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Personal Tax

Offshore clampdown 'set to increase'

HMRC's ongoing clampdown on tax evaders looks set to increase, according to Grant Thornton.

The accountancy and financial advisory company believes that the Revenue's pursuit of evaders using offshore bank accounts will increase as they move funds back to the UK to guarantee protection on savings up to £50,000.

This is likely to lead to a rise in retail banks issuing suspicious activity reports as they closely examine the movement of money by investors suspected of failing to comply with current tax legalisation.

A high-profile clampdown on those who did not disclose under last year's Offshore Disclosure Facility (ODF) seems more likely than ever, as HMRC seek to recoup lost tax and balance accounts during a difficult economic period, said Grant Thornton, adding that this year's Pre-Budget Report may give a clearer indication of the timescale of this clampdown.

The claims follow recent reports of HMRC plans to launch a new tax 'amnesty' for an estimated 70,000 people believed to be using offshore bank accounts to avoid paying the correct amount of tax.

The Revenue has, however, so far refused to publicly confirm any details of 'ODF II'. Last month, the department denied it was finding it necessary to hire expensive law firms to help deal with a backlog of litigation against suspected tax evaders.

Grant Thornton tax investigations director Gary Ashford said: 'The current problems in the global savings market may result in many high-net-worth individuals moving their funds back to the UK in a bid to seek the Government's protection.

He added: 'As time progresses HMRC will harden their approach. The Revenue is now stepping up its pursuit and is fully committed to commencing high-profile criminal prosecutions of taxpayers to act as a deterrent.

'That said, and given that HMRC is continuing to approach additional banks for details on their customers, I believe they will have to run some sort of ODF for those customers who they did not previously write to.'

Use of losses arising from property income

In the current climate losses of all descriptions are likely to be more prevalent than they were a year ago. Property losses will undoubtedly arise as the stock of properties for letting rises and as a direct result occupancy levels fall. Maximising the use of loss relief then becomes an important issue for our buy to let client.

Non-corporates

This term includes individuals either acting solely or in partnership (including a limited liability partnership), but also companies resident outside the UK which have a UK property business.

For these non-corporates, interest on borrowings to buy property or on loans to fund repairs, improvements or alterations is a deductible expense of the property income business, as is interest payable on an overdraft or hire purchase agreement. As a result, it is far more likely that a loss will arise on a property business carried on by a non-corporate than it is for property business carried on by a company.

Losses can be set sideways against general income only to the extent that they arise from capital allowances or from 'relevant agricultural expenditure' and so does not include any loan interest (ITA 2007, s 123). Capital allowances on residential buy to lets are however few and far between due to the dwellings exclusion in s.35 CAA 2001.

Losses arising from furnished holiday lettings are treated in the same way as losses from a trade and, like other trading losses, can be set off sideways against general income for the year of loss or of the previous year (ITA 2007, s 64). However, the offset of these losses is subject to all the restrictions which generally apply to an offset of trade losses. In particular, it is very likely that as a question of fact, a partner in a furnished holiday lettings business will be a 'non-active partner' as defined at ITA 2007, s 103B with the result that the annual £25,000 cap on the offset of losses will apply.

Any losses which cannot be set off sideways, as will be the case for most rental businesses, can be carried forward, but they can only be set against property income profits of the future.

On the other hand, the rate of capital gains tax for a non-corporate will be 18% (or conceivably 10% in a very limited range of circumstances where entrepreneurs' relief is due), and the restriction on the use of losses for income tax purposes has to be weighed against the capital gains tax advantage when deciding on whether a corporate or LLP structure is better for a property investment business.

By contrast, the scope for using losses in a company is much greater.

Companies

The legislation governing corporate losses is in TA 1988, s 392A. This provides that a Schedule A loss is first set off, for the purposes of corporation tax, against the company's total profits for that period. So if an investment property has been sold at a gain in the period, a Schedule A loss for the same period can be set against any capital gain arising on the disposal, or indeed against any other income or gains.

'Excess Schedule A losses' can be carried forward against any other profits in the future. They are not restricted to being set against future Schedule A income, but can be set against any other income or capital gains that might arise.

Better still, in the hands of a company, Schedule A losses do not even disappear when the rental business ends. Provided the company continues to have some kind of investment business, the losses change their form and are carried forward as expenses of management. In this new guise, the losses continue to be carried forward for as long as the investment business continues and can be offset not only against investment income, but also against total profits including capital gains (whether on investment assets or trading assets) or even against trading income.

Possibly the only restriction on the use of Schedule A losses of a company is that they cannot be carried back.

It should however be noted that interest is not a qualifying Schedule A deduction and consequently the chances of a Schedule A loss are not high.

Loan relationship rules

For UK-resident corporate property investors, interest paid on borrowings to purchase or repair or improve property, or indeed interest on an overdraft connected to the property business, are governed by the loan relationship rules in Finance Act 1996.

So, interest is not an expense in computing the rental business profits, but is a separate deduction with its own set of rules. Finance Act 1996, s 83 contains the provisions.

The interest will create or contribute to the 'non-trading deficit on loan relationships' (NTDLR). Such a deficit can first be set off against any profits of the company for the deficit period. Any deficit not used in this way can be carried forward and set against non-trading profits of the company for succeeding accounting periods. This means that the deficit can be carried forward against future Schedule A profits or against capital gains but not against any trading profits of the future.

A NTDLR can also be carried back for a period of 12 months but in that case use is restricted to an offset against income chargeable under Case III (which will include, and usually be limited to, interest received).

From an article by David Young writing in Taxation

Lecture P501 (7.15 Minutes)

Tax relief available for investment losses

The normal rule is that chargeable gains are set against allowable capital losses of the same tax year and, if not used in a previous tax year, against allowable losses brought forward from any previous tax year. Thereafter any unrelieved allowable losses are carried forward to be set against capital gains of a future tax year (TCGA 1992, s 2(2)).

This article, however, deals with the application of allowable losses against the general income of individuals.

General income

The aim of share loss relief is to give relief against income for allowable capital losses. Income Tax Act 2007, ss 131 to 133 provide the rules whereby an individual who has realised an allowable capital loss, having disposed of 'qualifying shares', or having made a claim that the shares have become of negligible value (TCGA 1992, s 24), can offset that capital loss against his income.

All shares to which EIS relief is attributable are qualifying shares. However, the relief is also available for losses suffered on shares which are not within the EIS regime, but are in a qualifying trading company and which have been subscribed for by the individual.

Share loss relief can only apply if the disposal of the shares is:

- by a bargain made at arm's length;
- by a distribution in the course of dissolving or winding up the company; or
- by negligible value claim.

Making a claim

An individual who is eligible for share loss relief may make a claim for it to be deducted in calculating his net income for the year of the loss, for the previous tax year, or for both tax years.

The deductions allowed under share loss relief are dealt with in the following way:

Step 1 — Deduct the loss in calculating the individual's net income for the specified tax year.

Step 2 — If the claim is made in relation to both tax years, deduct the part of the loss not deducted at Step 1 in calculating the individual's net income for the other tax year.

Share loss relief is restricted if relying on Condition B (continuous period of meeting the requirements in Condition A (see below).

Non-EIS shares

For non-EIS shares, a 'qualifying trading company' is a company which meets each of the following four conditions.

Condition A is that the company either:

- meets, as at the date of disposal, each of the 'trading requirement', the 'control and independence requirement', the 'qualifying subsidiaries requirement', and the 'property managing subsidiaries requirement'; or
- has ceased to meet any of those requirements at any time within three years prior to that date, and has not since that time been an 'excluded company', an 'investment company' or a 'trading company'.

Condition B is that the company either:

- has met each of the requirements mentioned in condition A for a continuous period of six years then ending; or
- has met each of those requirements for a shorter continuous period then ending and has not before the beginning of that period been an 'excluded company', an 'investment company' or a 'trading company'.

Condition C is that the company:

- met the 'gross assets requirement' both immediately before and immediately after the issue of the shares in respect of which the share loss relief is claimed; and
- met the unquoted status requirement at the relevant time.

Condition D is that the company has carried on its business wholly or mainly in the UK throughout the period beginning with the incorporation of the company or, if later, 12 months before the shares in question were issued, and ending with the date of the disposal.

The subscription for shares rule that applies to non-EIS shares is that an individual must subscribe for shares in a company issued to him by the company in consideration of money or money's worth. However, if A subscribed for shares, which he later transferred to B (his spouse or civil partner at the time of the transfer) during their lives, B is treated as having subscribed for the shares. Also, if an individual has subscribed for shares, and any corresponding bonus shares are subsequently issued to him, he is treated as having subscribed for those bonus shares.

Qualifying trading companies

A number of requirements apply to qualifying trading companies for them to be able to claim relief on losses.

Trading

The company or group, ignoring any incidental purposes, must exist wholly for the purpose of carrying on one or more qualifying trades. Certain activities can be ignored.

Administration and receivership

A company does not cease to meet the trading requirement merely due to anything being done because the company or any of its subsidiaries is in administration or receivership for a genuine commercial reason..

Control and independence

The company must not control any company which is not a qualifying subsidiary (ITA 2007, s 191) of the company, and no arrangements must be in existence whereby the company could fail to meet this requirement, whether at a time during the continuous period that is relevant for the purposes of Condition B (see above) or otherwise.

The independence element is that a company must not be a 51% subsidiary of another company. Nor can it be under the control (TA 1988, s 416(6) to (9)) of another company (or of another company and any other person connected with that other company), without being a 51% subsidiary of that other company.

Furthermore, under both the control element and the independence requirement there can no arrangements, i.e. any scheme, agreement or understanding whether or not legally enforceable, whereby the company could fail to meet the above requirement, whether at a time during the continuous period that is relevant for the purposes of Condition B or otherwise.

Share loss relief is also available for non-EIS shares in the following circumstances:

- a new company in which the only issued shares are subscriber shares, acquires all the old shares in another old company;
- the consideration for the old shares consists wholly of the issue of new shares in the new company;
- the consideration for the new shares of each description consists wholly of old shares of the corresponding description;
- new shares of each description are issued to the holders of old shares of the corresponding description in respect of and in proportion to their holdings; and
- under TCGA 1992, s 127 (as applied by TCGA 1992, s 135(3) company reconstructions etc.), the exchange of shares is not treated as involving a disposal of the old shares or an acquisition of the new shares.

Also for the purposes of share loss relief the exchange of shares is not regarded as involving any disposal of the old shares or any acquisition of the new shares (ITA 2007, s 145(2). Here old shares and new shares are of a corresponding description if, on the assumption that they were shares in the same company, they would be of the same class and carry the same rights.

Gross assets

The gross assets requirement, in the case of a single company, is that the value of the company's gross assets must not exceed £7 million immediately before the shares in respect of which the share loss relief is claimed are issued, and must not exceed £8 million immediately afterwards.

In the case of a parent company, the gross assets requirement is that the value of the group assets must not exceed £7 million immediately before the shares in respect of which the share loss relief is claimed are issued, and must not exceed £8 million immediately afterwards.

The value of the group assets means the sum of the values of the gross assets of each of the group members, ignoring any that consist in rights against, or shares in or securities of, another member of the group.

Unquoted status

The unquoted status requirement is that, when the shares for which share loss relief is claimed are issued:

- the company must be an unquoted company (ITA 2007, s 184(2));
- there must be no arrangements in existence for the company to cease to be an unquoted company; and
- there must be no arrangements whereby the company could become a subsidiary of another company under an exchange of shares, if:
- the equation of old shares for new applies to the exchange, and
- arrangements have been made with a view to the new company ceasing to be an unquoted company.

Limits on relief and mixed holdings

Share loss relief may be restricted if the qualifying shares are part of a mixed holding of shares such as a 'section 104 holding' (TCGA 1992, s 104(3)) or a '1982 holding' (TCGA 1992, s 109(1)) at the time of the disposal, or formed part of such a holding at an earlier time.

The detailed rules are set out in ITA 2007, ss 147 to 149.

From an article by David Bertram writing in Taxation

Lecture P502 (10.26 Minutes)

HMRC outlines effect of PAYE change after Demibourne

The Special Commissioner's decision in *Demibourne Ltd v HMRC* [2005] STC (SCD) 667 cast doubt on the long-established practice of allowing tax paid by a worker formerly regarded as self-employed to be deducted in arriving at a PAYE settlement following the worker's recategorisation as an employee (see TPT 29.8, 11 April 2008).

The effect of such a recategorisation is that the income tax has been paid by the wrong legal person. The Demibourne decision meant that HMRC 'had to seek recovery of PAYE from the employer even if tax had already been paid by (or on behalf of) the employee under self assessment'.

HMRC began discussions with the professional bodies in 2006 in an effort to find a solution, and arranged as an interim step for employees to sign a mandate authorising repayments of tax paid under self assessment to be set off against the employer's PAYE liability.

The amendments set out in the Income Tax (Pay As You Earn) (Amendment) Regulations 2008 (SI 2008/782), effective from 6 April 2008, mean that the employer's PAYE liability may be transferred to an employee where the employee received a payment from which the employer should have deducted or accounted for tax under PAYE and failed to do so and:

- tax on that payment has been included in the employee's self assessment (SA), or
- no self assessment has been made but tax has been paid as SA payments on account, or
- tax has been deducted as a subcontractor deduction under the construction industry scheme.

In addition, one of the three conditions summarised below must be met.

- it appears that the amount which the employer was liable to deduct from the relevant payment exceeds the amount deducted;
- it appears that the amount the employer was required to account for under SI 2003/2682 reg 62(5) (notional payments) in respect of the relevant payment exceeds the amount accounted for;
- tax on the relevant payment was included in a determination under SI 2003/2682 reg 80 (determination of unpaid tax) and the full amount of the determination is not paid within 30 days from the date on which the determination became final and conclusive.

The amended rules apply only where a 'trigger event' occurred on or after 6 April 2008 and no such event occurred prior to that date. A 'trigger event' occurs on the issue of a reg 80 determination; receipt of the employee's self assessment return including tax treated as deducted on the relevant payment; receipt of an employee's amended return including an adjustment for a PAYE credit in relation to the relevant income; receipt of an error or mistake claim including an adjustment for a PAYE credit in relation to the income; and receipt of a letter of offer agreeing to an amount in settlement of the employer's liability.

The employee would not have to pay additional tax as a result of a direction, HMRC said: 'A [SI 2003/2682 reg 72F] direction would not be appropriate if the effect of this will be to increase the amount of tax payable by an individual in accordance with a self assessment. This is because one of the principal conditions for making a direction is that the tax in question has already been assessed as being payable under SA by the employee.'

The ICAEW Tax Faculty said: 'Provided that there is sufficient income self-assessed to cover the income from the employer concerned, HMRC will accept that the tax self-assessed or paid on account represents the tax on the re-categorised income.'

The Faculty added that 'nothing relating to this case has been simple'. The legal and practical complexities involved in the 'who owes what debate' continued to perplex, it said.

Andrew Goodall writing in Tolley's Practical Tax Newsletter, October 2008

Capital Gains Tax

Update on HMRC's current views on goodwill.

HMRC have historically identified different types of goodwill. This was well illustrated in the case of *Balloon Promotions Ltd & Others v Wilson* [2006] SSCD 167 (SpC 524). In the course of the case, the Special Commissioner referred to the legislation in TCGA 1992, the legal and 'zoological' definitions, the different types of goodwill then identified in HMRC's manuals and goodwill from the perspective of an accountant and a chartered surveyor.

<u>The zoological classes</u>

Historically, HMRC had taken the view that a franchisee can never acquire any interest in the goodwill of a franchise. The franchisee can exploit it to increase the income from the franchise, but HMRC considered that this increased:

i) the free goodwill belonging to the franchisor as he exploits the name, operations, staffing, etc, all 'controlled' by the franchise agreement; and/or

ii) the goodwill belonging to the franchisee: i.e. the personal goodwill which cannot be transferred.

HMRC derived their goodwill categorisation by analogy to the zoological classes referred to in *Whiteman*, these classes being as follows.

- The cat — which stays faithful to the location, not the person.
- The dog — which stays faithful to the person, not the location.
- The rat — which is casual and is attracted by neither person nor location.
- The rabbit — which comes because it is close by and for no other reason.

These distinctions could more practically be interpreted as the following categories of goodwill.

- Inherent — the goodwill attaching to the property by virtue of its location.
- Personal — related to the skills and personality of the proprietor; e.g. a chef, or hairdresser.
- Free — related to the overall worth of the business and is split into adherent and separable goodwill.

Adherent goodwill was defined in HMRC's *Capital Gains Manual* as that which does not arise from the locational advantages, but arises from the carrying on of a particular business for which those premises have been or are specifically adapted or licensed; i.e. free goodwill which runs with the premises and is inseparable from them. As a result, adherent goodwill can only be disposed of along with the premises and the business.

Separable goodwill was defined as the true free goodwill generated independently from the premises and is generated by the 'rat'.

<u>The surveyors' views</u>

The Special Commissioner considered the valuation principles applicable to restaurant businesses, as set out in the *Valuation Information Paper and Guidance Notes* published by the Royal Institute of Chartered Surveyors (RICS). The principles state that the component parts comprise:

- land and buildings;
- fixtures and fittings; and
- the market's perception of the trading potential, excluding personal goodwill together with an assured responsibility to renew existing licences, consents, certificates and permits.

The RICS guidance notes state that liaison with other consultants who have specialist knowledge of analysing the business's financial performance and valuing intangible assets, such as brands and trademarks, may be necessary.

In *Balloon Promotions*, HMRC's expert witness suggested that the RICS's definition of inherent goodwill was equivalent to that which HMRC described as adherent goodwill and that the RICS's definition of personal goodwill was equivalent to HMRC's view of free separable goodwill. HMRC's own definition of inherent goodwill related to the value which attaches by virtue of the location; e.g. strategic siting on a corner of a high street for a pub or on a main road for a petrol station.

The Commissioner's approach

The Special Commissioner pointed out that HMRC's *Capital Gains Manual* (as it was when *Balloon* was heard in late 2005) classified adherent goodwill with separable free goodwill, not inherent goodwill, which suggested that adherent goodwill would be valued separately from the property. In *Whiteman*, the adherent goodwill was included in the property valuation because that was the requirement of the Landlord & Tenant Act 1927.

The Special Commissioner questioned the applicability of the approach of HMRC categorising goodwill into three types with the third, free goodwill, broken down into sub-categories. The Special Commissioner preferred the approach advocated by the appellants' counsel, that goodwill in TCGA 1992 should be looked at as a whole, which he considered to be consistent with the authorities and conformed to the principles of statutory construction.

The decision

In the light of the facts relating to the way in which the appellant franchisees ran their businesses — i.e. with minimum influence and branding from the franchisor — the Commissioner decided that the consideration described as goodwill in the sale agreement was goodwill belonging to the franchisees within TCGA 1992, s 155 for the purposes of rollover relief.

Most accountants would agree that the evidence of the taxpayers' expert and the conclusion of the Special Commissioner were logical and properly reflected economic reality.

After the Balloon Promotions case

Since *Balloon*, in *Tax Bulletin 83* (June 2006), HMRC have set out their views relating to the goodwill in franchise businesses, namely that each case will be considered on its merits dependent upon the strength of the franchisor's brand (see *Capital Gains Manual* at CG68220).

Debating the approach

In the minutes of the SAVF meeting of 19 February 2008 (http://snipurl.com/4iwvj), it was reported that legal advice had been sought and there had been subsequent debate between various departments of HMRC and RICS.

However, it appears that HMRC may now have reached a view about the identification and treatment of goodwill in property related businesses. As recently as 23 September 2008, the *Capital Gains Manual* has been substantially amended to remove all references to the old analysis or identification of goodwill, as discussed in *Balloon*. All references to the animals have gone and there is a very much shorter section at CG68010, which includes a reference to the *Balloon* case.

In addition, in August 2008, the *Corporate Intangibles Research and Development Manual*, CIRD25030, which relates to intangible assets excluded from Sch 29, has been substantially amended, specifically stating that the amendments were 'to remove any reference to adherent goodwill to clarify the role of FRS7 in business acquisition accounting'. It appears that the treatment of goodwill for corporation tax purposes will follow the accounting treatment, as set out in FRS7 ('Fair Values in Acquisition Accounting'). FRS15 sets out the principles of accounting for tangible fixed assets and expressly refers to RICS's definitions of property based businesses in its Appendix 1.

The *SDLT Manual* appears still to refer to *Capital Gains Manual* chapters relating to goodwill which no longer exist.

HMRC's arguments

What are the arguments put forward by HMRC to support their view that most, if not all, of the goodwill of many 'property-related' businesses, such as nursing homes, is part of the property and therefore not goodwill deductible under Schedule 29?

It appears that there is considerable crossover between the three types of goodwill historically identified by HMRC, inherent, adherent and personal. In *Balloon*, the differences in interpretation were expressly noted by HMRC's expert.

The manifestation of these approaches appears to lead to arguments from the District Valuer that people go to, say, a nursing home because of the property. It is true that, if you wish to run a nursing home or a restaurant, certain modifications need to be made and licences granted. Is this not also true, albeit to a lesser extent, of office or commercial or industrial premises? The use of a building can change from a hotel to a nursing home to a private house. If the value as a nursing home is greater than that of a house, then is not the difference the goodwill attaching to the business, i.e. free goodwill?

If one is choosing a nursing home for an elderly relative, would one be concerned about the staff and the appropriate level of care or the location? The location might be relevant, but this would only be to the extent of being a property within x miles of where one lives, not the exact property. As a matter of common sense one would think that the most important functions are the level of care and the attitude of the owner and/or manager and the staff, including the cook! Although it would not be easy to move premises, it is not the property itself which gives rise to the trade. In practice, of course, one does not move elderly people. DVs appear to argue that location is key both in terms of locality, which seems to fall within the old HMRC definitions of inherent goodwill, namely that a property in an urban area is likely to have a greater value than one in a rural area, and in terms of adaptation. The latter is accepted but does not in my view mean that the goodwill as defined by FRS10 and as viewed by accountants attaches to the property, or certainly not in its entirety.

Do taxpayers agree?

It appears that HMRC feel that they have reached a decision/ consensus as to the identification of goodwill. However, I wonder if this will result in acceptance by many taxpayers of the HMRC view, which appears to ignore entirely the views of the Special Commissioner in *Balloon*.

It appears that the issue of goodwill in relation to property based businesses will be dependent on the circumstances of each case and that more liaison between accountants and surveyors may be helpful in order to consider the tax consequences of surveyors' valuation reports.

It must be remembered that the allocation of goodwill in a sale and purchase agreement does not dictate the tax treatment, as confirmed in *Balloon*.

Although I understand that HMRC have talked to many parties about this matter, in the light of which the reference to goodwill has been changed significantly in the manuals, the issue determined in *Balloon*, by reference to the legal definition for capital gains purposes, that the goodwill of restaurants, i.e. property-based businesses, was free and separable goodwill, using HMRC's own terminology as it existed in the *Capital Gains Manual* at that time, does not appear yet to have been addressed. Will we have one basis for corporation tax, which follows accounting definitions, and another for capital gains purposes, which follows the legal definition?

From an article by Jenny Nelder writing in Taxation

Lecture P503 (15.10 Minutes)

Deferred consideration and earn-outs

Capital Gains Tax Treatment

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

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

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

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

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

Deferral of gain

Section 138A TCGA 1992 allows an earn out right in paper to be treated as a security and therefore the disposal is deemed to be paper for paper. This defers the gain on the receipt of the right to the earn out to the ultimate disposal of the new shares or loan notes earned through the earn out. The provision also clarifies the position where QCBs forms part of the earn out consideration.

Section 138A treats the earn out right as a security of the new company and as a non-QCB where:

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

Therefore, if the paper for paper deferral provisions apply to the balance of the consideration (or would if appropriate), then the earn out right shall be treated as a security of the new company and as a non-QCB, hence the gain can be deferred.

The relief is automatic but can be disapplied by election. Obviously the decision as to whether or not to elect must be considered in great detail and will be influenced as to the availability of losses on the initial/subsequent disposal.

Loss carry back

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

Example

Ernie Wright sold his shares in his trading company to a competitor on 1 February 2005. The terms of the deal were that Ernie received £500,000 cash immediately plus further cash in two years time dependant upon the future profits of the business. The amount of the future cash was determined by a formula that would provide an amount ranging from nil to £2 million in cash.

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

The right to the future consideration (a chose in action) is treated as a new asset acquired at the time of the deal and accrues business taper at the non-business rate, i.e. none unless held for at least 3 years.

Let us assume that the amount that Ernie receives in 2007 under the earn–out formula is only £200,000. This would mean that Ernie realises a capital loss of £300,000 on the new asset acquired. S279B enables the loss to be set against the earlier gain.

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

Stamp duty

Clearly, if an amount of consideration is unascertainable at the time of transaction, there would be difficulty, without specific rules, to calculate the correct amount of stamp duty payable.

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

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

Consideration for shares which is wholly unascertainable is not chargeable. However, this may be challenged by Stamp Office who may wish to refer to the market value of the shares at completion in assessing the duty (following the decision in LM Tenancies 1 plc v CIR (1998) STC 326.

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

Employment related securities

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

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

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

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

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

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

a) The sale agreement demonstrates that the earn-out is part of the valuable consideration given for the securities in the old company

b) The value received from the earn-out reflects the value of the securities given up.

c) Where the vendor continues to be employed in the business, the earn-out is not compensation for the vendor not being fully remunerated for continuing employment with the company.

d) Where the vendor continues to be employed, the earn-out is not conditional on future employment, beyond a reasonable requirement to stay to protect the value of the business being sold.

e) Where the vendor continues to be employed, there are no personal performance targets incorporated in the earn-out.

f) Non-employees or former employees receive the earn-out on the same terms as employees remaining.

The following factors may also be relevant:

g) Negotiations between the seller and buyer as to the level of the earn out in relation to the value of the consideration given for securities in the old company.

h) Any clearance that might have been obtained under Section 138 and Section 707 demonstrating the bona fide nature of the transactions, and the level of the earn-out linked to profitability or other key performance indicators of the business.

i) Evidence that future bonuses were reclassified or commuted into purchase consideration would indicate that the earn-out was, at least partly, remuneration rather than consideration for the disposal of securities.

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

This guidance is only applicable to the computation of earnings under Chapters 2, 3 or 5 Part 7 ITEPA 2003 and has no bearing on the rules for Capital Gains Tax.

Lecture P504 (12.19 Minutes)

HMRC's conflicting views on entrepreneurs' relief

HMRC have issued new guidance in their *Capital Gains Manual* on entrepreneur's relief. While most of this guidance is unsurprising, there are three particular points which are interesting.

Disposal of a business

Entrepreneurs' relief applies to gains arising on disposals of business assets as part of the disposal of the **whole or part of a trading business** that is carried on by the individual.

The individual must have:

- Owned the business throughout a period of one year ending with the date of the disposal
- Used the assets for the purpose of the business which has been carried on by the individual

HMRC's view

HMRC's view is based on retirement relief case law. and will be an area of contention under entrepreneurs' relief, as it was under retirement relief.

The old guidance on retirement relief is still available in HMRC's *Capital Gains Manual* and HMRC have confirmed that they will continue to apply this guidance where appropriate.

The case of *McGregor v Adcock* 51 TC 692 serves as a reminder of the distinction. The disposal of land by a farmer was held not to be the disposal of a business, rather it was a factor in deciding whether there had been such a disposal.

Partners

Partners will be able to obtain entrepreneurs' relief in a number of situations:

1. where an individual makes a disposal of assets used in his own business as part of the entry into a partnership which will continue the business;
2. where a partner disposes of the whole or part of his or her interest in partnership assets, that will be treated as a disposal of part of the business carried on by the partnership; and
3. at any time a business is carried on in partnership it will be treated as owned by each individual who is a partner at that time.

Focusing on point 2, this appears to mean that if a partnership, such as a farm, sells an asset, such as land, the criteria are met. Partners have sold the whole or part of their interest in partnership assets. The legislation then pretends that this is the part of a business and hence relief is due.

However, the new guidance (CG64040) contains the following comments:

> 'TCGA 1992, s 169I(8) enables partners to qualify for entrepreneurs' relief upon:
>
> - a disposal of the whole of their interest in the partnership – by treating it as a disposal of the whole of a business;
> - a disposal of part of their interest in the partnership – by treating it as the disposal of part of a business;
> - a disposal BY THE PARTNERSHIP of the whole or part of the partnership business – by treating the business as owned by the individual;
> - a disposal of partnership assets following the cessation of the partnership business – by treating the business as owned by the individual partner.'

The guidance adds that 'relief will NOT be available for disposals of partnership assets, unless the disposal constitutes the disposal of part of the partnership business'.

So while the legislation seems to create a difference between continuing sole trades and partnerships that sell assets, HMRC disagree.

Associated disposals

Additionally, relief may be available in respect of an asset owned by an individual personally and used in partnership business or by a company under the associated disposal rules.

Three conditions need to be satisfied:

- individual makes a material disposal of whole or part of his interest in the assets of a partnership or the shares in a company;
- associated disposal is made as part of the **withdrawal of the individual from participation** in the business of the partnership or the company; and
- assets are in use in the business for one year ending with the earlier of the date of material disposal of business assets or the cessation of the business of the partnership or company.

Withdrawal from participation

It had been assumed that the phrase 'withdrawal from participation' meant severing all or most of the ties with the business. However, the legislation appears to allow the disposal of one share followed by the associated disposal to qualify.

However, the *Capital Gains Manual* (at CG 63995) states otherwise.

While the individual does not appear to have to 'retire' to obtain the relief, it does appear from the above that he has to reduce his interest 'materially'.

Delays

Where a partnership or company ceases to trade, it is possible that there may be an interval between the material disposal and the disposal of the asset that is the subject of the associated disposal.

The legislation does not specify how long the gap can be before the disposal ceases to be associated with the material disposal.

However, HMRC's *Capital Gains Manual* (at paragraph CG 63995) states:

> 'In such cases you may accept that a disposal of an asset is associated with a "material disposal" if the asset is disposed of:
>
> - within one year of the cessation of a business; or
> - within three years of the cessation of a business and the asset has not been leased or used for any other purpose at any time after the business ceased;
> - where the business has not ceased, within three years of the material disposal provided the asset has not been used for any purpose other than that of the business.
>
> 'Cases which do not fall within the above guidelines will have to be considered carefully on their particular facts to see whether they meet the requirement of TCGA 1992, s 169K(3). For example if the asset has been used for any other purpose for a significant period following the material disposal, it is unlikely that the conditions for relief will be met.'

From an article by Mark Morton

Lecture P505 (11.18 Minutes)

Inheritance Tax and Trusts

Will shares in group companies be eligible for business property relief?

HMRC announced on 1 May 2008 that, for an initial six-month period, they would give non-statutory clearances in relation to BPR (see http://snipurl.com/3ta8b).

The individual

There is no minimum required shareholding in an unlisted company: shares will qualify for BPR provided they have been *held for two years* (s 106; with replacement rules in s 107, succession rules in s 108) and are still held by the recipient of an inter-vivos transfer which is now chargeable (see s 113A).

Remember also that for inheritance tax purposes, one aggregates the holdings of husband and wife or civil partners and of a life tenant's trust interests with his absolute holdings. Interests in possession created after 22 March 2006 will not be amalgamated unless they are transitional serial interests (TSIs) or immediate post-death interests (IPDIs).

Finally, there must not be in place any contractual arrangements for the sale of the shares (s 113).

Singleton companies

Shares in an unlisted company will qualify whether they are ordinary shares or preference shares — with or without voting rights. Loan notes and quoted shares *may* be eligible for relief under s 105(1)(b) and (cc) if (in both cases) the holder has control of the company, through his total holdings, prior to the transfer in question. Control is defined in s 269 as voting control.

To qualify for relief, the company must be 'wholly or mainly' (i.e. more than 50%) a 'trading company'. Relief will then be available in respect of the value of that company, but will be restricted if it has 'excepted assets' (see below).

Groups of companies

Each company must be assessed individually, rather than looking at the group as a whole; and it is the position at the specific valuation date that matters and not, for example, over the period of ownership or the last two years.

The rules may be summarised as follows.

(1) The top company must be 'wholly or mainly' (i.e. more than 50%) a qualifying trading company (T) or the holding company of a (qualifying) trading group (H). If it is not, then none of the group is eligible for BPR.

(2) If the top company is eligible, BPR is then due on it and any other subsidiary companies that are wholly or mainly T or H companies. Values attributable to investment companies (I) are taxable.

(3) Any non-subsidiary associate company (A) (i.e. a 50/50 joint venture or minority holding) in the group is potentially taxable, regardless of what the company does, unless the parent is an H company, by reference to its T subsidiaries. Note that if the parent company is a T company, the associate will not be exempt.

(4) If a company is eligible for BPR, inheritance tax may still be due on the value of certain assets, under the 'excepted assets' rules (see below).

Case law and activities

The exclusion for investment business does not apply to market makers or discount houses. The leading case on whether a business consists wholly or mainly in making investments is *Farmer v IRC* [1999] STC 321.

The exclusion for 'property' companies does not extend to property construction companies (see HMRC's *Inheritance Tax Manual* at IHTM25264); additionally hotels and residential homes may qualify, as will short-term holiday lets where the owner is 'substantially involved' with guest activities (*Inheritance Tax Manual* at IHTM25277 and 25278). Caravan park businesses will be 'considered carefully' (IHTM 25279) — see *CIR v George* [2004] STC 147 for a company that succeeded. There is no reference in the *Inheritance Tax Manual* to other 'property rich' enterprises such as golf clubs.

Property letting was held not to qualify in *Clarke & Southern (Clark's Executors) v HMRC* [2005] SSCD 823. Making informal group loans was held to be trading as a money lender, not investment, in *Phillips & Others (Phillips' Executors) v HMRC* [2006] SSCD 639.

Excepted assets

Under the excepted assets rule in s 112, one excludes from relief the value of any assets that were not used wholly or mainly 'for the purposes of the business' in the two years before the valuation date, or are not required for future use.

In practice, excepted assets will include 'lifestyle company' assets such as racehorses and yachts.

We are also seeing 'excess cash' being challenged; i.e. cash beyond what Shares and Assets Valuation consider necessary as normal working capital. However, with the latest economic reports, it may now be easier to defend any level of cash as being potentially required in the business; in times of recession there is seldom any 'excess' cash.

Planning opportunities

There are still plenty of planning opportunities around, and the new clearance mechanism could be useful where there is doubt over activities or structures. A short check-list might include the following:

(1) Is BPR important? Following the changes to capital gains tax the previous tensions with taper relief are now largely gone. If shares will be sold or transferred to a spouse on death, it may not be a priority to restructure a group in an inheritance tax-efficient way.

(2) Where are investments held? There may be scope to spread these between subsidiaries or to remove them from the group — e.g. as dividends in specie or for value — to make the rest of the group qualify. There may be scope to add investments into a very 'clean' group that would suffer inheritance tax if held personally. Think about where new investments are put.

(3) Avoid 'bear-traps'; e.g. 50/50 trading joint ventures held through holding companies or sub-holding companies held under trading companies.

(4) Where owners are elderly, the use of preference shares rather than debt is more tax-effective. Debt will attract BPR only when held with a controlling shareholding while any unquoted shares in a qualifying group will qualify.

(5) Remove contractual arrangements for the sale of shares inherent in the Articles of Association or shareholders' agreements. Replace with pre-emption rights or put and call options.

Group structures

Having considered the basic BPR rules, what is the position regarding deep group structures and split shareholdings?

As mentioned above, in order for a group of companies to be eligible for BPR at all, the parent of the group must be 'wholly or mainly' (i.e. more than 50%) a qualifying trading company (T) or the holding company of a (qualifying) trading group (H). If a parent company is a trading company, T, no BPR will be due for any companies it owns unless these are themselves other T trading companies. Equally, if a company is set up to hold less than 50% of a trading company — for example to consolidate the interests of a family and then bring in another investor — this will not be the 'holding company of a trading group', so no relief is due. Note that relief would have been due if the trading company had remained a singleton company and the family were, say, locked into a shareholders' agreement instead.

If the company is a holding company, H, relief will be due on the values inherent in that company, in the qualifying trading subsidiaries (T) it owns, and in any non-subsidiary associated companies (A), but will still be chargeable on investment companies or companies carrying on non-qualifying trades and on any excepted assets.

Deeper structures

What happens if the group is deeper, with more than one holding company?

What if two trading companies are held through two layers of holding company and a third trading company is held one level further down?

S 105 is not phrased in terms of holding companies and subsidiaries: it says that to be eligible for relief, the company must be a qualifying trading company. Section 105(4)(b) adds that it may also be a company which holds shares in such a trading company.

Section 111 then 'allows' a second layer of holding company.

Despite the provisions in s 111, in 1995 the CIOT obtained a confirmation from Capital Taxes Office that BPR *would* be available in respect of a group where two trading subsidiaries were held through a double layer of holding company 'as it is usual policy to look through the intermediate holding company' (CIOT 9/95).

It does not extend s 111 to further layers of holding company, which might have been helpful, and the phrase 'usual policy' is far from ideal in the context of a valuable group held through multiple holding companies. Following the recent cases on residence where the taxpayer has sought to rely on an HMRC booklet, IR20, and was given short shrift at the Commissioners, it would perhaps be a brave taxpayer who sought to rely on a 13-year-old 'usual policy' statement which does not even merit a cross reference in the legislation.

For most UK groups it will not be difficult to re-arrange the structure to reduce the number of holding companies, although this is more complex for international groups.

Given the uncertainty here, we have taken advantage of the new BPR clearance procedure to see the latest HMRC view. We recently received confirmation that a structure with up to six levels of holding company would be within the BPR regime (subject to meeting the rules on qualifying activity and not having any excepted assets). This indicates that the same 'policy' interpretation is still held by HMRC, although it would be better to amend the legislation and put the issue beyond doubt.

From an article by Jan Ellis writing in Taxation

Administration

Receipts for Self Assessment returns - 'Reasonable Evidence'

On 5 December 2005, HM Revenue & Customs (HMRC) confirmed that Enquiry Centres would no longer be able to issue receipts for Self Assessment returns delivered by hand to local offices, as the department wished to concentrate its available resource in an effort to ensure that all returns are logged correctly, when received. This remains the case for 31 October 2008.

The professional bodies reluctantly accept HMRCs resourcing issues, but in view of the legal deadlines for filing of tax return forms and consequences of delays, taxpayers and agents nevertheless have a need for evidence of delivery. It is also essential, in view of the repercussions arising from the issue of an incorrect penalty notice.

Following feedback from agents, HMRC have accepted that mistakes may still be made, and therefore issued guidance to their staff that, in the event of an agent challenging a penalty notice on the basis that the return had in fact been lodged, they should accept any reasonable evidence the agent has that the return was filed on time. Experience over the past few years suggests that this has worked well and HMRC is happy to refresh that guidance for 31 October 2008.

In order to satisfy the requirement for 'reasonable evidence' to be held by the agent, the professional bodies recommend the following:

- each batch of returns to be hand delivered to HMRC should be accompanied by a list, date stamped for the relevant date of delivery, and listing the name and the Unique Taxpayer Reference of each return in the batch
- each entry on the list should be checked back to the returns by a senior member of staff (for example, a manager), and this individual should sign the list to indicate that this has been done
- in all firms other than sole practitioners, each list should then be checked and countersigned by, for example, a Partner
- a sole practitioner should mark the items clearly as having been checked, and sign to this effect
- a copy of the list (signed and dated) should be retained in case of subsequent problems
- a copy of the signed and countersigned list should also be attached to each batch of Returns handed in at HMRC Enquiry Centres

HMRC is happy to reconfirm our previous message via the Working Together Steering Group that the 'audit trail' generated above will normally be accepted as 'reasonable' evidence of delivery.

Members should also be aware that Royal Mail offers an online 'Track and Trace' facility with its special and recorded delivery services. HMRC recommends that returns be filed by Internet, as this enables electronic receipts to be issued automatically.

Self-assessment online filing update for agents guidance

The number of instances where you are unable to file returns online should significantly reduce over the coming weeks as commercial software developers complete their programmes to deploy workarounds or fixes for outstanding issues in advance of the paper filing deadline of 31 October. It is important that you download/install software updates for your products so you benefit from these fixes. After 31 October we will try to identify any areas that are still creating significant problems and publish an update to this guide.

If I cannot file online will you accept a paper return?

We hope that this guidance will help you to solve most of your problems. But if you still have difficulties then HM Revenue & Customs (HMRC) will accept a printout from your commercial software as long as it is identical to the HMRC form.

Penalties and reasonable excuse

Returns that are filed on paper after 31 October will normally trigger a penalty.

HMRC will, as usual, accept an appeal (under s.93, 93(A) or 118(2) TMA 1970) and remove the penalty for the late submission of a return where a reasonable excuse exists.

Where you can show us that one or more of the reasons shown in Annex A or C (for example, where you are unable to use the suggested workaround) prevented you from filing a particular Self Assessment return online, we will accept an appeal against a penalty for the late submission of a paper return on the basis of reasonable excuse.

We will also consider sympathetically claims for reasonable excuse where you advise us that a paper return has been filed late because of another issue relating to use of the online service.

When and how should I advise you that a case for reasonable excuse applies?

Please send a separate form or letter with the completed paper return as soon as you encounter problems with online filing. Please do not include the information within the white space as this may lead to a delay in processing your claim.

What information do I need to include?

WTeSSG in collaboration with HMRC has produced a form that you may choose to use. It provides details of all the information required by HMRC for a claim for reasonable excuse.

The distinctive format will ensure that on receipt it is quickly identifiable, and will receive early consideration.

If you prefer not to use this template, then any letter you send needs to include the following information—

– the taxpayer's name

– UTR (Unique Taxpayer Reference)

– agent name, address and contact details

– reason for claiming reasonable excuse

– the date you tried to file a particular return online or realised that it could not be filed online

– date of claim

It would also be helpful if you would include a copy of any error message, or provide details of why a return could not be filed online along with details of the software package you are using.

Will this mean that a penalty notice will be suppressed?

We understand that you would prefer to prevent a penalty notice being issued to your client in these circumstances. If a claim of reasonable excuse is received and accepted prior to the penalty notice being issued, we will normally be able to inhibit the issue of the penalty notice. We will give you further guidance on this closer to the online filing deadline.

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How will HMRC adopt a consistent approach?

The claims will be dealt with by specialist teams who are experienced in the handling of reasonable excuse cases.

What about capping of penalties?

The capping provision will continue to apply this year to returns for Individuals and Trusts. This means any penalty charged would be the lesser of £100 or the tax due and remaining unpaid as at 31 January. We would therefore encourage your clients to pay any tax due by 31 January to ensure they minimise any penalty. No capping applies to Partnership returns.

Late filing penalties are being reviewed by the Powers Review and it is possible that the capping provision will change in the future.

Tax investigations

Selection criteria

Enquiries are made on the basis of the department's computerised risk analysis system. Each tax return is examined by the computer and allocated a risk score. If the computer selects a return because it has a high risk score, the identity of the accountant is not normally considered.

The complete absence of an agent might trigger a higher risk score. An unusually high level of accountancy fees is also likely to increase the risk score. But HMRC compliance staff are not allowed to de-select a case merely because the taxpayer has a qualified or reputable accountant. This is equally true of enquiries selected at random by the computer.

Recurring investigations

Legally speaking, the same taxpayer or business could be selected for enquiry each and every year; it is solely dependent upon the risk scoring and random drawing from the computer system.

In practice, if a case is selected for enquiry but the taxpayer or business has been investigated quite recently, the investigator may request permission to de-select. However, de-selection is not guaranteed in these cases.

The interview

Being interviewed by an Inspector as part of a full enquiry is not a compulsory element of an investigation and it is not always necessary from the Inspector's point of view.

Furthermore, there is no piece of legislation that entitles an Inspector to interview anyone; it is quite acceptable and entirely reasonable to request that all questions be put in writing.

Private records

The misconception that tax investigators are not allowed access to private bank accounts is one of the big causes for concern when an investigation is instigated. This is often an integral part of investigations and a large number of cases are 'broken' following an examination of private bank account or credit card statements. If HMRC are ever prevented by law from examining private bank accounts, they might as well abandon compliance work altogether!

HMRC do require justification in order to do this; however, in practice, it is not too difficult for the investigator to justify extending his enquiries into private areas.

Complaints

The complaints procedure is there to be used, and in appropriate circumstances it should be used. Provided the complaint is reasonable, it should not prejudice the case. The complaints procedure can sometimes be frustrating, but it can also be very useful in bringing tedious enquiries to a satisfactory conclusion.

Lack of documentary evidence

It is always worth remembering that if a tax investigation looms, a taxpayer's explanation, even if not supported by documentary evidence, is not always completely unacceptable.

It is true that the burden of proof is normally on the taxpayer, in accordance with the legislation on tax appeals. However, it is not for the tax authorities to define the nature of proof; only the independent appeal commissioners can do that. If the appeal goes to a formal hearing, the commissioners are quite at liberty to accept the personal testimony of the taxpayer, or of any witness appearing on the taxpayer's behalf. It is always best practice, however, to keep all receipts organised so that if a tax investigation ever does occur, all documentary evidence is available to make the process go as quickly, and smoothly, as possible.

From an article by Ben Chaplin

Business Tax

Rules and restrictions for sideways set off of trading losses

There appears to be an increase in the number of income tax enquiries challenging the commerciality of loss making businesses run by individuals and partnerships. With traders encountering difficulties as economic growth falters, such enquiries may become more prevalent in the next 12 to 24 months.

The legislation

Trading losses are relievable against an individual's general income in accordance with ITA 2007, s 64 (formerly TA 1988, s 380). The first question to be asked is whether a trade is actually being carried on; if not, no tax relief is available.

Assuming for the purposes of this article that a trade does exist, we need to consider ITA 2007, s 66 (formerly TA 1988, s 384), which denies the sideways set off for losses where the trade demonstrably lacks commercial inspiration. The test in this section is that a trade must be carried on throughout the basis period for the tax year both (a) on a *commercial basis* and (b) with a *view to the realisation of profits*.

Individuals who are genuinely trying to make a profit from their trade should not be denied sideways set off in respect of any losses.

Five year test and hobby farmers

The 'five year test' is set out in ITA 2007, s 67 (formerly TA 1988, s 397). Under this, if a loss has been incurred by a farmer or market gardener in each of the last five years, then the loss incurred in the sixth year cannot normally benefit from sideways set off against general income; it can only be carried forward to set against future farming profits.

If a profit is made in the sixth year, the five year clock is reset. Note also that the first year of trade is not counted for s 67 purposes, meaning that for a new farming business, the (consecutive) loss of the seventh tax year would be the first to be caught.

Because of s 68, the five year restriction does not apply where the farming activities meet a 'reasonable expectation of profit' test decided by reference to the 'expectations of a competent farmer'. This test is met where a competent person carrying on the:

- farming activities in the current tax year would reasonably expect future profits; but
- activities in the last five years could not reasonably have expected the activities to become profitable until after the end of the current tax year.

HMRC will not seek to apply the five year test if the farm trade is ancillary to a larger undertaking. In recent years some farmers have struggled to realise a profit from the main farm business and have diversified. Animal parks which provide facilities for children to see and mingle with horses, lambs, goats and pigs are becoming popular and in such circumstances the farm trader may be able to defend a sideways loss relief claim by arguing the ancillary point.

HMRC recognise that stud farms are effectively farms for tax purposes and that these take a long time to establish. HMRC accepted that by concession for stud farms they would not invoke s 67 until 11 years after the start of the trade, rather than the usual five.

Opening year losses

There is a separate relief available for losses incurred in the first four years of trade under ITA 2007, ss 72 to 74 (formally TA 1988, s 381). This allows a loss to be carried back against other income for the previous three tax years. However, a specific restriction in s 74 means that not only must it be a commercial trade, but also a profit must reasonably be expected to be made in the period or within a reasonable time afterwards. The definition of 'reasonable time afterwards' will depend on the individual circumstances but HMRC take the approach that this is a short period.

Restricting relief

If an individual is not actively involved in running the business then the loss available for sideways relief is restricted to a yearly maximum of £25,000. The legislation defines 'non-active' as devoting less than ten hours a week on average engaged in the activities of the business but it must still be carried on on a commercial basis with a view to realising a profit. Any losses over and above the £25,000 are carried forward to set against future profits from the same trade.

Commercial basis

To achieve sideways set off, the commercial trader should be able to demonstrate clear intentions that he wants to make a profit from the business. The serious trader can most suitably evidence this by carefully prepared business plans and profit projections. A comparison can be made with the amateur who may have a good idea, but lacks the knowledge and substance to follow it through as a profitable business.

Traders do have unexpected losses which arise for many reasons which are outside of their control. As well as the state of the economy, such reasons could be increased interest rates, new sources of competition, departure of key staff members, and more dramatic events such as the foot and mouth outbreak (for which special concessions applied), fires, floods (think back to 2007) and prolonged bad weather (think back a few months!).

Establishing the precise facts is critical as ultimately these may need to be brought out before an independent tribunal and HMRC should take all such matters into account when considering whether a trade is being run on a commercial basis.

View to realising profits

If a trader is incurring losses without any real prospect of realising a profit, HMRC will consider that he must have another purpose or motive for undertaking the trade.

In the furnished holiday lettings case of *Brown* [1997] STC(SCD) 233 sideways losses were denied because it was held that income was generated purely to offset expenditure rather than with a view to realising a profit.

Traders should be ever mindful of a possible tax enquiry in the future and set down on paper their aims and objectives for their business from the outset.

In seeking to establish the facts at an early stage of an enquiry, it may be useful to meet HMRC to discuss fully the likelihood of future profits and demonstrate how the business operates on a practical level. Accordingly, in a farming enquiry, the provision of a guided tour (complete with wellies) may help to convince the Inspector that he is looking at a genuine working farm.

It is also helpful to provide comparisons with other similar businesses in the locality in order to illustrate market trends which may be having an impact on results, such as any unusual circumstances which have influenced profitability.

Farmers and market gardeners

Inspectors will always look closely at gentleman farmers who they perceive may be seeking to live the good life at the Treasury's expense. Are they really carrying on commercial farms with a view to realising a profit, or is it more a case of having made an alternative lifestyle choice?

Conclusion

It should be remembered that where the sideways set off for losses is denied or not applicable, the loss can still be carried forward to set against future trading profits of the same business. As such, the loss will not be lost altogether but no immediate tax relief can be secured.

To summarise, businesses feeling the pressures of the current economic climate may also fear the threat of any sideways loss claims being challenged by HMRC. Such businesses should be made aware of the risks so that hard evidence can be gathered to support the claim to relief.

From an article by Sarah Turgoose and Mike Down writing in Taxation

Where 'duality' divides allowable from non-allowable expenses

As you may know, Mr Winner writes a weekly column for *The Sunday Times* as a restaurant critic, 'Winner's dinners'. The question that no doubt naturally occurs to you — and naturally occurred to HMRC — was whether the cost of the meals is tax deductible.

Live to eat?

Assuming that he is a self employed freelance writer, when he went to a restaurant to review it for a newspaper column was their a problem with 'duality of purpose' making the meal not tax deductible as he had to eat to live?

'Food critics have to go out to eat. They have no choice. Unlike most citizens, they don't eat to satisfy their need to live. They eat to produce articles for their editor.'

Perhaps the most interesting part of the article is where Mr Winner says of Mr Kain that 'he actually suggested that if I had to write about a restaurant meal when I was not hungry, he might consider it deductible.

In *Caillebotte v Quinn*', Lord Templeman noted that the taxpayer, like any other, must eat to live and no part of his lunch was laid out 'wholly and exclusively for the purposes of his trade'. However, he did note that the cost of a cup of tea drunk by an actor in a play of 'The Mad Hatter's Tea Party' might be allowed on the basis that quenching his thirst would be incidental to playing the part.

Do the clothes fit?

Probably the best known case on this subject is *Mallalieu v Drummond* [1983] STC 665, where a female barrister purchased black and white clothes to wear in court as required by the Bar Council. Her personal preference was for more brightly coloured clothing and she therefore claimed a tax deduction for the cost of these 'work' clothes.

Lord Brightman said 'if it appears that the object of the taxpayer at the time of the expenditure was to serve two purposes, the purposes of his business and other purposes, it is immaterial to the application of s 130(*a*) that the business purposes are the predominant purposes intended to be served'.

Warmth and decency

But was not the 'natural warmth and decency' afforded by Ms Mallalieu's dark clothing an 'unavoidable effect' of her having to wear such clothes to comply with Bar Council rules? In the same way that it would be impractical for the restaurant critic to eat a meal to satisfy his hunger at his own expense before then consuming a tax deductible meal for the purposes of his review, presumably it would have been impractical for her to have worn her own brightly coloured clothes underneath to satisfy the former requirement, with the dark clothes on top to comply with the latter.

It seems to me that the personal 'satisfaction' (covering one's nakedness or satisfying one's hunger) afforded by the clothes and the food are both either 'unavoidable effects' or they are both objects (albeit secondary) of the taxpayer.

The dividing line

Simon's Tax Cases report on *Mallalieu* reads as follows, but I have inserted in square brackets words that I feel relate to Mr Winner's claim. 'But for the requirements of her profession that she should be so clothed [fed] … the taxpayer would not have purchased those clothes [meals]. The taxpayer had an ample supply of other clothes [meals] to keep her in comfort and decency. The preservation of warmth and decency was not a consideration which crossed her mind when she bought the clothes [meals].'

Dinner and dichotomies

Of course, once one does start to consider this subject, dichotomies do start to crop up.

HMRC's *Business Income Manual* at BIM50160 refers to 'Actors and other entertainers: expenses'.

The paragraph headed 'Clothing' refers to *Mallalieu* and states that 'a self-employed person could not claim a deduction for the cost of "a wardrobe of everyday clothes" even if they were used solely for work. There is an inevitable non-business purpose in the acquisition of such clothing: the provision of warmth and decency'.

However, the *Business Income Manual* then goes on, 'the *Mallalieu* decision does not mean that the cost of clothing is always disallowed. BIM37910 gives examples of the costs of a "uniform" or protective clothing. The cost of clothing acquired for a film, stage or TV performance is also allowable. The clothing in such event is not part of "an everyday wardrobe"; it is "costume" used in a performance'. HMRC then give the example of a self-employed television interviewer who can deduct the costs of a lounge suit acquired solely for use before the cameras ('it is the interviewer's "costume"'). However, a self-employed architect who buys a suit to create a good impression while being interviewed on television may not have a deduction for the cost. 'The suit is not a self-employed performer's costume'.

I would hazard a guess that many trial lawyers would consider that what they do is a 'performance', and is this really any different from the ('put on a white coat and you are a doctor syndrome') position when a professional person wears a £3,000 suit to meet and advise clients even though his advice would be exactly the same as when wearing his 'off duty' t-shirt and jeans?

Maas and meals

Robert Maas considers this subject in his book, *Taxation of Employments*. 'It should be borne in mind that the test is a motive test, "why was the expenditure incurred?" If the motive was solely a business motive, it does not matter that the taxpayer may obtain a personal benefit as a side effect of the expenditure.'

But was this not the position in *Mallalieu*? According to Robert, no. He says that 'even the *Mallalieu* decision does not breach this principle; it merely stresses that the professed motive for incurring an expense may not be the sole motive.' In *Mallalieu*, the other motive was 'warmth and decency' although why visiting the friend was not also a motive rather than a side effect might cause one difficulty.

Actor's expenses

HMRC also refer to the costs of costume and grooming incurred by a performer making 'personal appearances' to promote his business activities. They posit the example where 'a film actress may acquire an evening gown solely for the purpose of attending the premiere performance of her latest film. The cost of the gown is allowable. The later private use of a gown, which as a question of fact was bought solely for use at a premiere or other such occasion, does not result in disallowance of the expenditure. If the actress had bought the gown with a view to using them both at the premiere and on other private occasions, no deduction would be due. Again, what about 'natural warmth and decency'?

I think I may understand HMRC's approach to cosmetic surgery even less. As mentioned, it has been held that 'health-related surgical, hospital and medical expenses are inadmissible deductions in computing profits' (BIM50160). However, HMRC then say that 'some performers may, however, be able to show that expenditure on cosmetic surgery has been incurred *solely* for professional purposes. Such expenditure may be allowed'.

The numbers of those able to claim the cost of clothes for theatrical or TV performances, or indeed food for their business as a restaurant critic, are obviously much smaller than the general self-employed population.

Conclusion

So if case law was in their favour, why *did* HMRC allow the expenditure on the Michael Winner's meals? It's quite well known that the department will take famous people to court if they believe that there has been tax evasion on the grounds that the publicity of a high profile case — like a public execution of yore — can serve to 'encourage the others'. I do wonder whether HMRC might have felt that taking this case to the Commissioners, and possibly further, could — in view of Mr Winner's journalistic career and the possible press coverage — have backfired.

Another possibility of course is that *Mallalieu* was wrongly decided. After the General Commissioners found for HMRC, the High Court judge, three Court of Appeal judges and a dissenting House of Lords judge found for the taxpayer. Of no legal effect, but a 5-4 'moral' victory for the taxpayer.

Perhaps the ultimate reality is that HMRC can use *Mallalieu* to refuse pretty much any claim where 'the many' (say those who wear a suit to work) might be involved and where 'duality' could be argued, but are less likely to do so when only a few (e.g. food critics and television presenters, say) are involved.

From an article by Richard Curtis writing in Taxation

Tower MCashback LLP and another v Revenue and Customs Commissioners [2008]

The taxpayer limited liability partnerships (the taxpayers) submitted partnership tax returns and self-assessments for the tax years 2003/04 and 2004/05, in which they made claims for first-year allowances (FYAs) pursuant to s 45 of the Capital Allowances Act 2001, in respect of the whole of the consideration payable under software licence agreements which the taxpayers had entered into with M Ltd on 31 March 2004.

Following investigation and correspondence, the Customs and Revenue Commissioners (the commissioners) took the view that the expenditure in question had been incurred 'with a view to granting to another person a right to use or otherwise deal with any of the software in question' within the meaning of s 45(4) of the 2001 Act, with the result that it was disqualified from being first-year qualifying expenditure under s 45. By virtue of s 28B(1) of the Taxes Management Act 1970, a closure notice: should inform the taxpayer that the officer who gave the notice had completed his enquiries; state his conclusions; and if any amendments were needed in order to give effect to his conclusions, they should be made. On 20 June 2006, F, the Revenue and Customs official who headed the enquiries, sent closure notices to KPMG, who were acting for the taxpayers, setting out the commissioners' reasons for disallowing the FYAs, stating that the 'scheme fails on the s 45 CAA 2001 point alone'. On the same date, F wrote to the taxpayers' representative members giving formal notice of the conclusion of his enquiries into the taxpayers' tax returns, amending the taxpayers' tax returns to reflect the relevant disallowances. The taxpayers wrote to F appealing against those amendments, pursuant to s 31(1(b) of the 1970 Act, which provided that an appeal might be brought against any conclusion stated or amendment made by a closure notice pursuant to s 28B of the 1970 Act. On the third day of the hearing before the Special Commissioner, the commissioners abandoned their only contention based on s 45(4) of the 2001 Act. However, the Special Commissioner decided the closure notice issue in favour of the commissioners. He further made rulings on other issues between the parties. The taxpayers appealed.

Held—Pursuant to s 31(1)(b) of the 1970 Act, no provision was made for an appeal against the reasons given by the officer for reaching his conclusions. Similarly, the duty of the General or Special Commissioners hearing the appeal was not to review or adjudicate upon the officer's reasons, but rather (in the context of a partnership return) to consider whether the amounts contained in the partnership statement included in the return were excessive or insufficient, and (if it so appeared to them) to reduce or increase the amounts accordingly. Provided they acted fairly, and on the basis of evidence that was properly before them, the commissioners might take the initiative and apply the law to the facts in the manner that appeared to them to be correct, regardless of the arguments advanced by either side. That was not to say, however, that an appeal against a closure notice opened the door to a general roving enquiry into the relevant tax return. The scope and subject matter of an appeal against a closure notice would be defined by the conclusions stated in the closure notice and by the amendments (if any) made to the return. A taxpayer's right of appeal under s 31(1)(b) of the 1970 Act was confined to an appeal against any conclusions stated or amendments made by a closure notice. That was the only appeal which the commissioners had jurisdiction to entertain.

The limitation on the scope of the appeal was part of the protection given to Parliament to taxpayers under the self-assessment system. There was always a balance to be struck between the interests of individual taxpayers on the one hand, and the interests of the state and the general body of taxpayers on the other hand. Parliament had decreed how the balance was to be struck. If there was a moral to be drawn, it was that the commissioners should ensure that they had considered all the points on which they might wish to rely before a closure notice was issued. Issue of the notice was an irrevocable step, and once it had been taken the battle ground on any future appeal would be defined by reference to it.

In the instant case, the scope of any appeal had been confined to the question of whether s 45(4) had indeed applied, and in particular to the factual issue whether the taxpayers had incurred the expenditure on the software with a view to granting another person a right to use or deal with it. Accordingly, the Special Commissioner had had no jurisdiction to entertain the wider question as to whether the other requirements of s 45 had been satisfied, because the appeal would then no longer be an appeal against the conclusions stated in the closure notice. It followed that instead of deciding the closure notice issue in the commissioners' favour, as he had done, the Special Commissioner should have refused to consider the other issues, or at least should have done so on the footing that he had been wrong on the closure notice issue.

The Special Commissioner had erred in his reasoning.

The appeals would be allowed.

Corporation Tax

Tax relief on loans to companies and to purchase shares

A close company situation is assumed throughout this article. The advantage of a close company is that the individual loaning monies to it may obtain tax relief on any interest paid in arranging loans to inject funds. This only applies where the individual satisfies either the 'material interest conditions' or 'full-time working conditions' as far as the company is concerned.

The material interest conditions (ITA 2007, s 393(4)) are that the individual:

- must own more than 5% of the ordinary shares: or
- be entitled to more than 5% of the assets on a winding up.

The full-time working conditions are that the individual must work for the greater part of his time in the actual management or conduct of the company or an associated company (ITA 2007, s 393(3) from 2007-08, previously TA 1988, s 360(3)(b)).

The full-time working conditions

A shareholder will normally be regarded as meeting the 'full time working condition' if they are directors of the company or have significant technical or managerial responsibilities. The shareholder must be involved in the overall running and policy making of the company as a whole, not just one area.

'Greater part of the time' should normally be interpreted as more than half of the normal working day.

Qualifying close company

In addition to the material interest and working conditions, the company must satisfy the qualifying close company condition. This is defined in TA 1988, s 13A(2) — the company must be either wholly or mainly carrying on a trade on a commercial basis or, if let property is involved, it must be let to unconnected third parties. A holding company owning shares in a qualifying company would pass this test. In summary, the company must be close throughout the accounting period concerned, but not a close investment holding company.

Tax relief

Provided all the above conditions are satisfied at the time the interest on the loan is paid, tax relief will be available to the director/shareholder concerned. If, later, the company loses its close company trading status, relief may still be available under Statement of Practice SP3/78, provided the company continues to trade.

'SP3/78 provides that relief should not be refused in a case where, after the application of any loan, the company ceases to be close, provided that all the other conditions for relief, including those referred to in SAIM10250, are satisfied.'

Any recovery of capital from the business would restrict the amount of interest relief the individual is entitled to — ITA 2007, s 406.

Cash extraction

Interest could be charged and paid on the loans advanced by the director. This would have the two-fold benefits of providing the director with cash flow to pay the interest on the loan advanced to him by the bank and be tax efficient in that interest paid, although taxable, is not subject to NICs.

What if it all goes wrong?

The rules outlining relief for capital losses in respect of irrecoverable shareholder loans are to be found at TCGA 1992, s 253. It is a principle of capital gains tax that relief is not available for a simple debt as it is outside the scope of capital gains tax, but a shareholder can claim relief for a capital loss equal to the irrecoverable loan. Section 253 gives the detailed conditions, but the main ones can be summarised as follows:

- The monies must have been used wholly for the purposes of the trade or, if used by a group member, that group member must be in a 75% group relationship.
- The borrower must be resident in the UK.
- The loan must be irrecoverable and must not have been assigned by the lender.
- The loan must not be a debt on a security — i.e. a marketable investment producing a return to the investor.

If all the conditions are satisfied, the claimant may make a capital loss claim to the extent that agreement can be reached with HMRC that the loan has become irrecoverable in respect of the principal of the loan. In arriving at this agreement, the Inspector will consider whether there is a likelihood of future recovery based on his judgment as to the future financial prospects of the company. He will examine recent accounts and any other information in his possession in arriving at his agreement of the amount considered to be irrecoverable. This could result in only part of the claim being allowed! Indeed, there is a stark difference between a loan becoming irrecoverable and the director choosing to waive that loan in order to make the balance sheet look better or to please the bank manager because the company is going through a tough time.

In some instances the Inspector may even consider that the loan was made at such a time when the company was in an extremely poor financial position and when a reasonable person would have not considered there was any real prospect of recovery. Relief may therefore be denied in full.

To agree a claim, HMRC will need to be convinced of the circumstances between advancing the loan and the, possibly short, time until it became irrecoverable and will wish to make a detailed examination of the facts of the case. Anti-avoidance measures exclude the possibility of gaining a tax advantage from a scheme or similar arrangement to extract resources from a company that then becomes unable to repay its loan.

A claim is made when the loan is considered to be irrecoverable. It can be made for an earlier time if it can be shown that it was irrecoverable at that earlier time and that date is within two years before the start of the tax year in which the claim is made (TCGA 1992, s 253 (3) and (3)(a)).

Shares purchased rather than loans

If, rather than advancing a loan to the company, the director had purchased further shares, his tax position would be as above for income tax in that he would be entitled to relief for interest paid on any loan used to acquire the share capital. (This is under ITA 2007, s 392(2)(a).) The conditions to be satisfied (being very similar to those outlined earlier for loans) are that he must own more than 5% of the issued share capital of a close company or, if a smaller percentage is held, he must work for the greater part of his time in the management or conduct of the company or an associated company.

To qualify, the shares must be newly issued. It is not sufficient that they are purchased from another shareholder, as such expenditure would not qualify.

An important difference arises for capital gains tax in that a loss on shares in similar circumstances would also create an allowable loss under the negligible value rules, but that loss can be extended to income under ITA 2007, s 631. This contrasts with the position on losses in respect of qualifying loans where only capital gains tax relief is available. Bearing in mind that the individual concerned may very well have just lost his largest asset in the demise of his business, such a capital loss may have to wait a long time to be relieved against a subsequent gain, whereas the 'income tax' loss on shares could immediately be used by set-off against earnings from another source, at least helping with immediate cash flow problems.

Space does not permit a discussion of the implications of issuing further share capital, but it is worth making a note of caution on conversion from loan to share capital.

Temptation to convert

It should be borne in mind that any shareholder tempted to convert a loan into share capital to take advantage of this relief may experience a problem if the company is insolvent. TCGA 1992, s 17 deems market value to apply and the cost of shares would be unlikely to be accepted as part of the shareholder's base cost in these circumstances.

Article by Penny Bates writing in Taxation

Share acquisition tax traps

Trading losses

If the target company has substantial corporate tax losses brought forward then the availability of these to the purchaser, to utilise against future taxable profits, will be of considerable importance.

Anti-avoidance provisions provide for such trading losses to be disallowed where there is a change in ownership of the company and where the following applies:

- where in any period of three years there is both a change in the ownership of the company and a major change in the nature or conduct of a trade carried on by the company; or

- at any time after the scale of the activities in a trade carried on by a company has become small or negligible, and before any considerable revival of the trade, there is a change in the ownership of the company.

Considerable care therefore has to be taken to make sure that the above provisions are not invoked. This may prove difficult where a company has been trading at a loss as to make it profitable, it may be necessary to make fundamental changes to the way it operates.

'Major change in the nature or conduct of a trade' is defined by the legislation to include:

- a major change in the type of property dealt in, or services or facilities provided, in the trade; or

- a major change in customers, outlets or markets of the trade.

Case law in this area is abundant and needs to be considered when contemplating the impact of this provision. The precedents that have been established are reflected in HMRC's Statement of Practice 10/91, revised in 1996, which sets out the Revenue's view on what they will and will not regard as a major change in the nature or conduct of a trade.

For instance, the following will not be regarded as a major change in the nature or conduct of a trade:

- changes to increase efficiency;
- changes which are needed to keep pace with developing technology;
- changes concerned with developing management techniques;
- rationalisation of a company's product range by withdrawing unprofitable items and, possibly, replacing them with new items of a kind related to those already been produced.
- Examples of changes which are therefore not to be regarded as major changes include:
- a company manufacturing kitchen fitments in three obsolescent factories moves production to one new factory (increasing efficiency);
- a company manufacturing kitchen utensils replaces enamel by plastic, or a company manufacturing timepieces replaces mechanical by electronic components (keeping pace with developing technology);
- a company operating a dealership in one make of car switches to operating a dealership in another make of car satisfying the same market (not a major change in the type of property dealt in);
- a company manufacturing both filaments and fluorescent lamps (which filament lamps form the greater part of the output) concentrates solely on filament lamps (a rationalisation of product range without a major change in the type of property dealt in); or
- a company, whose business consists of making and holding investments in UK quoted shares, etc, changes its portfolio of shares (not a change in the nature of the investments held).

Examples of where a major change would be regarded as occurring include:

- a company operating a dealership in saloon cars switches to operating a dealership in tractors (a major change in the type of property dealt in);

- a company owning a public house which is to operate a discotheque in the same, but converted, premises (a major change in the services or facilities provided);

- a company fattening pigs for their owners which is to buy in pigs for fattening (a major change in the nature of the trade, being a change from providing a service to being a primary producer); or

- a company switches from investing in quoted shares to investing in real property for rent (a change in the nature of investments held).

Note that the three year period does not just apply to the period following the change of ownership, it also applies to the three years prior to the change of ownership. Potential purchasers will therefore seek warranties and indemnities from the vendors in this regard.

There is thus a risk that losses may not be able to be utilised by the purchasers but nevertheless it should be remembered that unrelieved losses have a value. £1,000,000 of trading losses carried forward could potentially save £300,000 of tax at the full rate of 30% (reducing to 28%) but it is unlikely that the purchasers would pay the full £300,000 for the losses.

Capital gains degrouping charge

Members of a 75% capital gains group may transfer chargeable assets to one another at no gain/no loss. This applies automatically under the provisions of s171 TCGA 1992.

However where the transferee company leaves the group within 6 years of the intra-group transfer, whilst still owning the asset, a corporation tax charge arises on that transferee company at the beginning of the accounting period it leaves the group. This "degrouping charge" under s179 TCGA 1992 is computed by using the market value of the transferred asset at the time of the no gain/no loss transfer. This is an important matter to be reviewed by investigating accountants performing due diligence into the target company.

Reallocate degrouping charge

The transferor and transferee may make a joint election under s179A TCGA 1992 that allows the de-grouping charge to be reallocated to the transferee or another member of the selling group.

Example

A Ltd and C Ltd are both 100% UK subsidiaries of B Ltd, thus forming a 75% group for gains.

B Ltd transferred a chargeable asset to A Ltd in March 2004 when its value was £1 million. Assume that cost plus indexation to March 2004 was £600,000. This transfer will automatically give rise to neither gain nor loss under the provisions of s171 TCGA 1992.

A Ltd, still owning the chargeable asset now worth £2 million, is then sold to X Ltd, the holding company of the XYZ group, on 2 April 2007. This being within 6 years of the original s171 transfer will trigger a s179 de-grouping charge of £400,000, being the gain computed by using the value in March 2004.

Normally the charge would arise within A Ltd the company leaving the group but it is possible to elect to reallocate the charge back to B Ltd or C Ltd provided that they were group members at the time that the gain or loss arose. The reallocation requires a joint election by A Ltd and B Ltd (or C Ltd) within 2 years of the end of A Ltd's accounting period in which the s179 charge accrued and for the companies concerned to be within the charge to corporation tax. Any payments in respect of the transfer of the charge are disregarded for corporation tax.

The election may be made in respect of de-grouping events taking place on or after 1 April 2002.

The main practical impact of the election is that the vendor group does not need to indemnify the purchaser for the potential s179 charge that would otherwise arise in the target company provided the election has been correctly made. This should simplify a company sale and make the target company more attractive to the purchasers.

It not unusual for the buyer to negotiate a clause in the tax covenant that ensures that the seller makes the necessary election under s179A to reallocate the charge; with additional comfort typically sought through defining the tax liabilities in the covenant as not only pre-completion tax liabilities but also liabilities arising on completion and therefore including any degrouping charge.

Rollover of the degrouping charge

Section 179B and Schedule 7AB of TCGA 1992 provide rollover relief (or holdover relief as appropriate) for gains arising by virtue of s179 (the de-grouping charge) by extending the business asset rollover relief provisions, as modified by Schedule 7AB.

The extended rollover relief works in conjunction with the new s179A by allowing the companies to whom the de-grouping gain is reallocated to make rollover claims where there is reinvestment in replacement business assets.

Exemption from the degrouping charge

Section 181 provides for a complete exemption from the charge if the transferee leaves the group by reason of a merger as defined by that section. The merger exemption is considered in more detail later in these notes.

A further exemption is given by section 192 TCGA 1992 where the transferee leaves the group on a reorganisation subject to an exempt distribution on a statutory demerger under section 213 ICTA 1992.

Intangibles

The grouping and degrouping provisions in the intangibles rules mirror almost exactly the relevant provisions for chargeable gains. A group for this purpose is also defined the same as for chargeable gains.

Where a company leaves a group holding an intangible subject to a intra-group transfer within the previous six years, a degrouping charge arises on that company equal to the market value of the asset at the time of transfer. The charge is deemed to arise immediately before the transferee leaves the group.

As with the capital gains degrouping charge, a number of provisions help to mitigate the impact of the charge. There is, for instance, the opportunity to roll-over the charge against the acquisition of new intangibles or to reallocate the charge to another company in the old group (who may also rollover the charge).

The degrouping charge will be avoided completely if the company leaves the group because of a reorganisation involving the statutory demerger provisions in section 213 ICTA 1988 (see Part 2 of these sessions) or as part of a merger of companies. The definition of merger is the same is that found in section 181 TCGA 1992 and considered further later in these notes.

Financial instruments

Transfers within a group of companies of most debt instruments and derivative contracts (falling within the loan relationships and derivatives tax rules) are, like chargeable assets, treated as being transferred at a value that gives rise to neither gain nor loss. The transfer is effectively disregarded and the transferee takes on the instrument as if it were the original holder.

However, the sale of the transferee out of the group within six years of an intra-group transfer will crystallise a degrouping charge based on the fair value of the loan note or contract at the time the company leaves the group (and, note, not at the time of the intra-group transfer).

The charge will only arise where, if the loan relationship or derivative contract had been assigned at fair value immediately before the company had left the group, a 'tax credit' would have arisen.

While there is an exemption from the charge on a statutory demerger (as above for both chargeable gains and intangibles) there is not the equivalent exemption for mergers.

Neither is there the similar concession allowing the reallocation of the charge to other group companies.

SDLT

SDLT should not arise on the transfer of land between two companies in the same group. A group for this purpose is where one company is a 75% subsidiary of another or both are 75% subsidiaries of a third company. In other words, a similar definition used for group loss relief purposes.

Generally, group relief will later be withdrawn if the purchaser (and not the vendor) leaves the group within three years of the transfer. The SDLT that becomes chargeable is the SDLT calculated on the market value of the property at time of the intra-group transfer.

Capital losses

Since 1993, there have been anti-avoidance rules in Schedule 7A TCGA 1992 to prevent an acquiring company from using capital losses of a target company in order to reduce the tax liability on gains in the acquiring company or group; known as the pre-entry losses rules.

Anti-avoidance provisions were extended in 1998 to catch 'pre-entry gains' which operated in a similar way but this time by preventing a company acquiring a target company with capital gains in order for the acquirer to offset its own losses against those gains (Schedule 7AA TCGA 1992).

FA 2006 brought in a new layer of anti-avoidance legislation that provides for three targeted anti-avoidance rules ('TAARs') aimed at arrangements that are intended to avoid corporation tax involving:

the contrived creation of corporate capital losses

the buying of capital gains and losses, and

the conversion of income streams into capital gains, and the creation of capital gain 'matched' by an income deduction, where the gains are then wholly or partly franked by capital losses.

The second of these three TAARs supplements the existing rules in Schedule 7A, and replaces the rules in Schedule 7AA, where there are arrangements in place to avoid tax. Schedule 7A remains applicable in all cases that do not involve tax avoidance, including most mergers and acquisitions.

FA 2007 made a small amendment to the second TAAR and extended the scope of the first TAAR to persons paying income tax.

Pre-Entry Capital Losses

Company X has recently purchased the shares in Company Y, a company which has capital losses brought forward of £100,000. Company X is about to sell an asset that will result in a gain of £150,000 and is looking for a way to shelter this gain.

Company X could notionally transfer the asset to Company Y, so that Company Y is treated as having sold the asset realising the £150,000 gain.

However, under the anti-avoidance rules, transferred gains cannot be sheltered with pre-entry capital losses brought forward as these capital losses arose prior to Company Y joining Company X's group.

Use of Pre-Entry Capital Losses

Pre-entry losses can only be set against

- gains on assets held at the time the company joined the group; or

- gains on assets bought after joining the group, which are used in a trade carried on by the company at the time it joined that group.

In other words, pre-entry losses can only be set against assets the company owns at the time of joining or assets it would have purchased in any case.

Pre-entry capital losses can be divided into two groups:

- Realised pre-entry losses, which are losses on assets which have already been sold by the time the company joins the group, or
- Unrealised pre-entry losses, which arise on assets still held at the time of joining the group which are currently running at a capital loss. In other words, if the asset were to be sold at the time of joining the group, a loss would arise.

There are two methods of calculating the pre-entry loss: time apportionment or market value. In order to use the market value rule, we must physically make an election.

Example

Trevor Limited acquires a plot of land on 1 March 1996 for £850,000. It joins the MacDonald Limited group on 1 June 2001 when the land is worth £350,000. The land is sold on 1 June 2007 for £150,000. We need to calculate the pre-entry capital loss under each of the two methods.

The asset was purchased on 1 March 1996 and sold on 1 June 2007. It was held by the company for 11 years and 3 months in total. When the asset was sold, a capital loss of £700,000 was realised.

On 1 June 2001, Trevor Limited joined the MacDonald Group. Consequently, the pre-entry period is 5 years and 3 months and the post-entry period is exactly 6 years.

The pre-entry capital losses are restricted in usage and under the time apportionment method they work out to be:

£700,000 x $5\frac{3}{12}$ / $11\frac{3}{12}$ = £326,667

The post-entry fully usable losses are therefore
£700,000 - 326,667 = £373,333

However, an election can be made to calculate these pre-entry losses based on the market value of the asset at the time the company joined the group.

If the asset was sold at the time Trevor Limited joins the MacDonald Group, the pre-entry capital loss would have been £500,000, reducing the post-entry fully usable loss to £200,000.

In this situation, as the election increases the restricted pre-entry loss, it should not be made as it is not in the group's benefit.

Capital losses following Finance Act 2006

New rules to prevent what was seen as abuse of the capital loss rules by companies came into effect from 5 December 2005. Guidance notes were issued on 22 March 2006.

The new rules comprise three main TAARs intended to reflect three principles of the existing legislation:

- relief for capital losses should only be available where a group or company has suffered a genuine commercial loss and made a real commercial disposal;
- relief for a company's capital losses should usually only be available against its own capital gains or those of companies that were under the same economic ownership both when the capital loss was accrued and when the loss is used;
- except in certain restricted circumstances, capital loss relief is only available against capital gains, not income profits.

The TAARs are aimed at preventing the following abuses:

- the contrived creation of corporate capital losses (TAAR 1);
- the buying of capital gains and losses (TAAR 2); and
- the conversion of income streams into capital gains, and the creation of a capital gain matched by an income deduction, where the gains are then wholly or partly franked by capital losses (TAAR 3).

Each rule applies where there are arrangements with a whole or main purpose obtaining a tax advantage.

HMRC consider 'arrangements' to include 'any agreement, understanding, scheme, transaction or series of transactions (whether or not legal enforceable)' and 'tax advantage' is defined in s184D TCGA 1992, and applies to all three TAARs. Its scope is very wide and covers reliefs, repayments, the amount of a charge and the assessment of corporation tax. Offsetting losses against gains to save tax would therefore be expected to produce a tax advantage.

The 'whole or main purpose' test is now used extensively elsewhere in the legislation. The guidance suggests that 'purpose' is an objective concept such that it will not apply where transactions are 'straightforward', 'have genuine economic consequences' or do not involve 'additional, costly or complex steps'. However, many commentators have questioned whether 'purpose' is objective and whether the guidance itself can be relied on in providing what is effectively concessionary treatment.

TAAR 1

The first TAAR says that capital losses are not allowable if they arise in 'disqualifying circumstances'. Broadly, these are where the loss arises as a result of arrangements with a sole or main purpose of securing a tax advantage. A loss can accrue under disqualifying circumstances even if there are not yet chargeable gains against which it can be set or if the tax advantage were to accrue to another company. So schemes to crystallise capital losses for future use, or which might be used by another group company, would also fall foul of this new provision.

As a result of this TAAR, the 'bed-and-breakfast' rules of TCGA 1992, s 106 are repealed.

TAAR 2

It is intended to prevent companies from buying capital losses, or 'selling' gains to be washed through companies that have capital losses. Again, the rules apply where the transactions are part of arrangements with a sole or main purpose of obtaining a tax advantage by deducting the capital loss from a chargeable gain. The old pre-entry gains rules in Sch 7AA are no longer needed and have been repealed. But Sch 7A (pre-entry losses) is retained.

A qualifying change of ownership is needed for the TAAR to operate and this, broadly, involves a company becoming or ceasing to be a member of a group of companies or becoming subject to different control. This wide definition is designed to ensure that artificial arrangements changing economic ownership but not control, or vice versa, cannot be used to circumvent the rule. Helpfully, the legislation also provides that a change of ownership does not include the insertion of a new top company over a group or an internal group reorganisation.

Capital loss buying (Section 184A)

The rule prevents loss buying and applies broadly where there are tax avoidance arrangements involving a change of ownership of a company and a loss on the disposal of a pre-change asset, broadly, an asset owned by the company before the change of ownership. It does not matter whether the capital loss arose before or after the change of ownership, or indeed at the same time, nor whether there is not yet a chargeable gain against which it can be set. The loss can only be deducted from chargeable gains accruing on disposal of another pre-change asset.

Example

Company X intends to dispose of an investment at a large gain. X is offered the opportunity to buy, from an individual, a company, Company Y with capital losses agreed with HMRC. The chargeable gain arising on the disposal of investments could be sheltered by Y's losses. Section 184A prevents this as the capital loss accrued before the change of ownership on disposal of a pre-change asset as part of arrangements intended to secure a tax advantage. Had Y been acquired from another group of companies, it is likely that Sch 7A TCGA 1992 would also apply to prevent H being able to use the loss in Y.

Capital gain buying (Section 184B)

The relevant conditions are similar to those for s 184A, requiring tax avoidance arrangements involving a change of ownership of a company and a gain on disposal of a pre-change asset. Capital losses cannot be deducted from that gain unless the losses themselves accrue on disposal of a pre-change asset. Again, it does not matter when the qualifying gain arises, whether the losses available to shelter that gain are present at the time or which company the tax advantage accrues to.

Example

One of Company X's subsidiaries, Company Z, has a base cost of £20 million and a market value of £20 million. However, the underlying investments in the company only have a base cost of £1 million. A purchaser wishes to buy the investments, not the shares in Z. Company X is introduced to an intermediary group with capital losses that are agreed with HMRC. X sells Z to the intermediary for £20 million, at no chargeable gain. The intermediary then sells the underlying assets to the purchaser for £20 million, realising a £19 million chargeable gain, sheltered by the capital losses.

Section 184B would apply here: the intermediary will have acquired a company which disposes of a pre-change asset to generate a gain. But the loss used to shelter that gain did not arise from disposal of a pre-change asset, so it cannot now be used to shelter that gain.

Overall it is clear that this second TAAR addresses the second principle originally stated, that a company's capital losses should only be usable against its own chargeable gains or those of fellow group members.

<u>TAAR 3</u>

The third TAAR targets arrangements intended to convert income into capital which will be covered by capital losses and schemes that shelter chargeable gains with allowable losses, while generating a deduction that reduces income profits. This rule is only imposed by HMRC notice, and does not need to be self-assessed. The TAAR applies if the whole or main purpose of the arrangements is to secure a tax advantage.

Section 184G applies if there are tax avoidance arrangements where a chargeable gain arises to a company on disposal of an asset although, absent the arrangements, the receipt would have been brought into account as income, and the gain is sheltered by a capital loss. If these conditions apply, HMRC may issue a notice preventing the capital loss being deducted from the chargeable gain.

Example

One of Company X's subsidiaries, Company B, owns a number of valuable registered trademarks and copyrights, which are licensed out to third parties, bringing in £10 million a year. B sells the rights to receive this income for five years for a capital sum of £45 million. The chargeable gain on this disposal is sheltered by capital losses within the X Group. Prima facie, it seems that this transaction might be caught by s 184G if the arrangements had a tax-avoidance motive.

Section 184H applies to tax avoidance arrangements whereby a gain accrues to a company that can be sheltered by allowable losses, and the company or a connected company incurs expenditure allowable as a deduction in calculating its total profits but not against its chargeable gains. The arrangements must be intended to secure a tax advantage involving both the deduction of that expenditure and deduction of capital losses from the gain (although certain sale and leaseback arrangements in respect of land are excluded from this provision). Again, the counteraction is to prevent the allowable loss being taken against the chargeable gain and can only apply where HMRC issues an appropriate notice.

The guidance notes do not suggest any structures to which ss 184G or 184H might apply, although HMRC must assume that such planning is likely, or would have been but for the new legislation.

<u>FA 2007 changes</u>

Amendments are made to TAAR 2 to block a loophole which involves a group buying a capital loss company which also has a subsidiary company (a pre-change asset).

Example

Tracy plc acquires Wayne Ltd with a capital loss of £10m. Wayne Ltd has a subsidiary, Shane Ltd. The shares in Shane Ltd pre-date the acquisition by Tracy plc and any gain that Wayne makes on a disposal of the shares in Shane Ltd is not caught by the anti-avoidance rules and any gain can be set-off against the £10m loss.

Tracy can exploit this by transferring assets to Shane Ltd with a view to increasing Shane's value and sheltering that gain using the Wayne's loss.

The changes in FA 2007 stop these arrangements by removing relief for pre-change assets.

Roll-over relief

The target company, prior to sale, may have itself disposed of chargeable assets qualifying for roll-over relief, such as land and buildings and fixed plant, and claimed relief from another group company.

Alternatively, group companies may have rolled-over gains against qualifying assets held by the target.

In either case, the company making the asset disposal (and claiming relief) and the company making the reinvestment must be members of the same capital gains group when the respective transactions were carried out. This means that the company disposing of the asset may have left the capital gains group when the reinvestment is made by the other group company, so long as the reinvestment is made when the other company is a member of that same group.

Similar provisions apply, as we have seen above, for the replacement of intangible assets.

Sellers and buyers of companies therefore need to be aware of roll-over reliefs made, or to be made, involving the target and the allocation of relief.

Secondary liabilities

A secondary liability is one borne by the target company but is in respect of a liability for tax for which the seller or member of the seller's group is primarily liable.

Corporate purchase schemes

Sections 767A and 767AA ICTA 1988 were introduced in the 1990s to stop tax avoidance through schemes which involved the sale of companies with unpaid tax liabilities with the intent that the liabilities could not subsequently be recovered by HMRC.

S767A applies where there has been a change in the ownership of a company and corporation tax for accounting periods beginning before the change remains unpaid for six months and any of the following conditions is satisfied:

The activities of a trade or business of the company cease or their scale becomes small or negligible during the three years before the change in the ownership and there is no significant revival before that change.

The activities of a trade or business of the company cease or their scale becomes small or negligible after the change of ownership but under arrangements made before that change.

There is a major change in the nature or conduct of a trade or business of the company during the period of six years beginning three years before the change in ownership; there is a transfer or transfers of assets directly or indirectly from the company to a person who previously controlled it, or that person's connected person; the major change in the trade is attributable to that transfer or transfers; and these transfers occurred during the three years before the change of ownership or after that change but under arrangements made before it.

Where a condition has been met, unpaid tax may be collected by the Revenue from either:

- any person who at sometime during either the three years before the change of ownership of the company, or, if shorter, the period since a previous change of ownership, controlled the company, or
- any company which that person controlled at any time during the three years before the change of ownership The unpaid tax is recovered by means of a CT assessment on that person in the name of the defaulting company.

S767A may therefore be in point if a subsidiary of the target company has been sold and tax remains unpaid by that subsidiary for the accounting period which straddles completion of the sale of that subsidiary by the target. The provision could require the target to pay the unpaid tax.

The rule in s767A is extended by s767AA so that unpaid tax may also be collected from those same persons where

'It would be reasonable to infer from the terms of the transactions entered into in connection with the change in ownership, and/or other circumstances of the change, that at least one of the transactions was entered into on the assumption that a potential tax liability would not be met (Section 767AA (2)).'

Unpaid corporation tax on chargeable gains

Section 190 TCGA 1992 provides a mechanism for HMRC to recover corporation tax on a chargeable gain, unpaid more than six months after its due payment date, to be collected from another person. This will ordinarily be the principle company in the group when the gain arose. Alternatively, HMRC could assess another company in the same group who had owned the asset in the previous twelve months.

The latter scenario could therefore include the target company and the buyer would need to ensure that the tax indemnity negotiated included such potential liabilities.

A similar provision exists in the intangible assets regime in respect of a degrouping charge. HMRC may recover the corporation tax unpaid for six months from the principle company of the group or from another company in the same group who had owned the asset in the previous twelve months.

Lecture B502 (13.34 Minutes)

Impact of IAS on the taxation of loan relationships

Change of accounting policy Para 19A Sch 9

General rule

If on the change of accounting policy, in particular the move from UK GAAP (in the earlier period) to IAS (in the later period) or vice versa, there is a difference between the carrying value of a LR at the end of the earlier period and at the beginning of the later period, a corresponding debit or credit is to be brought in the later period.

The carrying value includes any accrued amounts, amounts paid/received in advance and impairment losses even if shown separately in the accounts.

In calculating the carrying value we ignore any debit in an accounting period beginning before 1 January 2005 that has been disallowed for tax, for example a general provision against bad debts.

The carrying value also takes account of any tax rules that apply for example connected party rules.

Illustration 1

Vickery Ltd a UK resident company moves to IAS on 1 January 2005. At 31 December 2004 the amount shown in the books of Vickery Ltd for LRs was £350,000 including £50,000 in respect of a debt with a 100% subsidiary that had previously been written down from £75,000. At 1 January 2005 it is decided that the fair value of the LRs is £320,000 including £65,000 in respect of the intra group loan.

What debit or credit must be brought in under section 19A?

Solution

In determining whether a debit or credit needs to be brought in under s 19A we need to compare

	31st December 2004	**1st January 2005**
	£	**£**
Debtors excl intra group	300,000	255,000
Intra group debtor	75,000	75,000
	375,000	330,000

Note that when considering the intra group debtor we use its carrying value taking account of the connected party rules, which would have disallowed the write down of £25,000 made in earlier accounting periods.

Thus we have a debit of £45,000 to bring into account. This amount will be brought in as set down by the statutory instrument.

Illustration 2

Worsley Ltd a UK resident company with a December year end has trade debtors of £500k before any bad debt provisions.

The following provisions had been made against the trade debtors at 31 December 2004 (under unmodified UK GAAP):

£35k specific bad debt provision;
£45k general bad debt provision.

Worsley Ltd prepares its 2005 accounts using IAS (or modified UK GAAP, including FRS 26).

What debit or credit must be brought in under section 19A?

Solution

General provisions are not permitted under IAS or FRS 26. Hence Worsley Ltd's IAS balance sheet at 1 January 2005 would contain gross trade debtors of £500k and the specific bad debt provision of £35k, but no general bad debt provision.

As above para 19A requires us to compare the accounting value of the LR (including any impairment losses – i.e. specific bad debt provisions) in the closing UK GAAP balance sheet with the accounting value in the opening IAS balance sheet.

We do not take account of the general provision for bad debts as, firstly, a general provision is not an impairment loss; and secondly, para 19A(4BA)(b) Sch 9 states that that previously disallowed provisions against debts should be excluded from the accounting value.

If we compare the tax carrying values on transition to IAS we have, at the end of the earlier period under UK GAAP, debtors of £465k (being £500k net of specific bad debt provision of £35k) and, at the beginning of the later period under IAS, debtors of £465k as well.

As the amount of debtors (net of specific provisions) does not change from the closing UK GAAP balance sheet to the opening IAS balance sheet, no adjustment on the change of accounting policy arises.

If the general provision is released in 2005, it will not give rise to a taxable a credit as it is the reversal of an amount that was disallowed under section 74(1)(j) ICTA 1988. Para 6D Sch 9 tells us that we must not tax the reversal of any amounts disallowed under section 74(1)(j).

Deferral of adjustment

SI 2004/3271 (as amended by SI 2004/3347 and SI 2005/3383) has effect for accounting periods beginning on or after 31 January 2005. They provide that any debit or credit adjustment on a change of accounting policy is delayed as follows:

One tenth of the applicable amount shall be brought into account for each year in the period of ten years ("the prescribed period") beginning with the later of:
the first accounting period of the company beginning on or after 1 January 2006, and
the accounting period in which the new accounting standards are used.

If a company ceases to be within the charge to corporation tax before the end of the prescribed period, the whole of the applicable amount, so far as they have not fallen to be brought into account for an earlier accounting period, shall be brought into account as a credit or debit for the accounting period ending when the company ceases to be within that charge.

This rule does not apply to a LR which falls to be discharged in an accounting period beginning on or after 1 January 2005 and ending before 1 January 2006.

There are special rules for dormant accounts of banks and building societies.

Tainted held to maturity assets

SI 2004/3271

SI 2004/3271 also deals with the position where the accounting rules cause a reclassification of held to maturity ('HTM') assets.

If financial assets are designated as HTM they are accounted for using amortised cost. The use of this category is very strictly controlled a company has to demonstrate the intention and ability to hold assets to maturity. Where there is a disposal of more than an insignificant amount of the assets from this category all remaining HTM assets are reclassified as 'available for sale' and thus must be accounted for at fair value. This 'tainting' continues for the rest of the period of account and the next two years.

Regulation 5 of SI 2004/3271 provides that a company can, provided certain conditions are met, ignore the 'tainting' and continue to use amortised cost basis for tax purposes. The conditions are that:

- in accordance with GAAP the asset is treated as available for sale having previously been treated as held to maturity;;
- it became treated as available for sale as a result of the sale of one or more assets previously classed as held to maturity; and
- the amortised cost of the asset(s) disposed in the accounting period of the disposal is less than 10% of all the assets then treated by the company as held to maturity.

This means that the amounts recognised in the accounts as a result of the move from amortised cost to fair value are not brought in for tax purposes.

The company has 90 days from the date of the disposal mentioned in (c) above to elect out of this treatment. The election must be made in writing and will apply to all the LR assets that satisfy the conditions shown above

Illustration 3

Flood Ltd with a December year end has two assets classed as HTM on the 31 December 2005. One is sold on 1 March 2006. This sale is not insignificant and as a result the remaining asset must be accounted for at fair value.

The remaining asset is a £150,000 6% loan stock in another UK company. This loan stock was bought on the 1 December 2005. It is intended that the loan stock will be held until maturity in 5 years time at a premium of 20%. The transaction cost incurred where £3,000 the effective interest rate is 8.9%.

At the 31 December 2006 the loan stock is recorded at its amortised cost of £157,617. On restatement to fair value a debit of £875 is made. In the year to 31 December 2006 a fair value credit of £14,000 goes to equity in respect of the loan stock.

The debit of £875 as a result of the reclassification to fair value is not brought in.

The tax computations will not follow the accounts and bring in the credit of £14,000. We need to calculate the amount that would have been charged had the company continued to use amortised cost accounting.

The accounting would be:

DR	Asset (£157,617 x 8.9%)	£14,027
CR	Income statement	£14,027
DR	Cash (£150,000 x 6%)	£9,000
CR	Asset	£9,000

The balance sheet would have shown £157,617 +14,027 - 9,000 = £162,644.

The income statement would have shown the effective interest of £14,027, thus this is the figure we will bring in for tax.

Perpetual debt

Para 14A Sch 9

The classification rules in IAS 32 may result in the issue of debt (so-called 'perpetual debt') to be treated as equity. If there is no contractual obligation to repay the debt, it will be classed as equity with the interest payments being treated as dividends.

However, the legal form of the debt determines its tax treatment and para 14A ensures any credits or debits recognised in equity or shareholders funds are brought into account. In this case the amounts will still be treated as interest under the LR rules. However, the interest would be allowed following the way in which the dividends are accounted for and therefore brought in on a due and payable, rather than accruals, basis.

Embedded derivatives

S94A

Under FRS 26, an embedded derivative is a component of a hybrid financial instrument that contains a host contract and a derivative contract. In certain cases the embedded derivative must be separated out (bifurcated).

The same approach will be taken for tax, with the loan relationship element of the contract being dealt with under the loan relationship rules and the derivative element under the derivative rules

The rules do not apply to indexed linked gilt edged securities - these are still dealt with wholly within section 94 which requires the amounts to be brought in to be based on fair value accounting, adjusting the opening value of the asset for movements in the RPI.

Where a company is not applying FRS 26, and thus the accounts do not split the contract into the two elements, it may elect to do so for tax for all assets held at the end of the first accounting period which begins on or after 1 January 2005. The election had to be made by 31 December 2005. For assets bought on or after 1 January 2005 the election has to be made within 90 days of their acquisition. The election is irrevocable and applies to all assets held or subsequently acquired.

Accounting treatment of convertible held intra-group S94B

FA 2008 introduced new anti-avoidance legislation to counter schemes where the creditor and debtor, who are connected persons, account for a convertible security in such a way that the debtor's debits and are larger that the creditors credits.

The legislation increases the creditor's credits to match the debtor's debits and the creditors election under section 94A is disapplied where the following conditions are all met:

- In accordance with GAAP, the debtor treats the loan as divided between a host contract and a derivative financial instrument or equity instrument
- In accordance with GAAP, the creditor does not bifurcate the loan
- The debits on the host contract exceed the credits brought into account

Companies are connected under these provisions if they meet the section 839 definition or are part of the same consolidated group.

The rule is introduced with effect from 12 March 2008.

Hedging foreign exchange risk S85A

Foreign exchange gains and losses on LRs denominated in a foreign currency are within the scope of the LR legislation. They are included in S84(1)(a) but, for the avoidance of doubt, specifically brought in by S85A.

However, there are two specific circumstances where the gains and losses are left out of account:

- The exchange movement is recognised in the statement of recognised gains and losses or statement of changes in equity; or

- The exchange movement arises as a result of the translation from one currency to another of the results of part of the company's business and it is recognised in the STRGL or statement of changes in equity.

Exemption (b) provides symmetry with the accounting treatment under SSAP 20 which allows exchange differences on translating the results of a branch to be taken to reserves.

Exemption (a) also provides symmetry with the accounting treatment under SSAP 20 which provides for exchange movements on an equity investment to be matched through reserves with exchange movements on a foreign denominated loan used to finance the investment; the so-called 'cover method'.

Section 85A therefore results in mandatory matching for tax purposes where hedge accounting has been used and ensures that matched amounts taken to reserves are not taxed and the hedge is effective post-tax.

The 'cover method' found in SSAP 20 is not allowed if a company is using IAS or 'modified' UK GAAP. Exchange movements on debtor LRs used to hedge movements on shares, ships or aircraft cannot be taken to equity. The exemptions in section 85A for bringing exchange movements into account are therefore redundant. Consequently, regulations have been introduced to disregard (or exclude) exchange gains and losses to allow companies to continue to use matching for certain debtor LRs. The regulations are the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profit and Losses) Regulations, SI 2004/3256. Often referred to as the 'Disregard Regs'

The Exchange Gains and Losses (Bringing into Account Gains or Losses) Regulations, SI 2002/1970 sets down when and how exchange movements will be brought in for tax purposes. The basic rule is that the exchange gains and losses on LR will be brought in when the matched asset is disposed of.

The 'Disregard Regs'

STI 2004/3256

We are only going to look at the regulations that apply to LRs as derivative contracts are beyond the scope of this course.

The regulations apply to accounting periods beginning on or after 1 January 2005 thus their scope is not limited to companies that apply IAS.

Regulation 3 of the Disregard Regs deals with exchange gains or losses arising from liabilities or, less likely, assets, hedging shares but also ships or aircraft. Matching is first with LR where there is a designated hedge and then with LR where there is an intended hedge such that the liability is expressed in a currency likely to eliminate or substantially reduce the economic risk of holding the asset to the company. (HMRC provide guidance on this 'intention test' in CFM9408)

In the absence of a designated hedge matching is only allowed to the extent that the carrying value of the liability does not exceed the unmatched carrying value (i.e. the accounts value) of the asset.

However, for periods beginning on or after 1 January 2008, for shares only, a company may elect to match the higher of the accounts value of the shares and value of the net assets underlying the shareholding (new Regulation 4A). The company, in making that election, must then nominate a 'review period' of no more than 92 days, for the Net asset value to be compared with the liability for matching purposes at the 'relevant time'.

This 'net asset value' election is irrevocable and applies to any future shares acquired by the company as well as to shares held at the time when the election is made. Where the company already holds shares that are matched under with an 'intended' hedging liability then the election is that of 31 March 2008 and 30 days from the start of its first period of account beginning on or after 1 January 2008.

Regulation 3 also provides that an asset is to be matched with share capital where in the accounting period prior to the regulations being in point exchange gains and losses on the asset where taken to reserves to match with gains and losses on the share capital.

Regulation 5 gives the rule for the order of matching where there is more then one Asset to be matched:

- first with assets that are ships and aircraft;
- then with assets on which a chargeable gain would accrue;
- then shares subject to substantial shareholdings exemption.

If only part of a debtor LR could reasonably be expected to eliminate or substantially reduce the economic risk of holding the asset which is attributable to fluctuations in exchange rates, the debtor LR or currency contract is to be treated as being matched with a corresponding amount of value of an asset.

<u>The taxation of matched amounts</u>

Where a debtor LR is matched against assets on a disposal of which a chargeable gain would arise, the net matched exchange movement is brought in as a chargeable gain or an allowable loss on a disposal of the matched asset.

Where a debtor LR is matched against an aircraft or a ship, the net matched exchange gains or loss is brought in as a LR debit or credit when the asset is sold.

Where a debtor LR is matched against shares which are eligible for substantial shareholding relief, the net exchange movement is not brought in for tax purposes on disposal of the shares.

Where a LR is matched against a net investment in a foreign business asset, any net exchange movement is not brought in for tax purposes when the company disposes of its overseas operation.

Where a debtor LR is matched against a creditor LR, the exchange movements arising on the debtor LR are brought in as a LR credit or debit in the accounting period in which the company ceases to be a party to the creditor LR.

It is possible for exchange movements arising on a creditor LR to be left out of account for tax purposes. This happens where loans to subsidiaries are treated as "permanent as equity". In such cases, the net exchange movement is included in computing the company's LR profits for the accounting period in which it disposes of that creditor LR.

Illustration 4

Richmond Ltd borrows €5,000,000 and makes the following investments.

Shares in a trading subsidiary Oldham Ltd €3,000,000
Shares in a non trading subsidiary Chadderton Ltd £3,500,000

If we assume that the shares in Oldham Ltd will qualify for SSE then matching rules state that the loan of €5,000,000 is firstly matched with the shares in Chadderton Ltd that will not be subject to SSE.

However it may be the case that the shares in Oldham are sold within twelve months or do not qualify for SSE for some other reason. In this case the statutory rule has to be revisited. The revenue guidance on this point states that matching is permitted on a just and reasonable basis.

Richmond Ltd could say that the matching is first with the shares in Chadderton and then with the shares in Oldham or it may say that the loan should be prorated 5/ 6.5 x 3 and 5/6.5 x 3.5.

From an article by Neil Insull

Lecture B504 (24.12 Minutes)

Connected Party Debt

Definition — S87(3) and S87A

Connection is defined by section 87(3): Companies are connected where one has control of the other or they are under common control.

Control means (in section 87A) the power to secure:

- by means of holding the share capital or voting power; or
- by virtue of powers conferred by the articles of association or other document (e.g. power to appoint majority of board of directors)
- that the company's affairs are dealt with in accordance with your wishes.

Where the creditor or debtor is a partnership, questions concerning connection are dealt with as if each partner were a creditor or debtor to the extent of the corporate partner's share of the partnership profits for the accounting period.

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In applying the test, shares held on trading account as excluded. This would apply to banks, share dealers and share underwriters.

Connection can also be indirect through a series of LRs. If A Ltd and B Ltd are connected, a loan between the two would come within the rules for connected party debt. If A Ltd instead lends X Ltd, an unconnected company, which in turns lends on identical terms to B Ltd then the indirect loan between A Ltd and B Ltd would also be deemed to be connected.

Accounting method S87 and S88

General rule

Where the parties are connected, the only accounting basis that can be used is the amortised cost basis.

If companies become connected, and fair value accounting was used previously for the LR, a debit or credit will be brought in to account to the extent that its fair value differs from its amortised cost. Equally, if companies cease to be connected and move to fair value accounting, any difference between the amortised cost basis and fair value is brought into account in the period in which the connection ceases.

Prior to the introduction of IAS it was unusual, outside the financial services sector, to see a LR accounted for at fair value or mark to market as it was referred to. However, with more companies adopting IAS or the modified form of UK GAAP going forward, we will see more LRs falling into the fair value heading.

Illustration 1

Sackey Ltd has £1m of loan notes in Farrell Ltd an unconnected company. These loan notes have been fair valued for accounting purposes with changes in fair value going through the profit and loss account. Both companies have a March year end.

During the year to March 2007, Farrell Ltd becomes a subsidiary of Sackey Ltd. At 31 March 2006 the loan notes had a fair value of £800K. The loan notes where issued to Sackey Ltd for £1m in 2005.

What credit or debit must be brought into account by Sackey Ltd in the period to 31 March 2007?

Solution

Section 87 requires that from 1 April 2006 Sackey Ltd must use amortised cost accounting for the loan notes.

We need to ask what would be the value of the loan notes at 31 March 2006 using amortised cost accounting. No impairment review will have been undertaken in respect of the loan notes (they have been fair valued through the profit and loss account). Thus under the amortised cost rules they are standing at £1m (the consideration on issue).

We compare the value of £1m to the value at which the loan notes are in the accounts of Sackey Ltd at 31 March 2006 i.e. £800K. The difference is £200K. Hence a credit of £200K needs to be brought in by Sackey Ltd in the accounting period to 31 March 2007.

Exemptions from amortised cost basis (S88)

The basic rule that connected party debt is accounted for under an amortised cost basis is disapplied for a creditor relationship (and not for a debtor relationship) meeting the following conditions:

Buying and disposing of creditor relationships is an integral part of the trade and the LR asset in question was acquired in the course of that trade

The asset is either listed on a recognised stock exchange or its redemption takes place within 12 months of issue

At some point in the accounting period other persons hold the same kind of asset, and

The company and connected persons do not hold for more than three months in that period 30% of more of assets of that kind (dealing with underwriting a debt issue).

If all these conditions are satisfied the creditor company may use fair value accounting but the debtor must still used an amortised cost basis

Benefit derived by connected parties S93C

An anti-avoidance provision, brought in by FA 2006 and effective from 22 March 2006, is aimed at companies exploiting relationships with connected companies to move the return from a creditor relationship into the hands of a connected company.

The rule operates where arrangements are made for the return from a creditor LR to be less than a commercial return on invested money and a connected company directly or indirectly derives a benefit, representing some of all of the return by which the return to the first company is less than the commercial return.

In these circumstances, section 93C brings credits into account for the company with the creditor relationship on the basis of fair value accounting including the benefit derived from the connected company.

Late Interest Para 2 Sch 9

Where the parties to a LR are connected and the interest is not paid within 12 months of the end of the accounting period**,** a debit for that interest will not be allowed until it has been paid unless the corresponding credit is brought into charge by a company within the LR regime. So, for example, where the creditor is the overseas parent of the debtor, interest outstanding for 12 months or more will not be relieved until paid.

- There is an extended definition of 'connected' for these purposes. It includes:

- Companies connected by virtue of section 87(3) defined above,

- A close company borrowing from a participator (or a person, or an associate, controlling a company which is participator; or a company controlled by either a participator or a person who controls a company which is a participator; or a company in which the participator has a 'major interest'!),

- One of the companies has a 'major interest' in the other, or

- An employing company borrowing from trustees of an occupational pension scheme.

A company has 'major interest' in another if:

- one company and other person together have control of the other company, and
- both the company and that other person each have at least 40% of the total rights / powers.

Rights and powers of connected companies are included.

Broadly, in (b) above, loans made to SMEs (under the EU definition), where the creditor is a limited partnership which is a collective investment scheme (CIS) or where the SME itself is close because of shareholdings among partners in a CIS limited partnership, are not deemed to between connected parties.

Illustration 2

In which of the following cases will the interest be debited when paid?

1. Cromwell Ltd a UK resident company borrows £750,000 from its Morton Ltd. Cromwell is a 100% subsidiary of Morton Ltd both companies are UK resident. Interest of £12,000 for its year ended 30 June 2005 is paid on the 30 November 2006.

2. Mr Smith who with his brother John owns all the share capital in Hutton Ltd, a UK resident company makes the company a loan of £300,000. Interest of £24,000 for its year ended 31 December 2005 is paid on the 31 July 2007

3. Pinta Ltd a UK resident company lends £2,000,000 to its Italian subsidiary, interest of £750,000 due for its year ended 31 March 2007 is paid on the 31 July 2008.

Solution

1. In the case of Cromwell Ltd both companies are UK resident therefore the late interest rule will not apply.

2. Mr Smith is a participator who has control of Hutton Ltd. The credit in respect of the interest will not come within the LR rules thus the late interest rule applies. A Debit for the interest will only be allowed in the accounting period in which it is paid, that is the year to 31 December 2007.

3. The late interest rule does not apply to Pinta Ltd as the UK company is the lender not the borrower.

Revenue & Customs Brief 33/08

HMRC have published a Revenue & Customs Brief 33/08 explaining their approach to the application of paragraph 2 of Schedule 9 FA 1996 in cases involving late-paid interest between connected companies:

‘Paragraph 2 (sometimes referred to as the “interest long stop” or the “late interest rules”) applies in a number of situations. One of these is where interest is paid by a company to a connected company that is not resident in the UK (paragraph 2(1A)).

‘Our interpretation of the rule has been challenged in a number of such cases on the basis that recent decisions of the European Court of Justice (ECJ) suggest that the rule contravenes one or more EC Treaty freedoms. While the correct legal position is not entirely clear, we have decided to put the point beyond doubt by amending the law and have issued a consultation document on options for changing the rule.

‘Corporation tax returns in which the application of paragraph 2(1A) is in question

‘We will not seek to apply paragraph 2(1A) Schedule 9 FA 1996 as it currently stands to computations forming part of corporation tax returns submitted on or after the date of this Revenue & Customs Brief, or to any other accounting periods ending before the law is amended, in cases where the creditor company is not resident in the UK. Nor will we pursue the application of paragraph 2(1A) as it currently stands in such cases where enquiries into returns are currently open on this point.

The application of paragraph 2 in cases that do not involve late-paid interest between connected companies, that is, cases within paragraph 2(1B) to (1D), is not in question. Our interpretation of the law remains that set out in our Corporate Finance Manual at CFM5600.’

Discounted securities

Para 17 Sch 9

The difference between the issue price and the price at redemption (i.e. the discount) on a deeply discounted security (previously known as a 'relevant discounted security') issued by a company will ordinarily be amortised to the P&L over the life of the security. Debits will therefore accrue to the issuer each year to redemption.

If the creditor is connected and not within the LR regime, then relief to the issuer for the discount will be deferred until the security is redeemed and the discount paid.

The definition of connected party for the purpose of this rule is broadly the same as the extended definition applied in the 'late interest' rule in 4.4 above.

Impairment and release of connected party debt

Paras 5(5) and 6 Sch 9

Where parties are connected in any part of accounting period, the creditor can claim no relief for any impairment loss or for the full or partial release of any debt except in certain circumstances. Equally, a debtor will not be taxed on the credit from the release of a debt with a connected party. We will look at these provisions in more detail in the following session.

From an article by Neil Insull

Lecture B501 (13.33 Minutes)

Impairment of debt

When is there an impairment loss?

This area of the legislation has seen many changes in recent years. The changes have mainly related to the treatment of bad debts between connected parties and the introduction of IAS.

For accounting periods beginning before 1 January 2005 the legislation provided for the assumption that all debts would be paid in full when due and that the only departure from this assumption was where:

- a debt was a bad debt;
- a doubtful debt was estimated to be bad;
- a liability to pay an amount was released.

Furthermore such a departure was only allowed where the debt was accounted for on an accruals basis and the accounting rules that allowed the departure also ensured that a credit would be recognised in the case of a recovery.

Following the changes to the legislation to deal with the introduction of IAS from 1 January 2005 it is no longer necessary to prescribe the conditions required. Where accounts are prepared in accordance with GAAP then all debits and credits recognised on those accounts are brought in for tax. This will include 'impairment losses' where these are calculated under IAS for the measurement of financial instruments, IAS 39 or its UK 'modified' equivalent, FRS 26.

'Impairment loss' is defined in the tax legislation as 'a debit in respect of an impairment of a financial asset' and that the term 'impairment' includes 'uncollectibility'. But the words are not tied to IAS so a company continuing to use 'old' (and not 'modified') UK GAAP or FRSSE can compute a provision for bad and doubtful debt.

HMRC's guidance in their Corporate Finance Manual at CFM5155 states that such a provision will be allowable if it is computed "in a way that follows, or substantially follows, the procedures in FRS 26." Effectively this means finding evidence that as a result of an event that has already happened that future cash flows from the debt will be reduced. It would appear that HMRC are more relaxed about 'smaller companies' and HMRC will be happy to allow impairment losses where provisions have been "accepted as reasonable in the past".

Restrictions on writing down debt

Para 6D Sch 9

Para 6D only allows the creditor company a debit to be brought into account on writing down the carrying value of a debt where it arises from:

- an impairment loss, or
- a release of all or part of the debt

It follows that no debit is allowed for a write down that is not an impairment loss. For example, a general bad provision made under UK GAAP.

The good news is that a credit from the reversal of a debit disallowed under this rule, or disallowed under section 74, is not taxable.

Para 6D applies if the company is using an amortised cost basis. A company using fair value accounting does not show impairment losses as the write down to fair value reflects doubts over repayment.

Note too that the debit (or credit) on an impairment loss (or its reversal) or a release of debt, will not be brought into account where parties have a connection. There is more detail in 5.4 below.

Releases of debt

Para 5 Sch 9

HMRC's view is that a debt is only released if the creditor has legally waived the debtor's obligation to pay (CFM5125). HMRC go on to suggest this is rare.

However, where there is a formal release, a credit will normally be recognised in determining the debtor company's profit or loss account under GAAP and taxed under the general rule. (It may be worth noting that HMRC's manual still refers incorrectly to section 85(3)(c), now repealed, that brought into tax the release of a debt specifically).

<u>Exemptions</u>

The credit on a full or partial release is not taxed where:

- the release is part of a statutory insolvency arrangement;
- the companies are connected (other than on a deemed release) (see;
- the releasing company is in insolvent liquidation etc and immediately before the liquidation the parties were connected, but are not connected following the liquidation;
- the parties are not connected and the debtor company is in insolvent liquidation etc;
- the release is in consideration of any entitlement to part of the ordinary share capital of the debtor company. In other words, a debt/equity swap (see 5.5 below), or
- the release is by the government of a loan to a company (Para 7).

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Statutory insolvency arrangement

Defined in section 834(1) ICTA 1988, it is broadly a formal agreement with creditors to release all or part of the debtor company's liabilities with the view that the company has a better prospect of continuing to trade and avoid liquidation without the burden of that debt.

Insolvent liquidation

Insolvent liquidation includes for this purpose a variety of insolvency proceedings including administrative receivership and administration (Para 6A(1)).

Where the debtor is in liquidation (4 above), the legislation ensures that the company is not taxed on the release of debts and thus not disadvantaging creditors who may have rights to assets from the company's liquidation.

Where the creditor is in liquidation (3 above), the legislation continues the pretence that the debtor and creditor remain connected notwithstanding that the liquidation itself will end any earlier connection. This ensures that the connected party rule (2 above) is still respected and the debtor is not taxed on the release even though there is no real connection.

Impairment losses on connected party debt

Para 6 Sch 9

Where companies are connected at any time in an accounting period, the creditor company cannot bring in debits relating to an impairment loss or release of debt on a LR.

Illustration 1

A Ltd and B Ltd set up a joint venture with C Ltd. A Ltd owns 49% and B Ltd owns 51%. To start C Ltd off, both companies lend it £1 million. Unfortunately, C Ltd goes into liquidation and both A Ltd and B Ltd have to write off the loans that they have made.

Explain the tax treatment of the loan relationships for each company.

Solution

For A Ltd, unconnected with C Ltd, this will be a non-trading debit. For C Ltd, the release of the loan amount will be taxable on C Ltd, but in all eventualities it is unlikely that any tax will be paid, because C Ltd is in liquidation.

That is all very well for A Ltd, because it gets its tax relief and the corporation tax bill is reduced. However, B Ltd's position is different. B Ltd and C Ltd are connected, because B Ltd controls C Ltd and therefore the write off is not deductible by B Ltd. Equally, though, the release is not taxable in C Ltd.

Exceptions

There are two exceptions to this disallowance:

When there is a forgiveness of debt for equity and no connection existed before the equity was issued. In which case a debit is allowed in the accounting period of the issue only and only in relation to the debt/equity swap (Para 6(4)). See 5.5.

When the creditor and debtor were connected prior to the creditor's liquidation and the creditor writes off debt while in liquidation. This exception allows relief for the impairment loss whether or not the companies continue to be connected. It effectively ensures that the insolvent company doesn't pay tax on a debt that may not be paid (Para 6A Sch 9).

Illustration 2

Gerrard Ltd lends £50,000 on 1 June 2005 to another group company, Lampard Ltd at an annual interest of 5%. The group is in financial difficulties and Lampard doesn't pay any interest. Lampard soon goes into liquidation and Gerrard writes off the interest of £2,500.

If Gerrard and Lampard remain connected after the insolvency proceedings commence then the impairment loss of £2,500 would not be relieved (under para 6). This despite that, in all likelihood, the interest will never be repaid. Para 6A ensures that the impairment loss is brought into account.

The general rule that impairment losses cannot be claimed where a loan is made to a connected party does not apply to the forex element of the loan (para 6(8)).

Illustration 3

Catt Ltd prepares accounts to 31 December. In 2005, it makes a loan of $2 million to its 100% subsidiary Kay Inc. On 31 December 2005, the exchange rate is $1.85/£, so the loan is translated at £1,081,081

During 2006, the subsidiary has financial problems; the directors of Catt Ltd decide that a 20% impairment loss should be made against the loan. Accordingly the loan is written down to $1,600,000. At 31 December 2006, the exchange rate is $1.75/£, so the loan appears in the company balance sheet at a figure of £914,286.

Had the debt not been partially bad, its sterling value at 31 December 2006 would have been £1,142,857, so the company would have brought in an exchange gain of £61,776 (£1,142,857 less £1,081,081).

Catt Ltd credits to profit and loss only the exchange gain on the good portion of the debt – that is, £49,421.

Catt Ltd also writes off to profit and loss account a quarter of the £1,081,081, i.e. £216,216.

Under para 6 Sch 9, the company gets no bad debt relief for the £216,216 by which the loan is written down. But credits and debits in respect of exchange gains and losses are allowed. In this case there is a credit of £49,421. Kay Ltd is not required to bring in a further credit in respect of the exchange gain on the bad portion of the loan.

Disposal of debt

Para 6(6) Sch 9

Where companies are connected and the creditor company sells the LR to an unconnected third party, the rules adjust any loss (or profit) on disposal. This prevents a creditor from getting relief for an impairment loss it was previously denied because of the connection and instead bringing in the loss on disposal. This rule also applies where the companies are connected and the creditor unconditionally releases a debt in full. This is because the creditor ceases to be party to that LR (i.e. it has effectively disposed of the LR).

The provisions in para 6(6) and (7) work by comparing:

- the debits and credits that would have been brought into account under the LR rules if there had been no disposal; and
- the actual debits and credits brought into account under the LR rules.

For debits, the amount to be brought in is the smaller of the assumed or actual debit. For credits, the amount to be brought in is the larger of the assumed or actual credit.

Illustration 4

Robinson Ltd makes a loan of £35,000 to its subsidiary, Noon Ltd, repayable in 5 years. In year 1, Robinson Ltd writes £7,000 off the loan as bad. In Year 2 it sells the loan to an unconnected company, Tait Ltd, for £25,000.

Actual debits
In Year 1 the bad debt of £7,000 is disallowed under FA 1996 Sch 9 para 6(3). Debit nil.
In Year 2 the loss of £3,000 is a potential debit under FA 1996 s.84.

Assumed debits (as if no disposal)
In Year 1 the bad debt of £7000 is disallowed under FA 1996 Sch 9 para 6(3). Debit nil.
In Year 2 we assume no disposal, so debit nil.
The assumed debit is smaller than the actual debit, so the amount to be brought is nil.

Debt / equity swaps

Para 6(4) Sch 9

Sometimes when a company is struggling to meet interest and or capital payments on its debts the creditor will take shares in place of the debt. This is commonly referred to as a debt/equity swap and may be part of a corporate rescue.

Often there is still an element of forgiveness of the debt for example a debt of £500,000 may be forgiven in return for share capital with a value of £300,000. Effectively there is a release of £200,000.

Creditor company (Para 6(4) Sch 9)

The general rule is that the creditor will be able to claim the debit for the release but the very act of exchanging the debt for shares may result in the two companies becoming connected and as a result disallowing the debit.

Special rules therefore apply where companies become connected on a debt/equity swap to avoid this problem. Where the creditor:

- was not connected to the debtor before the swap took place, and
- discharges the debtor from its obligation to pay in return for shares forming part of the ordinary share capital of the debtor company
- then the creditor is allowed relief for the amount released but only relating to the debt that was swapped, and only in the accounting period in which the swap took place.

Ordinary share capital means all share capital apart from fixed rate preference shares

All other existing debts are treated in the same way as debts where the parties are connected. There is no relief for subsequent write-downs or releases, including any amounts released in further swaps, because the creditor and debtor are now connected parties.

As an aside, the base cost of the shares in the exchange take on the market value of the debt that was swapped (and not the market value of the shares).

Debtor company (Para 5(8) Sch 9

The borrowing company is also supported in these circumstances.

The debtor does not need to bring in a credit for the release of the obligations under the debt. However, the release must be "in consideration" of the issue of shares. So if only part of the debt is released in consideration of the shares that are issued, and a further amount is released for no consideration, the latter amount will remain taxable on the debtor company.

Deemed release of impaired debt Para 4A Sch 9

Impaired debt is debt that is unlikely to be repaid in full. In practice the debt will be bought for less than full value in the hope that the debt can be sold at a profit on the back of a turnaround in the financial fortunes of the company that issued the debt.

Anti-avoidance legislation deals with the acquisition of debt where the debt is between companies that are currently or become connected; or where impaired debt is already held and then becomes connected with the debtor company. The legislation prevents the debtor company from taking advantage of the connected party rules and ensures that a credit for the effective release of the loan is brought in.

The two circumstances dealt with by the legislation are where a company acquires an impaired creditor LR and is either already connected with the debtor company or becomes connected at the same time. The carrying amount of the debt in the accounts of the debtor must exceed the price at which the debt is acquired.

Two types of scenario are covered:

A company purchases from a third party the shares in a company in financial distress, become connected, and, at the same time, acquires from third parties the debt issued by the ailing company.

Where as part of a restructuring of group finance, debt issued by a company to a third party lender (a bank for example) is acquired by a company connected to the issuer for less than full value (impaired debt in other words.

The exception to both of these is where the debt was acquired in an arm's length transaction, there was no connection between the old and the new creditor, and there was no connection between the new creditor and the debtor in a period beginning four years before and ending one year before the acquisition.

Where a company already holds impaired debt and becomes connected with the debtor company.

The typical scenario is where there is a takeover of the debtor company by the creditor or another group company.

In each case a release by a creditor company is deemed to take place and the borrower is deemed to realise a taxable profit.

The release in the first case is of the difference between the carrying value in the debtor's accounts and the amount paid, and in the second case the amount of the adjustment that would be required for impairment.

In determining the carrying value of the LR, no account is taken of accrued amounts, amounts paid or received in advance or impairment losses.

Illustration 5

Gomarsall Ltd has a loan from a bank of £800k the bank agrees to sell the loan to Moody Ltd for £620K which includes £20K in respect of accrued interest. Gomarsall Ltd and Moody Ltd are both 100% subsidiaries of Time Ltd.

Gomarsall Ltd accounts for the loan on an amortised cost basis thus it will be showing a liability of £800K in its balance sheet.

What adjustment, if any, must Gomarsall or Moody, bring into account?

Solution

Gomarsall and Moody Ltd are connected for the purposes of Para 4A Sch 9 FA 1996. Moody Ltd has paid £600K (£620K- £20K) for the LR.

The provisions of Para 4A mean that Moody Ltd the debtor company must bring in a credit of £200K (£800K- £600K)

If in a future period the debt is repaid in full Moody will be allowed to bring in a debit of £200K and Gomarsall Ltd will recognise a gain of this amount.

Impairment and cessation of connection

Para 6C Sch 9

A connection between companies may cease whilst a debt is still in existence for example if the debtor company is sold out of the group.

The creditor company cannot bring in any debits that relate to earlier write-downs in the accounts that were not relieved because of para 6 Sch 9. But neither does a company bring a credit into account for the reversal of an impairment loss that has been disallowed because the companies were connected (para 6(3A)).

If connection ceases because one of the companies enters insolvency procedures, separate rules apply.

Consortium Relief and Impairment Losses

Para 5A Sch 9

Where there is a consortium, the company owned by the consortium will not be connected with the consortium members for the purposes of LRs and as a result relief for impairment losses will be available on loans to the consortium company.

If relief has been allowed for impairment losses to a consortium member (or group member via a link company), then there will be a restriction on the consortium relief that can be claimed. The restriction applies where the lender is a company that is either:

- a member of a consortium that owns a consortium company; or
- a fellow group company of a consortium member;

and the borrower is:

- the consortium company; or
- if where the consortium company is a holding company, then a subsidiary of that company.

A number of circumstances are covered by the rule:

- Net debits, representing the excess of impairment losses over debt recovery credits on loans by the consortium member will be reduced by the consortium relief claimed by a consortium company in the same period.

- Any debit disallowed is carried forward and set against any future debt recovery credit

- Consortium relief claimed is reduced by the debits already allowed in earlier accounting periods for impairment against the loan.

Where consortium relief is claimed before an impairment loss, it is effectively carried forward to reduce impairment debits in later periods.

Any reversal of impaired amounts will be adjusted to take account of the debits disallowed.

When looking at impairment losses, the rules take into account all loans made to the consortium company by any group members of the consortium member, and not just the consortium member.

In addition, in arriving at the total amount of group relief claimed, all amounts claimed from the consortium company by any group company, not just the consortium member, are included.

Illustration 6

M Ltd holds 30% of CC Ltd. M Ltd has made a loan of £1,000,000 to CC Ltd. CC Ltd has been experiencing problems for many years and to date £250,000 of the loan has been written off by M Ltd.

In the period to 31 March 2004, M Ltd makes a consortium relief claim for losses of £300,000 from CC Ltd.

In 2005, no impairment loss is accounted for but M Ltd claims consortium relief of £100,000 from CC Ltd.

In 2006, an impairment loss of £200,000 is recorded.

In 2007, £50,000 of the loan is recovered by CC Ltd.

What are the necessary adjustments from 2004 to 2007?

Solution

In 2004, the losses under the consortium claim will be reduced to £50,000 to take account of the bad debt relief previously given.

In 2005, the claim for consortium relief would be reduced by any previous debits but these have been wiped out by earlier consortium relief claims. The claim of £100,000 therefore is unadjusted.

In 2006, an impairment loss is reduced by the consortium relief previously claimed of £150,000. The debit allowed in 2006 is just £50.000.

In 2007, the recovery credit is left as £50,000

The effect of the rules is to restrict the combined total relief for impairment losses and consortium relief to be no greater than the higher of two reliefs separately.

From an article by Neil Insull

Lecture B503 (18.45 Minutes)

Value Added Tax

Challenges for house builders

New Homes Ltd is a small company that builds and sells new homes. It consists of one managing director and ten employees. The director's wife is also a 50% shareholder with her husband, but no income splitting problems exist here because her husband insists she does at least 30 hours of bricklaying a week!

The basic VAT principles are as follows:

- The first sale or grant of a major interest of a new dwelling is zero rated
- All building work carried out by a contractor on a new dwelling is also zero rated and if the supply by the builder includes materials, these are zero rated as well. However, there are certain items that are not classed as 'building materials' where VAT needs to be charged. These items are considered later.
- Rental income generated from a dwelling is always exempt from VAT. There is no scope to make an option to tax election with residential property — what a shame!

Current project

New Homes Ltd is working on one project:

- a large area of land was bought from a farmer;
- the land includes a barn that is being converted into a bungalow;
- the remainder of the land will be used to build a block of six flats and a big six-bedroom detached house for the managing director and his wife to live in as their main residence.

Reduced rate challenge

Is it correct that the building contractor used by the company on the barn conversion work has charged VAT at 17.5%?

The answer is 'no' because building work carried out on the conversion of a non-residential property to a residential property qualifies for a reduced rate VAT charge of 5%.

Input tax can only be reclaimed by a business if it has been correctly charged in the first place. So a VAT credit note is the solution here.

The other point to remember is that New Homes Ltd has reclaimed input tax on the project because it intends to make a zero-rated supply by selling the bungalow. But what happens if the property is rented out rather than sold?

In this situation, the input tax is relevant to an exempt supply and there might be a potential disallowance (see later in this article). A 5% disallowance is much better than 17.5%.

Building materials

What if New Homes Ltd has made errors on past VAT returns because input tax has been claimed on white goods that have been installed into the new flats and bungalow.

The basic principles are as follows:

- input tax can be reclaimed on materials that are ordinarily installed into a dwelling
- there are certain items that are not classed as building materials and an input tax block means that the house builder cannot reclaim input tax on their cost, e.g. washing machines, tumble dryers, wardrobes, carpets, bathroom cabinets;
- the items that can and cannot be claimed are listed in HMRC's VAT Notice 708.

It is important to analyse closely the list of inclusions and exclusions. For example, the cost of buying carpets cannot be reclaimed, but there is no problem with wood flooring or linoleum.

The VAT error only needs to be adjusted for the last three years under current rules. The amount relevant to years can be forgotten.

If the value of the remaining errors is less than £10,000, the company can use the voluntary disclosure limits that apply for errors discovered after 1 July 2008 which means the underpayment of tax can be included in **Box 1** of the company's December 2008 return, thus avoiding any interest charge on the tax overclaimed.

Monthly returns

The company's income is currently all zero rated; there are no standard-rated supplies and input tax is always considerable because the company uses in-house labour, as well as building contractors, and therefore buys building materials. VAT is always charged on the supply-only of materials. The company is therefore a repayment trader for VAT purposes and able to submit monthly returns.

If the company registers for online filing to hasten the process of submitting future returns and, in a difficult economic climate, to get the VAT rebates more quickly.

House sold to a director

The key point to remember is that there is no VAT problem with a sale being made between connected parties.

It is not a problem from an output tax viewpoint when the new house is being sold to the director, because the sale is zero rated. To put it another way, if the managing director bought a new house from a competitor, it would be a property where all the input tax would have been reclaimed on building materials and costs: exactly the same VAT treatment as applies for his own company.

Property won't sell

It is now six months since New Homes Ltd completed the building project and things have changed dramatically for the company. None of the six flats has sold; the only sales relate to the converted barn and the house sold to the managing director.

The company needs to generate cash, so the director decides to rent the six flats out on a short-term basis until the property market improves, which he and John expect to be 2010. A two-year rental period is therefore anticipated.

However, there is positive news, and readers faced with a similar challenge should refer to HMRC's *Business Brief 44/08* and VAT Information Sheet 07/08 issued on 15 September 2008. These notes explain the potential input tax adjustment needed for a house builder generating short-term rental income. The good news is that the procedures recognise that although a business is making exempt supplies (rental), the overall intention is still to make an eventual zero-rated supply, so not all input tax is disallowed — what a relief!

To give a practical example of how the rules work, I am going to work through the figures to see if we can get a decent result for the company in its hour of need.

De minimis check

The first stage is for the house builder to carry out what is known as 'a simple check for de minimis'.

Example 1

The input tax reclaimed on costs relevant to the six flats for year ended 31 March 2008 was £30,000.

The company intends to rent the flats out for two years and then sell them. HMRC allow an economic life for a building of ten years within the 'simple check for de minimis'. So it is accepted that eight out of ten years (period after the flats are sold) are relevant to taxable supplies and two years to exempt supplies.

The exempt input tax is therefore £30,000 x 2/10 = £6,000. This annual amount is less than £625 on average (£7,500 a year) and 50% of total input tax — the de minimis limits as far as partial exemption is concerned. No further adjustment of past input tax claimed is needed (assuming the company has no other exempt input tax from other sources).

Input tax adjustment

'What happens if we end up renting the flats out for three or four years instead of two? Will HMRC expect us to go back and readjust the 2/10 figure to 3/10 or 4/10, which would then make the company partly exempt?'

The good news here is that the only relevant issue is the intended split at the time the decision is made to make an exempt supply; as long as this split can be supported with evidence, then no subsequent adjustment is needed if the future reality is different.

EXAMPLE 2 provides a practical explanation if the de minimis test had put the company in a partially exempt position.

Example 2

A change in the figures from **EXAMPLE 1** means that New Homes Ltd has now exceeded the partial exemption de minimis limits for year ended 31 March 2008. It has decided to rent out the properties for four years and sell them in 2012.

The company now needs to adjust some of the input tax originally claimed on the costs of the flat. An HMRC concession explained in VAT Information Sheet 7/08 means this can be done by any method that 'fairly reflects the use of costs in making taxable supplies' (this assumes the taxpayer does not already have an agreed partial exemption special method in place — unlikely for smaller house builders).

Note: expected total income equals expected rental income plus expected selling price of flats.

The current projections are that each flat will sell for £200,000 in four years time, and will generate rental income of £10,000 a year in the meantime.

Input tax to be adjusted:

$$\frac{(£10{,}000 \times 6 \text{ flats} \times 4 \text{ years})}{(£200{,}000 \times 6 \text{ flats}) + (£10{,}000 \times 6 \text{ flats} \times 4 \text{ years})} \times £30{,}000 = £5{,}000$$

Future VAT periods

The standard method may give some very strange results if the company is only generating exempt income (from renting out the flats) because the state of the property market means it cannot generate taxable income (zero-rated sales of new dwellings). I would need another four pages to consider the issues here, but always remember the number one objective of partial exemption calculations is to produce a fair recovery of input tax in relation to taxable supplies.

Do not forget that if you apply for a special method, the client needs to certify that he considers it is 'fair and reasonable' in terms of input tax recovery.

Professional fees

The services of professionals are always standard rated for VAT purposes. A recognised planning tip in cases where a house builder cannot reclaim input tax, for example, if the plan is to rent out new properties permanently, is to use the services of building contractors on a 'design and build' arrangement.

In such cases, the contractor is deemed to be making a single zero-rated supply of construction services to the house builder, and the professionals are then working for the contractor. The contractor can then reclaim input tax on these fees because he is making a taxable supply himself.

From an article by Neil Warren

Lecture B505 (15.46 Minutes)

Canterbury Hockey Club - sports club affiliation fees may be VAT exempt

Services closely linked and essential to sport supplied by a non-profit-making organisation are exempt. Moreover, the true beneficiaries of those services must be persons taking part in sport

Under the Sixth VAT Directive (77/388/EEC), certain services closely linked to sport, supplied by a non- profit-making organisation to persons taking part in sport, are to be exempt from VAT.

Canterbury Hockey Club and Canterbury Ladies Hockey Club field several hockey teams. Their members pay annual subscriptions to the clubs, which are unincorporated associations.

The clubs are themselves members of England Hockey, a non-profit-making organisation for the encouragement and development of the playing of hockey in England. The clubs pay England Hockey affiliation fees, in consideration for which England Hockey provides its members with certain services, namely a club accreditation scheme, courses for coaches, umpires, teachers and young persons, a network of hockey development offices, facilities for accessing government and lottery funding, advice on marketing and obtaining sponsorship, club management services and insurance, and the organisation of competitions for teams.

The Commissioners for H.M. Revenue and Customs, the UK tax authority, notified England Hockey that the affiliation fees it received should be subject to VAT. As the hockey clubs were not persons taking part in sport, those supplies of services did not fall within the exemption.

The clubs appealed against that decision. The High Court of Justice, before which the case has come, asked the Court of Justice whether the term 'persons', in the context of the exemption, includes corporate persons and unincorporated associations or whether it covers only natural persons.

The Court notes that the exemption does not apply only to certain types of sport but covers sport in general, which also includes sports necessarily practised by individuals in groups of persons or in clubs. Sport within such a structure generally entails that, for practical, organisational or administrative reasons, the individual does not himself organise the services which are essential to participation in the sport, but that the club organises and puts those services in place, as, for example, the provision of a pitch or referee. Thus, if the exemption were interpreted as meaning that it requires that the services be supplied to natural persons taking part in sport in a sports club, the result would be that a large number of supplies of services would be automatically and inevitably excluded from the benefit of that exemption. Such a result would run counter to the purpose of the exemption which is to extend the benefit of that exemption to services supplied to individuals taking part in sport. In addition, such an interpretation would not be consistent with the principle of fiscal neutrality inherent in the common system of VAT.

Accordingly, the Court holds that, in order to ensure the effective application of the exemption, it must be interpreted as meaning that services supplied in connection with, among others, sports practised in groups of persons or in sports clubs are, generally, eligible to benefit from the exemption from VAT.

However, the Court notes that to be eligible for that exemption, the services must satisfy three conditions:

- They must be supplied by a non-profit-making organisation;
- they must be closely linked and essential to sport; and
- the true beneficiaries of those services must be persons taking part in sport.

Supplies of services which do not meet those criteria, particularly those linked to sports clubs and to their operation such as, for example, advice about marketing and obtaining sponsors, cannot be exempted.

Finally, the Court points out that the services are not eligible for the exemption if their basic purpose is to obtain additional income for the organisation by carrying out transactions in direct competition with commercial enterprises liable for VAT.

It is for the High Court of Justice to determine whether the services supplied by England Hockey to the hockey clubs satisfy those conditions.

Change to cross-border VAT rules

HMRC have highlighted a forthcoming new requirement that businesses provide EC sales lists for certain taxable supplies of services.

The change affects all UK firms that make taxable supplies of services to business customers in other EU countries, where the customer is required to account for VAT under the reverse charge procedure.

Alterations to the EC VAT system were agreed by EU finance ministers in December last year. They aim to modernise and simplify current rules relating to cross-border supplies of services and to the recovery of VAT on purchases made in other EU countries.

The changes will begin to take place from 1 January 2010, and the Revenue will soon consult on the UK's implemention of the legislation.

The package includes:

- Changes to the rules on the place of supply of services for Business-to-Business (B2B) and Business-to-Consumer (B2C) transactions.
- A requirement to complete EC Sales Lists for supplies of taxable services to which the reverse charge applies.
- The introduction of an optional one-stop scheme for B2C supplies of telecoms, broadcasting and electronically supplied services.
- The introduction of an electronic VAT refund scheme.
- Enhanced administrative co-operation between member states to support the changes.

EC sales lists are currently only required for B2B intra-EC supplies of goods. From 1 January 2010, however, sales lists will also be required for intra-EC taxable supplies of services to which the reverse charge applies.

They will not be required for:

- Supplies exempt from VAT according to the rules in the member state in which the supply takes place.
- B2B supplies where the recipient is not VAT registered.
- B2C supplies.

HMRC hope to ensure that UK businesses are fully aware of the new requirement, so that they can begin to consider the arrangements or systems that they may need to put in place to gather the information needed to complete EC sales lists - particularly if these are, or will need to be, electronic systems that will require change.

At the present time the Revenue anticipates using the same form that is employed for reporting goods (VAT 101), and requiring the following data

- Country code.
- VAT registration number.
- Total value of supplies in sterling.
- An indicator to identify services.

Under the VAT package legislation (which was adopted in February), businesses will have to submit EC sales lists for taxable supplies of services subject to the reverse charge on a quarterly basis.

Member states are currently discussing an EC anti-fraud proposal that includes a provision that from 1 January 2010 all EC sales lists should be submitted on a monthly basis.

HMRC have received a number of comments from UK businesses objecting to the introduction of a monthly requirement in respect of supplies of services, and the department is feeding the grievances into the European discussions.

Queries on the VAT package should be made by email to vat.package@hmrc.gsi.gov.uk.