CONTENTS

Pre Budget Report

The Pre-Budget Report was delivered to the House of Commons on Monday, 24 November at 3.30pm. The following summary highlights the principal tax measures outlined in the Report.

Income tax rates and allowances

2009–10

The following rates and allowances will apply—

- rates of income tax will remain at 20% (basic rate) and 40% (higher rate);
- the basic personal allowance will be increased to £6,475;
- the basic rate limit will be extended to £37,400;
- all other personal allowances will be increased by indexation.

2010–11

Personal allowance

The basic personal allowance will be subject to income limits of £100,000 and £140,000. For those who gross income is above £100,000, the basic personal allowance will be withdrawn by £1 for every £2 of income above £100,000 up to a maximum of one half of the basic personal allowance.

Where gross income is above £140,000, the remaining half of the basic personal allowance will be withdrawn at a rate of £1 for every £2 of income, until no allowance remains.

2011–12

New higher rate of tax

Taxable non-savings income and savings income above £150,000 will be taxed at a rate of 45%.

There will be three rates of tax for dividends. Dividends otherwise taxable at the basic rate will continue to be taxable at the 10% rate and dividends otherwise taxable at the higher rate will continue to be taxable at the 32.5% upper rate. Dividends otherwise taxable at the new 45% rate will be liable to income tax at a new rate of 37.5%.

The dividend trust rate will be increased from 32.5% to 37.5%, and the trust rate of tax will be increased from 40% to 45%.

NICs rates and limits

For 2009–10 the upper earnings limit (UEL) will be increased to £844 per week (£43,875 a year) so that the UEL is aligned with the total of the income tax basic personal allowance and the basic rate limit.

From 2011–12 the primary threshold will broadly be aligned with the income tax basic personal allowance.

From 20011–12 the rates of primary Class 1 NICs and Class 4 NICs will be increased by 0.5% to 11.5% and 8.5% respectively. The Class 1 employer rate will also be increased by 0.5% to 13.3%. The increased rate will also apply to Class 1A and Class 1B contributions.

From 2011–12 the additional rate of Class 1 and 4 NICs will be increased by 0.5% to 1.5%.

Pensions

The lifetime allowance will remain at £1.8m and the annual allowance at £255,000 for 2010–11. Both of these limits will be held at their 2010–11 value until 2015–16.

Pensioners will receive a one-off payment of £60 in the New Year. This is designed to have the effect of bringing forward the April increase in the basic state pension for a single pensioner to January 2009.

There will also be an increase in the pension credit minimum income guarantee to £130.00 for single pensioners and £198.45 for couples in 2009–10.

Tax credits

The increase in the child element of the child tax credit by £25 above indexation will be brought forward to April 2009. This will be in addition to the existing commitment to increase the child element by £50 from April 2009. The child element will therefore increase by £75 above indexation to £2,235 from April 2009.

ISAs

The list of investments that can qualify for the ISA regime will be extended to include bonds which are issued by multilateral institutions (as defined by the Organisation for Economic Cooperation and Development). This will apply from 16 December 2008.

Income shifting

The Government has announced that, due to the economic downturn, it will not be bringing forward any changes in Finance Bill 2009 and will instead keep the issue of income shifting under review.

Capital allowances

Business expenditure on cars

From April 2009 the rules that restrict the amount of capital allowances for cars costing more than £12,000 will be abolished and replaced by new rules. Qualifying expenditure on cars will be allocated to one of the two general plant and machinery pools, according to the CO_2 emissions of the cars. Expenditure on cars with CO_2 emissions over 160g/km will be dealt with in the special rate pool and will attract writing-down allowances at a rate of 10%.

From April 2009, the rules that restrict the amount of lease rental payments that can be deducted for tax purposes for a car costing more than £12,000 will be reformed. The restriction will be changed to a flat-rate disallowance of 15% of relevant payments and will apply only in respect of cars with CO_2 emissions above 160g/km.

Hire cars will also be subject to emissions-based rules.

Disabled company car drivers

In calculating the company car benefit charge for disabled drivers who need to drive automatic company cars, the lower list price for an equivalent manual car may be used from 6 April 2009. This builds on the current rule which allows those drivers to use the emissions figure for an equivalent manual car, where that figure is lower, for the purposes of the car benefit charge calculation.

Employment-related securities

Measures will be introduced to simplify certain tax rules that apply to employment-related securities or shares acquired by employees for less than market value. Where an employee receives shares that are to be paid for in instalments, and the employee sells the shares before all the instalments have been paid, a tax charge can arise. Changes will remove this tax charge. The charge may be reinstated where the employee is released from the obligation to make instalment payments.

The tax charge that can arise where an employee sells nil or partly-paid shares is also removed.

A further change will remove a tax charge that arises where an employee receives shares from his employer and later receives scrip shares based on his existing shareholding.

Carry-back of trading losses

Current-year trading losses, which currently can be set against the previous year's profits, will be available to carry back for a three-year period, with losses being carried back against later years first.

The amount of losses that can be carried back to the preceding year remains unlimited. After carry-back to the preceding year, a maximum of £50,000 of the balance of the unused losses will then be available for carry-back to the earlier two years.

This is a temporary measure for one year only.

The change has effect for company accounting periods ending in the period 24 November 2008 to 23 November 2009. For unincorporated businesses, the measure will have effect in relation to trading losses for tax year 2008–09.

Further measures to support businesses

The Government has also announced the following—

- Measures to help small and medium sized enterprises facing credit constraints, including a new small business finance scheme.
- A new HMRC Business Payment Support Service to allow businesses in temporary financial difficulty to pay their tax bills on a timetable they can afford.
- A temporary increase in the threshold at which an empty property becomes liable for business rates. For 2009–10 empty properties with a rateable value of less than £15,000 will be exempt from business rates.
- An interest-free payment schedule for backdated business rates bills.

Corporation tax small companies rate

The planned increase of the small companies rate of corporation tax from 21% to 22%, from 1 April 2009, has been deferred until 1 April 2010. The marginal relief fraction will remain at 7/400.

For ring-fence profits the small companies rate will remain at 19% and the marginal relief fraction at 11/400.

Taxation of foreign profits

The Government has announced a package of reforms that will be brought forward in Finance Bill 2009. This will include an exemption from tax for most foreign dividends received by large and medium sized groups, regardless of the level of shareholding, along with anti-avoidance provisions. The Government will also continue to consider options for reform of the controlled foreign companies rules.

Loan relationships

Connected companies

Under the loan relationships rules, two companies are "connected" if one controls the other, or if they are both under common control.

A creditor that formally releases a connected debtor from a trade debt is denied a deduction for the loss but, under current rules, the debtor may be taxed on its "profit". Proposed changes will ensure that the debtor company will not be taxable on the release.

A further proposed change concerns the late payment of interest between connected companies. Options are being considered following consultation on how the rules should be amended.

The changes will have effect for accounting periods beginning on or after 1 April 2009.

Change of accounting practice

An anomaly is to be corrected in the Loan Relationships and Derivative Contracts (Change of Accounting Practice) Regulations, SI 2004/3271, in relation to the taxation of financial instruments following a change to International Accounting Standards (IAS). This will prevent companies suffering double taxation or receiving double relief on the reversal of exchange gains or losses that were (prior to a change to IAS) not taxed or relieved under the tax matching provisions.

The change will have effect from 1 January 2009.

Sale of lessor companies

Currently, when a lessor company changes hands, FA 2006 Sch 10 imposes a charge and matching relief calculated on the difference between the balance sheet value of the plant or machinery assets owned by the company and their tax written down value. The charge recaptures the timing benefit derived from a claim to capital allowances from the selling group. The relief, which equals the charge, returns this benefit to the buying group.

Where a lessor sells its plant or machinery and leases it back it becomes an intermediate lessor, and may be entitled to capital allowances. As a result, the company retains the timing benefit derived from the claim to capital allowances. Currently, the FA 2006 Sch 10 charge is calculated only by reference to owned assets, so when the company is sold no account is taken of the leased assets.

Schedule 10 will be amended to ensure that the charge is calculated by reference to all plant or machinery assets where the lessor has entitlement to capital allowances, not just by reference to plant or machinery owned by the lessor.

Plant and machinery leasing

Measures will be introduced to counter avoidance involving a leaseback following the sale or lease of plant or machinery. The measures will provide that—

- a business entering into sale and leaseback arrangements does not gain more relief than it would have done had it obtained loan finance;
- tax is not avoided when a lessor grants a long funding lease; and
- when a long funding lease ends, the lessee has obtained an appropriate amount of relief.

Leasing avoidance by film partnerships

Measures will target avoidance where existing leases are replaced by leases that are intended to qualify as long funding leases of plant or machinery, and the rent for which will fall outside the charge to tax. The measures will ensure that rentals under a long funding lease of a film are taxable in full.

The measure will have effect for long funding leases of films entered into on and after 13 November 2008 and for rents payable under long funding leases entered into before that date, but only to the extent that they are payable after, and refer to periods after, that date.

Real estate investment trusts

Changes will be made to ensure that the conditions to be met by a company, or group of companies, in the REITs regime cannot be circumvented by the creation of artificial group structures.

Property that is owned and occupied by a company or group falls outside the property rental part of the business. Some companies have attempted to split their activities, creating more than one group for REITs purposes. This would allow rentals between the two groups (which remain under the same economic control) with the income being treated as income of the property rental business.

The changes will ensure that the REITs regime conditions are applied more widely to the whole economic group.

The changes will have effect for accounting periods beginning on and after 1 April 2009.

Stock lending arrangements

Capital gains

Transfers and transfers back of certain securities under stock lending arrangements are disregarded for capital gains purposes under TCGA 1992 s 263B. Where it is clear that the securities will not be returned, under s 263B(4) the lender is deemed to have made a disposal of the securities at market value for capital gains purposes.

Proposed measures will provide that the lender is not deemed to make a disposal of the securities lent in situations where the borrower has become insolvent and the lender uses collateral provided by the borrower to buy replacement securities of the same kind.

The effect will be to allow the disregard to continue, so that no capital gains or losses arise to the lender.

The changes to the capital gains rules will have effect for stock lending arrangements where the borrower becomes insolvent on or after 24 November 2008. It will also be possible to elect for the changes to have effect from 1 September 2008 up to 24 November 2008.

Stamp taxes

Similar provision will be made for stamp duty and stamp duty reserve tax with effect for stock lending arrangements where the borrower becomes insolvent, or to repos where the purchaser becomes insolvent, on or after 1 September 2008.

Qualified investor schemes

The specific tax charge on substantial investors (10% or greater shareholding) in a qualified investor scheme (QIS) will be removed, allowing all investors in a QIS to benefit from the tax regime applying to authorised investment funds generally, subject to a condition that investment in the QIS will not be limited to specific individuals or companies.

The change will have effect from 1 January 2009, subject to transitional periods applying to existing QIS.

Property authorised investment funds

Stamp duty reserve tax (SDRT) currently applies both to a property authorised investment fund (property AIF) and a feeder fund. Measures will be introduced to provide an exemption from SDRT for feeder funds that satisfy certain conditions to prevent a double charge to tax.

Provisions will also allow net payment of distributions to property AIF feeder funds where requested, and clarify the tax treatment of manufactured payments representing property AIF distributions.

The changes will take effect from 1 January 2009.

Authorised investment funds—anti-avoidance

An anti-avoidance provision will prevent corporate streaming provisions in the Authorised Investment Funds (Tax) Regulations, SI 2006/964 from applying to investors for whom an AIF dividend is treated as a trading receipt. The intention is to block attempts to circumvent current anti-avoidance rules.

The change will take effect from 1 January 2009.

Disclosure of tax avoidance schemes

The procedure by which scheme users report scheme reference numbers (SRNs) to HMRC will be simplified and improved. The main change will require scheme users to first report the SRN in the tax return for the year, or the accounting period, in which the scheme is implemented.

The change will have effect for tax return periods beginning on or after 1 April 2009.

Lloyds

Proposed measures will allow corporate members of Lloyds to benefit from relief on amounts set aside to cover future payments concerning volatile and uncertain risk. The relief will broadly equate to the relief available to general insurance companies on claims equalisation reserves.

The legislation will apply to profits treated as arising in the year ended 31 December 2008.

VAT

Standard rate

The standard rate of VAT will be cut from 17.5% to 15% with effect from 1 December 2008. It will revert back to 17.5% on 1 January 2010.

The normal tax point rules will determine which rate of VAT should be charged when dealing with supplies around the 1 December 2008. If however the tax point is before 1 December 2008 (eg invoiced or paid) but the goods are not delivered until after 1 December, the supplier has the option of issuing a credit note to reduce the VAT charged to 15%. The same will apply to services which are performed after 1 December 2008 but invoiced or paid pre 1 December 2008.

The flat rate scheme rates have also been reduced with effect from 1 December 2008.

Bespoke retail schemes

The threshold above which a business may not use a published retail scheme to account for VAT on its retail supplies is increased from £100m to £130m. Businesses whose annual turnover exceeds the threshold must either agree a bespoke retail scheme with HMRC or apply normal VAT rules.

The change will take effect from 1 April 2009.

Flat-rate scheme

The VAT flat-rate scheme allows businesses with turnover of up to £150,000 to pay VAT as a flat percentage of turnover, with rates set according to business sector and intended to reflect the effective rates of VAT across the sector.

The tests which determine whether a business may use the scheme will be simplified. The entry test based on total business income will be removed altogether, and the leaving test will be amended as part of a wider VAT simplification review.

The changes will take effect from 1 April 2009.

Land remediation relief

Land remediation relief gives companies a deduction of 150% for qualifying expenditure on removing or mitigating the effect of contamination. Existing land remediation relief will be extended to give greater clarity on what categories of expenditure qualify for relief, while also giving companies greater certainty about whether their expenditure will qualify for relief.

The change will have effect for expenditure incurred on or after 1 April 2009.

Air passenger duty

Instead of the previously proposed aviation duty, air passenger duty will be recategorised into four bands based on distance from London to the capital city of the destination country or territory. Each band will have two rates, one for standard class of travel and one for other classes of travel.

Changes will have effect in relation to any carriage of a passenger which begins on or after 1 November 2009, irrespective of when the ticket for travel was booked or purchased.

HMRC Charter

The Government has announced that it will begin consultation in January 2008 on the wording of a Charter for HMRC, as an important contribution to HMRC's relationship with individuals, businesses and tax agents.

Further HMRC announcements

The following have also been announced—

- HMRC will set up a new joint forum with representatives from the private sector to oversee the implementation of provisions resulting from the review of HMRC powers, deterrents and safeguards.
- Consultations on—
  - modernising and aligning penalties for late filing of tax returns and late payment of tax and harmonising and simplifying the rules for interest on tax paid late and on repayments of tax overpaid;
  - the repeal of a number of specialist compliance checking powers which will no longer be needed following FA 2008 and on the application of the new compliance checking framework to other taxes administered by HMRC; and
  - further changes to make it easier for taxpayers to pay what they owe on time and to support HMRC in effectively tackling those who pay late.
- Simplification of the collection of Class 2 NICs, initially by aligning payment dates with those for self-assessment liabilities.
- Simplification, from April 2011, of PAYE arrangements for working students.
- An offshore disclosure facility in 2009, to allow offshore account holders a further opportunity voluntarily to disclose unpaid tax or duties and to settle debts.
- Following the consultation "Tax relief for travel expenses: temporary workers and overarching employment contracts", the Government has decided to leave the current rules unchanged.

Lecture P506 (8.53 Minutes)
Lecture B506 (12.37 Minutes)

Personal Tax

Grace v R & C Commrs [2008] EWHC 2708 (Ch)

The High Court held that a special commissioner had made errors of law in arriving at her decision ((2008) Sp C 663) that an airline pilot, who worked for British Airways and made long haul flights between the UK and South Africa and elsewhere, was not resident in the UK during the relevant years of assessment. The only possible conclusion from the primary facts found was that he was. It was common ground that if he was resident, he was also ordinarily resident during those years.

Facts

The taxpayer appealed against a notice of determination that he was ordinarily resident in the UK for the six years from 1997–98 to 2002–03 inclusive. The taxpayer was a British Airways pilot and received income from that employment which was paid into his bank in the UK.

The taxpayer was born in South Africa and regarded himself as domiciled in South Africa. He travelled on a British Overseas Citizens passport which he renewed in October 1998. The taxpayer had been living in the UK since 1986. He had purchased a house in South Africa in 1997 but retained a house in UK for use before and after flights.

The taxpayer claimed that he had departed from the UK in 1997 to live outside the UK permanently and that thereafter he was not resident in the UK. He had removed the centre of his life to South Africa in 1997 since when he had kept his visits to the UK to a minimum. He had relatives in South Africa. His former wife lived in the UK with their children but he saw them very rarely. He kept private aeroplanes in South Africa and did no private flying in the UK. He had retained a house in the UK as an investment but could have stayed in hotels. He did not agree that the South African house was in the nature of a holiday home and argued that ICTA 1988, s. 334 did not apply because he was in the UK for a temporary purpose only to rest before or after his flights. His visits to the UK were short and only on three occasions in the relevant period were they longer than seven days. He argued that he was a temporary resident in the UK within the meaning of s. 336 and that he had not spent more than six months in aggregate in the UK during any of the years in question.

The Revenue argued that the taxpayer was a Commonwealth citizen who had been ordinarily resident in the UK and that ICTA 1988, s. 334 applied. In the absence of a distinct break, any periods of residence abroad were to be treated as for the purpose only of occasional residence abroad.

The special commissioner ((2008) Sp C 663) concluded that the questions whether the taxpayer was resident and ordinarily resident in the UK in the years in question were matters of fact and degree. Taking into consideration all the evidence and the facts found, especially having regard to the taxpayer’s past and present habits of life, the reasons for his visits to the UK, the temporary nature of his ties with the UK, the more permanent nature of his ties with South Africa, and the distinct break made in 1997, the conclusion was that from 1 September 1997 he ceased to be resident and ordinarily resident in the UK. After that date the UK was neither where he dwelt permanently nor where he had his settled or usual abode which was in South Africa. Residence in the UK did not have a settled purpose and the taxpayer was not ordinarily resident in the UK. Section 334 did not apply and s. 336 did apply. Leaving aside the availability of living accommodation, all the factors pointed to the conclusion that after September 1997 the taxpayer was in the UK for temporary and occasional purposes only.

The Revenue appealed, contending that the special commissioner had misunderstood the nature of a 'temporary purpose' both in the context of s. 336 and more widely. She treated presence in the UK in fulfilment of duties to be performed under a permanent, or indefinite, contract of employment as amounting to a temporary purpose. That error of law led the special commissioner to discount the importance of the taxpayer's employment in considering whether he was resident or ordinarily resident in the UK during the years of assessment. Although she dealt with temporary purposes explicitly towards the end of her decision in her consideration of s. 336 (in which the phrase appeared), that error of law had 'infected' her whole approach.
Issue

Whether the special commissioner had misdirected herself in concluding that the taxpayer was not resident and ordinarily resident in the UK in the six years from 1997–98 to 2002–03 inclusive.

Decision

Lewison J (allowing the appeal) said that what was important was that the adjective 'temporary' in s. 336 was not descriptive of the taxpayer's presence. That was dealt with by the deeming provision which required the aggregation of the time spent in the UK during the year of assessment. Rather, the adjective 'temporary' was descriptive of the taxpayer's purpose, i.e. the reason why he was in the UK. So the question for the special commissioner was whether the reason for the taxpayer's presence in the UK was casual or transitory. He had been in the same employment since 1987, and had thus been in that employment for a decade before the first of the relevant years of assessment. Performance of his duties under his contract of employment was part of his settled pattern of life. Presence in the UK in order to fulfil duties under a permanent (or at least indefinite) contract of employment could not be described as casual or transitory. Standing in any of the years of assessment the objective observer would have known that the taxpayer would continue to be present in the UK to fulfil those duties in subsequent years, unless and until he changed jobs or retired. The recurrent nature of his regular presence in the UK led inevitably to the conclusion that his purpose for being here was neither casual nor transitory (Shepherd v IR Commrs [2007] BTC 426 considered).

Further the special commissioner was wrong in law to discount the reason for the taxpayer's regular presence in the UK in his own house as being attributable 'only' to his work. The repeated use of the word 'only' indicated that the commissioner had overlooked the principle that a person's residence might be dictated by the exigencies of work but that did not make it in any sense involuntary. The special commissioner had also referred in the summary of her reasons for deciding that the taxpayer was not resident to 'the temporary nature of his ties with this country' which must have been a reference to his ties by reason of his employment. Therefore, the special commissioner's error about the meaning of 'temporary purpose' had fed into her ultimate conclusion on the question whether the taxpayer was resident in the UK.

Further, the commissioner was wrong in concluding that there had been a 'distinct break' in the taxpayer's life when he set up home in Cape Town. That conclusion was inconsistent with the undisputed facts that the taxpayer had retained the house which remained furnished; continued the same employment both before and after the supposed distinct break, and continued to be present regularly in the UK for the purposes of that employment in the very same house that had been his only home. All that happened after he set up home in Cape Town was that he acquired another home there. From being a man who resided in one place, he became a man who resided in two. The phrase 'distinct break' did not feature in ICTA 1988. What it meant was not therefore a question of statutory construction. It was an idea that had been developed in the application of s. 334 and its predecessors, which required determination of the questions whether the taxpayer had 'left' the UK and, if he had, whether he had left for 'occasional residence' abroad. It was not, therefore, profitable to attempt to define what it meant if used as a tool to help decide whether the taxpayer was resident in the UK. However, the facts of the present case fell far short of those which, in other cases, had been held to amount to a 'distinct break' (Levene v IR Commrs (1928) 13 TC 486, Re Combe (1932) 17 TC 405 and Reed (HMIT) v Clark [1985] BTC 224 considered).

In the event the only possible conclusion from the primary facts found was that the taxpayer was resident in the UK in the relevant years of assessment.

Chancery Division, Judgment delivered 11 November 2008.

Lecture P507 (9.59 Minutes)

Firms can help with tax return costs

Internationally mobile employees with complicated tax affairs often need help in completing their tax returns. Employers sometimes cover these fees and they have in the past been subject to tax as a benefit in kind.

However, in the minutes of the last joint forum on expatriates tax and NICs meeting, HMRC have agreed that at least part of these fees will be allowable.

The minutes say:

> 'It was made clear that these discussions and any proposals or guidance based on them will relate only to circumstances where:
>
> - due to tax equalisation arrangements, the employer pays for accountancy services relating to the preparation and submission of the individual assignees' tax returns;
> - tax return preparation is part of a wider bundle of services provided by the adviser as negotiated with the employer;
> - section 9A enquiry services are not included as part of the bundle.
>
> 'In such circumstances HMRC accept that the level of benefit in kind should be arrived at by apportionment based on the facts.'

They suggest that 'the levels of benefit which appear both realistic and reasonable are £650 a head where a home and host country return is completed and £250 a head where only the host country (UK) return is completed.

Under existing circumstances these figures will represent levels which if returned or exceeded will not prompt an enquiry'.

However, HMRC recognise that dealing with the new remittance basis from 6 April 2008 is likely to lead to increases in the costs charged for UK tax return preparation where the remittance basis is claimed.

If this proves to be the case, it is noted in the minutes that there would be a need to revise the figures for 2008-09 onwards accordingly.

Capital Gains Tax

Valuation of shares - Fletcher

The appellant and M were founders and directors of a software company. They subscribed 400 of the 800 £1 ordinary shares in the company, as well as advancing £50,000 to it. As the initial company accounts showed a loss, the company obtained extra finance from S, a venture capital fund. In May 2003, S invested £250,000 in the company in return for £150,000 preference shares and £100,000 A ordinary shares. S also required the directors to capitalise their advances of £50,000 by taking 50,000 £1 B ordinary shares.

The company went into liquidation in 2005. The appellant claimed a capital loss of £50,400 under TCGA 1992, s 24(2), setting off the loss against taxable income under TA 1988, s 574.

HMRC allowed the loss in respect of the 400 £1 shares, but not that in respect of the B shares.

The appellant appealed.

The Special Commissioner said that issue of the B shares was a rights issue in respect of the existing holdings of ordinary shares, and that was a transaction of share capital for the purposes of TCGA 1992, s 126. As the issue of shares was the same for each the appellant and M, it was in proportion to the original holdings. It was also in respect of them, as the new shares were only issued to the holders of the existing shares. The pre-existing ownership of ordinary shares was vital factor influencing the terms of the capitalisation.

The ordinary shares and the B shares therefore had to be treated as one asset and as a new holding for capital gains tax purposes.

With regard to the value of the original shares, the Commissioner said they needed only to have a value of some positive amount, while the debts to the directors subsisted. They had a significant value in May 2003, this was clear from the terms of the third party subscription. S invested on the basis that the company would succeed.

The addition to base cost of the appellant's total holding in May 2003 was £50,000 and that her loss, in the negligible value claim, was £54,000. The capitalisation removed the prior charge of £50,000 of debts that could have been discharged, thus it increased the value of the appellant's new holding of ordinary and B shares by that amount over the pre-existing value of the original shares.

The appeal was allowed in full and accorded with the reality, justice and common sense of the situation.

Fletcher (SpC 711)

Disposals of chargeable assets by close companies at an undervalue

<u>The main provision</u>

Where a close company transfers an asset at an undervalue (and the transaction does not represent an arm's length bargain), the amount of the undervalue is apportioned among all the close company's shareholders on that date (S125(1) TCGA 1992). When such a shareholder subsequently disposes of any of his shares, he must reduce his base cost by the amount so apportioned (S125(2) TCGA 1992) – this is the case, regardless of whether the disposal gives rise to a gain or a loss. If the undervalue transaction took place before 31 March 1982 and rebasing is in point, the apportionment is ignored (S125(5) TCGA 1992). This procedure ensures that, when a close company sells an asset for less than its full worth, the entire gain is still effectively caught.

Illustration

Meier purchased 320 ordinary shares in Aquitaine Holidays Ltd (a close trading company) for £6,400 in September 1988. The company has 1,000 ordinary shares in issue.

In December 1997, Aquitaine Holidays Ltd deliberately sold an asset, which was worth £50,000, for only £42,000.

In January 2008, Meier sold his shares for £61,200. His chargeable gain is:

			£	£
Sale proceeds				61,200
Less:	Cost		6,400	
	Less:	Apportionment (32% x 8,000)	2,560	
				3,840
				57,360
Less:	Indexation allowance: £3,840 x 0.500			1,920
				55,440
Less:	Taper relief (75%)			41,580
				£13,860

Illustration

Jackson sold his 20% shareholding in Perkin Industries Ltd (a close trading company) for £14,000 in July 2008.

He had acquired these shares in May 1977 for £3,000. Since that time, the company has made two transfers at undervalue:

Date	*Amount of undervalue* £
January 1981	16,000
November 1987	7,000

The market value of Jackson's shares on 31 March 1982 was £20,000.

On the assumption that rebasing applies, Jackson's allowable loss is:

			£	£
Sale proceeds				14,000
Less:	Market value at 31.3.82		20,000	
	Less:	Apportionment (20% x 7,000)	1,400	
				(18,600)
				£(4,600)

Article by Robert Jamieson
Lecture P508 (8.22 Minutes)

Apportionment of chargeable gains of non-UK resident companies

The mischief

Although a close company cannot by definition be non-UK resident, special provisions in S13 TCGA 1992 apply to non-UK resident companies which would be close if they were resident in the UK.

Broadly, the rule is that, if a chargeable gain which would not otherwise be taxable accrues to a non-UK resident 'close' company, it will be apportioned to every UK-resident shareholder by reference to his interest in the company. The aim of the section is to prevent the avoidance of tax on chargeable gains through UK residents, whether individuals, trustees or companies, holding assets in non-UK resident companies.

The main requirements of S13 TCGA 1992

Where an individual shareholder is involved, he also had to be domiciled in the UK (S13(2) TCGA 1992). If he was not, the provisions could not apply.

Until 1981, it was possible to interpose a non-UK resident trust between the non-UK resident 'close' company and the persons who would otherwise be the UK-resident shareholders, thereby avoiding the operation of S13 TCGA 1992. However, following the enactment of S13(10) TCGA 1992, the gains apportioned to non-UK resident trustees are treated as trust gains which can then be passed on to UK-resident beneficiaries whenever capital payments are made.

Prior to FA 1996, the proportion of any gain which could be attributed to a shareholder was equal to his percentage entitlement of net assets in the event of the company going into liquidation. However, no gain was apportioned if it represented less than 5% of the total and, in determining a shareholder's entitlement, shares held by connected persons were ignored.

For gains accruing on or after 6 April 2008, the S13 TCGA 1992 legislation has been amended so that non-UK domiciliaries will in future be caught by these provisions. This has been achieved by the insertion of a new S14A TCGA 1992 (Para 104 Sch 7 FA 2008). S14A TCGA 1992 provides that gains on corporate disposals of non-UK situated assets will now be charged to tax if the shareholder is a non-UK domiciliary who is subject to the remittance basis and all or any part of the gain is remitted to the UK.

Avoidance techniques

The rules described above allowed a S13 TCGA 1992 charge to be sidestepped without undue difficulty. The techniques employed included the following:

(i) Taxpayers formed companies without share capital, ie. companies limited by guarantee. Since an apportionment could only be made on those who held *shares*, the members of such companies fell outside the scope of S13 TCGA 1992.

(ii) Companies were formed with hybrid share structures such as 'A' shares which had votes, 'B' shares which gave an entitlement to dividends and 'C' shares which had liquidation rights. It was then arranged that only those persons *not* caught by S13 TCGA 1992 (ie. non-UK residents) would hold the shares with the liquidation rights.

(iii) Shares were held by several connected persons, but with no one shareholder having 5% or more. In these circumstances, no part of a gain could be attributed to any shareholder, despite the fact that the non-UK resident company might effectively be controlled by various members of the same family.

It was not unreasonable that HMRC should try to put a stop to such ploys and the relevant amendments were duly enacted in FA 1996.

The FA 1996 changes

One of HMRC's difficulties with the section was that a charge could only be levied on those who held shares. It is now levied on 'participators' – see S13(2) TCGA 1992. This means that guarantee company structures will be caught, given that a guarantor clearly falls within the S417(1) ICTA 1988 definition of 'participator'.

FA 1996 amended S13(3) and (4) TCGA 1992 by saying that any attribution will be equal to the proportion of the gain which 'corresponds to the extent of the participator's interest as a participator in the company'. Thus hybrid share structures have become ineffective, since the calculation of an apportionment is no longer measured by reference to a percentage of net assets in the event of a liquidation. Any type of share falls within the scope of the revised regime, subject, of course, to a 'just and reasonable' limitation. Until relatively recently, there was still a 5% de minimis limit, but the interests of connected persons (see S286 TCGA 1992) are now included. However, for gains arising on or after 7 March 2001, the threshold has been raised to 10% (see S13(4) TCGA 1992).

Originally, it was unusual to come across attributed gains because of the so-called 'two-year rule'. This stated that there was no attribution of any chargeable gain which was paid out by way of dividend, capital distribution or on the dissolution of the company within two years from the time when the gain arose. In practice, this was what normally happened. However, in 1996, a new provision (S13(5A) TCGA 1992) was inserted which required all attributed gains to be charged, regardless of whether or not there was a later distribution. If, within two years, a dividend or capital distribution was paid out by the company, any tax paid as a result of the attribution was deducted from the tax due on the subsequent distribution. In 2001, the Government decided to extend the time limit for the operation of this rule in relation to gains arising on or after 7 March 2001 and so, in order for credit to be given, the distribution only has to be made within the earlier of:

(i) three years from the end of the period of account in which the gain accrued; or

(ii) four years from the date on which the gain accrued (S13(5B) TCGA 1992).

Unless the company has changed its accounting date, the relevant time limit will be that shown by (i). There are special ordering rules for dealing with the set-off, but, broadly, the relevant amounts are treated as representing the highest part of the taxpayer's income or gains (S13(7A) TCGA 1992).

If, or to the extent that, a gain is not subsequently distributed within this period, S13(7) TCGA 1992 allows the tax paid on the apportionment to be an allowable deduction on the eventual share disposal.

Illustration

Spensley, a UK-resident higher rate taxpayer, owns 25% of Spensley Investments (Guernsey) Ltd, a non-UK resident company which would be close if it were based in the UK.

On 31 March 2008, the company, which has a 31 December year end, sold some ICI shares and realised a gain of £76,000. 25% x £76,000 = £19,000 is therefore attributed to Spensley for 2007/08.

Spensley's CGT position for 2007/08 is:

		£
Attributed gain		19,000
Other gains (say)		1,500
		20,500
Less:	Annual CGT exemption	9,200
		£11,300
CGT @ 40% (This is payable on 31 January 2009)		£4,520

On 1 August 2011, Spensley received a dividend from the Guernsey company, the net amount of which was £16,000 (after deduction of 20% Guernsey tax). Thus the UK tax on this income is:

Dividend (16,000 x 100/80)		£20,000
		£
Income tax @ 32.5%		6,500
Less:	Guernsey tax (20% x 20,000)	4,000
		2,500
Less:	S13(5A) TCGA 1992 credit	2,500
		£Nil

In July 2012, Spensley sold his shares in Spensley Investments (Guernsey) Ltd and made a gain of £46,000. The chargeable amount is:

		£
Gain		46,000
Less:	S13(7) TCGA 1992 deduction (4,520 – 2,500)	2,020
		£43,980

Other matters

Non-apportionable gains

Certain types of gain are specifically non-apportionable. For example, S13(5)(b) TCGA 1992 used to exempt gains arising on the disposal of tangible property used solely for the purposes of a trade carried on by the company outside the UK. In the case of gains arising on or after 7 March 2001, this has been replaced by a provision which exempts gains on assets used solely:

(i) for the purposes of a trade carried on by the company wholly outside the UK; or

(ii) for the purposes of the part of a trade carried on by the company outside the UK (where the company's trade is carried on partly within and partly outside the UK).

This amendment introduces two relaxations. The first is that *any* assets used in a non-UK trade (including intangibles such as goodwill and intellectual property) are now covered. The second is that any assets used in a trade which is only *partly* carried on outside the UK are now exempt, provided that the assets in question are only used in that part.

Other non-apportionable gains include:

(i) gains arising on the disposal of foreign currency used for the purposes of a trade carried on by the company outside the UK (S13(5)(c) TCGA 1992); and

(ii) gains which are chargeable to tax under S10B TCGA 1992 (S13(5)(d) TCGA 1992).

Losses

A loss arising on a disposal by a non-UK resident 'close' company is never apportioned to its shareholders (S13(8) TCGA 1992). It can only be set against any gain arising to the company in the same accounting period. The net gain is then apportioned. Any unrelieved loss cannot be carried forward.

Sub-apportionments

It is not possible to avoid a charge under S13 TCGA 1992 by using a chain of non-UK resident companies (S13(9) TCGA 1992). Gains can be sub-apportioned through any number of such companies back to the ultimate UK-resident shareholders.

Problem areas

Despite the changes in 2001, the legislation in S13 TCGA 1992 is not without its problems.

For example:

(i) Holders of non-convertible loan stock are deemed to be participators by virtue of the definition in S417 ICTA 1988. Is it fair that part of a company's gain can potentially be allocated to such persons, even though they have no economic interest in the gain?

(ii) Because an apportioned gain is now always to be charged to tax, what happens when the gain is fully covered by, say, capital losses brought forward? The answer is that there will be no tax to pay. But if there is a subsequent distribution of this gain, there will then be no earlier tax to act as a credit – this represents an effective double charge.

(iii) Where a gain is not subsequently distributed, S13(7) TCGA 1992 allows the tax paid on the apportionment to be an allowable deduction on the eventual share disposal. This represents another form of double charge – the allowable deduction ought to be the gain apportioned rather than the tax on the gain apportioned.

Article by Robert Jamieson

Lecture P509 (20.28 Minutes)

Inheritance Tax and Trusts

Change to bare trusts for minors

HMRC have alerted life insurers, trustees, advisers and policyholders to a change to the treatment of chargeable event gains arising on life insurance policies held on bare trusts for minors.

Under generally accepted practice, where a chargeable event gain arose on a life policy held in a bare trust for a minor, gains were assessed to income tax on the settlor of the trust.

In the context of wider changes, guidance in the Revenue's *Trusts, Settlements and Estates Manual* TSEM1031 was clarified.

This confirmed that where a trust is a bare trust, the income belongs to the beneficiary even if the beneficiary is a minor. In this case, the persons liable to income tax on general income arising to the trust are the beneficiaries who are minors.

HMRC have subsequently taken legal advice to clarify the implications for gains arising from life insurance policies. This suggests that in these circumstances, the generally understood and long-standing HMRC view (that settlors were the persons liable for income tax on such gains) was incorrect.

The taxman's revised view is that regardless of the need for trustees to perform active duties on behalf of beneficiaries who are minors, those minors with an absolute entitlement to the trust income and capital have unimpaired beneficial ownership of life insurance policies held under a bare trust.

In line with the general treatment of trust income for such beneficiaries, they are the persons liable to income tax on gains arising on the insurance policies held in trust on their behalf. This view will apply from 2007-08 onwards.

Where either or both of the child's parents are the settlors of the bare trust, they will in spite of this change of view potentially be liable to income tax on gains from a life insurance policy under the 'settlements' legislation, which counters the income tax advantages of transferring property and/or income to minor children.

Income for this purpose includes amounts deemed to be income for tax purposes such as chargeable event gains.

This change means that where the minor beneficiary has an absolute interest in the trust income and capital, the beneficiary rather than the settlor may be subject to tax, so those affected may need to complete or amend 2007-08 self assessment tax returns.

Transfers of value by close companies and inheritance tax

The statutory provisions

Suppose that an individual owns all the shares in Head Ltd and that he would like to make a gift to another individual (Rolt). As an alternative to giving Rolt some of his Head Ltd shares, he could arrange for the sale of one of Head Ltd's assets to Rolt at a considerable undervalue; another possibility would be to allow Rolt to subscribe for some new Head Ltd shares at their nominal value when, in fact, the shares are worth considerably in excess of this figure. If Rolt already held some shares in Head Ltd, the controlling shareholder could always alter the rights attaching to his shares so that value passed out of his shares and into Rolt's – for example, he could amend the voting rights of his shares so that, instead of having one vote per share, he would only have one vote per five shares, a course of action which would reduce the value of his shareholding and increase the value of Rolt's. In none of these cases has there been a disposition by the individual and consequently he would appear not to have made a transfer of value.

In the first instance cited in paragraph 1(a) above (where Head Ltd sells one of its assets to Rolt for less than its full market value), it is the company which has diminished the value of its ‘estate’ and has therefore made a transfer of value. However, the problem here is that IHT is only chargeable ‘on the value transferred by a chargeable transfer’ (S1 IHTA 1984) and a chargeable transfer is ‘a transfer of value which is made by an individual but is not . . . an exempt transfer’ (S2(1) IHTA 1984) – thus, although ‘persons’ such as companies can make transfers of value, the privilege of making chargeable transfers is reserved for ‘individuals’. Legislation therefore exists to counter this situation.

It does so by the expedient of saying in S94(1) IHTA 1984 that, when a close company (as defined in S102(1) IHTA 1984) makes a transfer of value, the value transferred by this transfer is apportioned among its participators by reference to their respective rights and interests in the company immediately before the transfer (by virtue of S96 IHTA 1984, where a close company’s share capital includes preference shares and where a transfer of value made by such a company would only have a ‘small effect on the value of those shares’, the rights and interests of those shareholders are left out of account). IHT is then charged as though each individual participator had made a transfer of value of the amount apportioned to him – this type of transfer can never be potentially exempt.

The other possibilities envisaged in paragraph 1(a) above are also dealt with – see S98 IHTA 1984. The effect of the legislation is to make it clear that, where there is an alteration in a close company’s share or loan capital or where there is an alteration in any rights attaching to a close company’s shares or debentures, such an alteration is to be treated as though it were a disposition made by the company’s participators (‘whether or not it would fall to be so treated apart from this section’). As a result, if this alteration causes the estate of one or more participators to fall in value, a transfer of value will have been made.

Notice that the legislation appears to be unsure whether, for example, the act of voting on a resolution to improve the preference shareholders’ rights at the expense of the other shareholders is or is not a ‘disposition’; probably it is not in the ordinary sense of the word and so the import of S98 IHTA 1984 is firstly to confirm that, for IHT purposes, a disposition has been effected and secondly to say that, in view of this, any participator whose estate has diminished in value as a result is deemed to have made a transfer of value (which is then dealt with in the normal way).

Two operations must be carried out once the initial amount due to be apportioned to a participator has been established:

– if any participator’s estate is increased as a result of a company transfer, this increase can be set off against the amount apportioned to him; and

– the resulting sum must be grossed up in order to arrive at the amount of the transfer which the participator is deemed to have made.

Illustration

Wilson Ltd, a company resident in Jersey, owns property worth £160,000, which it sells to one of its shareholders, Roxburgh, for £70,000. Roxburgh owns one-third of the ordinary share capital of Wilson Ltd. There are two other shareholders, Hills and Swanston, who each also own one-third of the company’s ordinary share capital. All three shareholders are domiciled in the UK. Wilson Ltd, although non-UK resident, is a close company for IHT purposes. In the circumstances, Wilson Ltd has made a transfer of value amounting to £90,000. Assume that the respective cumulative totals of chargeable transfers of each of the three shareholders are currently as follows:

	£
Roxburgh	390,000
Hills	40,000
Swanston	291,000

The IHT position (assuming that only the 2008/09 annual exemption is available) is therefore:

Roxburgh

Roxburgh initially has one-third of the company's transfer of value apportioned to him (1/3 x 90,000 = £30,000); however, the increase in value of his estate as a result of the company's sale to him of property at a considerable undervalue is £90,000 – he has paid £70,000 for property worth £160,000. Thus:

	£
Initial amount due to be apportioned	30,000
Less: Increase in value of estate	90,000
NET INCREASE	£(60,000)

Since the result of this calculation is to show a net increase, no amount is apportioned to Roxburgh.

Hills

Hills also has one-third of the company's transfer of value apportioned to him (1/3 x 90,000 = £30,000); his estate does not increase as a result of this transfer and therefore this amount (less the annual exemption) must be added to his net cumulative total of chargeable transfers. Thus:

		Net	Tax	Gross
	£	£	£	£
b/f		40,000	–	40,000
Apportioned	30,000			
Less: Annual				
(2008/09)	3,000			
		27,000	–	27,000
		£67,000	£Nil	£67,000

Because his cumulative total of chargeable transfers does not exceed £312,000, no IHT is payable in respect of this apportionment.

Swanston

Swanston also has one-third of the company's transfer of value apportioned to him (1/3 x 90,000 = £30,000); his estate does not increase as a result of this transfer and therefore this amount (less the annual exemption) must be added to his net cumulative total of chargeable transfers. Thus:

		Net	Tax	Gross
	£	£	£	£
b/f		291,000	–	291,000
Apportioned	30,000			
Less: Annual				
(2008/09)	3,000			
		27,000	1,500	28,500
		£318,000	£1,500	£319,500

As a result, IHT of £1,500 is payable.

Liability for the tax

The company is primarily liable for tax on the amounts apportioned to participators under this legislation (S202(1) IHTA 1984). Consequently, it would have been Wilson Ltd which met the IHT liability of £1,500 in Illustration 6 above. However, if the IHT remains unpaid after it ought to have been paid, any persons to whom apportionments have been made and any other individuals whose estates have been increased by a company transfer can themselves be made to pay the tax, but effectively never more than their appropriate share. Any person to whom there is apportioned 5% or less of the value transferred by the company's transfer can never be made to pay any tax (S202(2) IHTA 1984).

Grossing up

Regardless of who pays the relevant IHT, the amount apportioned to each participator must always be grossed up. This follows from the wording in S94(1) IHTA 1984 which reads: 'Tax shall be charged as if each individual to whom an amount is apportioned . . . had made a transfer of value of such amount *as after deduction of tax* (*if any*) would be equal to the amount so apportioned.' The critical phrase is highlighted in italics.

Cumulation

Where an amount is apportioned to a particular participator, this amount together with any related tax remains, as might be expected, in that individual's cumulative total, unless the participator is one to whom there is apportioned 5% or less of the value transferred by the company transfer, in which case the chargeable amount does *not* cumulate (S94(4) IHTA 1984).

Other matters

A number of other small but important rules are found in IHTA 1984 in relation to close companies.

When a close company makes a transfer of value, no apportionment is made in respect of so much of any value 'as is attributable to any payment or transfer of assets to any person which falls to be taken into account in computing that person's profits or gains or losses for the purposes of income tax or corporation tax' (S94(2)(a) IHTA 1984). The payment of a dividend (which is technically a transfer of value) is the best example of such an exclusion – dividends are, of course, subject to income tax in the hands of the individual shareholders. Similarly, in view of Ss209(4) and 418(2) ICTA 1988, the sale of an asset at an undervalue by a UK-resident company to a participator would rank as a distribution and would thus be outside the scope of the IHT charge; however, if the company in question were non-UK resident, this would not be the case (given that the distribution rules only apply to UK-resident companies) – see S383 ITTOIA 2005. Another example would be the gift of an asset to a director or employee by a company (whether UK-resident or not).

- In an attempt to align itself with the excluded property rules, the close company legislation states that no apportionment is to be made of any amount which is attributable to property situated outside the UK and which would otherwise be allocated to a non-UK domiciled individual (S94(2)(b) IHTA 1984).
- The surrender of losses by way of group relief under S402 ICTA 1988 is specifically stated by the legislation to be outside the scope of these provisions, even if the value of a company's 'estate' has been diminished as a result of such a surrender (S94(3) IHTA 1984).
- It is, of course, perfectly possible for one close company, Kennedy Ltd, to be a participator in another close company, Agnew Ltd. If Agnew Ltd makes a transfer of value, the appropriate part will be apportioned to Kennedy Ltd and this, in turn, will be sub-apportioned through to the individual participators in Kennedy Ltd.
- If the trustees of a settlement are participators in a close company, a charge can rise in a similar way to that which applies for individuals (Ss99 and 100 IHTA 1984). Any tax which becomes payable is always due from the trustees and there is never any grossing up.

Article by Robert Jamieson

Lecture P510 (12.35 Minutes)

Administration

ESCs to be legislated

The House of Lords' decision in *R v CIR ex p Wilkinson* [2006] STC 270 made clear that the scope of HMRC administrative discretion is not as wide as previously thought to make concessions that depart from the strict statutory position.

While most ESCs will be able to continue in their current form, some exceed the scope of the discretion of the *Wilkinson* judgment. To retain the effect of those concessions, they will be put on a legislative basis where it is appropriate to do so.

Each concession will be considered carefully and, while the aim is to retain as many concessions as possible, some may no longer be required and it may not be possible to legislate for the effect of some others.

These ESCs may, therefore, need to be withdrawn. In such cases, HMRC say they will give taxpayers notice to allow them to review their affairs. There will be no retrospective effect of any change.

In anticipation of the need to legislate the effect of some concessions, FA 2008, s 160 provides an enabling power which allows the tax treatment afforded by existing published concessions to be legislated by Treasury order.

HMRC have published a consultation document which sets out draft legislation for inclusion in such an order, to be laid early in 2009.

The purpose of the consultation is to ensure that the legislation as drafted will successfully maintain the purposes and effects of the existing concession. As the review of the concessions continues, HMRC expect further such consultation on other ESCs that appear to exceed the scope of HMRC's discretion.

CGT computations – are your e-filed returns complete?

Following the changes to the 2007/08 redesigned personal tax return, a capital gains computation must be submitted whenever gains are declared on the return. This can be done either by an entry in the white space, or by making a pdf attachment.

The HMRC computer is programmed to reject a return which has a capital gain if an attempt is made to e-file it without one or other of these things. However, this is not foolproof. It may be that the white space contains a comment about some other aspect of the return. In such a case, even though there is no capital gains computation, the return will go through, but is nevertheless incomplete.

Contributed by Anita Monteith

Corporation Tax

Extended meaning of distribution

Benefits provided for participators

If a close company incurs any expense in providing a benefit in kind for a participator or an associate of a participator, the amount involved is disallowed in the company's adjustment of profits computation and is instead treated as a distribution (S418 ICTA 1988). The purpose of this provision is to prevent a close company from providing benefits such as living accommodation or a motor car for a shareholder who is not a director or employee. In the absence of S418 ICTA 1988, such benefits would be tax-free.

However, the rule does not apply if the benefit would anyway be subject to an employment income charge (as would be the case with a shareholder director).

The amount of the benefit which is taken into account as a distribution is always the cash equivalent of what would have been assessed on the participator had he been a director or employee. This will not necessarily be the same as the figure which was disallowed in the adjustment of profits computation.

Illustration

Sutherland Farms Ltd, a close company, provides a motor car for Sutherland, a 30% shareholder who no longer works in the business.

For the year ended 31 March 2008, the following amounts are charged in the company's profit and loss account in respect of this car:

	£
Depreciation	6,800
Running costs	4,300

Neither of these expenses will be allowable for corporation tax purposes – nor, incidentally, will it be possible to substitute capital allowances for the disallowed depreciation (the reason being that the company's expenditure on the car will not have been incurred for trading purposes).

Instead, the company will be deemed to have paid Sutherland a dividend equal to what would have been the benefit in kind had Sutherland still been a director or employee.

Let it be assumed that these figures are:

	£
Car benefit (35% x 27,200)	9,520
Car fuel benefit (35% x 14,400)	5,040
	£14,560

Sutherland will be treated as having received dividend income of £16,178 in 2007/08 (with an accompanying tax credit of £1,618).

Article by Robert Jamieson

Lecture B507 (5.23 Minutes)

Loans to participators – a current perspective

The 25% charge

Where a close company makes a loan or advance to an individual who is a participator or an associate of a participator, the company is required to account for an amount of tax equal to 25% of the loan (S419(1) ICTA 1988). Because the legislation refers to the loan being made to an 'individual', ordinary inter-company indebtedness is not caught.

As and when the loan is repaid to the company, so HMRC refund this tax (S419(4) ICTA 1988). The situation is therefore tantamount to the company making an interest-free loan to HMRC.

If a loan is subsequently released or written off, there are two tax effects:

(i) since 6 April 1999, the company's tax has been recoverable from HMRC (previously, this had not been the case); and

(ii) a higher rate income tax charge arises on the individual based on the amount written off, grossed up at the 10% rate (S416 ITTOIA 2005).

It should be emphasised that the charge under S416 ITTOIA 2005 takes precedence over the benefit in kind rules for a loan waiver in S188 ITEPA 2003 (S189 ITEPA 2003).

Illustration

Keen owns 20% of the ordinary share capital of Victa Ventures Ltd (a close trading company).

On 31 December 1998, the company lent him £60,000.

On 30 June 2007, Keen repaid £38,400, but Victa Ventures Ltd then agreed to waive the outstanding balance.

The tax effects of these transactions are:

(i) The making of the loan on 31 December 1998 is caught by S419 ICTA 1988. S419 ICTA 1988 tax at the rate then prevailing (20/80 x 60,000 = £15,000) was payable by the company.

(ii) When Keen repays the £38,400 on 30 June 2007, Victa Ventures Ltd is entitled to a refund of all its S419 ICTA 1988 tax, given that the balance of the loan is simultaneously being waived.

(iii) The release by Victa Ventures Ltd of the balance of £21,600 triggers an income tax charge on Keen for 2007/08. £21,600 is grossed up to £24,000 (100/90 x 21,600), which sum is then treated as part of Keen's income for the year. A tax credit of £2,400 is available.

Meaning of 'loan or advance'

Apart from its normal meaning of referring to advances of money, the word 'loan' has a specially extended meaning in the context of S419 ICTA 1988. If a participator buys an asset from the company but does not pay the purchase price, the debt which he owes is treated as a loan for this purpose (S419(2) ICTA 1988). Indeed, the subsection goes even further: if a participator owes money to a third party who subsequently assigns that debt to the close company, a participator loan is also deemed to have come into existence.

An indirect loan is caught so that, if, say, a close company transfers cash or property to another company as collateral for that other company making a loan to a participator, there will be a S419 ICTA 1988 charge, despite the fact that the close company is dealing with a person who is not an individual (S419(5) ICTA 1988).

Main exceptions

The main exceptions to these rules are that a charge does not arise if:

(i) the loan was made in the ordinary course of a business which includes the lending of money (S419(1) ICTA 1988); or

(ii) the loan resulted from a debt owed to the close company for goods or services supplied by it in the ordinary course of business, unless the credit which the company gives either exceeds six months or is longer than that normally available to its other customers (S420(1) ICTA 1988).

In connection with (a)(i) above, the question sometimes arises as to whether a loan comes within the S419(1) ICTA 1988 exception where it carries interest at a full commercial rate, the argument being that the close company is conducting a quasi-banking activity. However, in HMRC's view, it does not. The S419(1) ICTA 1988 exception comprises two tests, namely:

(i) that the company must carry on a business of lending money; and

(ii) that the loan must be made in the ordinary course of that business.

In *Steen v Law (1964)*, it was said:

'In their Lordships' opinion . . . "the lending of money" to be part of the ordinary business of a company must be what may be called a lending of money in general, in the sense, for example, that moneylending is part of the ordinary business of a registered moneylender or bank.'

Thus a single loan to a participator, even on commercial terms, would not be adequate evidence of a commercially constituted moneylending business. Since test (b)(i) fails, test (b)(ii) is irrelevant. Even if test (b)(i) was met, HMRC say that a loan to a participator would still have to be 'made in the ordinary course of the business and that would not be the case where the size, terms or conditions of the loan differed from those which normally applied'.

In addition, loans are not caught by S419 ICTA 1988 if:

(i) the borrower works full-time for the company; and

(ii) he does not have a material interest in the company (ie. ownership of more than 5% of the company's ordinary share capital); and

(iii) his aggregate indebtedness to the company does not exceed £15,000 (S420(2) ICTA 1988).

FA 1996 changes

In a Press Release dated 25 July 1995, HMRC announced that they intended to amend the S419 ICTA 1988 rules. These changes were duly implemented as part of FA 1996 for accounting periods ended on or after 31 March 1996. They covered:

(i) the due date for settling a S419 ICTA 1988 tax liability; and

(ii) the position where tax is refunded following the repayment (or writing off) of a loan.

Due date for payment of S419 ICTA 1988 tax

For accounting periods which ended before 31 March 1996, the due date for paying over S419 ICTA 1988 tax was 14 days after the end of the accounting period in which the loan arose. Interest on unpaid tax automatically accrued from this date. One of the practical difficulties with this arrangement was that, since the majority of S419 ICTA 1988 charges relate to overdrawn current account balances, timely payment of the tax was seldom achieved, given that the extent of the overdrawing could usually not be quantified until the company's accounts were finalised following the audit. Even if the overdrawn balance was subsequently restored to credit by the voting of a bonus or a dividend (so that no tax was actually payable), this would only be effective from the date on which the bonus was voted or the dividend paid and so HMRC were still able to collect interest on the tax which should have been paid – this would take in the period from 14 days after the year end until the loan was repaid.

Following the FA 1996 amendment, the due date was changed to nine months after the end of the company's accounting period (S419(3) ICTA 1988). Thus, provided that a loan is repaid within this nine-month deadline, there is no tax and no interest. In other words, if a director's current account becomes overdrawn during the first month of his company's accounting period (in, say, January 2007), there will be no fiscal consequences provided that his debit balance is made good by 30 September 2008 at the latest.

Repayment of loans after due date

Where a loan is still outstanding on the due date (even though it may be repaid shortly afterwards), companies must now pay over their S419 ICTA 1988 tax which will only be refunded by HMRC nine months after the end of the accounting period in which the loan was repaid to the company (S419(4A) ICTA 1988). Previously, there had been no fixed rules governing the timing of HMRC refunds. This makes it all the more important to ensure that loans are, if possible, repaid within the nine-month time limit.

Consequences of the 1996 changes

Close companies and their shareholder directors should always keep their loan arrangements under review. For example, if an existing overdrawn current account balance is restored to credit by the payment of a dividend, say, three or four months after the company's year end, no S419 ICTA 1988 charge will be made. If, at a later date, the shareholder director again borrows from the company, the position can be dealt with by another dividend paid in, say, 12 months' time.

<u>Interaction with S175 ITEPA 2003</u>

A participator who receives a loan will often be a director or employee of the company. As a result, there will also be a S175 ITEPA 2003 charge to the extent that the loan does not carry interest at the official rate (currently 6.25%).

It is important to appreciate that the company's liability under S419 ICTA 1988 and the director's or employee's liability under S175 ITEPA 2003 are totally separate and unconnected charges. There is no question of a S175 ITEPA 2003 charge not being invoked merely because S419 ICTA 1988 applies (or vice versa).

<u>Company law and loans to directors</u>

S197 Companies Act 2006 prohibits companies from making loans to directors (subject only to certain exceptions such as S207 Companies Act 2006 which sanctions loans of up to £10,000 and S204 Companies Act 2006 which allows companies to advance funds to directors for the purposes of meeting legitimate business expenditure), unless the transaction has been approved by a resolution of the company's members. Where a close company makes an unapproved loan to a director, the remedy is a civil one: by virtue of S213 Companies Act 2006, the arrangement is voidable at the company's option so that, technically, it could rescind the loan and recover its money.

However, this is unlikely to happen in practice, given that the company's owners and directors will usually be one and the same.

Article by Robert Jamieson

Lecture B508 (27.10 Minutes)

Interest relief for loans to buy shares in, or lend money to, close companies

The conditions

If an individual takes out a loan to acquire ordinary shares in a close company or to lend money to a close company, any interest which he pays on that loan will qualify for full income tax relief (S392 ITA 2007).

However, before this relief can be obtained, the company must satisfy one of two sets of conditions.

First set of conditions

The conditions are (see S393 ITA 2007):

(i) The company must not be a CIC.

(ii) The individual must have a material interest in the company (see S394 ITA 2007). This means that he and/or his associates must be the beneficial owners, directly or indirectly, of more than 5% of the company's ordinary share capital. An alternative test involves the relevant parties being entitled to more than 5% of the company's assets in the event of a winding up. The term 'associate' has its normal close company meaning.

Condition (i) must be satisfied both at the time when any interest is paid as well as at the time when the loan was originally applied.

Where the company is a trading company, it must, strictly speaking, be both close and trading at the time when the borrowing is incurred. Particularly in the context of start-up situations, this rule can be troublesome and so, in 1992, the ICAEW raised the matter with HMRC as follows (see TAX 15/92 dated 16 November 1992):

'Individual entrepreneurs commonly invest in a company which has been newly formed to undertake a trading venture, the company being close at the outset but ceasing to be so shortly afterwards as a result of the introduction of institutional finance. We understand HMRC's present practice is to allow relief under S392 ITA 2007 for interest on money borrowed to fund the individual's investment only if the company is both close and trading at the time when that investment is made.

In our view, this discriminates against investment in new ventures as compared with existing businesses. It may also make it necessary for the parties to accept the possible commercial disadvantages of implementing the various steps of the transaction in a different order rather than lose the tax relief. We recommend that the former practice, of allowing relief provided that the company is close when the individual's investment is made and commences trading within a reasonable time thereafter, should be reinstated.'

HMRC responded thus:

'Our practice has not changed in the sense implied by the (above) representation. Strictly, relief depends on the company invested in being both close and trading at the time the borrowing is incurred. We recognise, however, that for practical reasons it may sometimes not be feasible for a start-up company to commence trading until the funds are available in respect of which relief is sought. In such cases, it has been, and remains, HMRC's practice to allow relief so long as trading commences within a reasonable time after the investment in respect of which relief is sought and the company remains close when trading starts.

In some cases, as the ICAEW notes, the start-up's capital requirements may be such that significant institutional investment – as well as that by the initial participators – is required before trading can commence. In such a case, the company's close status necessarily comes to an end before the trading condition can be satisfied. Relief is not allowed in such cases. This seems to us consistent with the objectives of the legislation and to involve no discrimination between new and existing ventures with broadly comparable sources of capital.'

Thus, provided that trading starts within a reasonable period following the application of the loan and the company is still close at the commencement of the trade, relief will not be denied. However, there will be no relief if the company ceases to be close (for whatever reason) prior to the trade commencing. Note that, by virtue of Statement of Practice SP 3/78, there is no requirement that the company must continue to be close at any later time when interest is paid.

In the case of *Lord v Tustain (1993)*, the High Court rejected HMRC's argument that the company in question was a non-qualifying one. Although the company's *raison d'être* at the time of the taking out of the loans was to purchase a business as part of a management buyout, it was held that this was merely incidental to its main purpose which was to carry on that business (so that, under the current legislation, it would not be a CIC). Accordingly, the borrowers were entitled to tax relief for their interest payments.

Acquiring an interest in a close company

The proceeds of a loan must be applied for one of three purposes (see S392(2) ITA 2007):

(i) to acquire any part of the ordinary share capital of a close company;

(ii) to lend money to a close company provided that it then uses the money wholly and exclusively for the purposes of its business (or for that of an associated company); or

(iii) to pay off another loan, interest on which would have qualified for relief (irrespective of whether the replaced loan was interest-bearing or interest-free).

In *Hendy v Hadley (1980)*, an individual who paid off the bank overdraft (including interest) of a close company in his capacity as guarantor was not allowed to claim tax relief for the interest element. The interest paid under the guarantee was interest on a loan to the company (and was not, therefore, interest on a loan to an individual).

By virtue of S392(3) ITA 2007, relief is denied if a borrower claims EIS relief in respect of close company shares which he has acquired with the aid of a loan. Originating in 1989, this restriction put a stop to a highly tax-efficient scheme which allowed an individual who borrowed money in order to finance what was effectively an investment in residential property under the BES (as it then was) to obtain tax relief both for the cost of his shares and for the interest on his borrowings. Although the EIS did not continue the relief for investments in let property, the general prohibition remains.

<u>Second set of conditions</u>

An alternative means by which an individual can qualify for interest relief is if:

(i) the company is not a CIC; and

(ii) the individual has worked for the greater part of his time in the actual management or conduct of the company's business (or of that of an associated company) – see S393(3) ITA 2007.

In this case, the only shareholding requirement is that the individual must hold 'part of the ordinary share capital of the company'. A single share will suffice. HMRC interpret the phrase 'the greater part of the individual's time' as meaning more than half a normal working day throughout the period in question.

In the November 1993 issue of 'Tax Bulletin', HMRC provided guidance on the meaning of 'actual management or conduct of the company'. They said:

'S392 ITA 2007 describes the conditions which have to be satisfied for an individual to obtain relief for interest on a loan to acquire an interest in a close company. One of the conditions is that the individual either has a material interest in the company or holds ordinary share capital of the company and works for the greater part of his time in the actual management or conduct of the company or of an associated company.

Questions sometimes arise as to how the phrase "actual management or conduct" is to be interpreted. Individuals will normally be regarded as meeting this requirement if they are directors or have significant managerial or technical responsibilities. Because the statute refers to "actual management or conduct of the company", the individual must be involved in the overall running and policy-making of the company as a whole. Managerial or technical responsibility for just one particular area will not be sufficient.

Whether an individual does satisfy the "actual management or conduct" test is a question which can only be answered by consideration of the full facts of the particular case.'

Joint loans

Where a joint loan is taken out in the names of both spouses but only one spouse meets the qualifying conditions, full tax relief can still be claimed by the spouse who satisfies the relevant criteria (see 'Tax Bulletin' February 1992).

This is the case even if the interest payments are made out of a joint bank account.

Denial of relief

Relief is denied if an individual has recovered capital from the company without using it to repay all or part of his loan (S393(2) ITA 2007). This provision operates on a pro rata basis and a capital recovery includes the sale of any part of his holding, a repurchase of any of his shares by the company and the receipt of value for the assignment of any debt due to him from the company (S407(1) ITA 2007). Note that this latter situation is activated when a close company converts its loan stock to ordinary share capital – this can represent an unfortunate trap for the unwary.

When, following a takeover, close company shares are exchanged for shares in another close company, there has, strictly speaking, been a recovery of capital. However, S392 ITA 2007 relief will not, in these circumstances, be discontinued, provided that a loan to acquire the new shares would also have qualified for income tax relief. This concession is provided by ESC A43.

Article by Robert Jamieson

Lecture B509 (20.05 Minutes)

New interpretation of SME status

HMRC have announced a change of interpretation of a company's small and medium-sized enterprise (SME) status when it is taken over by – or its merging or becoming associated or linked with – another enterprise.

The revamp will take effect from the begiining of next month, and will affect companies making claims under the research and development (R&D) and vaccine research relief schemes.

It has been the practice to accept that if a company is an SME at any time in an accounting period then, for the purposes of the R&D and VRR schemes, it will be treated as an SME for the whole of that accounting period.

This will change so that where a company loses its SME status on or after 1 December 2008 as a result of being taken over by a large enterprise – either a single large company, or a collection of smaller entities that when taken together are regarded as large – it will be regarded as a large company for R&D and vaccine research purposes for the whole accounting period in which the change occurred.

Where an SME becomes large by growing so that it exceeds the staff or financial thresholds, however, a transition period allows SME status to be retained until the limits have been exceeded for two consecutive accounting periods.

No such transition period applies where the loss of SME status is due to merger, takeover or linking.

Where a large company decreases in size or demerges from a larger group of entities, it will not attain SME status until it has met the SME staff number and financial thresholds for two consecutive accounting periods.

Value Added Tax

VAT – new zero-rated dwellings – whether arrangements are abusive

This brief is for house builders who have built or are building new dwellings with the intention, when they are completed, of selling either the freehold interest or a long lease of over 21 years (at least 20 years in Scotland) in each of the properties.

Several such house builders have sought guidance on whether HMRC considers certain transactions involving the supply of new dwellings to be abusive. This brief identifies those situations that HMRC considers not to be abusive.

Background

The first grant of a major interest (freehold sale or a long lease of over 21 years (at least 20 years in Scotland)) of a new dwelling is zero rated. This allows the house builder to recover all the input tax they have incurred in connection with the development (subject to the normal rules about blocked input tax) and to sell the dwelling without adding VAT.

In the current economic climate, many house builders have found that they are unable to sell new dwellings. For most, this leaves them with the choice of leaving them empty until they find a buyer, or renting them out in the short term while they wait for the housing market to recover in order to sell them.

Revenue & Customs Brief 44/08 and Information Sheet 07/08 (both published on 15 September 2008) provide guidance for house builders renting out new dwellings on short term lets while retaining the intention to sell a major interest in the dwellings when the markets recover. As those documents explain, short term lets of this kind can sometimes give rise to adjustments of input tax previously recovered.

Approach made

HMRC have been asked about the possibility that house builders might, in advance of any short term lets, make the first grant of a major interest in the completed dwellings to a connected person, who would not be a member of a VAT group with the house builder. This zero-rated sale might remove the need for the kind of adjustments explained in Information Sheet 07/08. The suggestion put to HMRC is that the connected person would then rent out the properties until such a time as they could be sold. The rentals would be exempt and not give rise to input tax deduction on ongoing costs including the costs of the eventual sale (for example estate agency and legal costs). However, deduction of the VAT associated with the original construction would have been secured. We have been asked whether we would see this arrangement as abusive from a VAT point of view. This brief does not attempt to address any other tax consequences that might flow from such transactions or any commercial or legal issues.

Is this intended structure abusive?

For a scheme to be abusive, it must (as well as having the essential aim of saving VAT) produce a result contrary to the purpose of the VAT legislation. HMRC believe that Parliament intended that the construction of new dwellings should be relieved from VAT. The first grant mechanism introduced by Parliament does achieve this but it relies on the assumption that there will always be a grant of a major interest around the time the dwelling is complete, so ensuring deduction of VAT on all appropriate costs.

In HMRC's view, the arrangement set out above does not produce a result contrary to the purpose of the legislation, but rather ensures that a transaction of the kind Parliament envisaged will actually take place at the appropriate time. That view rests on the assumption that the purpose of the zero rating provisions associated with new dwellings is to relieve fully from VAT the provision of precisely that – new dwellings. That means that all the costs (save on blocked goods such as washing machines, carpets etc – see Section 13 of Notice 708 Buildings and Construction for more details) associated with producing a new house should either not carry VAT, or carry VAT that is deductible in full.

However, whilst we believe it is the policy objective that new dwellings should be zero rated, that does not extend to other goods or services that might be packaged up with the supply of a dwelling. HMRC consider it abusive when a major interest is granted with an essential aim of deducting VAT on costs such as repair, maintenance and refurbishment of dwellings (other than for remedying defects in the original construction) the relief of those kinds of costs not falling within the policy objective as we see it. These types of arrangements are likely to be challenged.

Summary

In short, HMRC agree that the arrangement outlined above is one that they would not see as abusive and so would not seek to challenge. However, if the VAT deducted goes beyond the VAT that would normally be deducted in relation to the supply of the new dwelling (for example VAT on costs such as repairs, maintenance or refurbishment, which is not normally deductible) such arrangements are likely to be challenged as abusive.

VAT Change of standard rate: technical note

This online lecture reviews the rules which are relevant to the change of standard rate of VAT which was announced on 24 November 2008 to have effect on 1 December 2008. There will be another change back from 15% to 17.5% on 1 January 2010. The same rules will apply then, but different practical considerations may be relevant where the rate is rising – so customers will want the tax point to be advanced before the change of rate – to the immediate situation where the rate is falling, so customers will want the benefit of the new rate.

There is a range of guidance, including FAQs, summary and detailed notes, available on the HMRC website at www.hmrc.gov.uk/pbr2008/measure1.htm. All registered traders were sent the summary guidance in the post on 24 November.

Outline of the problems

The basic technical issues are these:

- what rate of VAT should I charge to my customers on sales?
- what rate of VAT should I deduct as input tax?

The starting point lies in the tax point rules:

- if the tax point for a supply fell up to 30 November 2008, the supplier should charge 17.5% and the customer should deduct that as input tax;
- if the tax point for a supply falls on or after 1 December 2008, the supplier should charge 15% and the customer can deduct no more than that as input tax.

There are some special rules which allow traders to charge the new rate if they want to, even though the normal tax point rules appear to put the supply in November. These are described below after the "normal" tax point rules.

There are also major practical problems involved in a change of rate, in particular:

- for retailers, repricing everything in the shop between close of business on 30 November and opening on 1 December – or deciding some other practical way of dealing with the rate change;
- for retailers, making sure that electronic tills are adjusted to use the new rate at the right time;

- for retailers, dealing with extra complications on retail scheme calculations (beyond the scope of this lecture – described in the HMRC detailed guidance);
- for everyone, correcting errors that are likely to arise;
- for everyone, the possibility that paperwork issued in December should still properly use the old VAT rate because it relates to something that happened before the change of rate – this may be difficult to spot, and it may also be difficult to achieve if the computer believes that there can only be one standard rate of VAT at a time.

Tax point rules

There is a basic tax point when the supplier provides the purchaser with the subject matter of the supply. In short, this is:

- for goods, when the goods are "removed" from supplier to the purchaser (s.6(2) VATA 1994);
- for services, when the services are "performed" (normally meaning "completed") (s.6(3)).

The basic tax point is overridden by:

- issue of a tax invoice or receipt of payment, which will advance the tax point if it falls before the basic tax point (s6(4));
- issue of a tax invoice, if this takes place in period up to 14 days after the basic tax point (s6(5)).

The "14 day rule" can be waived by the taxpayer (i.e. it is permissible to apply the basic tax point rule even if a tax invoice is issued a few days later), or extended by application to Customs (e.g. where the trader sends out all invoices at the end of the month).

Note that receipt of payment is only relevant if it occurs before the basic tax point, whereas the raising of a tax invoice can affect the tax point if it is before or after the basic date. There are other rules in s.6 to cover a number of special situations, for example "sale or return" in s.6(2)(c) and s.6(4).

Note that the tax invoice is required to show not only the date of the issue of the invoice but also the time of the supply. These may be the same (because the invoice may trigger the tax point) but they do not have to be.

It is possible to have more than one tax point for the same supply – for example, if a deposit is received for a sale, and the balance is paid on the date of delivery, and a tax invoice is issued three days later, the rules above provide that:

- the tax point for the deposit is the date it is paid;
- the tax point for the balance is the date the invoice is issued.

Where services are supplied "continuously", they are never finally "performed". There is therefore no basic tax point, and payment or invoice have to be used instead. SI 1995/2518 reg.90 provides that a single invoice can be issued in advance for a period of up to a year, specifying periodic payment dates, and these are used for the tax point of each period payment – not the date of the invoice itself. Continuous supplies of services include rent, most subscription supplies, and some consultancy agreements, and are defined as any situation where supplies are made over a period for a periodic payment (e.g. monthly/quarterly) rather than specific payments being made for specific supplies.

Where supplies are deemed to be made under the reverse charge rules, the tax point is only determined by the date the services are paid for – the time they are actually performed, and the date of an invoice, have no effect (reg.82).

Special rules on a change of rate

The special rules on a change of rate are in s.88 VATA 1994. These provide that:

- the rate ruling on the tax point date is the starting point;

- if the basic tax point (delivery/completion) falls one side of the rate change but the special rules in s.6 have shifted the time of supply to the other side, the supplier can choose to charge VAT at the rate ruling on the basic tax point instead.

S.88 does not appear to affect the actual tax point (i.e. the time at which the supplier must put an entry in the VAT account) – only the rate at which the supply is charged.

As traders are likely to want to prefer to charge VAT at 15% rather than 17.5%, the rule is likely to be applied as follows:

Basic tax point	s.6 "shifted" tax point	s.88 choice?
November 2008	December (invoice in 14 days)	No – charge 15%
December 2008	November (payment/invoice in advance)	Yes – charge 15%
December 2009	January 2010 (invoice in 14 days)	Yes – charge 15%
January 2010	December 2009 (payment/invoice in advance)	No – charge 15%

We are warned that there are likely to be anti-avoidance measures to stop traders fixing tax points artificially before the rate rises again in January 2010. Details have not yet been given.

Continuous supplies

The HMRC guidance points out a distinction between a continuous supply of services and a single supply in applying s.88. In both cases, the starting point is the basic tax point; for a continuous supply, that can only be the invoice or the payment. A trader is likely to want to use s.88 for supplies which have been paid for or invoiced in advance:

- if it is a continuous supply, s.88 will apply by apportioning the affected amount on a reasonable basis to the period up to 30 November and the period afterwards;
- if it is a single supply, there will be no apportionment – even if the supplier has done some of the work before 1 December, the 15% rate can be applied to the whole amount.

The guidance gives the example of rent as a continuous supply: if a landlord has received £10,000 + £1,750 in VAT in advance for the 3 months to December 2008, it will be possible to issue a credit note for 1/3 x £250 to reduce the VAT rate applicable to December to 15%.

The contrasting example is a solicitor preparing a will. That is a "single" service, even though some of the work may have been done in December. A single VAT rate will apply.

It is not always easy to tell what is continuous and what is single. Accountancy services provided to regular clients are often regarded as continuous supplies, but one-off consultancy services are generally not. Construction services are subject to special rules in reg.93 SI 1995/2518, and they are likely to be treated as continuous services where regular stage payments are made. That means that payments up to 30 November will probably be charged at 17.5% without the option of reducing them later. However, the guidance does recognise that a construction service can be a "single payment contract", in which case s.88 could be applied to the whole price and an apportionment would not be required.

A continuous supply of services can be the subject of a special "scheduled" VAT invoice, which specifies the amounts payable and the due dates for up to a year in advance. The scheduled dates, rather than the issue of the invoice itself, trigger tax points. Where such a document has been issued before 24 November covering periods later than 1 December, the rates will be wrong and the document will have to be reissued.

Adjusting prices

Where the trader exercises the choice under s.88 and as a result reduces the VAT from 17.5% to 15%, it will be necessary to issue a credit note to the customer (and a refund, if payment has already been received).

17.5% still used in December

It will be necessary to use the 17.5% rate after 30 November in the following circumstances:

- invoice issued more than 14 days after a supply that happened up to 30 November, so the tax point is not shifted;
- credit note relating to returns or price adjustments on supplies with tax points up to 30 November – the rate on the original supply must be used for any adjustments to it.

Mistakes

The guidance accepts that this is a big change and it is likely that traders will make mistakes. We are promised "policing with a light touch". The main errors that are likely to occur are:

Traders getting the basic cut-off wrong – still charging 17.5% in December. This is mainly a problem for the customer, who is not allowed to deduct more than 3/23 of the gross amount where the time of supply properly falls after the change. The customer should insist on a credit note.

Traders getting the tax point rules wrong – accounting for 15% in December even though the appropriate rate remains 17.5%. Such errors need to be corrected, but HMRC are supposed to help rather than penalise.

Particular issues may arise in relation to cash accounting and the flat rate scheme, where the delay in accounting for VAT on receipts and payments may lead traders to apply the wrong rate. The guidance emphasises that it is the date of the supply that fixes the amount of VAT, and cash accounting does not change that: cash accounting traders, and FRS traders who use receipts under that scheme, must identify their receipts and account for the correct amount of VAT on them according to when the original supply was made.

Flat rate scheme

The flat rates are reduced to take account of the lower standard rate, but not uniformly. This is explained in the guidance: some flat rates are low because the trader is forgoing a lot of input tax, and such rates should perhaps rise rather than fall because the amount of input tax forgone is reduced. However, no rates have been increased.

FRS traders will have to apply s.88 to their sales and choose whether to charge 17.5% or 15% on the same basis as all other traders.

The cut-off for flat rate then depends entirely on the correct outcome of the sales decision:

- if 17.5% was correctly charged to the customer, the old higher flat rate applies, whenever the customer pays;
- if 15% was correctly charged to the customer, the new lower flat rate applies, whenever the customer pays.

A FRS trader who uses the FRS version of cash accounting will have to keep receipts separate for pre- and post-change supplies.

The new rates are:

Category of business	New rate	Old rate
Post offices	2	2
Retailing food, confectionary, tobacco, newspapers or children's clothing	2	2
Wholesaling food	5	5.5
Farming or agriculture that is not listed elsewhere	5.5	6
Membership organisation	5.5	5.5
Pubs	5.5	5.5
Retailing that is not listed elsewhere	5.5	6
Retailing vehicles or fuel	5.5	7
Wholesaling agricultural products	5.5	6
Retailing pharmaceuticals, medical goods, cosmetics or toiletries	6	7
Sport or recreation	6	7
Wholesaling that is not listed elsewhere	6	7

Printing	6.5	7.5
Repairing vehicles	6.5	7.5
Agricultural services	7	7.5
Manufacturing food	7	7.5
General building or construction services*	7.5	8.5
Hiring or renting goods	7.5	8.5
Library, archive, museum or other cultural activity	7.5	7.5
Manufacturing that is not listed elsewhere	7.5	8.5
Manufacturing yarn, textiles or clothing	7.5	8.5
Packaging	7.5	8.5
Repairing personal or household goods	7.5	8.5
Forestry or fishing	8	9
Mining or quarrying	8	9
Social work	8	8.5
Transport or storage, including couriers, freight, removals and taxis	8	9
Travel agency	8	9
Veterinary medicine	8	9.5
Advertising	8.5	9.5
Dealing in waste or scrap	8.5	9.5
Hotel or accommodation	8.5	9.5
Manufacturing fabricated metal products	8.5	10
Photography	8.5	9.5
Publishing	8.5	9.5
Any other activity not listed elsewhere	9	10
Investigation or security	9	10
Boarding or care of animals	9.5	10.5
Business services that are not listed elsewhere	9.5	11
Entertainment or journalism	9.5	11
Estate agency or property management services	9.5	11
Film, radio, television or video production	9.5	10.5
Laundry or dry-cleaning services	9.5	11
Secretarial services	9.5	11
Computer repair services	10	11
Catering services including restaurants and takeaways	10.5	12
Financial services	10.5	11.5
Hairdressing or other beauty treatment services	10.5	12
Architect, civil and structural engineer or surveyor	11	12.5

Management consultancy	11	12.5
Real estate activity not listed elsewhere	11	12
Accountancy or book-keeping	11.5	13
Computer and IT consultancy or data processing	11.5	13
Labour-only building or construction services*	11.5	13.5
Lawyer or legal services	12	13

"Labour-only building or construction services" means building or construction services where the value of materials supplied is less than 10 per cent of relevant turnover from such services; any other building or construction services are "general building or construction services".

Article by Mike Thexton

Lecture B510 (27.42 Minutes)