditure for the purpose of Vaccine Research Relief has been restricted by removing the category "contributions to independent research and development" which was originally in subpara (c) of para 2(1) of Sch 13 to FA 2002. This change leaves VRR applying only to qualifying expenditure on direct R & D and expenditure on subcontracted R & D, which has further been modified by removing the favourable treatment applied to charities, universities and scientific research associations. All subcontract R & D is now treated in the same way, with the rules about connected person treatment applying to all subcontract VRR.

1.4.1 Commencement

The Appointed day for this change is 1 August 2008, the relevant order being issued on 22 July 2008 (SI 2008/1930). The change therefore applies in respect of expenditure incurred on or after that date.

1.4.2 Commencement Order – previous changes

Finance Act 2006 allowed payments to those taking part in clinical trials to be treated as qualifying expenditure for the purposes of VRR. The commencement order for this change (in Section 28 FA 2006) was issued on 16 July 2008 (SI 2008/1878) and commences the change from 1 August 2008.

1.5 Companies in difficulty

In order to meet the requirements of the EC State Aid scheme, the SME and Vaccine Research relief schemes are amended so that claims will not be open to companies whose last set of accounts was not prepared on a going concern basis. This change is implemented by Section 28 and Schedule 9 of FA 2008.

1.5.1 Technical summary

Schedule 9 deals with the change by inserting new conditions into the legislation providing for the two forms of relief (SME : new para 18A of Sch 20 to FA 2000; VRR : new para 18A of Sch 13 to FA 2002). The new condition is that a company may only make a relevant claim or election under the relief provisions if it is a going concern. If a company ceases to be a going concern after it has made a claim for tax credit (that is the payable element of relief) it is to be treated as if it had not made the claim, unless the amount has been paid or applied before the company ceased to be a going concern.

A company is a going concern for these purposes if its last published accounts (under company law) were prepared on a going concern basis and nothing in those accounts indicates that they were prepared on such a basis because of the expectation of relief or tax credits under SME or VRR legislation.

1.5.2 Commencement

The commencement Order for Section 28 and Schedule 9 was issued as SI 2008/1929 and provides a commencement date of 1 August 2008.The new rules apply to claims and elections made, and amounts paid or applied on or after that date.

1.6 Cap on R & D Aid

Once again, in order to comply with the State Aid rules, a cap on claims is introduced, by Section 29 and Schedule 10 to the Act. The cap applies to the SME R & D scheme, and the Vaccine Research Relief (VRR) scheme. The limit of relief under these schemes will be €7.5 million per R & D project.

1.6.1 Technical summary

Section 29(1) simply states that a company is only entitled to R & D relief if at that time the total R & D aid in respect of expenditure by the company attributable to that project would not exceed €7.5 million. R & D relief is defined as any relief or tax credit under Sch 20 FA 2000 (SME scheme) and Sch 13 FA 2002 (VRR scheme). Total R & D aid is to be calculated in accordance with Part 1 of Sch 10 of FA 2008 (see below). The balance of Schedule 10 is consequential amendments.

1.6.2 Computing R & D Aid

The main purpose of Sch 10 is to provide a methodology to compute the R & D awarded so far on a project. Note that the restriction to €7.5 million is on a project by project basis, although the rules do not apply retrospectively (see below) so companies will need to bear the cap in mind when preparing records of R & D claims made in future. In reality as the amount is substantial, and VRR is an unusual activity it is likely that only larger claimants will be subject to this cap. Note that large companies can claim VRR and therefore may be subject to this restriction.

The total R & D aid (A) received in respect of a particular project is given by the following formula :

$$A = (TC + R + (P \times CT)) - (N \times CT)$$

The following terms are used : (all of which relate only to the specific project under consideration)

TC is the aggregate amount of tax credits paid to the claimant under both Sch 20 FA 2000 and Sch 13 FA 2002. Tax credits claimed but not yet paid should be included unless already refused.

R is the actual reduction in tax liability, which is the aggregate of the amounts by which the CT liability has been reduced as a result of R & D relief, and the amounts of reduction of other companies CT liabilities as a result of the surrender of losses arising in consequence of R & D relief through group relief.

P is the potential relief, which is the aggregate amount of any R & D relief (other than tax credit) which has been claimed but which has not been brought into account by the claimant or any other company (this represents the unrelieved losses). Exclude claims which have already been refused.

CT is the main (i.e. large company) rate of corporation tax at the date of the calculation.

N is the notional relief which is the total amount of relief the claimant could have claimed under Sch 12 FA 2002 (large company R & D scheme) had it been a large company.

Thus the calculation values unrelieved losses at the full rate of corporation tax, irrespective of the likely claim rate, but then isolates the “favourable” element for SME and VRR by reducing the aid figure by the amount which could have been claimed under the large company scheme.

1.6.3 Commencement

The transitional provisions are in para 7 of Sch 10. This provides that no account shall be taken of any R & D relief in respect of expenditure incurred before the commencement of these rules. Thus the computation only applies to aid in respect of expenditure incurred in the future, in respect of which claimants can be aware that they need to record relief on a project basis, to provide the data for the calculation. The appointed day order was issued on 22 July 2008 (SI 2008/1928) and the commencement date is 1 August 2008.

1.7 Declaration about effect of relief

Large companies claiming VRR are now required to make a declaration as to the incentive effect of the additional relief they have received. Any claim to VRR by a large company must be accompanied by a declaration that the availability of the relief claimed has resulted in an increase in either the amount, scope or speed of the research and development undertaken by the company, or the company's expenditure on research and development.

There is, however, no requirement that this effect be quantified, so the requirement can be met by including a simple statement to that effect on the claim by the large company.

1.7.1 Commencement

The appointed day order is SI 2008/1925 and was issued on 22 July 2008. The appointed day for the purpose of Section 30 is 1 August 2008. The declaration is therefore required in relation to claims made on or after that date.

The cap will not apply to the large company R & D scheme, as it is not regulated by the State Aid rules, as the rate of relief is lower.

1.8 FA 2007 – definition of SME

The size criteria applying to SME were doubled by FA 2007, Section 50. The commencement Order has now been issued in respect of this change. (SI 2008/1880) and the appointed day is 1 August 2008. This means that the size criteria are amended in respect of expenditure incurred on or after 1 August 2008, but in respect of that expenditure are deemed always to have been the greater amounts.

Reminder – old and new limits for SME

	Old	New
Employees	250	500
Turnover	€50 million	€100 million
Balance Sheet value	€43 million	€86 million

Companies must meet the employee limit and one of the remaining two.

1.9 Associated companies

Section 35 amends the associated companies rules. This change forms part of an ongoing process of simplification of corporation tax for small companies.

Section 35 starts by amending the principal legislation in Section 13 of ICTA 1988. In subsection (4) the meaning of control for these purposes is referred out to Section 416 TA. The new legislation limits the application of Section 416(6) in treating a person as an associate of another person (P) when they are a partner of P. Partners are only treated as associates of P when the condition in new Section 13(4A) is met. The context for identification of associated persons, is that rights of an associate of P are attributed to P in determining common control of two companies.

New Section 13(4A) provides a condition that relevant tax planning arrangements (as defined by new Section 13(4B) and (4C)) have at any time had effect in relation to the taxpayer company. Relevant tax

planning arrangements involve P and the partner and secure a relevant tax advantage – which is a reduction in the company's tax liability as a result of increased relief under this section.

1.9.1 Practical effect

Companies which have previously been treated as associated because they are under the control of persons who are members of a partnership will no longer be regarded as associated by virtue of this connection. The change takes effect from 1 April 2008, but will in practice apply to the first accounting period of any company which commences on or after that date (as companies remain associated if they have been associated at any time in the accounting period).

1.10 Company investments in life assurance contracts

Where life assurance contracts are held as investments by companies (other than life insurance companies), there are highly complex rules determining how the gains on these policies are taxed. These are all repealed by Sch 14, as Section 36 and Schedule 13 provide a new tax regime for gains on such policies. The new regime brings policies within the loan relationship rules for tax purposes.

1.11 Trading profits : changes in trading stock

Section 37 and Schedule 15 introduce rules to deal with what are termed "certain changes in trading stock". These largely specify the value to be used when goods are appropriate from or transferred into trading stock.

1.11.1 Summary

In essence, the new legislation gives statutory effect to the case of Sharkey v Werner which determined that goods removed from stock should be accounted for at market value. Changes in the requirement for accounts to be drawn up in accordance with Generally Accepted Accounting Principles meant that the accounting treatment should prevail, and companies had been challenging the legal force of Sharkey v Werner for some time.

The changes detailed below have effect in relation to changes in trading stock occurring on or after 12 March 2008.

Schedule 15 falls into two parts, Part 1 relating to income tax, which amends ITTOIA 2205, and Part 2 which relates to Corporation Tax, which measures stand alone until the tax law rewrite of Corporation Tax consolidates them into main legislation. The provisions are, however, identical. The references are provided in the detail below.

1.11.2 Definitions

Common definitions are used, the definition for income tax forming new Section 172A ITTOIA, and for corporation tax will remain as para 5 of Sch 15 to FA 2008.

Trading stock is anything which is sold in the course of the trade, or would be so sold if it were complete. It includes land and property, but does not include raw materials, services and articles used or produced in the performance of services performed in the ordinary course of the trade.

1.11.3 Appropriation of trading stock

Where trading stock is appropriated by the trader for any other purpose, the amount treated as received is the open market value of the goods, and any value received is ignored. The receipt is treated as arising on the date of the appropriation. (New Section 172B and para 6 Sch 15 FA 08)

1.11.4 Trading stock supplied by the trader

Where goods belong to a trader but are not part of the stock of the trade, and are transferred into trading stock, the cost attributed to the stock acquired is to be treated as the open market value at the time. The

cost is treated as incurred on the date of the transfer into stock. (New Section 172C and para 7 Sch 15 FA 08).

1.11.5 Disposals not made in the course of trade

Where trading stock is disposed of other than in the course of trade, and otherwise than by appropriation, the open market value is to be used for the disposal, except where transfer pricing rules take precedence. (New Section 172D, subject to 172F, and para 8 subject to para 10 of Sch 15 FA 08).

1.11.6 Acquisitions not made in the course of trade

Any acquisition of trading stock which is not made in the course of the trade, and to which Section 172C or para 7 do not apply is treated as made at open market value on the date on which the acquisition was made, unless the transfer pricing rules take precedence. (New Section 172E, subject to 172F, and para 9, subject to para 10).

1.12 Gift Aid Supplement

As a result of the reduction in the basic rate of income tax, charities faced losing a significant amount of income in relation to Gift Aid payments. Until charities can encourage donors to increase their net donation, in view of the reduced tax deduction, they would suffer a shortfall in donated income.

Section 53 and Schedule 19 provide for additional gift aid payments as a supplement to the standard gift aid tax claims for a period of three years, giving charities time to adjust and seek more donations. Claims will, however, have to be made separately for the supplement, which is known as "gift aid supplement". The time limit is two years from the end of the year to which the claim relates.

The legislation has been written sufficiently flexibly to allow for further variations in the basic rate of tax during the three year period (known as transitional tax years). The transitional supplement will always be 2%, so if the basic rate were to reduce further charities would not receive sufficient supplement to reinstate the 2007/08 position.

1.13 Anti avoidance : leasing of plant and machinery

Section 55 and Schedule 20 include legislation designed to counter avoidance associated with leasing plant and machinery. Four types of avoidance are dealt with by the measures, all of which were notified under the disclosure of tax avoidance scheme rules.

Sale and finance leaseback

Rules were introduced in 1997 to counter tax avoidance involving the sale and finance leaseback of plant or machinery by entities that were not liable to tax. These arrangements relied on the purchaser being able to claim capital allowances on the plant or machinery it leased back to the original owner. These rules allow most of the sales proceeds to be received untaxed but restricted the capital allowances that could be claimed by the purchaser. Abuse of these rules was partially countered in 2004 but new arrangements continue to exploit the 1997 rules.

This measure removes the 1997 legislation that is being exploited, as well as some of the rules introduced in 2004. In order to ensure that the avoidance countered in 1997 does not return, leases in sale (or lease) and finance leaseback arrangements are brought within the scope of the long funding lease rules.

Long funding leases

A lessor under a long funding lease is not entitled to claim capital allowances on the cost of the leased asset but, to compensate, it is only taxed on a small proportion of the lease rental income. Avoidance schemes have been developed that purport to establish an alternative deduction for the cost of the leased asset, particularly by claiming that the leased asset has been acquired on trading account. If these arrangements are effective they will generate a tax loss approximately equivalent to the cost of the leased asset, even though there is no commercial loss.

This measure puts beyond doubt that where a deduction is available for the cost of the leased asset the rules restricting the amount of taxable income do not apply.

Mismatched lease chains

A business may act as an intermediate lessor, leasing in plant or machinery under one lease and leasing it out under another. Such leases may be broadly similar but be designed to exploit differences in the way in which leases are taxed. The avoidance involves arrangements which allow the business, as lessee, to deduct all the lease rentals payable under the lease but, as lessor, to be taxed on only a small portion of the rentals receivable. This creates a tax loss where there is no commercial loss.

This measure ensures that rentals received by intermediate lessors are taxed on the same basis as rentals paid and that intermediate lessors are taxed on their commercial profits.

Lease premiums etc

Businesses were granting leases on plant or machinery for a premium plus a small amount of annual rentals. The premium, which is commercially broadly equivalent to the sale of the asset, escaped tax because it is not brought in as a disposal receipt for capital allowances purposes and little or no tax would be payable under the chargeable gains regime.

This measure ensures that premiums and similar sums are taxed as income of the lessor where they are not otherwise taxable as income or as a capital allowances disposal receipt.

1.14 Anti avoidance : sale of lessor companies

Section 56 modifies previous anti avoidance legislation by ensuring that where a partnership carries on a leasing business and that business is transferred to a single limited company the existing legislation works properly. The original legislation on the sale of lessor companies (in Sch 10 FA 2006) places a charge on the seller and relief for the buyer of the leasing business. A technical flaw in the rules means that in the circumstances where a partnership sells the business to a single limited company, although there is a charge on the partnership, there is no corresponding relief on the purchaser company. This Section corrects that flaw.

1.15 Capital allowances : thermal insulation

The tax treatment of expenditure on thermal insulation installed in industrial buildings is that it is classified as plant and machinery by S28 CAA 2001. Section 71 amends this legislation to extend the same treatment to all thermal insulation in any building used for a trade, with the exception of expenditure in dwelling houses and expenditure which is also allowable as energy saving items. The new tax treatment applies to expenditure incurred on or after 1 April 2008 for corporation tax and 6 April 2008 for income tax. The expenditure will attract 10% writing down allowance (see Integral Features)

1.16 Capital allowances : fire precautions

Section 29 of CAA 2001 allows expenditure on required fire precautions to be treated as expenditure on plant and machinery. This provision is repealed by Section 72 in relation to expenditure incurred on or after 1 April 2008 for corporation tax and 6 April 2008 for income tax.

1.17 Capital allowances : Integral Features

Fixtures in buildings often qualify as plant and machinery and until now have attracted a 25% per annum writing down allowance. Section 73 makes significant changes to this rule by segregating certain expenditure as relating to Integral Features, and qualifying for a reduced rate of WDA of 10%.

1.17.1 Technical summary

Section 73 starts by deleting from the list (List C) in section 23 CAA 2001 the following items :

- Electrical systems (including lighting systems) and cold water
- Space or water heating systems; powered systems of ventilation, air cooling or air purification; and any floor or ceiling comprised in such systems, and
- Lifts escalators and moving walkways.

These items previously qualified as plant, as the list is of items unaffected by Sections 21 and 22 which specify the components of a building and structures for capital allowance purposes (these being outside the remit of plant and machinery allowances).

Next, the relevant section describing expenditure on the provision or replacement of integral features is inserted in CAA 2001 at Section 33A. Section 33A is also excluded from the remit of Sections 21 and 22 by FA 2008 S 73(1)(a). Section 33A defines the relevant expenditure as plant and machinery for the purposes of CAA 2001.

The following are then listed as integral features :

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

However, the assets listed do not include any asset whose principal purpose is to insulate or enclose the interior of a building or to provide an interior wall, floor or ceiling which (in each case) is intended to remain permanently in place.

The new classification will mean that some fixtures, which are currently classified as part of the building and do not generally attract any capital allowances, will in future attract 10 per cent capital allowances. Assets in this category are :

- general electrical lighting and power systems; and
- cold water systems.

Re-classifying these systems as plant and machinery will also entitle businesses that invest in these systems, where the expenditure includes items of equipment on the 'Green Technology' ECA list, to a 100 per cent capital allowance on those items. Currently, expenditure of this type is not usually classified as plant and machinery and so cannot qualify for the enhanced allowances.

1.17.2 Replacement expenditure

The legislation describes expenditure on replacement integral features in new Section 33B. The treatment of replacement expenditure is the same as the treatment of expenditure on new integral features, so it will attract capital allowances at the new 10% rate, but will not be allowed as a deduction in the computation of profits.

For this purpose, expenditure incurred on an integral feature which is more than 50% of the cost of replacing the integral feature when the expenditure is incurred is treated as replacement expenditure. If an amount is incurred which is less than 50% of the replacement cost, but further expenditure is incurred within 12 months on the same feature, the total expenditure in the 12 month period is compared to 50% of the replacement cost, and if the limit is exceeded then the replacement expenditure provision applies to all of the expenditure.

Section 73(3) and (4) make the necessary amendments to the provisions regarding computation of profits for tax purposes to exclude expenditure on integral features.

1.17.3 Second hand features

Where a building includes fixtures which were acquired before the new regime came in, it will be necessary to segregate out integral features for these purposes when the building is sold. This means that assets which are currently within the main pool will move across into a 10% pool on first disposal of the building or structure on or after 1 or 6 April 2008. Where the transfer is between group companies, integral features can retain the same treatment in the hands of the acquirer as the disposer, and may be transferred at tax written down value by election under para 17 Sch 26 FA 2008. Sale between other connected parties will not allow expenditure which did not previously qualify for allowances to come within the special rate pool (ref Sch 26 FA 2008 para 15)

Where the features concerned were previously plant and machinery, the value attributed to them will be subject to the election under S198 CAA 2001. However where assets which have not previously qualified as plant and machinery now form part of the amount transferred, these assets will have to be identified and a value attributed to them – this aspect is not subject to the election under S198.

1.18 Capital allowances : Annual Investment Allowance (AIA)

Section 74 and Schedule 24 introduce the new annual investment allowance, which will provide a deduction from profits of the first £50,000 in any year that the business invests in plant and machinery, other than cars.

1.18.1 Claimants

Under new Section 38A CAA 2001 (inserted by para 2 Sch 24 FA 2008) the AIA will apply to qualifying expenditure on plant and machinery – covering the vast majority of capital assets, apart from buildings. Qualifying expenditure is incurred by a qualifying person on or after the relevant date.

For these purposes a qualifying person is :

- an individual;
- a partnership of which all of the members are individuals, or
- a company.

The relevant date for corporation tax is 1 April 2008, and for income tax 6 April 2008.

1.18.2 Exclusions - expenditure

The general exclusions from qualifying expenditure are :

- Expenditure in the final period of trade
- Expenditure on a car (as defined by Section 81 CAA)
- Expenditure in respect of a ring fence trade (oil trades)
- Expenditure incurred in connection with a change in the nature or conduct of a trade of a person other than the person incurring the expenditure and the obtaining of AIA is the main benefit of the making of the change
- Expenditure to which any of the following sections applies :
  - Section 13 – acquisition of assets which were previously use for other purposes (deemed expenditure0
  - Section 13A – plant and machinery preciously used for long funding leases
  - Section 14 – use for qualifying activity of plant and machinery which is a gift.

The annual allowance is £50,000, with a pro rata amount available for shorter or longer periods. All qualifying expenditure up to that level will receive a 100 per cent first-year allowance, which may be disclaimed as desired. Any additional expenditure over the £50,000 level is dealt with in the normal capital allowances regime, entering either the 10 per cent or 20 per cent pool. Claimants are permitted to choose which assets are covered by AIA, so that the allowance is given in the most favourable way. Note that AIA differs from FYA's in that a writing down allowance may be claimed in the same year as the AIA, providing more than £50,000 of allowances if the expenditure exceeds the limit.

The AIA does not replace the existing 100 per cent enhanced capital allowances (ECA) schemes for 'Green Technology'; these will continue to be available. Similarly, expenditure that qualifies for 100 per cent capital allowances under separate capital allowances codes (for example, Business Premises Renovation Allowances, Flat Conversion Allowances or Research & Development Allowances) will be unaffected by the introduction of the AIA.

1.18.3 Restrictions – companies and groups of companies

Single companies which are not members of a group will each receive a single annual allowance to be used in respect of all qualifying trades carried on in a period. Companies which fall within the company law definition of a group will receive a single allowance across the whole group; they may choose how this is to be shared between them. Where more than one group is under common control and those groups are related to one another, only one amount of AIA is available between the related groups.

Where companies (or groups of companies) are under the control of the same person or persons, the allowance will only be restricted if the companies are related to each other.

1.18.4 "Control" of companies and groups

The control test is performed for a financial year, and a company or group is controlled by a person for a financial year if it is controlled by them at the end of the chargeable period ending in that financial year. Control takes the meaning in Section 574(2) CAA 2001, which means that the person is able to secure (whether by the holding of shares or otherwise) that the affairs of the company are conducted in accordance with that person's wishes.

1.18.5 "Related " – companies

Companies are related to each other in a financial year if either

- the shared premises condition, under which at the end of the chargeable period the companies carry on qualifying activities from the same premises, or
- the similar activities condition, under which more than 50% of the turnover of each company is derived from qualifying activities within the same NACE classification.

are met in relation to the companies in the financial year. If companies C1 and C2 are related, then company C1 is also related to any other companies that are related to C2 for that financial year. A similar test operates for groups of companies, whereby groups are related if any member of one group is related to a member of the other.

The NACE classification is the first level of the common statistical classification of Economic activities in the EU established by Regulation (EC) No 1893/2006 of the European Parliament and the Council of 20 December 2006.

1.18.6 Unincorporated businesses

Each business that is carried on by a sole trader or by individuals in partnership will receive a single annual allowance in its own right, even where the individual owns a number of businesses or is involved in a number of partnerships. The related businesses rule will only restrict the availability of the annual amount where the businesses are controlled by the same person or persons, and once again occupy the same premises or carry on the same business.

1.18.7 Business activities under common control

Where a qualifying activity is carried on by a person other than a company, the control and related tests are performed for a tax year. The control test is defined for unincorporated activities by new Section 51I, under which a qualifying activity carried on by an individual is controlled by that individual, although in respect of partnerships the control test is the existing test in section 574(3) – the right to more than half of the assets or income. The related test merely test the activities rather than the turnover.

1.18.8 Periods longer than 12 months

Where unincorporated businesses have an accounting period of longer than 12 months, the annual amount is scaled up but the operation of this is highly complex where businesses are also under common control and the "related" rule applies to them for a tax year. The correct treatment is set out in Sections 51M and 51N, and provides a methodology for both scaling up the allowance and sharing it between the two or more activities.

1.18.9 Anti avoidance

As the allowance is generous, there are specific anti avoidance rules. The annual investment allowance is denied if an arrangement is entered into for a disqualifying purpose. This applies if the main purpose or one of the main purposes is to enable the person to obtain AIA to which they would not otherwise be entitled.

1.18.10 VAT liabilities arising subsequently

AIA follows other capital allowance rules in providing that any VAT subsequently incurred in relation to expenditure would also qualify for allowance, in the period in which the additional liability accrues.

1.18.11 Transitional rules

The annual investment allowance (AIA) will apply to qualifying expenditure incurred on or after 1 April 2008 in the case of businesses within the charge to corporation tax, and on or after 6 April 2008, for businesses within the charge to income tax. The existing capital allowances rules for determining when expenditure is incurred will apply to determine whether expenditure is incurred before or after the 1 or 6 April start date.

For those businesses whose chargeable periods span the 1 or 6 April 2008 start date, the AIA will be proportionately reduced or increased on a time-apportioned basis.

Thus, for a company with a chargeable period starting on 1 January 2008 and ending on 31 December 2008, the AIA available (from 1 April to 31 December, i.e. for 9 months) will be ¾ of £50,000 = £37,500. In other words, the AIA will simply be reduced on a time apportioned basis.

Example 1

A small company has a year-end of 31 December. It spends £30,000 on a new lorry on 1 February 2008 and £45,000 on a new lathe on 30 November 2008.

The £30,000 qualifies for a 50% first-year allowance (FYA) of £15,000 and the balance of the expenditure (£15,000) will go into the general pool in the next chargeable period.

As the company's chargeable period spans 1st April 2008, its AIA is reduced proportionately to ¾ of £50,000 = £37,500. So, £37,500 is written off against the expenditure on the lathe. The balance of the expenditure over the AIA (i.e. £45,000 - £37,500 = £7,500) is added to the general pool and will qualify for a hybrid 21.25 % writing-down allowance. 21.25% x £7,500 = £1,594.

The total allowances due will therefore be:

- 50% FYA: £15,000
- AIA: £37,500
- WDA: £1,594
- Total: £54,094

Example 2

A sole trade (small enterprise) starts up in business on 1 March 2008 and incurs expenditure of £20,000 on a baler in March 2008 and £65,000 on a tractor in November 2008. The first accounts are drawn up to 31 July 2009.

The £20,000 qualifies for a 50% FYA of £10,000 and the balance of the expenditure (£10,000) will go into the general pool in the next period.

As the period of account spans 6th April 2008 and is also longer than 12 months, the AIA is calculated on a time-apportioned basis. The number of days from 1 April 2008 to 31 July 2009 is 487 so the AIA calculation is 487/365 x £50,000 = £66,712. So, the total expenditure of £65,000 on the tractor will qualify for 100% AIA. Therefore, the total allowances due will be:

- 50% FYA: £10,000
- AIA: £65,000
- Total: £75,000

1.19 Capital allowances : First year allowances

The first year allowances available to small and medium sized businesses up to 31 March (5 April) are abolished by Section 75. The first year allowance remains in respect of additional VAT liabilities incurred after the date of change on expenditure to which FYA's related. Section 76 repeals other spent FYA legislation.

1.20 Capital allowances : Low emission cars

The existing allowance of 100% on new cars emitting no more than 120g/km of CO_2 is modified by Section 77 as follows :

- The expiry date is extended to 31 March 2013, and
- The emissions rating is reduced to 110 g/km from 1 April 2008.

Cars leased before 31 March 2008 continue to benefit from the 120g/km limit so that their lease payments are not restricted.

1.21 Capital allowances : Alternative fuels

The existing first year allowance of 100% on expenditure on gas refuelling stations is extended to 2013 by Section 78.

1.22 Capital allowances : First year tax credits

Companies (but not other businesses) will be permitted to claim first year (payable) tax credits in respect of losses arising as a result of certain first year allowances. The detailed provisions are in Section 79 and Schedule 25, which inserts Schedule A1 into CAA 2001..

Where a company has claimed ECA allowances and this has resulted in the company showing a trading loss (or a loss making company has claimed the allowances) the company will be able to surrender any unrelieved loss relating to the 100% ECA for payment.

The loss is reduced by deducting relief available against other income in the accounting period, and group relief must also be claimed if it is available. Deduction is also made for losses carried back against earlier periods to the extent claimed. The balance will be an unrelieved loss and may be surrendered in return for a payable tax credit at a rate of 19%. This (the payment, not the loss surrendered) will be capped at the following limit : the greater of :

- The total PAYE and NIC liabilities for the period for which the loss is surrendered, or
- £250,000.

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Where the related plant or machinery is sold within four years of the end of the period for which the tax credit was paid, the tax credit will be clawed back.

Claims will be made on a corporation tax return, or amended return, meaning that the time limit for claim will be 24 months after the end of the accounting period. Where the equipment is of a type for which a certificate is necessary to approve qualification for ECA, the certificate must accompany the claim. The amount of the tax credit claimed will be identified separately on the return, to comply with EU state aid rules.

The new payable tax credit relates to qualifying expenditure incurred on or after 1 April 2008, and runs until 31 March 2013.

1.23 Capital allowances – main rate of WDA

The rate of writing down allowance given on plant and machinery in the pool reduced from 25% to 20% with effect from 1 April 2008 for companies and 6 April 2008 for income tax businesses. Section 80 makes the necessary changes.

The same rate will apply to single asset “expensive car” pools, but the cost limit of £12,000 and the upper limit on the WDA of £3,000 has not been changed, in view of the changes to the allowances system for cars to be implemented from 2009. This produces a somewhat distorted effect when calculating the WDA on a car with net value of between £12,000 and £15,000.

For a period spanning the date of change, a hybrid rate is computed by time apportioning the 25% and the 20% rates by reference to days. The resulting rate is rounded up to the second decimal place.

Example 1

A company has a year end of 30 September 2008. The following WDA will apply for that year :

6/12 x 25%	12.5%
6/12 x 20%	10.0%
Total	**22.5%**

Example 2

A sole trader has a 16-month chargeable period that starts on 1 September 2007 and ends on 31 December 2008. Her chargeable period spans more than a year (it amounts to 1.33 years). In this situation, s.56(3) CAA 2001 provides that the rate of writing-down allowance (WDA) should be increased proportionately. Thus, had the 25% rate still applied, the trader’s effective rate of WDA would have been increased to 1.33 x 25% = 33.33%.

On this basis, her hybrid rate would be similarly increased as follows:

- 1 September 2007 to 5 April 2008 - 218 days at WDA rate of 25%. The rate for this part period is: 218 / 366 x 25% = 14.89%
- 6 April 2008 to 31 December 2008 - 270 days at WDA rate of 20%, the rate for this part period is: 270 / 365 x 20% = 14.79%
- Therefore hybrid rate to be applied to her chargeable period of 1.33 years is (14.89 + 14.79) = 29.68%

Example 3

A sole trader newly starting up in business has an initial period of account of 28 months that starts on 1 September 2006 and ends on 31 December 2008. His period of account therefore spans a period of 2.33 years. In this situation s.6(6) CAA 2001 applies, so that the first and second chargeable periods are periods of 12 months and the third chargeable period is a part period of 4 months or 0.33 of a year.

In this example, the hybrid rate applies only to the second chargeable period, as follows:

- First period: 1 September 2006 to 31 August 2007, WDA 25%, as currently.
- Second period: 1 September 2007 to 31 August 2008

For this period, his hybrid rate would be calculated as follows:

- 1 September 2007 to 5 April 2008. 213 days at WDA rate of 25%, the rate for this part period is 218/366 x 25% = 14.89%
- 6 April 2008 to 31 August 2008. 148 days at WDA rate of 20%, the rate for this part period is 148/365 x20% = 8.11%
- Therefore hybrid rate for the second period = (14.89 + 8.11) = 23%

In the third period: 1 September 2008 to 31 December 2008 (0.33 of a year), the rate of writing down allowance will now be the new rate of 20 per cent and 0.33 of 20% = 6.6%.

Example 4

A company has a chargeable period that starts on 1 January 2008 and ends on 31 December 2008 and owns an 'expensive car' in a single asset pool, which has been written down to a value of £20,000 by 1 January 2008.

The single asset pool in this example would be subject to the hybrid rate of 21.25%. (3/12 x 25% + 9/12 x 20%)

21.25% of £20,000 = £4,250, which exceeds the cap of £3,000 so allowances for this period would be restricted to £3,000.

Example 5

Using the facts in the previous example, but assuming that the written-down value as at 1 January 2008 had become £14,000, the hybrid rate would, once again, be 21.25%. 21.25% of £14,000 = £2,975.

This is less than the cap of £3,000, so allowances for this period would be £2,975.

1.24 Capital allowances : Small pool write off

Section 81 introduces a new writing down allowance in relation to small pools. The allowance will be given to write off in full a pool of expenditure when the balance on the pool falls to £1,000 or less.

The allowance claimed may be the entire balance on the pool, if no more than £1,000, or such lower sum as the business desires. This makes the measure flexible for income tax businesses. The calculation of the balance on the pool will be the available qualifying expenditure less the total disposal receipts, that is the balance before WDA is computed.

This measure commences for accounting periods starting on or after 1 April 2008 for companies and 6 April 2008 for income tax businesses. It will apply only to the main plant and machinery pool and the "special rate", that is the 10% pool.

1.25 Capital allowances : special rate expenditure and pool

Sections 82, 83 and Schedule 26 set out the detail of the new "special rate" expenditure and pool, which will attract writing down allowances at 10% per annum.

Schedule 26 inserts Section 104A into CAA 2001, which lists special rate expenditure as follows :

- Expenditure incurred on or after the relevant date on thermal insulation of buildings,
- Expenditure incurred on or after the relevant date on integral features,
- Long life asset expenditure incurred on or after that date, and
- Long life asset expenditure incurred before that date but allocated to a pool in a chargeable period beginning on or after that date.

The relevant date is 1 April 2008 for corporation tax and 6 April 2008 for income tax.

Special rate expenditure is allocated to the special rate pool, which is a class pool (meaning that balancing allowances are only granted on the cessation of trade), unless other parts of CAA require that it is allocated to a single asset pool (mainly through use partly for non business purposes). Special rate expenditure is not eligible for short life asset election.

Existing long life assets in the long life pool are to be written down by a hybrid rate of allowances for the period spanning the relevant date, and the balance on the long life pool is then transferred to the special rate pool. The hybrid rate is arrived at by time apportioning the 6% rate applying to long life assets with the new 10% rate from the relevant date.

Example

A company has a chargeable period beginning on 1st January 2008 and ending on 31st December 2008.

(i) Pre-existing expenditure

At 1 January 2008, it has unrelieved expenditure of £1million in the 6 per cent long-life asset pool. A hybrid rate therefore needs to be calculated on a time apportioned basis as follows:

- 1/1/08 to 31/3/08 = 3 months at WDA rate of 6%. So the rate for this part period is 1/4 x 6% = 1.5%
- 1/4/08 to 31/12/08 = 9 months at WDA rate of 10%. So the rate for this part period is ¾ x 10% = 7.5%
- Hybrid rate on existing pool for the chargeable period = 9.0%

Therefore WDA on £1 million at 9 per cent = £90,000 and balance of unrelieved expenditure to be carried forward into new 10 per cent pool = £910,000.

(ii) New "10% expenditure" incurred after April 2008

On 1 May 2008, the company incurs new expenditure of £400,000 on additional long-life assets and on 31 August 2008 it incurs £100,000 on assets falling within the new classification of "integral features".

This total expenditure of £500,000 will receive the full 10 per cent rate in the company's 2008 chargeable period. So this expenditure will give rise to allowances of 10% x £500,000 = £50,000, leaving £450,000 to be carried forward in the 10% pool.

Thus, from 1 January 2009 (after the transitional period), the total in the new 10% pool will be £910,000 + £450,000 = £1,360,000.The pool will in future attract 10% WDA.

1.26 Capital allowances : phasing out and abolition of IBA's and ABA's

Section 84 abolishes Industrial Building Allowances and Agricultural Buildings Allowances with effect from 1 April or 6 April 2011. Schedule 27 makes various consequential amendments, but also includes a provision retaining a balancing charge in respect of enterprise zone allowance expenditure in respect of balancing events within 7 years of the allowance being given.

Section 85 provides for the phasing out of allowances in the run up to abolition. The amount of WDA given in each year is calculated by taking the amount that would otherwise be available and applying the following reducing factors:

Financial year beginning 1 April 2007 & earlier financial years	Tax year 2007-08 and earlier tax years	100 per cent
Financial year beginning 1 April 2008	Tax year 2008-09	75 per cent
Financial year beginning 1 April 2009	Tax year 2009-10	50 per cent

Financial year beginning 1 April 2010	Tax year 2010-11	25 per cent
Financial year beginning 1 April 2011	Tax year 2011-12	0 per cent

For period spanning the financial year for corporation tax and tax year for income tax, the allowances given are arrived at by time apportioning the allowances arrived at using the table above.

The residue of chargeable expenditure at any time is calculated by reference to the WDA which would have been given without the adjustment required by this provision. This means that the tax written down value transferred to a subsequent owner will be reduced by a **full** WDA each year.

Section 86 retains writing down allowances for enterprise zone expenditure in full throughout the transitional period. Section 87 includes anti-avoidance provisions designed to prevent the sale of a building to trigger a tax advantage by duplicating allowances. The provision applies to buyers and sellers under control of the same person or who are connected (ref Section 567 CAA 2001).

Example

A company is entitled to industrial buildings allowances (IBAs). It has a chargeable period that starts on 1 January 2008 and ends on 31 December 2008. Its annual entitlement to IBAs will be made as normal (either under s.310 or s.311) and that amount will then be time-apportioned.

In this example the annual amount is calculated at £46,000. So the time apportionment calculation would be as follows:

- 1 January 2008 to 31 March 2008: ¼ of £46,000 x 100% = £11,500
- 1 April 2008 to 31 December 2008: ¾ of £46,000 x 75% = £25,875

Year ended 31 December 2008, total IBAs deductible in computing profits £37,375

In the year ended 31 December 2009, assuming no new expenditure is incurred, the time apportionment will be:

- 1 January 2009 to 31 March 2009: ¼ of £46,000 x 75% = £8,625
- 1 April 2009 to 31 December 2009: ¾ of £46,000 x 50% = £17,250

Year ended 31 December 2009, total IBAs deductible in computing profits £25,875.

1.27 Capital allowances : anti avoidance

Section 89 introduces a new Section 343ZA into ICTA, which provides that where a trade is transferred between companies in order to obtain the benefit of balancing allowances on plant and machinery the transfer will not produce that effect. Section 343ZA does not apply where Section 343 (Company reconstructions without a change of ownership) applies, but invokes Section 343(2) to mean that the transfer is treated as a succession to a trade and the allowances are given to the successor company as for a continuing trade.

1.28 Anti avoidance : spreading pension contributions

Section 90 amend the pension legislation in FA 2004 to ensure that where a large contributions which would otherwise be subject to spreading is routed indirectly through an intermediate party (sometimes a scheme) then spreading applies to the payment as if it were a payment direct into the scheme. The change applies to payments made on or after 10 October 2007 unless they are payments made pursuant to a contract entered into before 9 October 2007.

1.29 Capital allowances : Enhanced capital allowances (ECA's)

The existing scheme of 100% first year allowances for expenditure on energy efficient technology and water saving technology continue, with further technologies and assets being added to the lists of approved items. These allowances are generally referred to collectively as ECA's.

The Water Technology list will include one new technology :

- Waste water recovery and re-use systems.

The energy technology list will be revised to include four additional new sub-categories :

- Compressed air master controllers
- Compressed air flow controllers
- Heat pump dehumidifiers, and
- White LED lighting.

The qualifying criteria in relation to combined heat and power units will also be revised to ensure that those which burn solid waste materials as a fuel will also qualify. New lists were issued in late July 2008, and more information can be found at www.eca.gov.uk

1.30 Disincorporation for smaller companies

Some very small businesses may believe now that they do not wish to trade through a limited company as the tax savings are now too small to justify the expense of running the business though a company. In this case, advising about disincorporation involves covering a wide range of difficult tax issues.

Steps to disincorporation – phase 1 the practicalities

- Cease trading in the company and recommence trading privately. This will involve ensuring that invoices are no longer issued in the name of the company, and that all documents issued by the business make it clear that the company is no longer trading.
- New business stationery may be required
- The client may also need to contact suppliers to ensure that any credit accounts in the company name are closed and new accounts opened in the name of the sole trader.
- The trader will need to open a new bank account for the new business. It would be very risky to continue to use the company bank account, as this would at best be regarded as transactions passing through the director's loan account, and at worst that the company is still trading.

Advice to clients will need to be specific and clear, so that they understand what they need to do regarding the practicalities of trading under a new name. There are also a few formalities to be completed at this stage :

- Dealing with the VAT registration (if appropriate). It is not necessary to transfer the VAT number from the company to the sole trader, and many clients will probably prefer to register afresh. This can be achieved in around 2-3 weeks under normal circumstances.
- Registering the trader as self employed. This can be done online if desired. The trader must register to pay Class 2 NIC within three months of commencing trade as a sole trader otherwise a penalty of £100 can apply.

Steps to disincorporation – phase 2 dealing with the assets of the company

- Assets in the company's name will need to be transferred back into the name of the sole trader. The values of the assets for this purpose will need to be arrived at and the trader will need to pay for the assets he takes over. This may prove problematical, both in valuation and in cash terms, as the trader may not have sufficient cash to fund the balance. He may also be unwilling to "purchase" what he regards as his own assets.

- The degree of difficulty and complexity involved in this phase is directly related to the value of the assets on the company balance sheet. The extraction of very many tangible fixed assets can mean that disincorporation becomes an expensive and therefore unattractive option.
- Valuation of the assets is more risky than when the company was set up, when any reasonable value would be acceptable. Now that the assets are to be transferred back into the name of a sole trader, who is also a director of the company, there is a risk that under values will prompt a P11D benefit in kind, with associate tax and NIC implications, plus penalties if this has been overlooked.
- For capital allowance purposes, the assets can be transferred at tax written down value. To do this the company and the trader must jointly elect for this treatment within two years of the date of transfer. If this is the chosen route, remember that there can be no allowances in the final period of trade in the company, as only balancing adjustments would be available. The opening tax written down value in the final period plus the cost of additions in that period is transferred to the sole trader. The loss of AIA could be a significant factor.
- Transferring the assets and trade from the company to the sole trader is a transfer of going concern for VAT purposes, and attracts no VAT on the value of the assets.
- Removing goodwill from the company back into private ownership can generate a capital gain in the company, on which corporation tax is payable. The expectation is that in a very small company, there is unlikely to be goodwill of sufficient value to cause a problem, but it should be remembered that there is no relief against such a gain arising in the company.
- This will be a particularly tricky aspect if goodwill was introduced into the company when it was formed. IT is very unlikely that if the goodwill had value some three to five years ago that HMRC will accept that it has no value now. Do not overlook goodwill that has been amortised down to nil.
- If the company has been incorporated since 2002, and the goodwill attracted intangibles relief in the company, the disposal of the goodwill does not result in a capital gain, but in a profit, as goodwill which is subject to the intangibles rules is a revenue item not a capital item. The profit is calculated by reference to the tax written down value. In this case, the tax cost of disincorporating could be sufficient to dissuade the client from this course of action.

Steps to disincorporation – phase 3 winding the company up

There are two options once the balance sheet has been reduced to a single asset – normally the bank account. The company can either be liquidated, or struck off as inactive.

- The proceeds of winding up the company would attract entrepreneurs' relief if the company has been a trading company and the shares have been owned for at least twelve months. This would be applicable on liquidation of the company, but would also be available in the event that the company is struck off, provided the proceeds are treated as capital not revenue.
- Where the company is to be struck off as inactive, the proceeds will only be taxed as capital if clearance is obtained under ESC C16. In future Extra Statutory Concessions are to be included in legislation, but for the present clearance will be necessary as has been the case until now.
- Where the balance sheet shows a debt due by a participator to the company, HMRC may be willing to accept that this debt is treated as part of the distribution to the shareholders. However, it is very important that this is included in the letter of clearance, as otherwise the write off of the loan due by the director could be taxed as income from employment, with both tax and NIC implications.
- It is also important that if there is a debt due by the director that the striking off is progressed as quickly as possible otherwise the tax due under Section 419 would become payable, and this would then interfere with the striking off of the company, as this asset would pass to the Crown unless repaid before the striking off. However, the time delay involved means that once the nine month due date for the original liability has passed, there can be a delay of up to 21 months before the tax is due to be repaid to the company.

- Where the company is to be struck off as inactive, technically the share capital cannot be distributed as this can only be repaid to shareholders on liquidation. In this case, sufficient cash should therefore technically be left in the company to cover the share capital. This would then pass to the Crown. If the cash is distributed to the members, then the Crown obtains the right to pursue the shareholders for the return of this money. The Bona Vacantia guidance on the repayment of share capital on form BVC 17 (see www.bonavacatia.gov.uk) states that where the technically illegal distribution does not exceed £4,000 no action will be taken to recover from the shareholders.
- Note also that the Companies Act 2006 will allow companies to reduce share capital by repaying it to shareholders. When this particular provision commences this will present a solution for companies with shares in excess of £4,000.

The use of ESC C16

The undertakings given under ESC C16 allow the distribution on the dissolutions of the company to be treated as a capital distribution and thus obtain the benefit of the CGT annual exemption, and Entrepreneurs' Relief if sufficiently large to warrant it. This involves a director providing certain undertakings to HMRC in return for the agreement to capital treatment. The text of the concession follows :

C16 Dissolution of companies under the Companies Act 1985 ss 652, 652A: distributions to shareholders

A distribution of assets to its shareholders by a company which is then dissolved under the Companies Act 1985 s 652 or s 652A (or any comparable provisions) is strictly an income distribution within TA 1988 s 209. In most circumstances and providing that certain assurances are given to the inspector before the event, the Revenue is prepared for tax purposes to regard the distribution as having been made under a formal winding-up so that the proviso to s 209(1) applies. The value of the distribution is then treated as capital receipts of the shareholders for the purpose of calculating any chargeable gains arising to them on the disposal of their shares in the company.

The assurances include :

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

HMRC Manuals – ESC C16 guidance

The HMRC manuals explain (in the company taxation manual) how ESC C16 is to be operated :

36220: Distributions treated as being made on formal winding up [June 2007]

If all the following conditions are satisfied, you may agree to treat distributions made in circumstances described in CTM36205 as if they had been made in the course of a formal winding-up. They are treated as if a formal winding-up commenced on the date the company declared its intentions to seek or accept striking off and dissolution, or at an earlier date if the company had then ceased to carry on business and commenced to distribute its assets.

Liability under Section 209 ICTA 1988 will not then arise on the distributions of assets to shareholders. But, any CGT liability that would arise on such distribution must be paid. It should be borne in mind that it may not always be in the interest of the company and its members to make this tax arrangement. You should make it clear to the company that the arrangement is made on the assumption that the company will be struck off and dissolved. The arrangement may be cancelled, and the full tax charged, if the company is not dissolved (see CTM36240).

The concession is not necessarily refused because not all the conditions are met. Where a company requests concessionary treatment, and the conditions are not all met, submit the case to CT&VAT (Technical).

Treatment of assets loaned to participators – HMRC guidance

36205: Distributions prior to

Companies that cease business may wish to save the costs etc involved in the formal winding-up procedure under the Insolvency Act 1986.

They can do this by either:

- asking the Registrar of Companies to strike the company off the Joint Stock Companies Register and so dissolve it under Section 652 Companies Act 1985,

or

- ·becoming inactive and waiting to be so struck off and dissolved.

Dissolution under Section 652 is not considered to amount to a winding-up under the Insolvency Act. You should not refer to it as a winding-up, nor as an ‘informal liquidation’.

Such companies normally pay off their creditors and distribute the remaining assets to their shareholders. As there is no winding-up, Section 209(1) ICTA 1988 does not apply and these distributions normally fall within Sections 209(2)(b) and (4) ICTA 1988 (see CTM15250 and CTM15350). These provisions should not, however, be applied where the arrangements described in CTM36220 to CTM36240 can be made with the company and its members.

Where a company other than one having a share capital proposes to distribute its assets and seek or await striking off, the case should be submitted to CT&VAT (Technical).
Where a notification is received that a company may be struck off the Joint Stock Companies Register, see AC1350 onwards, INS2303 and INS6104.

36210: Loans to participators

A company that has ceased business and appears to be seeking or awaiting striking off may allege that it has made no distributions but merely passed its assets to shareholders on loan. This may be an indication that the company intends to continue in existence. Liabilities may arise in respect of loans or the use of assets, – see SE21000 onwards, as regards directors and higher paid employees and CTM60500 onwards and CTM61500 onwards as regards participators and associates.

Usually, the company will have overlooked Section 654 Companies Act 1985 (property of dissolved company to be bona vacantia). If a company is dissolved under Section 652 Companies Act 1985 any assets belonging to the company immediately before dissolution belong to the Crown. This provision, and any liabilities in respect of loans etc, should be drawn to the company's attention. If the company then agrees that it has distributed or will distribute its assets, CTM36205 and CTM36220 to CTM36240 may be applied.

If loans to participators etc are called in to allow the company's assets to be distributed before dissolution, according to the members' interests in a winding-up, there should be no difficulty. Any Section 419 ICTA 1988 tax on close company loans repaid (or released or written off on or after 6 April 1999) will be cleared under Section 419(4). However, loans may be set off, cancelled, released etc or the right to recovery may be transferred to one or more shareholders in satisfaction of their rights to share in the company's assets. These transactions should be taken into account in measuring the total amount realised by any shareholder in respect of his shares for CGT purposes. Exceptionally, such transactions may also give rise to transfers of value between shareholders, or between shareholders and others. Liability under Section 421 ICTA 1988 may arise on close company loans released or written off (CTM61630).

Where money due from a shareholder is not collected but is set against his share of the company's assets (including his debt), the loan should be treated for Section 419(4) purposes as repaid up to the amount of the loan or of his share of the assets, whichever is less.

Where loans to participators etc, which are made in an accounting period ending on or after 31 March 1996, are repaid, whether by set off of the shareholders' assets or otherwise, Section 419(4A) ICTA 1988 applies to the repayment. Therefore, if a loan is repaid more than nine months after the end of the accounting period in which it was made, relief is deferred until the due date for the accounting period in which the repayment takes place. The practical effect of this is that the company cannot dissolve itself under Section 652 Companies Act 1985 until Section 419(4) relief is due.

Companies House guidance on striking off

Notice GBW2 explains the striking off process – an extract follows :

A company may be struck off the register and dissolved if:

- it has applied to the Registrar to be struck off; or
- the Registrar concludes that it is not carrying on business or in operation.

A private company can apply to be struck off if*, in the previous three months*, it has not:

- traded or otherwise carried on business;
- changed its name;
- for value, disposed of property or rights that, immediately before it ceased to be in business or trade, it held for disposal or gain in the normal course of its business or trade (for example, a company in business to sell apples could not continue selling apples during that three-month period but it could sell the truck it once used to deliver the apples or the warehouse where they were stored); or
- engaged in any other activity except one necessary or expedient for making a striking-off application, settling the company's affairs or meeting a statutory requirement (for example, a company may seek professional advice on the application, pay the costs of copying the Form 652a, etc). However, a company can apply for striking off if it has settled trading or business debts in the previous three months.

A company cannot apply to be struck off if it is the subject, or proposed subject, of:

- any insolvency proceedings (such as liquidation, including where a petition has been presented but has not yet been dealt with); or
- a Section 425 scheme (that is a compromise or arrangement between a company and its creditors or members).

The form must be signed and dated by:

- the sole director, if there is only one;
- by both, if there are two; or
- by the majority, if there are more than two.

Within seven days after sending Form 652a to the Registrar, you must provide copies of the form to the following:

- **members**, usually the shareholders;
- **creditors** including all contingent (existing) and prospective (likely) creditors such as banks, suppliers, former employees if they are owed money by the company, landlords, tenants (for example, where a bond is refundable), guarantors and personal injury claimants. Also, you must notify appropriate offices of HM Revenue & Customs (HMRC) , and the Department of Work and Pensions (DWP) if there are outstanding, contingent or prospective liabilities;
- **employees;**
- **managers or trustees of any employee pension fund;** and
- **any directors who have not signed the form**.

Anyone who becomes a member, creditor etc, after the application must also be sent a copy of the form within seven days of doing so.

Reduction of share capital under Companies Act 2006

The measure will commence on 1 October 2008. The relevant Regulations have laid. The explanatory notes to Regulations follow :

<u>Explanatory text</u>

Companies Act 2006 implementation:
The Companies (Reduction of Share Capital) Order 2008 and related Commencement Order

1. At present companies wishing to reduce their share capital can only do so by means of an application to court and a court order confirming the reduction. The Companies Act 2006 introduces for private companies only a cheaper and less burdensome “non-court route” procedure, the solvency statement route.

2. Most 2006 Act provisions relating to share capital will be commenced in October 2009, but Ministers agreed last year, in the light of strong representations from the Institute of Chartered Accountants in England and Wales, and the Law Society, that provisions of the Act relating to the solvency statement route for capital reduction should continue to be commenced on 1 October 2008.

3. It was not possible to include the relevant commencement provisions in the Fifth Commencement Order made before Christmas (which covered almost all other provisions to be commenced in 2008), and consequently, alongside the Companies (Reduction of Share Capital) Order we are making a further Commencement Order.

4. The Companies (Reduction of Share Capital) Order 2008 is intended to meet two objectives. The first to prescribe the form in which a solvency statement must be made when a private company proposes to reduce its share capital when relying on the statement without getting a court order; and the second to provide for the treatment of reserves arising from a reduction in share capital: that when a company reduces its share capital, and the reduction has been confirmed by a court order, subject to some exceptions, in some circumstances, the reduction is distributable unless the court orders that it is not.

5. A consultation exercise was conducted between February and May 2007 on secondary legislation to be made under the Companies Act 2006. Although the draft Companies (Reduction of Share Capital) Order 2008 is not identical to the draft regulations published in May 2007, the substance of the Order is essentially the same as the substance of the equivalent provisions in those draft Regulations and is a consequence of that consultation exercise and subsequent contributions from stakeholders.

Article by Rebecca Benneyworth

Lecture B492 (19.29 Minutes)

1.31 Practical implications of the annual investment allowance (AIA)

The annual investment allowance will provide a deduction from profits of the first £50,000 in any year that the business invests in plant and machinery, other than cars.

Recap - Detailed rules

The AIA will apply to expenditure on plant and machinery but will not be available for expenditure on business cars. Expenditure on most other plant and machinery, including integral fixtures and long life assets, will be eligible. It is expected that 94% in number of all businesses will see their entire capital expenditure covered by AIA.

The annual allowance is £50,000. All qualifying expenditure up to that level will receive a 100 per cent first-year allowance. Any additional expenditure over the £50,000 level will be dealt with in the normal capital allowances regime, entering either the 10 per cent or 20 per cent pool.

Claimants will be able to choose which assets will be covered by AIA, so that the allowance is given in the most favourable way. Note that AIA differs from FYA’s in that a writing down allowance may be claimed in the same year as the AIA, providing more than £50,000 of allowances if the expenditure exceeds the limit.

One amount of allowance will be available each year, that is for a twelve month period. However if a business’s chargeable period is more or less than a year the AIA will be proportionately increased or reduced.

Single companies which are not members of a group will each receive a single annual allowance. Companies that fall within the company law definition of a group will receive a single allowance across the whole group; they may choose how this is to be shared between them.

Where companies are under the control of the same person or persons, the allowance will only be restricted if the companies occupy the same premises or carry on similar business activities.

Each business that is carried on by a sole trader or by individuals in partnership will receive a single annual allowance in its own right, even where the individual owns a number of businesses or is involved in a number of partnerships. The related businesses rule will only restrict the availability of the annual amount where the businesses are controlled by the same person or persons, and once again occupy the same premises or carry on the same business.

Commencement

The annual investment allowance (AIA) will apply to qualifying expenditure incurred on or after 1 April 2008 in the case of businesses within the charge to corporation tax, and on or after 6 April 2008, for businesses within the charge to income tax. The existing capital allowances rules for determining when expenditure is incurred will apply to determine whether expenditure is incurred before or after the 1 or 6 April start date.

For those businesses whose chargeable periods span the 1 or 6 April 2008 start date, the AIA will be proportionately reduced or increased on a time-apportioned basis.

Thus, for a company with a chargeable period starting on 1 January 2008 and ending on 31 December 2008, the AIA available (from 1 April to 31 December, i.e. for 9 months) will be ¾ of £50,000 = £37,500. In other words, the AIA will simply be reduced on a time apportioned basis.

Practical implications – new businesses

The impact of the new allowance on new businesses is likely to be marked. Start up losses are likely to be very common, and may be more significant amounts than previously. Therefore you will need to consider how the losses might best be used, including which form of relief will give the best tax outcomes and the most speedy relief. This will also impact on considerations in relation to choice of accounting date as choosing a fiscal accounting date may allow the use of the losses earlier than would otherwise have applied. However, using a short accounting period for the first period of trade will restrict the amount of the AIA in the first period correspondingly, and thus the balance will need to be struck between the best outcome in terms of allowances and therefore quantum of loss, and the earliest possible relief.

Practical implications – tax credits

The reduction in income for one year provided by the annual investment allowance could have very significant implications for those self employed tax credit claimants who have modest income and are thus at or near the "fast taper" income band for tax credits.

<u>Example</u>

A client has profits form his self employment of £30,000 per annum. Taking into account spouse's income and all other relevant personal circumstances for this current year, a provisional tax credit award notice has been issued for 2008/09 showing tax credits of £602. His accounting date is 31 March.

On 1 June 2008 he purchased a new van for £20,000 for use in his business, which attracts 100% annual investment allowance. This has the following tax and tax credit implications.

Tax credits 2008/09

Provisional award issued July 2008.	
Based on "normal" income of £30,000 in 2007/08	
Impact of expenditure on van on provisional award	Nil
Final award issued on renewal in June 2009	
Based on actual income for 2008/09	
Reduced by £20,000 against last year due to AIA	
Impact of expenditure on van on final award	39% (£7,800)

Tax and NIC 2008/09

Tax relief available when final liability for the year is met	
January 2010	28% (£5,600)

Tax credits 2009/10

Provisional award issued on renewal in June 2009	
Based on previous year income (reduced by AIA)	
Impact of expenditure on van on final award	39% (£7,800)
Final award – provisional award revised to reflect actual income	
Increase in income for 2009/10 due to absence of AIA	
Increase £20,000; below the income disregard so no revision is made	
Total tax, NIC and tax credits in relation to AIA	106% £21,200

This makes it even more crucial that practitioners ensure that all clients who may be able to benefit from tax credits after AIA is taken into account make a protective claim to tax credits as soon as possible.

Practical implications – payment of tax

Clients who are self employed can find managing their tax liabilities quite difficult when their profits fluctuate. A year in which a repayment of payments on account is received in January is frequently followed by a very substantial payment the following January to make up for the shortfall in payments on account the following year.

The already difficult area of fluctuating profits will be exacerbated by the introduction of AIA, as profit fluctuations are likely to be more significant as a result of the amounts of allowance under the new regime. This will be particularly true for smaller self employed businesses which invest in a major item of equipment as a one off, or very infrequently. Advisers will need to consider the future tax payments due by businesses when AIA unwinds and be prepared to advise accordingly. In companies, deferred tax provisions will be needed to smooth the difference between depreciation in the accounts and the capital allowances on the same assets.

Article by Rebecca Benneyworth

Lecture B493 (12.51 Minutes)

2 Personal Income Tax

2.1 Tax rates and bands

Section 1 sets out the new rates of tax for 2008/09. The basic rate has been reduced from 22% to 20%, and the upper limit has been increased slightly. The new basic rate limit (which has not been subject to statutory indexation and therefore needs to be specifically legislated for) is established by Section 4. Section 4(3) restricts the commencement of the new higher rate threshold for PAYE purposes to the date of 7 September 2008. The alternative amount applying from 6 April to 6 September for PAYE purposes only is £36,000 (the amount originally announced in the 2008 Budget).

The abolition of the starting rate of income tax is dealt with mainly by Section 5, with consequential changes dealt with by Schedule 1. Schedule 1 also introduces the new starting rate for savings, which is 10%. Sch 1 para 5 provides that the starting rate limit for savings will be subject to statutory indexation in the same way as the basic rate band upper limit.

The starting rate for savings applies only if the taxable non savings income is less than the limit. Personal allowances are applied to non savings income first in determining the rates of tax applying to income. If an individual's taxable non savings income exceeds £2,320, the 10% savings starting rate will not be available to a taxpayer.

Table : income tax bands and rates 2007/08 and 2008/09

	Upper limit	
	2007/08	**2008/09**
Starting rate 10%	£2,230	-
Starting rate for savings 10%	-	£2,320
Basic rate 22% / 20%	£34,600	£34,800
Basic rate upper limit for PAYE purposes until 7 September 2008	N/A	£36,000
Higher rate 40%	N/A	N/A

2.2 Personal allowances

The personal allowance was increased to reflect inflation, with a higher basic personal allowance announced in May 2008, applying for the whole of the year 2008/09. As this exceeded normal indexation, this also needed specific legislation to implement. Section 2 deals with the increased basic personal allowance, and indicates that no change to the amount deductible or repayable under the PAYE Regulations before 7 September, thus similarly delaying the change for PAYE purposes as for the change to the higher rate threshold.

Significant above inflation rises have been awarded to elderly taxpayers, which were planned from 2007 and implemented as originally announced. Section 3 implements the change.

Table : Personal allowances 2007/08 and 2008/09

	2007/08	**2008/09**
Personal allowance	£5,225	£6,035
Personal allowance age 65 – 74	£7,550	£9,030
Personal allowance age 75 and over	£7,690	£9,180
Married couples allowance age 74	£6,285	£6,535
Married couples allowance age 75 +	£6,365	£6,625
Married allowance – minimum	£2,440	£2,540
Income limit: age related allowances	£20,900	£21,800
Blind person's allowance	£1,730	£1,800

2.3 Residence for tax purposes

Section 24 introduces new rules to determine periods of residence for tax purposes.

A person is resident in the UK if they are present here for 183 days. In determining how many days a person is here, HMRC have traditionally excluded days of arrival and departure, and counted only full days spent in the UK. The same method is used for checking the non statutory test of length of visits to the UK, which must not exceed 91 days on average in the period someone is living abroad.

Although it was originally planned to include days of both arrival and departure as days present in the UK, this has been slightly modified. In future, any day on which the taxpayer is physically present in the UK at midnight will count as a day in the UK. Individuals transiting through the UK and doing nothing else other than changing modes of transport will not be treated as in the UK if their transport arrangements means that they would be counted as in the UK. The legislation (Section 24 (3), inserting new Section 831(1B) into ITA 2007) refers to the individual not engaging in activities that are to a substantial extent unrelated to the individual's passage through the UK.

The legislation introduced into Section 831 in relation to foreign income is then replicated by Section 24(4) FA 2008 to apply to Section 832 of ITA in relation to employment income of individuals in the UK for a temporary purpose.

The new rules apply from 6 April 2008, and are on a statutory basis rather then the old non statutory basis. A statutory test of residence itself (replacing the 183 day test and 91 day test) is hoped for in the near future.

2.3.1 Examples of the test in operation

These were issued as part of the explanatory notes on the Finance Bill.

Example 1
Peter works for the Jersey arm of HSBC and is travelling from Jersey to Frankfurt. He flies from Jersey to Gatwick and will catch his onward flight the next day to Frankfurt from London City airport. He travels from Gatwick to Canary Wharf for a meeting with several other HSBC colleagues before staying overnight in a nearby hotel.

The meeting with colleagues is not an activity substantially related to completing travel to a foreign destination. The transit passenger provisions will not apply.

Example 2
John works for the Jersey arm of HSBC and is travelling from Jersey to Frankfurt via Gatwick and London City airport. In lobby of his hotel near London City Airport, he unexpectedly spots another colleague who has just arrived from Paris. They have a couple of pints together and their conversation covers a number of business-related issues. Peter then travels to London City airport to catch his onward connection.

This meeting was not planned and therefore it can be considered that John's activities in the UK substantially related to completing travel to a foreign destination. The transit passenger provisions will apply.

Example 3
Shirley lives in Guernsey and is travelling to New Zealand by way of Gatwick and Heathrow. She has planned to spend most of the day with her daughter and grandchildren, who live in Crawley and will also spend the night there before travelling to Heathrow for her onward flight.

Her visit is not an activity substantially related to completing travel to a foreign destination. The transit passenger provisions will not apply.

Example 4
Phil lives in Guernsey and is travelling to New Zealand by way of Gatwick and Heathrow. His flight from Guernsey is delayed by fog and he arrives too late to make his onward connection to New

Zealand that day. His son had already arranged to meet him at Gatwick and drive him to Heathrow, now he drives him to a hotel near Heathrow instead where Phil will stay overnight before catching his rearranged flight. At the hotel they have a snack together.

These activities are substantially related to completing travel to a foreign destination – Phil would have eaten in the hotel even if he had been unaccompanied. The transit passenger provisions will apply.

Example 5
George lives in the Isle of Man and is flying to New York on business via Manchester. He has made an appointment with a consultant orthopaedic surgeon based in Manchester to carry out a number of tests. He will stay in the clinic overnight before travelling on to New York the following afternoon.

The appointment is not an activity substantially related to completing travel to a foreign destination. The transit passenger provisions will not apply.

Example 6
George lives in Jersey and is travelling to Stavanger. He does not fly and travels to the UK by ferry before continuing to London by train. He stays overnight at a West End hotel, having prearranged dinner and a trip to the theatre with friends. The next day he travels to Newcastle by train, where he boards a ferry to Stavanger.

His activities in the UK are not substantially related to completing travel to a foreign destination. The transit passenger provisions will not apply.

2.4 EIS : increase in limit

Section 31 increases the limit of investment applying to the Enterprise Investment Scheme (EIS) from £400,000 to £500,000 with effect from 6 April 2008 to invest up to £500,000 per annum from 2008/09. This is an increase of £100,000 from the previous limit of £400,000. The Treasury Order commencing this change has yet to be made as at 20 August 2008.

2.5 Venture capital schemes

Section 32 and Schedule 11 make a number of changes to the scope of VCT schemes.

Schedule 11 changes the definitions of qualifying trades to exclude certain activities which are subject to separate State Aid provisions within the EU. The changes apply to the Corporate Venturing Scheme (paras 1 – 3), Enterprise Investment Scheme (paras 2 – 6) and Venture capital trusts (paras 7 – 9).

Each of these inserts three excluded activities sections into the relevant legislation as follows :

- Shipbuilding (which takes its meaning from the Framework on state aid to shipbuilding (2003/C 317/06) published in the Official Journal on 30 December 2003;
- Producing coal, including the extraction of it, taking definitions from Article 2 of Council Regulation (EC) No. 1407/2002 (state aid to coal industry), and
- Producing steel, including any steel products listed in Annex 1 to the Guidelines in national regional aid (2006/C 54/08) published in the official journal on 4 March 2006.

2.5.1 Commencement

These changes come into effect on 6 April 2008, but do not apply to shares issued before that date, and for VCT's do not apply to the investment of "protected money" – money raised before the commencement date.

2.6 Tax credits on foreign distributions

Section 34 and Schedule 12 introduce tax credits on certain foreign distributions (normally dividends) with effect from 2008/09.

These changes will be introduced in two stages as follows :

- From 6 April 2008, those with no more than 10% of the shares in a non UK company will be entitled to a tax credit equal to one ninth of the distributed amount.
- From 6 April 2009, this tax credit entitlement will be extended to all shareholdings in companies where the home state operates a tax on profits similar to corporation tax (irrespective of the actual rate). This will form part of Finance Bill 2009.

It was originally planned to restrict the availability of tax credits in this way to those receiving no more than £5,000 in foreign dividends in a year. This element of the new rules has been abandoned.

2.6.1 Technical summary

UK resident taxpayers, and certain eligible non residents become entitled to a non payable 10% tax credit in respect of dividends paid by non resident companies in which they are minority shareholders (as defined). The tax credit does not apply to distributions by offshore funds. Schedule 12 achieves this by inserting new Section 397A into Chapter 3 of Part 4 of ITTOIA 2005. The tax credit of one ninth operates in exactly the same way as a tax credit attaching to a UK dividend, which is not repayable, but set against the tax liability on the income concerned.

Section 397A(7) defines an eligible non-UK resident as an individual who at any time in the tax year in which any part of the distribution is brought into charge to tax is not UK resident but is entitled to claim UK personal allowances under Section 56(3) of ITA 2007.

New section 397B applies section 397A to recipients of manufactured overseas dividends which are representative of an overseas dividend.

2.6.2 Minority shareholder

This is defined by new Section 397C. A minority shareholder for these purposes is someone whose shareholding in the company is less than 10% of the company's issued share capital, taking into account shares to which the individual is beneficially entitled, or to which he is beneficially entitled to the distribution arising on the shares.

Normally only the shares owned by each individual will be taken into account for the minority shareholding test, but where an individual has transferred shares to a connected person wholly or mainly in order to avoid tax then the shares transferred to the connected person are aggregated with the shares held by the transferor. Shares transferred to any other person as part of a repo or stock lending arrangement are treated as owned by the transferor.

Part 2 of Schedule 12 makes a large number of consequential changes.

2.7 Dormant bank accounts

The Dormant Bank and Building Society Accounts Act 2008 permits dormant accounts (as defined by the Act) to be used for beneficial purposes, which may include the transfer of some of the assets directly to charities. This is achieved by transferring the balances into an authorised reclaim fund. Section 39 of the Finance Act 2008 makes provisions so that if a customer reclaims his account from dormancy, he is in the same position for tax purposes as he would have been if the transfer had not occurred. It also relieves the institutions operating the reclaim funds from additional tax obligations.

2.8 New offshore fund tax regime

Proposals to radically revise the tax treatment of participants in offshore funds have been the subject of enabling legislation in Sections 41 and 42 of the Act. These authorise HM Treasury to legislate through secondary legislation as to the new rules for income tax, capital gains tax and corporation tax in relation to participants in offshore funds. Much of this scheme is still under consultation, so this enabling legislation stands to await completion of the work.

2.9 Double tax relief : trading income

Section 57 amends Section 798 of ICTA to ensure that double tax relief given on trading or professional income is restricted to the UK income tax on those earnings. The change applies from 6 April 2008, and only affects income tax. It does not make any significant changes, but closes a potential loophole in the legislation.

2.10 Anti avoidance : UK resident members of foreign partnerships

Section 58 makes various changes in relation to foreign partnerships which have a UK resident member. The changes clarify that nothing in any Double Taxation Agreement affects the liability of the UK resident member to UK income tax, capital gains tax or corporation tax, and that members of a partnership include any person entitled to a share of income or capital gains of the partnership. The legislation seeks to also ensure that this has always been the case. The changes come in response to tax avoidance scheme disclosures. Section 59 makes further changes related to the interpretation of common clauses in Double Taxation Treaties to ensure that they cannot be abused.

2.11 Anti avoidance : restrictions on loss relief for sole traders

Legislation introduced successively over the last few years has restricted the offset of losses by individuals trading as a partnership. The intention of the restrictions is to limit the availability of certain income tax mitigation schemes.

However, these partnership based schemes have now been replaced by schemes in which the investing individual operates as a sole trader rather than a partner.

Section 60 and Schedule 21 make changes to restrict loss relief against other income and capital gains where the trade is carried on in a non active capacity.

2.11.1 Technical summary

Para 2 of Schedule 20 inserts new Section 74A into ITA 2007. This restricts the use of trading losses when they arise to an individual carrying on a trade in a non active capacity. The losses so relieved must not exceed the annual limit of £25,000, which applies to the total amount of any sideways relief and capital gains tax relief that an individual may claim.

Where the individual also carries on a trade as a non active partner, the cap applying to the self employed losses is reduced by the amount of the loss arising in the partnership, thus displacing sole trader loss relief in favour of partnership loss relief (which is similarly capped at £25,000 in any year). So the limit applies to the total amount of relief for any trade carried on on a non active basis, whether as a sole trader or partner.

The restrictions do not apply to qualifying film expenditure, nor to trades carried on as Lloyds names. (Qualifying film expenditure is defined by new Section 74D)

New Section 74B is even more aggressive, and eliminates any form of sideways relief at all for losses arising from a trade carried on as a sole trader in a non active capacity, and which arises directly or indirectly in consequence of or otherwise in connection with relevant tax avoidance arrangements.

2.11.2 Non active capacity

An individual carries on a trade in a non active capacity in a tax year if the individual carries on the trade at any time during the tax year and does not devote a significant amount of his time to the trade in the relevant period for the tax year. Significant amount is defined as 10 hours per week on average personally engaged in the activities of the trade, and those activities are carried on on a commercial basis with a view to the realisation of profits as a result of those activities.

The relevant period is the basis period for the tax year, unless this is shorter than 6 months, in which case it means the six months staring at the date trade commenced, or the six months ending on the date trade ceased.

For these purposes an individual, other than a partner, carries on a trade in a non-active capacity where the individual spends an average of less than 10 hours a week, in a relevant period, personally engaged in activities of the trade carried on commercially and with a view to the realisation of profits from those activities. This definition will be extended to replace the definition of non active to partners.

2.11.3 Commencement

The provisions apply to the tax year 2007/08, but do not apply to any loss made by an individual in a tax year for which the basis period ended before 12 March 2008. For straddling period, the "pre announcement loss" must be calculated, by time apportioning (in days) the trading loss excluding capital allowances and qualifying film expenditure plus the capital allowances on expenditure incurred before 12 March 2008. If the trading result after adding back capital allowances is a profit, that element is ignored.

Section 74B excludes losses where the loss arises from relevant tax avoidance arrangements entered into on or after 12 March 2008, unless they were made pursuant to an unconditional obligation in a contract made before that date.

2.12 Anti avoidance : partnership losses

The definition of non active partner in Finance Act 2007 (which inserted Section 103B(2) into ITA) has been slightly amended by Section 61. This now ties up with the definition produced in Sch 21 for sole traders. The change replaces :

"….an individual devotes a significant amount of time to a trade in the relevant period for a tax year if, in that period, the individual spends an average of at least 10 hours a week personally engaged in activities carried on for the purposes of the trade."

with

"….an individual devotes a significant amount of time to a trade in the relevant period for a tax year if, in that period, the individual spends an average of at least 10 hours a week personally engaged in activities of the trade and those activities are carried on :

(a) on a commercial basis, and
(b) with a view to the realisation of profits as a result of those activities."

2.13 Income from settlor interested trusts

There is a flaw in the legislation taxing the income of settlor interested trusts. The problem is in the ordering of income liable to each rate of tax, and this can result in additional tax being payable. This problem is resolved by Section 67 which corrects the mistake in the 2006 trusts legislation. It has only affected taxpayers with income from the trust and other savings and dividend income which in total exceeds the higher rate threshold.

2.14 Income charged at the dividend upper rate

Section 68 corrects a mistake in ITA 2007. When the tax law rewrite project issued the Income Tax Trading and Other Income Act in 2005, an error was included in the taxation of foreign dividends on a remittance basis – largely applying to non UK domiciled individuals. The rate of tax applying was previously 40%, but had been reduced to 32.5% in error. This has been the case since 6 April 2005, but comes to an end on 5 April 2008, from which date this change takes effect.

2.15 Payments on account

ITA also unintentionally changed the rules regarding payments on account in respect of annual payments, excluding them from the computation of payments on account. Section 69 corrects this mistake, which largely affected Unauthorised Unit Trusts.

2.16 Pensions changes

Section 91 and Schedule 28 introduce rules to ensure that the rules recently introduced to restrict the use of ASP's when the member dies are also effective in relation to scheme pensions and lifetime annuities. These rules prevent the use of tax relieved pension savings to provide an inheritance for members families other than dependants.

Section 92 and Schedule 29 make further changes to both FA 2004 and IHTA 1984 to implement the policy objective described above. There are also changes to existing legislation in this area to clarify the law and make certain arrangements more flexible.

2.17 Non domiciled individuals – the remittance basis

The remittance basis available to non domiciled individuals in respect of both foreign income and gains will effectively be withdrawn for all but the very wealthy from 2008/09. Non domiciled individuals are taxed on their worldwide income, but income arising abroad is taxed on a remittance basis. The same rule applies to capital gains on assets situated abroad.

From April 2008, the remittance basis will have to be claimed by most non domiciled UK resident taxpayers, with the following consequences :

- No claim will be needed if the taxpayer has unremitted income and gains in the year of less than £2,000. The remittance basis will be automatically available, and there will be no impact on the taxation of their UK income.
- If the unremitted income and gains exceeds £2,000 in any tax year, then the taxpayer will have to make a claim to retain the benefit of the remittance basis. Such a claim will deny the availability of the UK income tax allowances, including the personal allowance (including age related allowances), married allowance, blind person's allowance and tax relief on life assurance premiums. They will also be denied the UK CGT annual exempt amount.
- If the taxpayer has been resident for seven out of the last 10 tax years, then the remittance basis will only be available to them on payment of a £30,000 tax charge on the unremitted income and gains. It is hoped that this charge will be treated as tax on the non UK income by tax authorities elsewhere, so that double tax relief is available on it.
- The £30,000 charge will not apply to minors.

The new charge will apply **in addition** to income tax and CGT on remitted income and gains. However, the amount remitted to the UK to pay the £30,000 charge will not be regarded as remitted income. The taxpayer may choose which income and gains the tax charge relates to, so that when that income is remitted to the UK it will not be taxed again.

Individuals will be permitted to choose from year to year whether they wish to claim the remittance basis or not. Careful records of remittances will be needed to ensure that the correct tax position is observed when taxpayers move from the remittance basis to the arising basis and back again.

There will also be significant reform of the remittance basis rules to ensure that they work properly. This will include taxing remittances in the form of assets purchased from untaxed income and brought to the UK (subject to certain exemptions), and new rules for offshore mortgages. There will also be significant changes to the rules affecting capital gains on non resident trusts.

2.18 Qualifying overseas pension schemes

These are becoming increasingly popular. Transfers from a registered pension scheme to a QROPS are permissible provided the QROPS meets all of the following conditions:

1. It is an overseas pension scheme under Section 150(7) FA2004
2. it is a recognised overseas pension scheme under Section 150(8)
3. it meets other conditions under Section 169

HMRC periodically issue a list of QROPS that have consented to have their details published.

The transfer to a QROPS has particular benefits where the scheme member becomes non-UK resident, but for some UK residents there are advantages as well.

The costs of a transfer are likely to be between 2.5% and 5% of the transfer value.

UK residents

UK residents are still subject to UK pension rules.

If value of pension funds and rights exceed the lifetime allowance, a transfer could reduce the recovery charge to 25%.

The lifetime allowance is:

tax year	limit
2008/09	£1.65m
2009/10	£1.75
2010/11	£1.8m

The 55% and 25% charges on excess funds can be avoided.

An annuity need not be purchased as in many other countries the concept of an annuity does not exist.

Non-UK assets can be purchased more efficiently and without currency risk.

UK retirement wealth can be aligned with other worldwide assets in a tax-favoured territory.

Non-UK residents

After 5 years of being not resident in the UK, a transfer to a QROPS results in the UK pension rules ceasing to apply.

The rules of the jurisdiction chosen must of course be followed, but with care there will be no requirement to purchase an annuity and there can be access to the whole of the fund (or at least far more than 25% in the UK).

Residential property is not debarred as an investment.

The potential tax charge of up to 82% for inherited retirement wealth is avoided. This can otherwise apply where an annuity is not purchased by the age of 75 and instead an Alternatively Secured Pension is received. The 82% charge is on the death of the member under UK pension rules and comprises:

- UNAUTHORISED PAYMENTS CHARGE of 40%
- UNAUTHORISED SURCHARGE of 15%
- SCHEME SANCTION CHARGE of 15%
- IHT at 40% on balance remaining of 30%

Those likely to benefit

In broad terms, a QROPS is likely to be of particular benefit to the following categories of pension scheme members:

- Overseas workers.
- Former UK residents who have retired abroad. or plan to do so.
- Owners of OMBs, professionals, entrepreneurs and senior executives who since the new pension regime started on 6 April 2006 have wanted to place profits and wealth into a pension arrangement up to the lifetime allowance. A transfer to a QROPS can ring-fence this wealth from further tax recovery charges.

- SIPPs or SSASs holding land or commercial property where the performance (notwithstanding the current value issues) generally outperforms the expected increases in the lifetime allowance.
- International professionals / sports stars who work in the UK and accumulate wealth in the UK but do not intend living in the UK on retirement.

Scheme investments under UK rules

The potential is clearly substantial, but this was drastically reduced under Section 158 and Schedule 21 FA2006 which effectively prohibited the following assets:

1. Residential property (but not so as to exclude a commercially used property, such as a shop, with an unconnected flat above it).
2. Tangible moveable property such as fine wines; classic cars; art; antiques.
3. Indirect investment in prohibited assets (e.g. a flat owned by a company in which a SIPP holds all the shares).

The prohibition is in the form of a substantial tax charge rather than an outright ban. The charge can be up to 70%.

The following investments are not prohibited, however, so a scheme member keen to have residential property in his pension scheme does not necessarily have become non-resident and transfer to a QROPS.

1. Indirect investments in genuinely diverse commercial vehicles that hold residential property or other prohibited assets (e.g. the new REIT vehicle).
2. A "Hall of Residence" for students which is connected to a particular educational establishment and provides accommodation on a communal basis for students of that establishment only. Seemingly this would need to involve more than a single property, and ownership being by several people. following this rather unclear statement in Standing Committee A Finance Bill 2006, 20th sitting, column 726:

   "If a college or private company invested in a block with a number of rooms or a set of houses that were to be commercially let, that property would clearly count as a hall of residence if a number of individuals who were probably unconnected to the investors in normal business were to rent from that company".

Article by Gerry Hart

Lecture P491 (8.55 Minutes)

3 Employment taxes

3.1 Enterprise Management Incentive scheme

This scheme allows very favourable share option schemes to be offered to key employees. The scheme is amended by Section 33 which makes the following changes :

- Companies wishing to offer EMI schemes to their staff will in future be subject to an employee numbers limit. The scheme may not be operated by companies with 250 or more full time equivalent employees. This is a new restriction on the scheme. Section 33 provides the method of computing the number of full time equivalent employees for this purposes, which parallels calculations used for other schemes where there is an employee restriction. Where a company is a parent company, the number of employees in each of its qualifying subsidiaries must also be taken into account for this purpose. Previously restrictions on size were related to the value of the company balance sheet.
- Certain trades are to be excluded from the scheme. In future companies in the shipbuilding, coal and steel industries will not be permitted to operate the scheme at all. (this parallels a change made in respect of EIS, CVS and VCT – see the Personal Income tax section)

These changes are required in order to meet EU State Aid provisions. They commence for options issued on or after the date of Royal Asset – 21 July 2008.

3.2 Homes abroad owned through a company

Welcome relief has been introduced for those individuals who own homes abroad through a company. This is often necessary to meet the requirements of tax law in the country concerned, or to mitigate the effect of certain tax rules, but unfortunately the individual concerned can often find that he is liable to tax on a benefit in kind due to his position as director or shadow director of the company. HMRC announced in 2007 that this would no longer be the case, and that the tax charge would be removed.

3.2.1 Technical summary

Finance Act 2008 Section 45 therefore introduces a new Section 100A into ITEPA, which exempts the charge that would otherwise apply if :

- The property is outside the UK and owned by a company, and provided for a director or officer (D) or a member of D's family or household, and
- The company is owned by D or D and other individuals, and
- The company has been the holding company of the property at all times after the relevant time – this means that :
  - The property is the company's only or main asset
  - The company's only activities are those that are incidental to its ownership of the property.

The relevant time is the date the company first owned a relevant interest in the property, or when D first acquired an interest in the company from an unconnected party, provided the company owned the property at that time.

New Section 100A introduces exceptions to the new exemption. The exemption will not apply if :

- The company acquired the property from a connected company at an undervalue, or
- Expenditure on the property has been incurred by a connected company or borrowings remain outstanding to a connected company
- The provision of the living accommodation is made in connection with any arrangement the main purpose of which is to avoid tax or national insurance.

A connected company is a company connected with D, a member of D's family or an employer of D, or a company connected with such a company.

The change is retrospective, and excludes the benefit in kind tax charge for the entire period of ownership of the property.

3.3 Tax exempt social security payments

The following new social security payments are exempt from tax under modifications to ITEPA made by Section 46 FA 2008 :

- In work credit
- In work emergency discretion fund payment
- In work emergency fund payment
- Return to work credit.

The exemption applies to payments made on or after 6 April 2008.

3.4 Company cars : CO_2 emissions

There is to be no change in the Table of emissions and the corresponding percentage of list price taxable as a benefit in kind for 2009/10. However, from 2010 the starting point for the Table on benefit in kind rates will be reduced from 135g/km to 130 g/km CO_2, meaning that many drivers will see a rise in the tax liability on their company car of between 0% and 7%. The change has been made by Section 47 FA 2008.

3.5 Fuel benefit in vans

There is a fuel benefit applicable to the provision of a van for unrestricted motoring; this is £500. The introduction of the benefit from 2007 was not implemented in exactly the same way as the car fuel benefit charge, and consequently some element of double taxation can arise, depending on the method of fuel provision.

The legislation is amended by Section 48 to ensure that if a driver is liable to the fuel benefit of £500, then no other charge to tax can arise in connection with the provision of free fuel for private motoring.

3.6 Employment related securities

Section 49 tightens up certain rules in relation to employment related securities The amendments make it clear that references to amounts that constitute earnings or employment income in various sections of tax legislation are limited to those amounts which have been taxed as employment income. This removes a potential anomaly under which deductions given for amounts that constitute earnings could be argues to be sums greater than those already taxed.

This is intended to put beyond doubt that amounts to be subject to tax and National Insurance Contributions in relation to employment-related securities are calculated as intended.

3.7 Armed forces – council tax relief

Payments to members of the Armed Forces under the Council Tax relief scheme are exempted from income tax by Section 51 FA 2008, which introduces the exemption into ITEPA at new Section 297B. An exemption from National Insurance Contributions will be made by secondary legislation. The exemptions apply from 6 April 2008.

3.8 Greater London Authority : severance payments

Section 52 ensures that payments made under the Greater London Authority severance payments scheme are taxed as termination payments rather than normal earnings, which means that the £30,000 tax exemption can apply to them. The necessary modification has been made to Section 291(2) of ITEPA 2003, by including payments to the former Mayor of London and Greater London Authority within the current arrangements for severance payments made to MP's.

3.9 Company car now and in the future

Taxable benefit for the car

This is based on a % of the list price of the car, graduated according to the level of the car's carbon dioxide emissions. Business mileage levels are ignored, as is age of the car. The graduation is in 1% steps for every additional 5 grams per kilometre, with a maximum charge of 35%.

The level of CO2 emissions qualifying for the minimum 15% charge is 135 g/km for 2008/09 and 2009/10; 130 g/km for 2010/11. From 2008/09 there is a lower charge of 10% of list price where CO2 emissions do not exceed 120 g/km (= QUALECS – qualifying low emissions cars).

Also from 2008/09 there is a 2% discount if the company car is capable of running on E85 fuel but is not a QUALEC. E85 fuel is basically biofuel with ethanol mixed with 15% petrol to produce fuel which contains 85% bioethanol. It is commercially produced alcohol made from crops such as sugar beet, corn or wheat. Biofuel-enabled cars currently available include the Ford Focus flexi-fuel and the Saab Biopower, and they hardly have a low starting-point for CO2 emissions so a 2% discount will not help much. At present most cars run on blends of 5% biofuel and 95% petrol so clearly there is a long way to go to obtain the 2% discount. In any event it is reckoned that biofuels are a temporary stepping stone on the way to running cars on hydrogen.

Diesel cars emit less CO_2 than petrol cars and so would be taxed on a lower % of list price than an equivalent petrol car. However, diesel cars emit greater quantities of air pollutants, and accordingly a supplement of 3% of the list price applies – e.g. a diesel car, which would give rise to a 20% charge on the basis of its CO_2 emissions, is instead charged at 23%. The maximum charge for diesel cars is capped at 35%.

The position for **alternative fuel** vehicles is that they will have CO2 emissions of not more than 120 g/km so normally start at a base of 10% of list price. They then enjoy a 3% discount, resulting in a tax charge on 7%. However, **electric-only** cars with nil CO2 emissions do not start at a base of 10% and accordingly the 6% discount available to them results in a tax charge on 9% rather than 4%.

Private use fuel tax charge 2008/09

The tax charge is based on the same % used in calculating the taxable car benefit which therefore takes into account supplements and discounts. The % is then applied to a fixed amount of £16,900 (previously £14,400) so for the lowest rating of 10% the tax charge is on £1,690. The tax charge is reduced proportionately where private fuel is not provided for the complete tax year.

It has been stated that the fuel benefit charge will be increased *"at least in line with the RPI"* in future.

This charge is generally prohibitive, especially as it applies even if some private fuel is not provided as it is an "all or nothing" charge. If the employee makes good all the private use fuel there is no tax charge, but that is not the case if that takes place in a later tax year. That was the conclusion of the Commissioner in *Impact Foiling Ltd, M R Flay and G J Plumb v HMRC SpC562* where it was held that there is no evidence in the legislation or guidance notes that the employee is required to make good the expense in any year other than the relevant tax year for the private use fuel tax charge to be eliminated.

Advisory fuel rates for company cars

Published guidelines are issued by HMRC. The stated aim is to save time for all concerned by setting out figures which they reckon can be used in the majority of cases

They are only advisory, and can apply where the employer reimburses the employee for fuel for business travel in a company car or where the employer requires the employee to repay the cost of fuel for private travel in a company car.

They are reviewed twice a year on 1 January and 1 July, but more frequently at HMRC's consideration if fuel prices fluctuate by 5% from the current rate and that is likely to be sustained.

From 1 July 2008 (1 June if employer so chooses) the rates are as below based on petrol at 114.8 per litre:

Engine size	*Fuel cost per mile*		
	Petrol	*Diesel*	*LPG*
to 1,400 cc	*12p*	*13p*	*7p*
1,401 to 2,000cc	*15p*	*13p*	*9p*
over 2,000 cc	*21p*	*17p*	*13p*

Qualifying low emission cars (QUALECS)

The tax charge on a company car should not be looked at in isolation. The position of the employer also needs to be considered – that may indeed be of greater importance.

Expenditure on a new car qualifies for 100% FYA provided the following conditions are met:

- expenditure incurred to 31 March 2013
- CO_2 emissions no more than 110g/km from 1 April 2008 (this was previously 120 and still is in determining the tax charge on the company car driver) OR it is electrically propelled

For a bi-fuel car there is more than one CO_2 emissions figure. The lowest certified figure is then used.

The new Stop and Start technology may well in time result in several desirable models qualifying for 100% FYA. The engine is automatically turned off and is in standby mode when the vehicle stops at traffic lights and in traffic jams. The engine instantly starts up again when the brake pedal is released, with the vehicle pulling away once the accelerator is pressed.

In testing the Stop and Start system has reduced fuel consumption by 10% for city driving, 6% in a standard combined cycle and up to 15% in heavy traffic.

Examples of QUALECS are:

Model	**List price**	**CO_2 emissions g/km**	**0 – 60 secs**
Citroen C1 1.0i Vibe	£7,295	109	13.7
Honda Civic 1.4i VTEC Hybrid	£16,600	109	12.1
Peugeot 107 Urban Lite	£7,295	109	14.2
Mini Cooper 1.6D	£14,190	104	9.9
Mini Cooper Clubman 1.6D	£15,400	104	10.4
Seat Ibiza 1.4 TDI 80 Ecomotive	£11,000	99	12.8
Toyota Aygo VVT-i	£6,950	109	14.2
Toyota Prius 1.5 Hybrid T3	£17,782	106	11.5
Polo 1.4TDi 80 Blue Motion 1	£12,125	99	12.8

Many of these cars are diesel-engined, so of course create a tax charge in 2008/09 on 13% of list rather than 10%.

Road fund tax is low for these cars, at £35 per annum if between 101 and 110 g/km (£15 if using alternative fuel) or nil if not over 100 g/km.

In the right circumstances, members of a family can have a company car with low tax charges all round. This strategy could also apply to senior executives of a larger company where the company has a selection of benefits it is willing to provide.

Illustration for 2008/09

Mother runs a small company and decides to provide her 2 children with a company car each. They do not work for the company, so all mileage is private. She is a 40% taxpayer.

Taking a Citroen C1 1.0i, the tax position is as follows:

Income tax on mother per car: List price £7,295 @ 10% = £729 @ 40% = £291 pa

Company's position per car:

1. *100% FYA on £7,295 @ 21% = £1,532*
2. *Class 1A NIC on £729 @ 12.8% = £93 pa*
3. *full VAT reclaim on input tax on car servicing etc.*
4. *corporation tax relief on running costs and on £93 above*

Capital allowances on business cars from 2009

Emissions based approach will apply from 1 April 2009 (6 April 2009 for sole traders or partnerships) as under, in place of the current £3,000 WDA limit:

CO2 emissions	**WDA**
to 110 g/km	100%*
111 to 160 g/km	20%
over 160 g/km	10%

This will create interesting results in cash-flow terms as illustrated below, with cars over 160 g/km being placed in the 10% Special Rate Pool.

Illustration

Mercedes S350L cost £60,000. Sold after 3 years for £30,000.

	NOW *£*	*FROM APRIL 09* *£*
Cost	*60,000*	*60,000*
WDA year 1	*3,000*	*6,000*
WDA year 2	*3,000*	*5,400*
WDA year 3	*3,000*	*4,860*
WDV after 3 yrs	*51,000*	*43,740*
Proceeds	*30,000*	*30,000*
Balancing allwce	*21,000*	-
WDA year 4	-	*1,374*
WDV after 4 yrs	-	*12,366*

The unavailablility of a balancing allowance does not apply in either of the following circumstances:

– The car is used by a sole trader or partner with some private use, as the car then continues to be in separate pool.

– The business ceases.

The disallowance of leasing costs of a car, currently based on a retail price of £12,000, will simply be 15% if over 160 g/km. Otherwise no disallowance applies. This could create a new demand for leasing of high-performance cars as a 15% restriction in tax-deductible leasing costs equates under the current system to a retail price of about £18,000. However, leasing costs are likely to rise by April 2009 given

(a) the increasing costs of finance, and (b) greater depreciation of high-performance cars, such that the resale value to the lessor will reduce.

Article by Gerry Hart

Lecture P492 (17.59 Minutes)

4 Capital Gains tax

4.1 Rate and structure

Section 8 and Schedule 2 make the reforms to Capital Gains Tax that were proposed in the October 2007 announcements. As a result there is now a flat rate of CGT of 18%. (Section 8(1)).

Schedule 2 is lengthy and deals with the consequential changes associated with the flat rate in paras 1 – 22, and then moves on to the wholesale reform of CGT.

4.1.1 Abolition of taper relief

Paras 23 to 56 deal with the abolition of taper relief, and all references to taper relief in TCGA. However, in doing so, the definitions of "holding company" "trading company" and "trading group" need to be salvaged from the taper relief legislation in order to allow these to continue to be used for other purposes. So para 34 of Schedule 2 introduces a new section 165A into TCGA to reinstate the definitions of those three terms. The definitions have been reinstated unchanged from the previous legislation, where they were at paras 22(1), 22A and ""B of Sch A1 to TCGA.

4.1.2 Abolition of the kink test

Paras 57 to 71 of Sch 2 deal with this aspect of the changes. The abolition of the kink test, used in computing gains for pre 1982 assets where a rebasing election has not been made, essentially introduces mandatory rebasing of all pre 1982 assets to 31 March 1982 value. This applies even in respect of assets which were excluded form the rebasing election permitted previously. The changes are made to retain the original rules in respect of corporation tax, as this aspect of the changes applies only to individuals and trustees.

Para 59 introduces new Section 35A into TCGA. This provides that where a person makes a disposal of an asset on or after 6 April 2008, and that asset was acquired by way of a no gain/no loss disposal between 31 March 1982 and 5 April 2008, then the base cost for the disposal on or after 6 April 2008 will be the market value plus indexation allowance due up to the date that they acquired the asset by way of a no gain/no loss transaction.

4.1.3 Abolition of halving relief

Paras 72 to 76 deal with the abolition of halving relief. This relief applied in certain circumstances to assets which had gains rolled into them as a result of a previous disposal of between 31 March 1982 and 6 April 1988 which had been subject to hold over, rollover or similar reliefs. The relief taken on the earlier disposal prejudiced the application of indexation allowance, and thus the deferred gain was halved as a rough and ready remedial provision. As indexation no longer applies to disposals by individuals and trustees, halving relief becomes redundant and can be abolished. It remains in place for companies.

4.1.4 Abolition of indexation allowance

This is achieved by paras 77 to 83, which simply restrict the application of indexation allowance to corporation tax.

4.1.5 Simplification of pooling

Paras 84 to 100 deal with the simplification of the pooling arrangements for quoted shares and securities. As a consequence of all of the above changes, multiple pools are no longer necessary, and all shares of the same type in the same company can be pooled together.

This means that the matching rules on disposals of shares and securities of one type will be as follows :

- Match first with shares acquired on the same day as the disposal;

- Match next with shares acquired within 30 days after the date of disposal, and
- Finally match with shares in the pool.

All shares owned at 6 April 2008 are pooled together at cost, except that shares purchased prior to 31 March 1982 are brought in at market value as a result of the abolition of the kink test. Once again, these rules only apply to individuals, and not to corporation tax on gains.

There is one category of securities for which the new pooling arrangements do not apply – these are "relevant securities" which have been separately identified for CGT by section 108 TCGA for some time (and have been subject to a LIFO rule on disposal). It is intended that S108 will now apply to companies only, so the definition is lifted across into a new Section 106A(10), retaining the LIFO rule. This does not represent a change, and retains the previous treatment for qualifying corporate bonds, securities within Chapter 2 of part 12 of ITA 2007, and securities which have at any time been a material interest in a non qualifying offshore fund.

Finally, paras 101 to 102 amend the terminology of some legislation to explain that "tax year" and year of assessment mean the same thing. This allows a read-across between ITA and TCGA without problems.

4.2 Entrepreneurs' Relief

4.2.1 Overview

Section 9 refers us immediately to Schedule 3 for the detail of Entrepreneurs' Relief.

The relief is very largely modelled on retirement relief, which was available for many years up to the late 1990's and was effectively replaced by Taper Relief. However the relief is much broader and much simpler than retirement relief, and is therefore likely to be more widely applicable. It should be remembered, however, that both retirement relief, and now entrepreneurs' relief is designed for the disposal of a business rather than an asset.

The legislative change is achieved by inserting new Sections 169H to 169S into TCGA.

4.2.2 Material disposal of business assets

Section 169H being an introduction to the relief in the style of the tax law rewrite, providing a summary of the structure of the legislation, Section 169I commences with the detail of the relief by defining a material disposal, to which relief will apply.

The main form of relief is where an individual makes a material disposal of business assets. This is defined as a disposal of business assets by an individual, which meets the conditions for a material disposal.

A disposal of business assets is defined as :

- A disposal of the whole or part of a business (including an interest in a partnership),
- A disposal of (or of interests in) one or more assets which were in use in a business at the time the business ceased, or
- A disposal of shares or securities in a company.

The interpretation section (Section 169S) states that a business is any trade profession or vocation which is conducted on a commercial basis with a view to the realisation of profits. This is extended by para 3 of Schedule 2 to include furnished holiday lettings.

The criteria for a disposal to be a material disposal place further qualifications on each type of asset listed above.

- Where the disposal is of the whole or part of the business, the disposal is a material disposal if the business was owned by the individual disposing of it for the whole of the year ending with the date of disposal.

- Where the disposal is of an asset used in a business which has ceased, the business must have been owned by the individual throughout the year ending on the dare the business ceased, and that date must be within three years ending on the date of disposal.
- Where the disposal is of shares or securities in a company, either condition A or B must be met :
    - Condition A – throughout the one year ending on the date of disposal the company was the individual's personal company and is either a trading company or holding company of a trading group, and the individual is an officer or employee of the company or of one or more companies which are members of the same trading group.
    - Condition B – The same conditions are met as for condition A throughout the one year ending on the date on which the company ceases to be a trading company without continuing to be or becoming a member of a trading group, or ceases to be a member of a trading group without continuing to be or becoming a trading company.

Section 169S provides the definition of personal company. It is a company in which at least 5% of the ordinary share capital is held by the individual, and at least 5% of the votes are exercisable by the individual by virtue of that holding. Where shares are jointly held, then the individual is regarded as entitled to a pro rata proportion. Trading company, holding company and trading groups are defined in the new Section 165A, which takes the old activity based definition from taper relief, including the "to no substantial extent" test.

Individuals who trade through a partnership are dealt with by Section 169I(8). This provides that the disposal of assets on entering into a partnership and the disposal of all or part of an individual's interest in the assets of a partnership are the disposal of a business, and are therefore treated the same as the disposal of a business by an individual trader.

4.2.3 What does not qualify

By a process of elimination, it is possible to identify major disposal which do not qualify for relief. The sale of assets without the sale of the business, or the cessation of trade will not qualify for relief. This will affect farmers who sell off parcels of land, which previously qualified for BATR, but do not attract relief after 5 April 2008. It would also be an issue where a property used by the owner's personal trading company is sold either to the company or to a third party without the sale of the shares.

Commercial properties which are let on the open market, while previously qualifying for BATR will never qualify for ER under any circumstances.

4.2.4 Disposal of trust business assets

Entrepreneur's relief can also apply to the disposal of assets by trustees, and Section 169J sets out the basic conditions for a disposal to qualify.

There is a disposal of trust business assets within this relief when :

- The trustees of a settlement dispose of settlement business assets
- There is an individual who is a qualifying beneficiary, and
- The relevant condition is met.

Settlement business assets are shares or securities of a company and assets used or previously used for the purposes of a business which are settlement assets.

An individual is a qualifying beneficiary if under the settlement he has an interest in possession in either the whole of the settled property, or that part of it which comprises the settlement business assets disposed of.

The relevant conditions are :

- In relation to a disposal of shares or securities that throughout a period of one year ending not more than three years before the date of disposal, the company is the qualifying beneficiary's personal company, and is either a trading company or holding company of a trading group and

the qualifying beneficiary is either an officer or employee of the company or another company in the same trading group.

- In relation to a disposal of assets, that the settlement business assets are used for the purpose of the business carried on by the qualifying beneficiary (alone or in partnership) throughout the period of one year ended within three years of the date of disposal and the beneficiary (or partnership) ceases to carry on the business (or the beneficiary ceases to be a member of the partnership) on the date of disposal or within three years before that date.

4.2.5 Associated disposal

Section 169K deals with associated disposals. An associated disposal is a disposal associated with a material disposal of business assets (a relevant material disposal) if the following three conditions are met :

- Condition A – an individual makes a material disposal of business assets that consists of the whole or part of an individuals interest in the assets of a partnership, or the disposal of shares or securities in a company.
- Condition B – the individual makes the disposal as part of his withdrawal from participation in the business of the partnership or company
- Condition C – throughout the period of one year ended with the earlier of :
    - The date of the material disposal of business assets, or
    - The cessation of the business of the partnership or company

  the assets which are disposed of are in use for the purposes of the business.

4.2.6 Relevant business assets

Section 169L restricts relief to relevant business assets. This applies where the material disposal is of assets other than shares or securities, and denies relief unless the assets disposed of are relevant business assets. These are defined as assets used for the purposes of a business carried on by the individual or partnership, with a parallel provision for trusts, or if it is an associated disposal, assets used for the purposes of the business of the company or partnership. There follows in Section 169L(4) excluded assets which are shares and securities and other assets held as investments.

4.2.7 Claims

Entrepreneurs' relief is only available on a claim, which is made jointly by the trustees, or by the individual making the disposal. The time limit for claim is twelve months after 31 January following the year of disposal. (Section 169M).

4.2.8 Amount of relief

The **net** gains on the disposal of business assets must be computed, so that losses on disposal of business assets are netted off before relief is given on the net gain. The net gain is subject to a deduction of 4/9 of the gain, unless the net gains exceed £1 million, in which case only the first £1 million of net gains attract relief. Thus, if gross gains exceed £1 million, relief will still be given on the net gains, which is less advantageous than allowing relief against the gross gains, leaving the losses to be deducted in full. (Mathematically any losses are therefore also subject to a 4/9 deduction when set off against relieved gains).

The £1 million is a lifetime limit, so if any previous disposals have attracted Entrepreneurs' relief, then the limit is reduced accordingly. Where the disposal is by an individual, previous disposals by that individual, and disposals of trust business assets for which he was the qualifying beneficiary are taken into account. Where the disposal is of trust business assets, previous disposals by the trust in respect of which the same qualifying beneficiary has an interest and disposals by that individual are taken into account.

Where there is more than one beneficiary interested in the assets disposed of by a trust, then relief is only available on the proportion of the gain relating to the qualifying beneficiary. This proportion is arrived at by taking the interest of the qualifying beneficiary in the income of the shares or securities disposed of in relation to the interest in that income of all of the beneficiaries who have interests in possession in the settled property. The time period used for this computation is the period of one year ended not earlier than three years before the date of disposal during which the relevant conditions are met.

The amount of relief for an associated disposal may be further restricted under Section 169P. The gain attracting relief is restricted to an amount which is just and reasonable, taking into account the following factors :

- The asset disposed of has been in use in the business for only part of the period of ownership by the individual
- Only part of the asset has been in use for the business for the period during which they are owned by the individual
- The individual has only been involved in the business for only part of the time he has owned the asset, or
- The asset has been provided to the business in return for rent.

These restrictions seem to apply for the entire period during which the property was owned. In determining what is a fair and reasonable proportion of the gain to which relief should apply, regard should be had to the length of time during which the assets are used in the business, or the proportion of the asset used in the business, the length of time the individual is involved in the business, and the proportion of market rent which has been charged for use of the asset.

The transitional rules at para 6 of Sch 3 restrict the consideration of rent charged to periods after 6 April 2008 only. This was a late amendment at the request of ICAEW Tax Faculty.

4.2.9 Business reorganisations

Section 169Q permits the disapplication of section 127 of TCGA. Where a disposal which would qualify for Entrepreneurs' Relief is in effect a take over by another company, the CGT rules will not treat this as a disposal, but will treat the cost of the old shares as the cost of the new shares. However, this might cause the loss of relief, if the new company did not meet the qualifying conditions.

The new legislation allows disposers to "opt out" of Section 127 of TCGA – thus triggering an actual disposal on which relief can be claimed. A claim to entrepreneurs' relief will automatically disapply section 127, thus crystallising a gain to which the relief will apply.

Further business reorganisation provisions in Section 169R allow for a disposal which qualifies for Entrepreneurs' Relief but under which QCB's are acquired to be treated as if the Entrepreneurs' Relief is applied to the gain on the initial disposal, so that only the net gain resurfaces on a subsequent disposal of the QCB's.

4.2.10 Transitional relief

A number of commentators expressed concern about those who had disposed of business assets on which Taper Relief would have been available, but had taken deferral relief, transferring the gain which would have arisen into a new asset. Of particular concern have been Qualifying corporate bonds (QCB's) and EIS and VCT investments (although deferral relief is no longer available in relation to VCT investments).

In all three of these cases, transitional relief is now available so that if the original disposal took place before 6 April 2008, and would have qualified for Entrepreneurs' Relief at the time of the disposal (had it existed) then the gain deferred is treated as the amount after Entrepreneurs' Relief. The claim will be made on the first disposal (or other occasion of charge) of the QCB or EIS / VCT shares after 6 April 2008. The relief is provided by paras 7 and 8 of Sch 3 to FA 2008.

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Care is needed, however, as the transitional relief will only accrue to a holder of QCB's or other qualifying investments if they were the original disposer of the business assets. Where such investments have been passed, for example, to a spouse or civil partner, transitional relief will not be available. It is, however, open for the recipient to now pass those shares or bonds back to secure relief on a subsequent disposal.

4.3 Goodwill aspects of incorporation

HMRC reaction

They clearly do not like what is going on and can be expected to challenge some of the arrangements. This is quite apart from a reduction in the advantages now that there is no nil rate of corporation tax on the first £10,000 of profits and profits are taxed at 21% (increasing to 22%).

The main challenge relates to any attempt to sell goodwill to the company and then effectively extract profits from the limited company at a tax rate of only 10%.

Possible arrangements

T0 5/4/09	
route	***overall cost %***
remuneration	*47.7%*
dividend	*40.75%*
goodwill	*28.9%*

Consider selling the goodwill to the limited company at market value, with CGT at 10% assuming entrepreneurs' relief is available. The proceeds are left outstanding on loan account and drawn tax-free as and when the company can afford it. This can have a knock-on advantage to income tax on dividends paid to cover any profits in excess of the goodwill value, as the first approximate £35,000 per annum of dividends would be tax-free. There would be a corporation tax liability on the profits used to pay for goodwill, with the comparison being as under where the NIC UEL already reached:

FROM 6/4/09	
route	***overall cost %***
remuneration	*47.7%*
dividend	*41.5%*
goodwill	*29.8%*

The company can claim corporation tax on the amortisation of the goodwill if (and only if) that was created solely after 31 March 2002.

Type of goodwill

The goodwill value is likely to be a real bone of contention with Capital Taxes Office Shares Valuation Division often taking the wholly unacceptable line (particularly with someone providing professional services) that the goodwill is personal and therefore not capable of being sold to the limited company. They seemingly are willing to grudgingly accept that there is some goodwill when the sole practitioner or partners are providing services where there is an established client base, particularly where there are continuing services involved, but they try to force agreement to a low value to reflect the personal element.

For their likely stance on goodwill, see CGT Manual where they attempt to distinguish between:

- Personal goodwill
- Inherent goodwill
- Free goodwill

Resistance can be along the following lines:

- The normal formula for valuing goodwill of (for example) an accountancy practice, with countless examples of a value based on 1 to 1.5 x gross fees.
- Sales of a block of fees for (say) 0.75 to 1 x gross fees, to reflect the fact that there is no continuity for the purchaser.
- Alternative bases, such as taking the net profit; adding any exceptional expenditure; deducting a notional salary for the accountant; multiplying the result by (say) a PE ratio of 3 to reflect restricted marketability.
- In *Balloon Promotions Ltd v Wilson SpC524*, the Commissioner questioned HMRC's approach in the Capital Gains Tax Manual, specifically where it attempts to apply a zoological approach involving a cat, dog and rabbit.

Example - determining goodwill for service business Ms A (sole practitioner) the only fee earner

Although Ms A is the sole direct fee earner for the Practice, she uses the services of four experienced secretaries who create client reports from data provided by her. Clearly, therefore, to generate the fees the Practice relies on a number of important people in addition to Ms A.

The established and growing reputation of the Practice in providing an excellent service ensures that there is plenty of potential for future growth, and it also provides a firm basis for the existence of a goodwill value for the Practice.

Results

These can be tabulated as follows for the last 3 years, based on the accounts:

Year to:	31/3/08	31/3/07	31/3/06
	£	£	£
Fees receivable	418,643	312,040	215,905
Expenses	110,000	85,302	62,094
Net profit	318,643	226,738	153,811

It is understood that the current annual fees level of £418,643 does not represent the maximum attainable, and that the fees could rise quite considerably without needing the services of other qualified personnel. It would therefore be appropriate to regard the annual sustainable fees to currently be in the region of at least £420,000.

Possible valuation

We have undertaken some research into likely values of comparable businesses, but found limited data given that the Practice does specialise.

There is evidence from sales of Practices involved in similar activities that a reasonable basis is to value goodwill at 1 x annual sustainable turnover. Arguably that undervalues Ms A's Practice given that it provides an established service

HMRC will expect to see a reduction in the basic goodwill valuation to reflect the personal element. Indeed, they sometimes attempt to argue that the goodwill of a service provider is largely personal to the owner. A third party purchaser (which is what one has to assume when valuing goodwill) would down-value the goodwill to reflect the fact that some of the goodwill relates to Ms A personally and to that extent is not transferable.

In the Special Commissioner's case of *Balloon Promotions Limited and Others v Wilson and Another (SpC 524)*, the Commissioner made the following points:

- He cautioned against an over-analytical approach to goodwill.
- He questioned the normal HMRC approach of separating goodwill into the three categories of personal, inherent and free.

- He noted that the HMRC zoological definition of goodwill (identifying four types of customer in terms of cats, dogs, rabbits and rats) was considered to be of limited value in other cases.

Basically, the Commissioner considered that the exact composition of goodwill varied between trades, and in different businesses in the same trade. Whilst his comments do not help quantify the value of the goodwill of Ms A's Practice, they do suggest that any deduction for personal goodwill should be limited.

We consider that in this particular Practice the deduction for personal goodwill should not exceed 25%. The goodwill value then becomes £315,000 (= A in table below).

An alternative approach (= B in table below) to back-up the result in A is to take the net profit, deduct the level of remuneration likely to be paid to someone employed to do the work and then multiply the result by a factor of 2 (this the price/earnings ratio, set at that low level to reflect the lack of marketability for what would be shares in a private company). The goodwill value on that basis becomes £330,000.

Taking these two alternative approaches as under, we consider that the goodwill value of Ms A's Practice is **£320,000**.

	£	£
Sustainable annual turnover	420,000	
Deduct 25% for personal goodwill	(105,000)	
Goodwill value (A)		315,000
Net profit	320,000	
Deduct salary level	100,000	
	220,000	
PE ratio of 2	440,000	
Deduct 25% for personal goodwill	(110,000)	
Goodwill value (B)		330,000

Article by Gerry Hart

Lecture B491 (11.09 Minutes)

5 Inheritance Tax

5.1 Transfer of IHT nil rate band

The need for married couples and civil partners to plan for IHT by entering into nil rate band discretionary trusts and similar arrangements has been largely negated by a proposal in the Pre Budget Report 2007 which was legislated for in Section 10 and Schedule 4 to FA 2008.

Thus, for an individual who dies on or after 9 October 2007, leaving their entire estate to a surviving spouse, the nil rate band that is wasted (in view of the fact that the inter-spouse legacy is IHT exempt) will be available on the death of the surviving spouse. This change effectively provide a £624,000 nil rate band to all couples (married or civil partners) rather than only those who have executed some IHT planning steps.

5.1.1 Technical summary

The new provisions are contained in new Section 8A of IHTA 1984 introduced by para 2 of Sch 4 to FA 2008. Section 8A introduces the terminology. The legislation applies where immediately before the death of a person (a "deceased person") that person had a spouse or civil partner and had unused nil rate band on death. Thus the first spouse to die is referred to as the deceased person, and the second is referred to as the survivor. The legislation applies if the survivor dies on or after 9 October 2007.

There is unused nil rate band on the first death if the total chargeable transfers on first death are less than the amount on which IHT would be charged at a rate on nil per cent.

Where there is a claim under this section, the nil rate band of the survivor is increased by a percentage, being the amount by which the nil rate band exceeds the chargeable transfers on death divided by the maximum nil rate band at the date of death (subject to an upper limit of 100%). The terminology is phrased in this way to allow for those who had made chargeable transfers within seven years of death and thus have less than the full nil rate band available on death.

Paragraphs 10 and 11 modify these provisions to take account of the various estate duty regimes applying before 25 July 1984. To help with this, HMRC have now published various details about Capital Transfer Tax and its predecessor, estate duty, on the website. This includes details of the rules going back to 1914.

5.1.2 Claims

Claims are made by the personal representatives of the survivor within the permitted period, or by any other person liable to tax as a result of the survivors death if no claim has been made. The permitted period is normally two years from the end of the month in which the survivor dies or if later three months after the date on which the personal representatives began to act. Claims may be made late if an officer allows it, and can be withdrawn within quite a short space of time after being made.

5.1.3 Practical effect

The nil rate band thus transferred will be limited to the nil rate band at the time of the death of the second spouse. This will be relevant where an individual survives in a number of marriages or civil partnerships. For example, a widow who has survived four husbands, being left their entire estate on each occasion will still only benefit from two nil rate bands on her estate at the date of her death.

5.1.4 Examples of how the new rules will work

A. A dies on 14 April 2007 with an estate of £400,000, which he leaves entirely to his spouse, B. B dies on 17 June 2009 leaving an estate of £600,000 equally between her two children. When B dies the nil-rate band is £325,000. As 100% of A's nil-rate band was unused, the nil-rate band on B's death is doubled to £650,000. As B's estate is £600,000 there is no IHT to pay on B's death.

B. J dies on 27 May 2007, with an estate of £300,000. She leaves legacies of £40,000 to each of her three children with the remainder to her spouse K. The nil-rate band when J dies is £300,000. K dies on 15 September 2009 leaving his estate of £500,000 equally to his three children; the nil-rate band when K dies is £325,000. J used up 40% of her nil-rate band when she died, which means 60% is available to transfer to K on his death. So K's nil-rate band of £325,000 is increased by 60% to £520,000. As K's estate is only £500,000 there is no IHT to pay on K's death.

C. R dies on 14 April 2007 with an estate of £450,000, which he leaves entirely to his spouse, S. S dies on 17 June 2009 leaving an estate of £675,000 which she leaves equally between her two children. When S dies the nil-rate band is £325,000. As 100% of R's nil-rate band was unused, the nil-rate band on S's death is doubled to £650,000. This leaves £25,000 chargeable to IHT on S's death.

D. X dies on 14 April 2007 with an estate of £250,000, leaving £120,000 to his son Y and the remainder to his spouse Z. The nil-rate band when X dies is £300,000 so 60% of his nil-rate band is unused. Z later marries W who dies on 14 May 2008 and also leaves 60% of his nil-rate band unused. Z dies on 14 June 2009 with an estate of £700,000 when the individual nil-rate band is £325,000. Z's nil-rate band is increased to reflect the transfer from X and W, but the amount of increase is limited to 100% of the nil-rate band in force at the time. So Z's nil-rate band is £650,000, leaving £50,000 chargeable to IHT on Z's death.

5.1.5 Consequential amendments – CGT

When the unused nil rate band is computed, in some cases this will require the valuation of certain assets, which may have already been disposed of in the intervening period. Section 274 of TCGA requires that the CGT valuation is amended to reflect the valuation for IHT purposes. Due to the new relief, this would be unhelpful, so this will be amended to ensure that where an IHT valuation is not made on death, any subsequent IHT valuation will not require amendment of the CGT value.

More information : Guidance on how this will work in practice is available at
http://www.hmrc.gov.uk/pbr2007/it-nil-rate-guide.pdf
Nil rate bands back to 1914 are at
http://www.hmrc.gov.uk/cto/customerguide/page15.htm

5.2 IHT on pension arrangements

Sections 91 & 92 and Schedules 28 & 29 make modifications to the exemptions for schemes with 20 or more members from the legislation introduced in Finance Act 2007 to impose an IHT charge on certain pension arrangements. The charge affects ASP funds which become an inheritance on the death of the member. There are also amendments to ensure that tax relieved savings cannot become a tax free inheritance, these changes affecting more complex arrangements.

5.3 Life interest trusts – transitional rules

The changes to the trust legislation for IHT purposes which were made in Finance Act 2006 included some transitional arrangements for pre 22 March 2006 existing trusts.

In particular, the transitional rules provided that where a life interest was terminated by 5 April 2008, and a further life interest was created, this trust would remain under the old (pre 2006) rules until a further change in life tenant occurred. If however, on the termination of the Transitional Series Interest (TSI) the trust is wound up, then the new IHT rules would not bite on the trust at all.

There have been some difficulties with the new rules where one life interest is terminated and a second life interest created in favour of the same beneficiary. It is not clear how the rules for TSI's would work in this case. The legislation is amended by Section 140 to resolve this difficulty, but in the meantime it has been decided to extend the transitional period by a further 6 months to 5 October 2008; this being achieved by Section 141.

5.4 IHT planning

The old adage that Inheritance Tax (IHT) is a voluntary tax only paid by the poorly advised does not totally ring true today. However, it certainly is a tax that you can plan for. Below are five ideas to save IHT. Some are old. Some are new but all are worth considering for appropriate clients.

Basics

Starting with the very basic, a married couple (or civil partnership) can, over a period of seven years, give away free of IHT a total of £666,000 between them. Using 2008/09 rates this is worked out as follows:

2 Nil Rate Bands at £312K	624,000
2 annual exemptions at £3K x 7	42,000
Total	**£666,000**

And that assumes no assets which qualify for 100% **Business Property Relief** (BPR) or **Agricultural Property Relief** (APR), which can of course be gifted free of IHT without limit, subject to the relevant technical conditions applicable to the reliefs. The importance of BPR and APR should not be underestimated in estate planning as they allow more assets to be passed into a trust without an upfront IHT charge and can reduce the IHT liability within the trust (eg 10 year charges and exit charges

Spouses of course can make unlimited IHT free gifts to each other, assuming both are UK domiciled or that a non-domiciled spouse makes gifts to a UK-domiciled one and not vice versa. In the latter case there is a £55,000 limit.

And the above savings are before considering **potentially exempt transfers** (PETs). These are unlimited gifts to individuals which become tax free after seven years and bear tapering lower rates in the event of death from year 3 to year 7.

The reliefs

There are plenty of other exemptions to consider. So, if you hear that wedding bells will be ringing shortly or your client is quite rightly proud of numerous grandchildren, don't forget to remind them about **marriage exemptions** (up to £5,000 by each parent) or the **small gifts exemption** (up to £250 per recipient per annum).

Whenever a client is making a gift, either to an individual or a trust, the **annual exemption** may be available. For a married couple who have not made any gifts in the last 2 years, this equates to £12,000 that does not use up any of their nil rate band allowance. Talking of the **nil rate band allowance** (£312,000 for 2008/09 but set to rise to £350,000 in 2010/11), utilising your clients' nil rate band allowance by making gifts into trust every seven years will become more common. This is because it is now much more difficult to pass a significant amount of assets IHT free into a trust, so doing this with smaller amounts, more often, from a younger age will be a low-risk estate planning strategy.

Normal expenditure out of income

People often overlook the relief for 'normal expenditure out of income' (s21, IHTA 1984) which is valuable because such expenditure is not a chargeable transfer and does not eat into the annual exemptions or the NRB.

Section 21 says:

'A transfer of value is an exempt transfer if, or to the extent that, it is shown - that it was made as part of the normal expenditure of the transferor, and

(a) that (taking one year with another) it was made out of his income, and

(b) that, after allowing for all transfers of value forming part of his normal expenditure, the transferor was left with sufficient income to maintain his usual standard of living.'

Gifts which qualify for this relief effectively extend the NRB because they are exempt. Establishing a pattern of gifts to family members, eg by standing orders on birthdays or at Christmas, is important and it should be clear that the gifts are of such a size that the donor is still left, after tax, with enough

income to sustain their usual standard of living, but for the well-off quite large gifts can be made in this way so long as the pattern is carefully documented. Several points arise:

In HMRC's view 'income' bears its accounting meaning, net of normal outgoings and net of tax. The reference to one's standard of income is subjective. So Mr E Scrooge, who regularly saves or reinvests much of his income should be able to make larger gifts under this relief, than a very profligate individual who spends most of their income even if their gross income is much bigger than Scrooge's. If trying to fall within the 'normal expenditure out of income' rules (NEIR for short) it is important to set up a pattern of regular gifts each year, which of course goes to the 'normal' part of the NEIR conditions. This can either be done as a matter of fact and repetition, or by showing an intention-perhaps by writing an open letter to one's advisers and family setting out what is intended to happen over the next few years. Keep the evidence carefully in case HMRC disagree later.

- Having set the pattern, it should be possible to claim the NEIR even if in fact not many gifts are made, as happened in *Bennett v IRC* [1995] STC 54 where the donor set out her intentions but then died about a year later having made only two gifts.

- If one spouse has surplus income-producing assets and the other has a significant income it might be worth transferring assets to the 'asset poor' spouse to assist in helping him/her to set up a pattern.

- A large gift may still qualify in part for NEIR ('to the extent that…'part of s21 applies)

- Unlike PETs there is no need to survive seven years.

Nil rate band planning

Since 9 October 2007 it has been possible for married couples and civil partnerships to share their Nil Rate Bands on death. This has been covered in previous issues of this seminar programme but as a reminder here is an example.

Mr Smith died leaving a legacy to a Will trust, which used 25% of his nil rate band (say £200,000 nil rate band allowance at date of death). The balance passed to his widow absolutely so the spouse exemption applied. On the widow 's death, she will be entitled to an extra 75% of the nil rate band allowance at the rate then in force on her own death (say 75% of £312,000). This is in addition to widow's own nil rate band, so she would be entitled to a total of £312,000 plus 75% of £312,000 = £546,000.

The main issue here is to ensure that qualification is obtained and this requires an election. The claim for transfer of unused nil rate band will be made by the personal representatives of the estate of the second spouse or civil partner on submission of the IHT return. **No claim is required on the first death**

A claim must be made within two years of the second death although there are provisions to extend this in certain circumstances

A separate claim is required for each transfer of unused nil rate band if there was more than one deceased spouse or civil partner

Providing for grandchildren

Clients with excess income will often want to provide for future generation eg grandchildren.

Despite the Finance Act 2006 changes to trusts, they can still provide a flexible way of providing for grandchildren (and can give control if grandparents are the trustees). However, unless the trust is for a beneficiary who is disabled, no additions to the trust are PETs.

However, the normal expenditure out of income exemption (see above) can also apply to gifts into trusts so why not gift part of the excess income into a new discretionary trust each year? By keeping the total value of additions within the nil rate band amount, the discretionary trust may be able to avoid any IHT liability at the first 10 year charge. There is nothing to stop a new trust being created once the total value in the first trust starts approaching the nil rate band allowance so that each trust can benefit from its own nil rate band allowance.

Transitional serial interests

As an aside it is also worth remembering transitional serial interests (TSIs) which were one of the concessions added to the FA 2006 and relate to interests ending between 6 April 2006 and 6 October 2008. These broadly apply where:

- the settlement commenced before 22 March 2006;
- immediately before that date a person had an interest in possession trust (IIP);
- that prior interest comes to an end on or after 22 March, but before 6 October 2008;
- on that coming to an end, another IIP arises to which someone (whether or not the same person as before) is beneficially entitled; and
- that interest is not a disabled person's or bereaved minor's interest.

This could be used to indefinitely extend a spousal TSI and thus is obviously useful. An example is as follows:

Assume a revocable appointment created an interest in possession for a father with one of his children included as remainderman. It was decided that his second child should also be included as a remainderman so the initial appointment should be revoked and a new appointment made that included both children as remainderman. The fresh appointment would create a TSI for the same life tenant. Before the Finance Bill 2008 changes, this lead to a very unexpected and unwelcome IHT charge. So where necessary a TSI for the same life tenant can now be completed to avoid this problem. It is generous that the extension applies to all TSIs in favour of a new life tenant too. However, the extention of the TSI regime is only until 5 October 2008 so action needs to be taken soon if it is going to be used.

Article by Francesca Lagerberg

Lecture P493 (9.37 Minutes)

6 Other tax provisions

6.1 Landfill tax

Section 18 provides for a further hefty increase of 20% in the standard rate of landfill tax from £32 per tonne to £40 per tonne from 1 April 2009.

6.2 SDLT : zero carbon homes

Section 90 extends the SDLT relief for new zero carbon homes introduced in FA 2007 to new zero carbon flats, if they meet the same qualifying criteria

6.3 SDLT notification thresholds

It is a requirement to notify land transactions where the consideration exceeds £1,000. This is in spite of the fact that no SDLT will be chargeable until the consideration exceeds £125,000.

Section 94 increases this threshold to £40,000 for non leasehold transactions, which will reduce the reporting burden considerably. Grants of leases of seven years or more will only be notifiable if the chargeable consideration other than rent is £40,000, or the rent exceeds £1,000 per year. Assignments of leases with an original term in excess of seven years will be notifiable if the consideration is £40,000 or more. Grants and assignments of leases of less than seven years are not notifiable if the consideration does not exceed the nil rate threshold for SDLT.

These exceptions are included in new Section 77A of FA 2003, and have effect for transactions with an effective date on or after 12 March 2008. Schedule 30 includes consequential amendments in relation to this provision.

6.4 SDLT : consideration includes rent

Finance Act 2003 includes a measure to ensure that the SDLT thresholds cannot be manipulated where rent is charged in addition to other consideration. The rules work by disapplying the normal nil rate limit of £125,000 or £150,000 when the rent element exceeds £600.

Section 95 amedns this provision by amending Sch 5 to FA 2003 to remove the anti avoidance provision in relation to residential property, and increase the limit of rent for non residential property to £1,000. Where land is partly residential and partly non residential the consideration and rent must be apportioned between them on a just and reasonable basis.

6.5 SDLT : property investment partnerships

Section 97 and Schedule 31 make changes to SDLT to ensure that there is no charge to SDLT on the transfer of an interest in a property investment partnership. It amends changes brought in in Finace Act 2007, and thus commences from 19 July 2007.

6.6 Stamp Duty – admin

Documents have to be presented for stamping when stock transfers are executed. Normally the duty is £5, as the rate is ½%, rounded up to the next £5. Where the consideration is less than £1,000, therefore, the duty is always £5. There is also a £5 charge for stamping instruments for transfer other than by way of sale – such as a gift. 68% of documents presented for stamping carry duty of only £5.

Section 98 amends the law so that instruments with duty of less than £5 are exempt from stamping, and thus may be actioned once executed. The change takes effect in relation to instruments executed on or after 13 March 2008 and not stamped before 19 March 2008. Section 99 and Schedule 32 further abolish the fixed £5 charge on a number of common transactions, further reducing the burden of stamp duty.

For the purposes of the Stamp Act 1891, instruments with consideration of less than £1,000 or which are now exempt executed under the new rules will be deemed to be acceptable evidence.

7 Value Added Tax

7.1 Power to open or unpack containers

CEMA 1979 is amended by Section 117 to allow officers to open or unpack any container, and search it or anything in it, under the general power to inspect goods. The expense of making good is to be borne by the Commissioners.

7.2 Three year rule – retrospective transitional rules

Section 116 makes the changes to introduce a transitional period in relation to the commencement of the old three year rule for VAT. Section 115 includes legislation to enable assessments of overclaims to work correctly, which is needed both for this area and generally.

Traders who overpaid or underclaimed VAT in the period between 1973 and May 1997 can now recover the VAT they consider that they are owed.

When the three year cap on VAT reclaims was introduced in 1996 and 1997, inadequate time was given for those who wanted to make a claim under the old rules to do so. This is contrary to EU law, and recent appeal cases have resulted in HMRC announcing a transitional period until 31 March 2009. Those who believe that they are owed VAT for the period 1 April 1973 to 1 May 1997 for input tax, and 4 December 1996 in respect of overpaid output tax can now claim it back, but they will need to provide evidence to support their claim. The details of the new procedures for back claims are in Revenue & Customs Brief 07/08 issued in late February 2008. Claims may now be made for :

- Output tax overpaid or overdeclared (for repayment businesses) in VAT accounting periods ending before 4 December 1996, and
- Input tax in respect of which an entitlement to deduct arose in accounting periods ending before 1 May 1997.

The new opportunity arises because although HMRC introduced transitional arrangements in respect of the three year cap in 2002, the appellants successfully argued that this did not sufficiently rectify the issue for input tax claims. HMRC have accepted that it would not now be appropriate to rely on the transitional arrangements for output tax claims either (although this was not the subject of the Lords Appeal and judgement) and have introduced this legislation to permit claims in respect of all VAT owing, in relation to the periods outlined above.

7.3 Correcting VAT errors

Under the new penalty regime for inaccuracies on returns and documents disclosure plays a crucial part in the design of the new penalty regime. There is an important and complex interplay with the correction of VAT errors – previously known as voluntary disclosure, but now referred to as “correction of errors”.

Where a client has made a culpable error, that is an error through failure to take reasonable care over his tax affairs, or a misdeclaration on a return or document that is deliberate, disclosing the inaccuracy can result in a significant reduction in the penalty tariff. Unprompted disclosure of an error, that is not made under fear of discovery can result in the penalty for careless error being reduced to zero, assuming that the disclosure is prompt and complete.

However, this has important implications for the future of dealing with VAT errors, particularly in view of the new limit applying to the correction of VAT errors from July this year.

When a trader has made VAT errors which has subsequently been discovered, the errors can often be corrected on the next VAT return, provided that the total value of errors they seek to correct is less than the specified limit. The limit applying until July 2008 was £2,000; this means that if the total net value of errors to be corrected is less than £2,000 the errors can simply be corrected by making an entry on the next VAT return. Default interest does not apply to errors corrected in this way.

For errors in excess of this amount, the error must be disclosed separately to HMRC either by completing form VAT 652 or by writing to HMRC VAT Regional Business Advice centres. Once the error has been corrected by an assessment (which is issued on receipt of the notification) default interest will also apply to any late paid VAT as a result of the error.

The limit of £2,000 has been replaced for VAT accounting periods commencing on or after 1 July 2008. For these VAT periods, errors of £10,000 can be corrected on the VAT return by all traders. For larger businesses with errors in excess of this sum, the limit is 1% of current turnover up to a maximum of £50,000. The turnover for these purposes is the box 6 figure on the return on which the error is to be corrected. Thus, if box 6 exceeds £1 million for the current VAT period, the error may still be corrected on the return provided it does not exceed the lower of 1% of box 6 or £50,000. Errors in excess of the new limits must be separately disclosed to HMRC as before, using form 652. Default interest will not apply to errors corrected on returns, but will apply to errors which are separately notified.

Interaction with penalty regime

Voluntary disclosure of VAT errors, as it has always been known is **not** disclosure for the purposes of the new penalty regime. This is because if you wish to make a disclosure under the new penalty provisions, the law (para 9 of Sch 24 to FA 2007) defines a disclosure as comprising three aspects :

- ***telling*** HMRC about it,
- ***giving*** HMRC reasonable ***help*** in quantifying the inaccuracy, (also referred to as ***helping***) and
- ***allowing*** HMRC access to records for the purpose of ensuring that the inaccuracy or under-assessment is fully corrected.

When an error is corrected on a VAT return, arguably none of these requirements has been met. So a "voluntary disclosure" of a VAT error, will not meet the definition of a disclosure for new penalty purposes, and thus will not protect the trader in the event of a penalty being due. For this reason, HMRC are moving away from calling this "voluntary disclosure" and are now to call it the Error Correction Procedure.

Weighing all of this information, the adviser can come to the following conclusion, which is supported in the HMRC guidance on this at CH81141.

- they will need to evaluate the circumstances which caused the inaccurate return to be made. If they conclude that this was an error made despite taking reasonable care, then they should ensure that as much evidence of that exercise of care as possible is on file. There is no penalty for errors made despite taking reasonable care, unless the trader fails to take reasonable steps to notify HMRC of the error, so the issue of disclosure is not relevant. The client can safely correct the inaccuracy on the next return if it meets the new limits, and HMRC have confirmed that this will be "taking reasonable steps" to notify them of the error.
- If they conclude that there has been a failure to take reasonable care which has given rise to the error, (and the error has resulted in an underpayment of VAT) they will need to advise the client to make a separate disclosure, irrespective of the size of the error. This means that some small errors will be disclosed to HMRC in spite of the fact that the tolerance for separate disclosure has been increased.

Guidance on making a disclosure

The Compliance Handbook Manual explains that the three elements of disclosure command a different amount of discount. The manual considers each element in turn and provides the following help.

CH82440 explains what is mean by "telling". Telling includes :

- admitting the document was inaccurate or that there was an under-assessment
- disclosing the inaccuracy in full
- explaining how and why the inaccuracy arose.

The quality of the disclosure and the rate of discount therefore available for telling depends on the disclosure being given in full, essentially at the outset, subject to the complexity of the case.

CH82450 gives more guidance on "helping". Helping includes :

- giving reasonable help in quantifying the inaccuracy or under-assessment
- positive assistance as opposed to passive acceptance or obstruction
- actively engaging in the work to accurately quantify the inaccuracies
- volunteering any information relevant to the disclosure.

However, the judgement of the quality of "helping" will depend on the circumstances and capabilities of the individual concerned.

Finally, CH82460 explains "giving access". Giving access includes a person responding positively to requests for information and documents and allowing access to :

- their business and other records
- other relevant documents.

Access is needed to ensure that the inaccuracy or under-assessment is fully put right and is more than simply complying with requests for information.

Taking these three together, and specifically in the context of disclosing VAT errors, we might have the following approach.

- First the initial letter can include all of the aspects of "telling" described in the Manual. The error can be disclosed, setting out the quantum of the error if possible, and explaining the reason why the error occurred. This will cover both telling and in part helping.
- If it is not possible to calculate the effect of the error at the outset, then helping would require that the trader set about putting together sufficient data to both calculate the error and allow HMRC to check the calculation.
- Arrangements should be made early to make records available to check that the extent of the error has been correctly identified. This might include attending meetings with HMRC if that is the best way to test the calculations or assertions – see CH 82460.

HMRC have confirmed that using form VAT 652 will meet both the "telling and helping" requirements. Disclosure is quite a structured arrangement, much more than just notifying HMRC that there is a problem. Those working in this area in the future would do well to analyse the guidance carefully, so that the maximum discounts for disclosure are obtained and the minimum penalty under the law is the result.

Article by Rebecca Benneyworth

Lecture B494 (10.41 Minutes)

7.4 VAT bad debt relief: technical note

This online lecture reviews the rules for claiming bad debt relief for VAT purposes, and examines some recent cases in this area.

Bad debt relief in general

The problem with bad debts for VAT is that the trader is generally required to account for output tax on a sale when an invoice is raised. If the customer does not pay, the trader has failed to collect 117.5% of the sale price from the customer, and has paid 17.5% of it to HMRC. The VAT law at s.36 VATA 1994 and regs.165 – 172B SI 1995/2518 permit the amount accounted for to HMRC to be recovered in certain circumstances.

The subject is covered in detail in Notice 700/18/02. The main conditions are set out as follows:

What is VAT bad debt relief?

If you have made supplies to your customers on or after 1 October 1989 and have not been paid, you can claim relief from the VAT on bad debts for the goods or services that you have supplied as long as you meet all the conditions. You may claim relief whether the payment due to you was in money or in goods or services to be provided to you in a barter arrangement.

What are the conditions?

Conditions for claiming bad debt relief

1. You must already have accounted for the VAT on the supplies and paid it to Customs and Excise;
2. You must have written off the debt in your day to day VAT accounts and transferred it to a separate bad debt account;
3. The value of the supply must not be more than the customary selling price;
4. The debt must not have been paid, sold or factored under a valid legal assignment (see para 3.12);
5. The debt must have remained unpaid for a period of six months after the later of the time payment was due and payable and the date of the supply; and
6. If the goods were supplied before 19 March 1997, ownership must have passed to your customer, or through the customer to a third party;
7. For supplies made to a VAT registered customer between 26 November 1996 and 31 December 2002, you must send a notice to them. A copy of the notice must also be retained (see para 2.7 for an example).

Note: if you account for tax under the cash accounting scheme (see Notice 731 "Cash accounting" (Part V8)) or under one of the retail schemes (see Notice 727 "Retail schemes" (Part V8)) which allows you to adjust your daily gross takings for opening and closing debtors, you are only paying VAT on the amounts you have actually received from customers, so bad debt relief is unnecessary.

When can I claim bad debt relief?

You must wait at least six months from the later of when payment was due and payable or the date of supply.

You cannot claim on a return for an accounting period earlier than the one in which you become entitled to the relief.

For supplies made after 1 May 1997, you must claim within three years and six months of the later of, when payment is due and payable or the date of supply.

How do I claim bad debt relief?

To claim a refund you should include the amount of the VAT you are claiming in Box 4 of your VAT return, which covers the date when you fulfil the conditions to make a claim.

Do I have to keep any records?

Yes, when you can claim a refund you must keep—

— A copy of the VAT invoices for the supplies on which you are claiming a refund. (If you did not issue a VAT invoice you must have a document showing the equivalent information.); and

— A separate bad debt account showing the—

(a) amount you have written off as a bad debt;

(b) amount of VAT you wish to claim as bad debt relief;

(c) VAT period in which you have claimed a refund;

(d) total amount of VAT charged on each supply;

(e) VAT period in which you originally accounted for;

(f) payment received for each supply;

(g) name of your customer; and

(h) date and number of the invoice to which the bad debt relates. (If you did not issue an invoice you must include sufficient information to allow the time and type of the supply to be readily identified.)

(i) a copy of any notice issued (see paras 2.6 and 2.7).

Do I have to notify my customer that I'm making a claim?

Changes announced in the 2002 Budget remove the requirement for traders to issue notification letters for supplies made after 31 December 2002.

What should the notification look like?

[no longer relevant]

How long must I keep the records?

After making the claim you must keep all the records listed in paragraph 2.5 for 4 years from the date you make your claim. This requirement does not alter the standard requirement to retain records for six years—see Notice 700 "The VAT guide" (Part V8) for details.

Flat rate scheme

One curious rule which may have escaped some traders is the treatment of bad debts under the flat rate scheme. A trader authorised to use this scheme claims no input tax, but rather accounts for a lower figure of output tax on sales to allow for the input tax foregone. If such a trader has a bad debt, the bad debt relief is the full 17.5% shown on the unpaid invoice, not the flat rate percentage that has been accounted for on the VAT return. This seems surprisingly generous, but it is intended to reflect the fact that the trader may have incurred input tax in making the sale which will not be recoverable.

This is even extended to the situation where a flat rate trader is using the cash received basis of preparing VAT returns. The trader will not have accounted for anything to HMRC, but still makes a bad debt claim for the difference between the flat rate and the 17.5% that was shown on the invoice. Once again, this is to allow for input tax that may have been incurred in making the sale.

This is described in Notice 733 as follows:

Can I claim bad debt relief if I use the flat rate scheme?

Bad debt relief arises if you account for and pay output tax on supplies for which you are not paid later. The rules are explained in Notice 700/18 "Relief from VAT on bad debts" (Part V8) and these will apply to you.

If you use the basic or retailer's turnover methods of flat rate accounting, you can claim relief on eligible supplies at the standard rate of VAT, rather than the flat rate.

This is because the flat rate includes an allowance for input tax which only occurs if you have been paid by your customer. As you will not have been paid, you will not have had full credit for any input tax.

If you are using the cash turnover method, the rule for claiming bad debt relief are different, as explained at paragraph 14.2 below.

What if I use the cash turnover method of accounting?

If you use the cash turnover method of accounting you may be eligible for bad debt relief if—

— you have not been paid by your customer and it has been six months since you made the supplies

— you have not accounted for and paid tax on the supply

— you have written off the debt in your accounts.

If you meet all these conditions, your claim will be for the difference between the VAT you charged to your customer and the amount you would have declared to us had you been paid. As with businesses

that use the basic and retailer's methods, this is because your flat rate takes account of input tax that you would otherwise have been entitled to, if you had been paid by your customer.

You can make the adjustment as follows:

Step	What you need to do	Example
1	Identify the VAT in the unpaid supply	Total price = £1,175 VAT= £175
2	Calculate the VAT that would have been paid under the flat rate scheme if your customer had paid you. That is the total owed (including VAT) multiplied by your flat rate scheme percentage.	£1,175 x (say) 10% = £117.50
3	Subtract the sum of step 2 from the sum of step 1	£175 – £117.50 = £57.50
4	Step 3 is your special allowance under the flat rate scheme. Include it in your VAT account in your next return.	£57.50 is added to the VAT deductible portion of your VAT account and creates a claim or reduces the VAT payable.

Change to the rules

Following on from the closure in 2006 of the loophole that was highlighted by the *GMAC* case in 2004, early in 2007 HMRC announced changes to the way in which bad debt relief can be calculated by traders who make sales on credit terms.

Where a business makes such sales, there are two supplies: goods (usually standard rated) and finance (exempt). The tax point for the supply of goods is usually delivery, while the finance is a continuous supply of services and is therefore treated as made only when there is a payment (as an invoice cannot trigger a tax point for an exempt supply).

The issue for bad debt relief that this creates – as illustrated in the 2005 case of *Abbey National plc* – can best be illustrated by a simple example of a hire purchase or conditional credit sale. The cash price is £20,000 + VAT; the finance charges are £6,500; the total amount of £30,000 will be settled by payment of a deposit of £5,000 and the balance in five instalments (the last including a nominal "option to buy" amount). Accounting principles require a debtor to be set up for the capital outstanding (£23,500 – £5,000 = £18,500) and the instalments will reduce this. Common sense and simple economics dictate that the earlier instalments contain more of the finance charge, while the outstanding capital is greater; later instalments contain more capital repayments. An unsophisticated calculation uses "sum of the digits" (SOD – referred to by Customs as the "rule of 78", which is the sum of the numbers from 1 to 12) to allocate the charge – for 5 years, the SOD is 15, so 5/15 of £6,500 is the finance element for the first year, 4/15 goes in the second year, and so on.

	Capital repaid	Capital o/s	P&L
Year 1	£2,833	£15,667	£2,167
Year 2	£3,267	£12,400	£1,733
Year 3	£3,700	£8,700	£1,300
Year 4	£4,133	£4,567	£867
Year 5	£4,567	Nil	£433
Total	£18,500	N/A	£6,500

So, what happens if the debt goes bad at the end of year 3? The accountant will write off the outstanding capital balance of £8,700, and interest of £1,300 (£867 + £433) will never reach the P&L.

The £20,000 received will be treated as £14,800 capital and £5,200 interest. Any recovery on the repossession of the item will reduce the bad debt loss.

But what about the VAT? Up to 2007, the rules did not follow common sense and simple economics. Abbey National probably used a more sophisticated calculation than SOD, but the effect would be similar. On the above figures, they would have reclaimed bad debt relief on the write-off of £8,700. Until 31 December 2002, reg.170 SI 1995/2518 required bad debt relief to be calculated on the assumption that any payments covering more than one supply should be allocated to the earliest supply for which consideration was outstanding. The tax point for the goods (taxable) was the delivery date; the finance charge (exempt) would only have a tax point when payment was received. On the face of it, the rules required the £20,000 received all to be allocated to capital, and bad debt relief would be restricted to 7/47 of £3,500.

By concession up to the end of 2002, Customs were willing to take the more reasonable approach of rateably apportioning the instalments, so £6,500/£18,500 of each instalment would be exempt. From 1 January 2003, this was expressly set out in the law at reg.170A. However, it was still not in accordance with economics or accounting practice. In the *Abbey National* case, a High Court judge held that it was perfectly reasonable (being a lawyer rather than an accountant or financier).

A new reg.170A was introduced with effect from 1 September 2007. This requires traders to calculate bad debt relief on the basis of what they use for accounting purposes. For supplies made between 1 September 2006 and 31 August 2007, traders had the option of using the old or new method (the only reason for using the old method could only be that it was familiar – it could not be more favourable).

Defaulting customers are required to reduce their input tax claims. They are unaffected by the change: they are still required to apportion the payments on a straight line basis. This creates a small "VAT leakage", although presumably the customer is often unable to pay in any case. The straight-line calculation can always be done by the customer on the basis of information that the customer has, and does not depend on obtaining information from the supplier that might be commercially sensitive.

Customs' Brief on the subject ends with the s*light*ly peculiar remark: "*If you, as supplier, reduce your selling price after you have received a bad debt relief refund in relation to that supply, then you must repay the VAT element of the price reduction to HMRC. This is because, in reducing the selling price, you will be able to reduce the VAT you originally accounted for and therefore should not also receive bad debt relief as well.*" It seems a strange idea to reduce the price of a sale after claiming bad debt relief in respect of it, but the *GMAC* arrangements involved accepting the return of HP goods and a restatement of the original price rather than writing off the outstanding balances as a bad debt. In effect, Customs are saying that the price adjustment takes precedence over the bad debt claim. Clearly the trader should not be allowed to reduce output tax on a price adjustment and claim back input tax in the form of bad debt relief; if a price adjustment is claimed, the bad debt claim has to be adjusted accordingly.

Revenue & Customs Brief 14/07; SI 2007/313

Consideration received

A company (B) owned 41.5% of the shares in another company (F), which was in financial difficulties and owed B significant amounts of money. As part of a management buyout of F, B agreed to write off some of this debt. In return, F agreed to enter into an "exclusive supply agreement" with B for a period of 4 years. B claimed bad debt relief in respect of the consideration written off.

HMRC refused the claim on the basis that the exclusivity agreement represented consideration received for the debts. The Tribunal agreed with HMRC. No bad debt relief was due.

Part of the trader's problem was that he was asked in an e-mail whether the exclusivity agreement was part of the deal for the buyout, and he responded that it was. When he later realised the significance of this, he tried to change his story, claiming that he had misunderstood the question and misled the officer. The Tribunal found this unconvincing, highlighting the problems that arise from uninformed answering of Customs' questions.

VAT Tribunal (20,051): *Berck Ltd*

Bad credit clawback

A company P was the representative member of a VAT group with a separate company owned by the same individual R. R received a large invoice from British Telecom and the input tax claim arising (£680,000) was the subject of a visit. The officer accepted that P could claim the input tax but pointed out that, as it was likely that R could not pay the bill, P would have to repay that input tax when BT was entitled to bad debt relief.

BT subsequently decided (in the Tribunal's view, correctly) that the bill should have been outside the scope of VAT as a termination charge rather than for services rendered. It therefore issued a credit note to R and recovered the output tax accounted for to HMRC. Nevertheless, P made no adjustment to the input tax it had claimed.

The appellant tried a number of arguments to resist the assessment raised to recover the VAT on the cancellation charges. These included the contention that a Customs officer had "directed" him to form a group registration, without which P would not be liable for the VAT (as R had now been liquidated), that the officer had accepted that the VAT was deductible when checking the original claim; and that no credit note had ever been received from BT.

The Tribunal did not regard any of these arguments as having any substance. The other witnesses were all praised for their credibility, and the retention of the money by the company was characterised as bordering on dishonesty. Costs were awarded to HMRC.

VAT Tribunal (20,565): *Power TV Ltd*

Credit notes or bad debts?

A car dealership company (B) sold Ford cars. B had no corporate relationship with Ford. In 2002 B went into receivership. It held a number of cars for which it had not paid F. In accordance with the supply agreement between the two companies (which was terminated if either party went into an insolvency procedure), F reclaimed the cars and issued credit notes. The supply agreement contained a "retention of title" clause which was legally effective and which entitled F to recover its cars in priority to other creditors.

B's receivers needed to continue the business in order to try to sell it as a going concern, for which they needed stock. They agreed with F that, after the credit notes had been issued, F would re-sell the same cars to the receivers on the same terms. In effect, F exercised its rights under the supply agreement by issuing the credit notes, but then decided to carry on a new informal supply agreement with the receivers.

B's receivers subsequently submitted a claim for repayment of input tax in respect of these cars. The Commissioners rejected the claim and B appealed, contending that the credit notes should not have been treated as effective for VAT purposes, and that F should have claimed bad debt relief instead. This would have benefited B because B would not have had to repay the input tax under the usual bad debt rules if an insolvency procedure commenced between the input tax claim and the six month deadline at which F would make its claim.

The Tribunal rejected this contention and dismissed B's appeal, holding that the credit notes had been correctly issued and that F could not have claimed bad debt relief since it had recovered the cars in accordance with the supply agreement. The supply had been reversed, so there was no input tax for B to claim. However, it was not a straightforward case: the company's counsel had argued strongly from precedent cases that the supply did not cease to be a supply because of the retention of title clause, and the reclamation of the cars by F was not a supply either.

The High Court confirmed this decision. The parties had agreed that the first supply agreement had been rescinded, cancelling the original supplies, and the credit notes were validly issued on that basis.

High Court: *Brunel Motor Co Ltd v HMRC and another*

Bad debts

A company suffered several bad debts and subsequently went into liquidation. The liquidators claimed bad debt relief, and HMRC refused some of the claims on the basis that the company had not paid over the output tax on those sales.

The company claimed that it had "accounted for and paid VAT" in respect of the sales, because its input tax had exceeded its output tax for the periods concerned. For example, its return for its final period of trading showed output tax of £46,563 and input tax of £40,311. Its bad debts for that period totalled £20,600. It argued that its input tax should be treated as covering its actual output tax liability of £25,963, leaving a balance of £14,348 which could be set against the bad debts. Presumably the net VAT of £6,252 shown on the VAT return had not been paid.

HMRC argued that there was no mechanism in the legislation for the taxpayer to choose which output tax had been accounted for and which had not. Even though the taxpayer was taking the most pessimistic line – that the unpaid balance on the VAT return entirely related to the bad debts and restricted the claim – HMRC considered that no claim at all was possible.

The Tribunal held that the claim was valid to the extent that input tax covered the output tax on the VAT return. Although the trader could not identify individual invoices on which VAT had been accounted for, nevertheless it had accounted for and paid VAT within the requirements of the legislation, and it also appeared to have the right to relief under the 6th Directive.

VAT Tribunal (20,611): *Times Right Marketing Ltd (in liquidation)*

Article by Mike Thexton

Lecture B495 (21.34 Minutes)

8 Tax administration

8.1 Information and inspection powers

Section 113 and Schedule 36 introduce the new information and inspection powers which have resulted from the "Powers Review". The measures have attracted wide criticism from leading commentators, not least because the powers in Sch 36 do not all include corresponding safeguards for taxpayers.

The new powers will commence by Order, which is expected to be in 2009.

The following analysis of Schedule 36 is broken down into Parts to make it more manageable.

8.1.1 Part 1 Powers to obtain information and documents

An officer may give written notice to a taxpayer (known as a taxpayer notice) or a third party (known as a third party notice) requiring them to provide information or produce a document if the information or document is reasonably required to check the tax position of the taxpayer, or in the case of a third party notice a person whose identity is known to the officer.

Third party notices may not be given without either the agreement of the taxpayer or the approval if the First-tier Tribunal. Pre approval is not required for the issue of a taxpayer notice, but if approval of the Tribunal is obtained this eliminates the right of appeal (by either the taxpayer or the third party) against the notice. See Part 5 for detailed information about rights of appeal. The approval of the Tribunal may not be given unless :

- the application for approval is given by an authorised officer of HMRC (not yet defined)
- the Tribunal is satisfied that in the circumstances the officer giving the notice is justified in doing so,
- the person to whom the notice is addressed has been told that the information or documents referred to in the notice are required and has been given a reasonable opportunity to make representations to an officer of HMRC,
- the Tribunal has been given a summary of representations made by that person, and
- in the case of a third party notice, the taxpayer has been given a summary of the reasons why an officer requires the information and documents.

Where the Tribunal is satisfied that the assessment or collection of tax might be prejudiced, the last three conditions may be dispensed with. Where approval is given by the Tribunal for a third party notice, the Tribunal may also approve the withholding of the taxpayer's name if satisfied that the officer has reasonable grounds for believing that naming the taxpayer might seriously prejudice the assessment or collection of tax.

Third party notices must be copied to the taxpayer, unless the Tribunal has dispensed with this requirement, which it may do on application by an authorised officer who satisfies the Tribunal that he has reasonable grounds for believing that providing a copy to the taxpayer might prejudice the assessment or collection of tax.

Separately, under paragraph 5 an authorised officer of HMRC may by written notice require a person to provide information or produce a document which may be reasonably required by the officer for the purpose of checking the UK tax position of a person or class of persons whose identities are not known to the officer. The approval of the first tier Tribunal will always be required for such a notice. In granting approval, the Tribunal must be satisfied, that in addition to the conditions for giving the notice the following also apply :

- That there are reasonable grounds for believing that the person or any of the class of persons to whom the notice relates may have failed or may fail to comply with any provision of the Taxes Acts, or VATA 1994 and related legislation,
- any such failure is likely to have led or to lead to a serious prejudice to the assessment or collection of UK tax, and

- the information or document to which the notice relates is not readily available from another source.

All notices which have been approved by the Tribunal must state that fact. When someone complies with a notice he must do so within such a time and in such a way as is reasonably specified in the notice. Production of a document must occur in a place agreed between the recipient and an officer, or a place reasonably specified by an officer of HMRC – which specified place must not be a place used solely as a dwelling. Copies of documents rather than originals may be produced unless the notice specifies the original document, or an officer subsequently requests in writing sight of the original.

8.1.2 Part 2 – Powers to inspect businesses

An officer of HMRC may enter a person's business premises and inspect :

- the premises,
- business assets that are on the premises, and
- business documents that are on the premises

if the inspection is reasonably required for the purpose of checking that person's tax position. However, there is no power to enter or inspect any part of the premises that is used solely as a dwelling.

Business assets means assets that an officer of HMRC has reason to believe are owned, leased or used in connection with the carrying on of a business by any person, excluding documents.

Business documents means documents or copies of documents that relate to the carrying on of a business by any person, and form part of the statutory records of any person.

Business premises (in relation to a person) are any premises that an officer of HMRC has reason to believe are used in connection with the carrying on of a business by or on behalf of the person.

The right to enter and inspect premises is then replicated in respect of premises used in connection with taxable supplies, acquisitions form other member states and fiscal warehousing without the requirement that the inspection is reasonably required to check a person's tax position. This right of entry, once again, does not include a right to enter premises used solely as a dwelling.

Inspections carried out under this Part may be carried out at a time agreed by the occupier of the premises, or at any reasonable time if the occupier has been given seven days notice of the inspection. Inspections may also be carried out at any reasonable time without notice if agreed by an authorised officer of HMRC.

Inspections without notice must be accompanied by a written notice which is provided to the occupier, or other person in charge of the premises, or if empty, left in a prominent place on the premises. The notice must state the possible consequences of obstructing an officer in the exercise of the power, and if a Tribunal has approved the inspection (which it may do if an authorised officer applies, and the Tribunal is satisfied that the inspection is justified) the notice must state this.

8.1.3 Part 3 – Further powers

In relation to documents

The officer may make a copy of any document produced to him or which he has inspected, and may remove documents produced to him and retain them for a reasonable time. The person producing the document may request a receipt for it, and if the document is needed for a purpose may ask for a copy of it. If the document is lost or damaged, having been removed, the Commissioners are liable to compensate the owner for reasonable costs incurred in replacing or repairing it.

In relation to inspecting businesses

The powers under Part 2 include the power to mark business assets to indicate that they have been inspected, and the power to obtain and record information (whether electronically or otherwise) relating to the premises, assets and documents that have been inspected.

8.1.4 Part 4 – Restrictions on powers

A person cannot be required to produce a document if it is not in their possession or power. A notice cannot require a person to provide or produce information that relates to a tax appeal, or journalistic material (as defined by S13 of PACE 1984), nor to provide personal records within S12 of PACE, but may require the production of documents with information that makes them personal records omitted.

A notice may not require a person to produce a document if the whole of the document originates more than six years before the date of the notice, unless the notice is given by an authorised officer.

Where a person or company has already made a tax return in relation to a chargeable period, no taxpayer notice may be given in respect of that chargeable period unless any one of the following apply:

- A notice of enquiry has been issued in relation to the return or a claim or election in relation to the chargeable period to which the return relates,
- An officer of HMRC has reason to suspect that an amount that ought to have been assessed to tax for the chargeable period may not have been assessed, or may be insufficient, or relief given may be excessive
- The notice is given for the purpose of checking the person’s VAT position, or
- The notice is required for the purpose of checking the person’s position as regards deductions or repayments under PAYE etc.

Where a notice is issued in relation to a deceased person, it must be given within 4 years of the date of death.

A notice may not require a person to breach legal professional privilege. Regulations will be made to decide how a dispute about whether information or documents are privileged will be resolved.

A notice may not require a statutory auditor to produce information in connection with an audit or audit working papers. An information notice does not require a tax adviser to provide information about or documents which are his property and are relevant communications. For this purpose relevant communications means communications between the tax adviser and his client, and any other tax adviser of the client, the purpose of which is the giving or obtaining of advice about any of those tax affairs. A tax adviser is someone appointed to give advice about the tax affairs of another person.

However, in the case of both auditors and tax advisers, the exemption does not extend to documents or information which explain any information or documents which the person to whom the notice is given has prepared on behalf of the client for delivering to HMRC, nor in respect of a notice under paragraph 5 to information giving the identity or address of the person to whom the notice relates, unless the information has already been supplied to an officer of HMRC.

When HMRC are inspecting premises under Part 2, they may not inspect a document which they could not issue a notice in respect of due to restrictions in this Part of the Schedule.

8.1.5 Part 5 – Appeals against information notices

The taxpayer and the third party otherwise have a right to appeal to the First tier Tribunal against a notice, but not in respect of any documents or information which form part of the taxpayer’s statutory records. The third party’s ground of appeal are that it would be unduly onerous to comply with the notice. Neither have a right of appeal against the notice if the first Tier Tribunal approved the giving of the notice before it was given.

Appeals against notices in paragraph 5 are similarly made on the grounds that it would be unduly onerous to comply.

Notice of appeal must be given in writing before the end of 30 days beginning on the date the notice was given. The Tribunal may confirm the notice, vary the notice or set aside the notice, and if confirmed or varied may specify the period allowed for compliance. If no period is specified, then an officer may specify a reasonable period in writing after the decision.

8.1.6 Part 6 – Special cases

Notices in relation to VAT

Where a taxpayer or third party notice relates to information or documents which form part of the statutory records of any person and relate to the supply of goods or services, the acquisition of goods from another member state or the importation of goods from another member state in the course of carrying on a business, there is no right of appeal against the notice, and taxpayer consent or approval of the Tribunal are not required for the issue of a third party notice.

Groups

Notices can be given to a third party in respect of a group of companies – it will name the parent company. Notices given to the parent company as a third party in respect of the tax affairs of any subsidiary company are not subject to most of the controls on third party notices, and are largely regarded as taxpayer notices, there being very limited right of appeal, and none in respect of statutory records.

Partnerships

In the same way notices in respect of partnerships are subject to different rules, and need only name the firm. Notices to one partner in order to check information regarding other partners are not subject to approval or appeal.

8.1.7 Part 7 – Penalties

The standard penalty for persons who fail to comply with a notice or deliberately obstructs an officer in the course of an inspection which has been approved by the First tier Tribunal is £300. Once a penalty has been imposed, there is a further daily penalty of up to £60 per day for the period the default or obstruction continues.

The same penalty also applies where someone conceals, destroys or otherwise disposes of a document which is the subject of a notice, or which the taxpayer has been notified informally will be the subject of a notice (unless 6 months have elapsed since the informal notification was given).

No penalty applies where something was not done within a time limit, but the officer has agreed to allow more time, provided the person complied within that extra time.

No penalty can be imposed if the person satisfies HMRC or on appeal the First tier Tribunal that he has reasonable excuse for the failure to comply or the obstruction, but reasonable excuse is not :

- an insufficiency of funds, unless attributable to events outside that person's control;
- where the person has relied on someone to do something, and they have failed, unless the first person took reasonable care to avoid the failure or obstruction.

When the reasonable excuse has ended the person should comply without unreasonable delay, or otherwise may be liable to a penalty.

Penalties are assessed by HMRC and notified to the taxpayer, but must be assessed within 12 months of the relevant date – the end of the period allowed for appeal or the date the appeal is withdrawn or determined, or otherwise the date on which the person became liable to a penalty. Penalties are due for

payment within 30 days (or 30 days of the conclusion of an appeal) and are subject to enforcement as if they were an amount of income tax.

Appeal against the penalty is made to the First tier Tribunal, in writing within 30 days of the issue of the penalty assessment. The Tribunal may then overturn the penalty, confirm it or vary the amount.

Tax geared penalties are also available when a standard penalty has been imposed, the breach continues and an officer has reason to believe that as a result the amount of tax the person has paid or is likely to pay is significantly less than it would have been. Within 12 months after the relevant date (as defined above) an officer appeals to the Upper Tribunal requesting that a penalty be applied by it. In deciding the amount of penalty the Upper Tribunal must have regard to the amount of tax which has not been or is not likely to be paid by the person. This penalty is imposed in addition to the standard and daily penalties. Such a penalty is payable within 30 days and is subject to enforcement as if it were an amount of income tax.

8.1.8 Part 8 – Offences

If a person conceals, destroys or otherwise disposes of a document to which a notice approved by the Tribunal relates that person is guilty of an offence. On summary conviction the penalty is a fine not exceeding the statutory maximum, and on conviction on indictment the penalty is a term of imprisonment of up to two years and / or a fine.

A person is similarly guilty of an offence if he conceals, destroys or otherwise disposes of a document which he has been notified in writing that it is likely to be the subject of an information notice and that an officer intends to seek approval of the Tribunal before issuing an information notice in respect of the document. No offence is committed if at least 6 months has expired after he was last given such notification.

8.1.9 Part 9 – Miscellaneous provisions and interpretation

Much of Part 9 is basic background, but the following is of interest :

Premises means :

- any building or structure
- any land, and
- any means of transport.

An authorised officer is an officer of Revenue and Customs who is or is a member of a class of officers who are authorised by the Commissioners for the purpose of that provision.

Business includes the letting of property, the activities of a charity and the activities of a Government department, local authority, a local authority association and any other public authority.

Statutory records is information and documents which a person is required to keep and preserve under the Taxes Acts or VATA 1994, until the expiry of the time they are required to be kept. To the extent that any information is required to be kept under the Taxes Acts, but does not relate to a business, it is only part of a person's statutory records to the extent that the chargeable period to which they relate has ended.

Tax position of a person means that person's past present or future liability to pay tax, penalties that have been paid or may be payable in relation to tax and claims, elections, applications and notices that may have been made or given in relation to tax.

8.2 Supplementary powers in relation to computer records

All references to a document are deemed by Section 114 to include references to the information on the document and to anything onto which the information on the document has been recorded or copied, by whatever means. Section 114(3) then provides that an authorised person may at any reasonable time obtain access to and inspect and check the operation of any computer and any associated apparatus or

material which is or has been used in connection with a relevant document – that is any document that a person has been or may be required to produce, or to permit an officer to inspect and copy etc.

The officer may require the person on whose behalf the computer has been so used, or any person having charge of the computer to provide reasonable assistance as may be required for these purposes. Anyone who fails or obstructs the officer is liable to a penalty of £300.

8.3 Record keeping

Section 115 and Schedule 37 include new legislation in respect of statutory records. The provisions will commence by Order, but there are significant Regulations and guidance to be issued first.

The primary legislation amends Section 12B TMA 1970, with the main thrust of the new record keeping requirements introduced in new subsection (3A). This provides that the Commissioners may by Regulations :

(a) provide that the records to be kept and preserved under this section include or do not include records specified in the Regulations, and
(b) provide that those records include supporting documents so specified.

Supporting documents are defined as accounts, books, deeds, contracts, vouchers and receipts. The legislation also permits some of the specifics regarding record keeping to be specified in a Notice issued by HM Revenue & Customs. This would clearly relate to VAT Notices.

So HMRC's approach to record keeping legislation is to:

- set out the basic requirement for taxpayers to keep records relating to their tax liabilities in primary legislation;
- supplement the basic requirement with more detailed requirements in secondary legislation. Where the taxpayer is carrying out an obligation on behalf of the State (such as operating the VAT system or applying PAYE or NICs) there would be a more specific requirement as to the records required to be kept; and
- expand on the statutory provisions with non-statutory guidance on areas where there is the potential for greater flexibility.

Where taxpayers are essentially discharging their own obligations – to keep the records necessary for them to make a correct return – more would be left to their discretion while providing non-statutory guidance to help them.

8.4 Time limits for assessments and claims

Section 118 and Schedule 39 introduce new aligned time limits for assessments and claims. The measure will come into force by Order**.**

The following amendments are made :

Provision (TMA 1970)	Old limit	New limit
S28C(5)(a) issue of determination when no return made	5 yrs	3 yrs
S29(4) & 30B(5) discovery assessment – amend condition to "was brought about carelessly or deliberately by"	-	-
S33(1) & 33A(2) error or mistake claim	5 yr 10m	4 yrs
S34 ordinary time limit for assessments	5yr 10m	4 yrs
S35 income received after the year in which assessable – time limit for assessment	6 yrs	4yrs
S36 fraudulent or negligent conduct – new condition – careless behaviour	20 y 10m	6 yrs
S36 fraudulent or negligent conduct – new condition – deliberate default	20y 10m	20 yrs
S 40 assessment of personal representatives - new condition added "carelessly or deliberately"	3yrs	4yrs
S43 – time limit for claims	5yr 10m	4yrs
S43A & 43C(1) – further assessments in relation to claims – new condition "carelessly or deliberately"	-	-
ICTA 1988		
S36(2)(b) claims for repayment of tax on sale of land with right to reconveyance	6yrs	4yrs
S257AB(9) & 257BB(5)(a) elections in respect of MCA on post 5/12/05 marriage or civil partnership	5yr 10m	4yrs
S265(5) transfer of blind person's allowance	5yr 10m	4yrs
S270(4) claim for repayment of excess paid on surrender of life policy	6yrs	4yrs
S419(4) claim for relief when loan surrendered	6yrs	4yrs
S806(1), 806G(3)(a) & 806M(7)(a) – claims in respect of relief for foreign tax	6yrs	4yrs
FA 1991 S 65(6) assessment to corporation tax on receipt of reimbursement expenditure	6yrs	4yrs
TCGA 1992		
S203(2) Claims in relation to mineral losses	6yrs	4yrs
S253(4A) claims for losses on loans to traders	5yr 10m	4yrs
S279(5) claim in respect of delayed remittance of proceeds of foreign asset	6yrs	4yrs
Provision	**Old limit**	**New limit**
VATA 1994		
S33A(4) refunds to museums and galleries	3yrs	4yrs
S77(1) assessments – normal time limit	3yrs	4yrs
S77(4) assessments – deliberate failure or failure to notify (change in terminology)	20yrs	20yrs
S77(5) assessment after death of individual	3yrs	4yrs
S78 interest in cases of official error – time limit for claim	3yrs	4yrs
S80(4) claims for repayment of overpaid VAT	3yrs	4yrs
FA 1998 Sch 18		
Para 36(5) & 37(4) determination if no return delivered or notice complied with in part	5yrs	3yrs
40(3) time limit for self assessment superseding determination	5yrs	3yrs
43 new terminology "brought about carelessly or deliberately" for fraudulent / negligent conduct	-	-
46(1) general time limit for assessment	6yrs	4yrs
46(2) time limit where careless behaviour	21yrs	6yrs

46(2A) time limit where deliberate default	21yrs	20yrs
51(1)(c) relief in case of mistake on return	6yrs	4yrs
53 recovery of excessive payments by assessment	6yrs	4yrs
55 general time limit for claims	6yrs	4yrs
FA 2002 Sch 16 para 27 withdrawal of community investment tax relief	*	6yrs
ITEPA 2003 S711(2) notice by recipient of PAYE income requiring officer to give notice requiring a return	5yrs	3yrs
ITTOIA 2005		
S301(3) claims for repayment of tax in connection with a sale with a right to reconveyance	6yrs	4yrs
S302(3) claims for repayment of tax in connection with sale and leaseback	6yrs	4yrs
S840A(1) claims for relief in respect of foreign pensions taxed on an arising basis	5yr 10m	4yrs
ITA 2007		
S40(1)(a) election for transfer of blind persons allowance	5yr 10m	4yrs
S46(6)(b) election specifying relief for MCA post 5/12/05 marriage or civil partnership	5yr 10m	4yrs
S53(4)(a) transfer of unused relief (MCA)	5yr 10m	4yrs
S155 loss relief against miscellaneous income	5yr 10m	4yrs
S237 EIS relief time limit for assessments	6yrs	6yrs
S372 withdrawal of community investment tax relief	*	6yrs
S668(7) & 669(4) claim for unremittable transfer proceeds	5yr 10m	4yrs

* no time limit specified previously.

In summary the effect of these changes is to :

- to set the normal VAT assessing period at four years (increased from the current three);
- to reduce the period for IT, including PAYE, CGT and CT during which tax can be brought into charge under a discovery to four years instead of the present six;
- to limit all taxpayer claims to four years, mainly reduced from six years, except for Vat where it is an increase from three years.
- to set the period for error or mistake claims for IT, CGT and CT, and the period for VAT claims, at four years to retain symmetry;
- to set the period for tax lost as the result of a careless inaccuracy (failure to take reasonable care) at six years. This would be a reduction from 20 years for neglect for IT, CGT and CT. It would be an increase from three years for VAT;
- to maintain the period within which tax lost as a result of a deliberate inaccuracy (deliberate understatement) or failure to notify liability can be brought into charge at 20 years; and
- to set the period for charging tax lost as the result of an undisclosed avoidance scheme at 20 years.

This is most easily displayed in tabular form as :

Tax	Mistake	Discovery	Failure to take reasonable care	Deliberate understatement or Failure to notify liability
VAT	4 years	N/A	4 years	20 years
IT & CGT	N/A	4 years	6 years	20 years
CT	N/A	4 years	6 years	20 years
PAYE	4 years	N/A	6 years	20 years

8.5 Correcting returns

Section 119 introduces a power for an officer to amend a return unilaterally when he has information available to him which indicates that the return is incorrect. This extends the current powers in relation to amending returns, which apply only to correct obvious errors and omissions on the return. The power relates to income tax returns of individuals, partnerships and trusts and corporation tax returns. The taxpayer retains the right to reject the amendment.

8.6 Penalty provisions – the next phase

The new penalty legislation included in Finance Act 2007 has been slightly amended by Section 122 and Sch 40. Largely the amendments extend the provisions already enacted to create a single penalty regime for incorrect returns across all the taxes, levies and duties administered by HMRC. The penalty will be determined by the amount of tax understated, the nature of the behaviour giving rise to the understatement and the extent of disclosure by the taxpayer.

The following taxes and duties are now included :

- Insurance premium tax
- Inheritance tax
- SDLT
- Stamp duty reserve tax
- Petroleum revenue tax
- Aggregates levy
- Climate change levy
- Landfill tax
- Air passenger duty
- Alcoholic liquor duties
- Tobacco products duty
- Hydrocarbon oil duties
- Excise duties
- General betting duty
- Pool betting duty
- Bingo duty
- Lottery duty
- Gaming duty
- Remote gaming duty

The existing legislation is also amended to introduce a new category of penalty trigger, by inserting para 1A into Sch 24 FA 2007. This provides a penalty where an error in a taxpayer's document is attributable to the deliberate supply by another person (T) of false information, or the deliberate withholding of information by T with the intention of the document containing the inaccuracy. The penalty rate applying in such a case is 100% of the potential lost revenue, and is chargeable on T, whether or not any penalty is due by the taxpayer. There will be similar discounts for disclosure by T as in the existing rules.

Most of the remaining changes in Sch 40 are consequential changes. The new penalty provisions are likely to commence in 2009, but will therefore not be charged until returns due for filing on or after 1 April 2010.

8.7 Penalties for failure to notify

Section 123 and Schedule 41 make new penalty provisions in relation to failure to notify chargeability to tax, and certain offences in relation to VAT invoices. These provisions are intended to apply across the main taxes and are modelled on the penalty provisions in Sch 24 FA 2007, using a behaviour based approach and giving discounts for disclosure. They will be the subject of a commencement Order; it is intended that the new rules will apply to obligations arising on or after 1 April 2009.

This will affect all of the taxes and duties mentioned above (under para 8.6), but in mainstream tax practice will affect the following :

- Notification of chargeability to income tax or capital gains tax
- Notification of chargeability to corporation tax
- Notification of liability to be registered for VAT
- By extension through secondary legislation to notifying liability to NIC's, thus changing the £100 fixed penalty for failure to notify self employment by the due date.

This will also include a similar penalty for issue of a VAT invoice by an unauthorised person, and for putting products to a use that attracts a higher duty (e.g. red diesel as road fuel) and handling good subject to unpaid excise duty.

The penalty rates will be 30% of the potential lost revenue in any event (unless the taxpayer can show reasonable excuse) and 70% for deliberate failure followed by 100% for deliberate and concealed omissions – in this case concealment relates to the concealment of the obligation or the situation giving rise to the obligation.

Behaviour	Rate of penalty
Failure to notify / other failures	30%
Deliberate failure	70%
Deliberate and concealed	100%

Similar provisions apply to disclosure as apply to the errors legislation, with similar penalty reductions. The disclosure reduction for omissions other than deliberate will work in two stages depending upon the time that has elapsed since the failure occurred. The minimum penalty in some cases for unprompted disclosure will be 10% rather then nil.

Original penalty	Unprompted disclosure	Prompted disclosure
30% : within 12 months	0%	10%
30% : after 12 months	10%	20%
70%	20%	35%
100%	30%	50%

In the cases of income and capital gains tax, the potential lost revenue is the amount not paid by 31 January following the fiscal year, and in the case of corporation tax the amount not paid by 12 months after the end of the accounting period. For VAT the potential lost revenue is the VAT due from the date the business should have been registered until the date that notification is received. For other taxes and duties it is the amount that would be payable during the time the person was not registered but should have been. For the incorrect issue of VAT invoices it is the amount of VAT shown on the invoice.

Similar provisions apply as for the existing legislation in relation to assessment, appeals, and liability of company officers.

8.8 Tribunal reform – tax appeals

Section 124 is enabling legislation which will allow the appeals process to be changed by secondary legislation. HMRC need to modernise and streamline the appeals process across the various taxes and duties, particularly in view of the fact that the entire English Courts process is to be reformed by the Tribunals, Courts and Enforcement Act 2007.

The power to amend by Treasury Order will provide the flexibility that HMRC believes that they need.

The Section also provides for reviews of HMRC decisions. This new safeguard is intended to provide for an internal review process of HMRC decisions, prior to the making of a formal appeal. The new review process will also be specified by secondary legislation.

8.9 Enforcement : taking control of goods

Sections 127 to 129 and Schedule 43 introduce powers related to the enforcement of HMRC debts.

Section 127 introduces a single general power, applicable to England and Wales only to take control of goods to recover sums owed across all taxes, by reference to Sch 12 of the Tribunals, Courts and Enforcement Act 2007. This replaces four separate powers which arise from the old structure of Inland Revenue and Customs & Excise.

Section 128 introduces a single general power to issue a summary warrant for a debt in Scotland, once again replacing four sets of old powers. The section is longer as it needs to provide details of the process by which the warrant is applied for and executed.

Section 129 invokes consequential provisions in respect of both Ss 127 and 128 in Sch 43, and provides that the powers shall commence by Order.

8.10 Set off

Section 130 introduces a right of set off available to **HMRC** which will allow full set off between all taxes due by the same taxpayer or legal entity, including NIC. This applies in England, Wales and Northern Ireland. Thus a repayment due can be set off against liability to other taxes. The set off will be at HMRC's discretion and not a legal obligation. Repayments of tax due will also be set off against tax credit debt, but not vice versa. Set off will not disturb an income or capital gains tax repayment which has been donated direct to charity through the tax return.

Section 131 prevents set off from applying where an insolvency procedure has been applied. There is no set off where there is a pre insolvency debt and a post insolvency credit due. The types of insolvency procedure to which this restriction relates are :

- A bankruptcy order
- A winding up order
- The appointment of an administrator
- The person is put into administrative receivership
- A corporation passes a resolution for voluntary winding up
- A voluntary arrangement comes into force
- A deed of arrangement takes effect

Section 132 aligns set off in VATA 1994 S81 with the above powers.

Section 133 deals with set off when the right to be paid a sum has been transferred to another person – and allows the set off provisions to disturb the transfer of the repayment due.

8.11 Surcharges and interest – national disasters

Section 135 allows HMRC to waive interest and surcharges on tax in situations which are designated as National Disasters. This will permit the commitment for this to be applied in the case of the summer 2007 floods to happen, and allow HMRC the opportunity to react to further problems of this sort in the future at the time they happen rather than having to wait for the next Finance Bill to make the changes. The power will be exercised by a Treasury Order issued in the case of each event which is categorised as of national significance. Such an order has been issued since Royal Assent in relation to the 2007 floods.

8.12 Fees for payment of tax by credit card

Taxpayers will also be permitted to pay tax debt by credit card, but will be charged the merchant's fee at the time they settle the debt. Section 136 includes the enabling power for this measure. Regulations have been issued allowing payment by telephone, and setting the merchant's charge at 0.91% of the amount paid. (The Taxes (Fees for Payment by Telephone) Regulations 2008 SI 2008/1948, coming into force on 13 August 2008). It is anticipated that further Regulations will follow for alternative payment methods such as internet.

8.13 County Court proceedings

Section 137 allows for an officer of HMRC to take a single action to recover debts in relation to all taxes and duties in the County Court. This replaces a number of existing powers which were in legacy legislation, and simplifies the process of enforcement. Section 138 provides for an officer to issue a certificate of debt in relation to all or any taxes (once again unifying the powers across the taxes). Schedule 44 provides consequential changes.

8.14 Extra statutory concessions

The decision in the case of *'The Queen (on the application of John Wilkinson) v. Her Majesty's Revenue and Customs'* ('Wilkinson') made clear that the scope of the discretion of HMRC to make concessions from the strict application of tax law is not as wide as had previously been thought.

Through the Tax Law Rewrite project, many concessions have been incorporated into rewritten legislation, and HMRC are in the process of reviewing any remaining concessions. Section 160 introduces a power to implement the remaining concessions either unchanged, or with modifications by secondary legislation. Each concession can be the subject of an Order implementing it into law.

8.15 Penalties for inaccuracies on returns

Section 97 and Schedule 24 of the Finance Act 2007 set out the new penalty regime for errors on returns which have now commenced. The new penalty legislation introduces a completely new penalty structure for incorrect returns which will apply across all of the main taxes, replacing the numerous rules presently in force. The new system is based on the behaviour of the taxpayer and is intended to promote voluntary compliance, and provide greater sanctions on those who deliberately understate their tax liabilities.

The new rules replace penalties under income and corporation tax, capital gains tax, PAYE and VAT for periods commencing on or after 1 April 2008, but with a transitional rule relating for returns due for filing before 1 April 2009.

Penalty triggers

A penalty will apply when a person gives a specified document to HMRC, and the document contains an inaccuracy which is careless or deliberate and which amounts to or leads to any of the following :

- An understatement of his liability to tax;
- A false or inflated statement of a loss he has incurred, or
- A false or inflated claim to repayment of tax.

The types of return covered by the legislation are listed in para 1 as follows:

Tax	Document
Income tax or CGT	Returns under section 8 or 8A of TMA (personal and trustee tax returns)
	Return, statement or declaration in connection with a claim for an allowance, deduction or relief
	Accounts in connection with ascertaining a tax liability
	Partnership return
	Statement or declaration in connection with a partnership return
	Accounts in connection with a partnership return
Income tax	Return for the purposes of PAYE regulations
Construction industry deductions	Return for the purposes of regulations under Section 70(1)(a) of FA 2004 in connection with deductions on account of tax under the CIS. (monthly CIS return)

Corporation tax	Company tax return under para 3 of Sch 18 to FA 1998 (self assessment for CT)
	Return, statement or declaration in connection with a claim for an allowance, deduction or relief
	Accounts in connection with ascertaining a liability to tax
VAT	VAT return under regulations made under para 2 of Sch 11 to VATA 1994
	Return, statement or declaration in connection with a claim
Income tax, CGT, corporation tax or VAT	Any document which is likely to be relied upon by HMRC to determine, without further enquiry, a question about : • His liability to tax • Payments by him by way of or in connection with tax • Any other payment by him (including penalties), or • Repayments, or any other kind of payment or credit to him.

A penalty may also apply when an assessment is issued by HMRC to a person which understates his liability to tax and he has failed to take reasonable steps to notify HMRC within 30 days after that it is an under assessment, he is liable to a penalty. In determining what steps were reasonable to have taken, HMRC must consider whether the person knew or should have known about the under assessment, and what steps would have been reasonable to take to notify HMRC. The taxes affected by para 2 are income tax, capital gains tax, corporation tax and VAT.

The degrees of culpability which determine the rate of penalty are set out in para 3 to Sch 24. They are:

- Careless – if the inaccuracy is due to failure by the person to take adequate care, or if an inaccuracy which was not careless or deliberate is discovered and the person did not take reasonable steps to notify HMRC.
- Deliberate but not concealed – if the inaccuracy is deliberate, but the person does not make arrangements to conceal it, and
- Deliberate and concealed – if the inaccuracy is deliberate, and the person makes arrangements to conceal it, for example by submitting false evidence in support of an inaccurate figure.

Amounts of penalty

The penalty rates rise according to the degree of culpability by the person. The rates of penalty are as follows:

Culpability	Penalty rate
Careless	30%
Deliberate but not concealed	70%
Deliberate and concealed	100%

The penalty rate for a penalty under para 2 (under assessment not notified) is 30%.

Potential lost revenue

The rates of penalty are applied to the "potential lost revenue". This is defined by paras 5 to 8, with para 5 applying generally. The definition is logical and states that the potential lost revenue is the additional amount payable in tax and NIC as a result of the error being corrected. However, group relief and repayments of section 419 tax are ignored when calculating the potential lost revenue.

Where there are multiple errors, and the resulting additional tax would be different depending on the order in which the errors are corrected, then errors should be corrected in the following order:

1. Careless errors

2. Deliberate errors without concealment
3. Deliberate errors with concealment.

Where there are multiple errors in multiple documents, account shall be taken of any overstatements of tax due by the person in any document relating to the same year. The order of set off of overstatements is as follows:

1. against understatements in respect of which no penalty is due
2. against careless understatements
3. against deliberate understatements, and
4. against deliberate understatements which have been concealed.

No account is taken, however, of any tax which may be paid by another person as a result of the understatement, unless the law provides for the liabilities of the two to be offset.

Overstated losses

One aspect that is new is that there is a deemed amount of potential lost revenue where losses have been overstated. In normal circumstances, when the loss has been set off and relief gained, the potential lost revenue can be calculated as normal, by reference to the amount of relief given for the loss. However, where part of the loss has not been wholly used as relief against tax due, the amount of potential lost revenue in relation to the unrelieved losses is 10% of the unused losses. Where the inaccuracy overstates a loss in a group scenario, then group relief will be taken into account when calculating the potential lost revenue, as this would give relief to the loss. The potential lost revenue in respect of a loss is nil if there is no reasonable prospect of the loss being given relief and reducing the tax liability of any person.

Delaying tax due

There is also a deemed amount of potential lost revenue where the tax has been paid, but the liability has been delayed as a result of the inaccuracy. The potential lost revenue is 5% of the tax unpaid for each year, for each year of delay, with a pro rata adjustment for part years of delay. This does not apply where there are losses which have been overstated, as the rules on losses take precedence.

<u>Disclosure</u>

The old scheme of mitigated penalties will no longer apply, but taxpayers will be able to reduce the gross penalty by making a disclosure of the inaccuracy, for which a range of reductions have been specified by statute. The law defines a disclosure of an inaccuracy as :

- Telling HMRC about the inaccuracy,
- Giving HMRC reasonable help in qualifying the inaccuracy or under assessment, and
- Allowing HMRC access to records for the purpose of ensuring that the inaccuracy or the under assessment is fully corrected.

Disclosure is unprompted if made at a time when the person has no reason to believe that HMRC has discovered or are about to discover the inaccuracy or under assessment, and otherwise is “prompted”.

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The following rates of penalty will apply when there has been a disclosure of an inaccuracy :

Culpability	Maximum penalty (no discount)	Unprompted minimum penalty	Prompted minimum penalty
Careless	30%	0%	15%
Deliberate	70%	20%	35%
Deliberate & concealed	100%	30%	50%

Suspended penalties

One novel aspect of the new legislation is the power for HMRC to suspend a penalty for careless inaccuracy.

HMRC may notify a taxpayer that all or part of his penalty has been suspended for a period of up to two years, and will set conditions of the suspension. However, the power to suspend a penalty will only be available if compliance with a condition of the suspension would help the taxpayer to avoid becoming liable for further penalties for careless inaccuracies.

At the end of the period of suspension, if HMRC are satisfied that the conditions of the suspension have been complied with then the suspended penalty will be cancelled; if the conditions have not been complied with, the suspended penalty will become payable. If during the period of suspension a further penalty becomes payable for an inaccuracy in a return then the suspended penalty will also become immediately payable.

The suspension of penalties is intended to allow the taxpayer to use the money that would otherwise have been payable as a penalty to improve their systems or bookkeeping to ensure that no inaccuracies arise in the future.

Officers of companies

Where a company is liable to pay a penalty for a deliberate inaccuracy which was attributable to an officer of the company, the officer as well as the company shall be liable to pay the penalty, and HMRC may seek recovery of such proportion of the penalty from the officer as they may specify.

However, no more than 100% of the penalty assessed can be collected in this way, between the company and the officer. Officer in this context means director, shadow director and secretary.

Partnership returns

The person delivering the return in the case of a partnership return would be the firm. When an inaccuracy affects the amount of tax due by a partner, the partner is also liable for a penalty – this is termed the partner's penalty. The nominated partner would remain liable for the penalty on the firm.

Potential lost revenue is calculated separately for the penalty on the firm and each partner's penalty, by reference to the proportions of any tax liability that would be borne by each partner.

Commencement dates

The new penalty provisions in Schedule 24 of FA 2007 were the subject of a commencement order in March 2008 (Si 2008 / No 568). The penalties will commence as follows:

- The overall commencement date for the new regime is 1 April 2008. However, there is a transitional rule, preventing the penalty form applying to documents which are required to be submitted before 1 April 2009.

- This applies to relevant documents in respect of periods commencing on or after the date of 1 April 2008. This means that 2008-09 will be the first income tax returns affected by the new rules, as they are due for submission on 31 January 2010. For companies, returns for periods ending 31 March 2009 will be the first affected, which are due for submission by 31 March 2010. P35's relating to 2008-09 will be affected by the new penalty provisions with a due date of 19 May 2009.
- The same date applies to relevant assessments for periods commencing on or after that date. This means that penalties cannot be due for VAT returns or assessments except in relation to the quarter ended 31 March 2009, which would be due for submission on 30 April 2009.
- For eighth and thirteenth directive reclaims of VAT the dates are 1 January 2009 and 1 July 2008 for claims in relation to periods commencing on or after those dates.
- 1 April 2009 will be the commencement date for any other relevant reclaim of tax which is not related to a tax period.
- Finally 1 April 2009 will be the commencement date in relation to any other document when the person's liability to pay the tax arises on or after that date.

Article by Rebecca Benneyworth

Lecture P494 (9.14 Minutes)

8.16 Penalties – the importance of reasonable care

The big cultural change under the new penalty regime for both taxpayers and HMRC compliance staff is the concept that when taxpayers take "reasonable care", they will never be liable to a penalty in relation to errors and omissions which result in an underpayment of tax. This is a completely new idea, and is designed to encourage compliance, and gradually to support and enhance voluntary compliance by taxpayers. Provided everyone takes reasonable care over their tax affairs, they will never be liable to a penalty.

So the definition of reasonable care will be crucial, and understanding what is required of him will enable every taxpayer to minimise exposure to penalties. Everyone makes mistakes, but this way no penalty will be added when the mistake comes to light.

Guidance on reasonable care

All of the penalty reform depends upon the definition of reasonable care adopted by HMRC. Guidance on this aspect was issued on 1 April 2008 as the first release of a new HMRC manual – the Compliance Handbook Manual. So far, only chapter CH80000 has been released, this being the chapter on the new penalty legislation. This includes significant guidance on "reasonable care". This appears in CH81120. It sets out the principle that reasonable care will vary depending on the capabilities and circumstances of the individual acting, and in particular on the type of business or transaction he is dealing with.

What is reasonable care for an unrepresented taxpayer will differ from that for a large international company. All they both have to do is take care, within the limits of their competence. Even for one taxpayer, what is reasonable care in relation to a simple transaction will differ when the taxpayer is involved in a complex transaction which he has never encountered before. HMRC expects those in unfamiliar territory to take extra care to ensure that they apply the right tax treatment.

The basic minimum expected of any business or personal taxpayer is that they have a system of records designed to ensure that the correct income is declared for tax purposes. Although we shall have detailed statutory record keeping requirements later this year (as a result of the Finance Act 2008 proposals) this is a separate consideration.

For larger companies, more sophisticated tax geared systems would be needed, but provided the company has systems in place, which if adhered to would produce the correct tax liability, then if errors arise in processing, no error would be due. This carries the proviso that the size of the error is not of such significance that it would be obvious. Part of the systems one might expect would include a "reasonableness" check, so this should be sufficient to identify errors of sufficient magnitude to compromise reasonable care.

This guidance for larger businesses was developed by HMRC in association with the CBI, and introduces the concept of materiality of the error in determining whether reasonable care has been taken.

There is particular guidance for those undertaking a transaction about which the tax outcome is uncertain :

"In HMRC's view it is reasonable to expect a person who encounters a transaction or other event with which they are not familiar to take care to find out about the correct tax treatment or to seek appropriate advice.

If after that the person is still unsure they should draw attention to the entry and the uncertainty when they send the return or document to us. In these circumstances the person will have taken reasonable care to draw our attention to the point and if they are wrong they will not have been carelessly so."

Thus, disclosure, which is normally considered in the context of the issue of discovery, now will extend to the issue of penalties where it is found that a transaction or event has been incorrectly reported or taxed. The proper disclosure of the transaction and the uncertainty relating to it will achieve the "reasonable care" required in order for the taxpayer to avoid a penalty should the treatment prove incorrect.

The guidance then provides some examples of when reasonable care has been applied and no penalty is due :

"Examples of when a penalty would not be due include

- a reasonably arguable view of situations that is subsequently not upheld
- an arithmetical or transposition inaccuracy that is not so large either in absolute terms or relative to overall liability, as to produce an obviously odd result or be picked up by a quality check
- following advice from HMRC that later proves to be wrong provided that all the details and circumstances were given when the advice was sought
- acting on advice from a competent adviser which proves to be wrong despite the fact that the adviser was given a full set of accurate facts.

You should treat a person as taking reasonable care if

- arrangements or systems (such as comprehensive internal accounting systems and controls with specific reference to tax sensitive areas) exist that, if followed, could reasonably be expected to produce an accurate basis for the calculation of tax due by the internal tax department, or external agent, **and**
- despite the above, inaccuracies arise in processing or coding items through the person's accounting system which result in a mis-statement of tax liability, **and**
- the effect of the inaccuracies is not significant in relation to the person's overall tax liability for the relevant tax period."

There are excellent examples of reasonable care, and errors made despite taking reasonable care, including a taxpayer transposing the figures of his car benefit when transferring them from P11D to his tax return. Provided the error is not of such significance as to "look wrong" he has taken reasonable care. In the example, he writes the benefit of £5,910 as £5,190. The error is £720, which at over 10% is clearly material, but the guidance states that this is not an error of such magnitude as to fail the reasonable care test.

Represented taxpayers

There is a slightly more complex situation when an adviser is acting. The legislation states that the taxpayer shall not be liable to a penalty in relation to an act or omission by his appointed agent provided the **taxpayer** took reasonable care to ensure there were no errors. So the onus is still on the taxpayer to take care, even when he has appointed an agent, who may have failed to take care! This of course could be a matter for a negligence claim, but still the taxpayer can protect himself from a penalty.

The guidance (CH84540) indicates that several issues will be considered when deciding whether the taxpayer took reasonable care to avoid the inaccuracy. HMRC will seek evidence that the taxpayer took care to avoid the inaccuracy as follows :

- making sure that they gives the agent all relevant information with which to work. No agent, for example, can produce correct accounts and returns from grossly deficient records, or give accurate advice if they do not have all the facts
- implementing the professional advice received, and not neglecting some vital step
- checking the agent's work to the extent that the person is able to do so. For example, an ordinary person cannot be expected to challenge specialist professional advice on a complex legal point. But they ought to be able to recognise the complete absence of a major transaction.

"The benchmark is a person who goes to an apparently competent professional adviser

- gives the adviser a full and accurate set of facts
- checks the adviser's work or advice to the best of their ability and competence and
- adopts it.

The person will then have taken reasonable care to avoid inaccuracies on the part of themselves and their agent."

Letter of engagement

It is useful to remind your client of his obligations under the law and that the law expects him to take reasonable care over his tax affairs. That is the basis on which he has engaged you to perform your services, and it is probably worth setting out for him what HMRC has said in relation to this. It is that he will not be liable to a penalty if he takes reasonable care to ensure that his returns are accurate, despite them being prepared by an advisor or agent. This means he should

- Appoint a competent advisor or agent
- Provide the agent with all of the information he needs, and
- Check the return as far as he is able before authorising its submission.

What constitutes a competent advisor is still quite a tricky issue, and HMRC would not be willing to recommend one or other particular qualification as "competent". Rightly so, and this will be a difficult area; we must also accept that unqualified accountants can quite easily be competent, just as there are less competent members of professional bodies. One can only assume that having behaved reasonably in the selection of an advisor, the client would have no problem.

Requests for information

The adviser could consider both the timeliness and completeness of information here. If the full information is not supplied until late January, then it would be difficult for a client to argue that he is taking care over his tax affairs, particularly if he has been chased for the information for months. It is worth therefore making clear to clients that late submission of information can impact on the level of penalty at the outcome of an enquiry. You might also think about how you evidence the information supplied and in particular any missing data, and how this is followed up. It is important to remember that at the penalty phase you will need **evidence** that your client took care to support your arguments. Clearer and more specific requests and follow up letters will be the likely outcome of this.

Checking the return

No sane agent would submit a return which has not been checked and signed by his client. But how is the actual check of the return properly evidenced? The signature on the return does not actually evidence that it was checked, just that it was signed at some point – this may have been before it was completed! The client needs to check the return “to the best of his ability”. In general, small business clients would not be able to spot a calculation error or some technical mistake. However, he should be able to point out the absence of a source, or the omission of a benefit in kind, if he checks the return carefully.

How many could spot an error in the voluminous number of pages presented to him? Might it be worth preparing a simple summary of the types of income reported on the return and the amounts, so that the client can sign this as approval of the data?

Wider issues

The basic minimum expected of any business or personal taxpayer is that they have a system of records designed to ensure that the correct income is declared for tax purposes. Although we shall have detailed statutory record keeping requirements quite soon as a result of the Finance Act 2008 this is really a separate consideration.

So can we look at our clients’ basic systems and make recommendations which would help the integrity of their records? Do they regularly lose paperwork? Can we provide a simple box file which will enable them to keep everything together (and even serve as an advertisement and reminder about due dates)? This might suit personal taxpayers who have shown themselves to be disorganised with paper, for example in relation to rental property. Are your clients’ books and records up to a basic minimum so that they could be said to form a basis for the tax return? What recommendations can you give to improve the records, and indeed save you time and your client money? The message on records is not a new one, but it is possible the new penalty regime will help drive it home in a way that has not been possible before.

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