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Personal Tax

Pensions Lifetime Allowance protection notifications—guidance

HMRC have published this guidance which covers notifications of lifetime allowance protection in the run up to the deadline of 5 April 2009.

Introduction

This guidance covers notifications of lifetime allowance protection in the run up to the deadline of 5 April 2009. We have changed form APSS200, which you use to notify us, to make it clearer which boxes you need to complete. We have also amended the completion notes for questions 3 and 4.

Select the link to the new version of form APSS200 (www.hmrc.gov.uk/pensionschemes/apss200.pdf) (Notification of claim to life time allowance) which you must use from today. None of the questions have been changed. If you have already successfully completed an APSS 200 you do not need to make a change to your notification unless you have discovered that notification is incorrect.

What is lifetime allowance protection?

When you crystallise benefits valued more than the lifetime allowance the amount over the lifetime allowance will be liable to a tax charge called the lifetime allowance charge. When introduced on 6 April 2006 the lifetime allowance was £1.5 million. Currently the lifetime allowance is £1.65 million.

Lifetime allowance protection means that part or all of your benefits that are worth more than the lifetime allowance will be protected from the lifetime allowance charge. There are two main forms of protection—

– Enhanced protection – protects all your pension rights from the lifetime allowance charge. Strict conditions must be met to continue to be covered by enhanced protection

– Primary protection–broadly this protects the value of all your pension rights built up before 6 April 2006 from the lifetime allowance charge. So if on 5 April 2006 your pension rights were worth £3 million you can take this amount of benefits without being liable to the lifetime allowance charge. This value is increased each year in line with the increase in the lifetime allowance, so that your £3 million as at 5 April 2006 would now be worth £3.3 million.

Who can claim lifetime allowance protection?

It is the individual scheme member who must make the notification for protection. There are limited circumstances where someone other than the individual can complete the notification–

Only individuals who already had pension rights worth more than £1.5 million on 5 April 2006 can qualify for primary protection.

There is no monetary limit for enhanced protection.

Deadline

The deadline for submitting your notification that you wish to claim lifetime allowance protection is **5 April 2009.**

Notification made on time

If your notification is acceptable (see what is an acceptable notification) and has been received in one of HM Revenue & Customs (HMRC's) offices by midnight on 6 April 2009 it will be treated as being made on time.

Form needed

You need to download the form APSS200 (www.hmrc.gov.uk/pensionschemes/apss200.pdf) from the HMRC website.

Late notification

Any notification received after midnight on 6 April 2009 will be considered on a case by case basis on its own facts to see if there is a reasonable excuse for it being late and whether the notification was made within a reasonable period of time after that excuse ceased to exist.

A reasonable excuse can only exist where an exceptional event beyond your control prevented you from submitting the notification in time.

There has been a period of 3 years from 6 April 2006 to 5 April 2009 allowed for making the claim.

What is an acceptable notification?

Your notification to claim the Life Time Allowance protection is made using form APSS200 (www.hmrc.gov.uk/pensionschemes/apss200.pdf).

All appropriate sections of the form are completed where there is an instruction starting "You must".

The form is signed and dated.

Note—Photocopies, emails and facsimiles of completed forms will not be accepted.

Common errors

Boxes on the form which require completion are left blank resulting in rejection–please note "nil" or "N/A" should be entered when appropriate for the avoidance of doubt.

Only one tick box is completed in the signed declaration at part 5.

Conflicting information is given on the form when an individual is claiming both protections creating an "obvious error", eg question 3.6 (for enhanced protection) and 4.4 (for primary protection) request the same information, and 3.7 should equal the sum of 4.1a and 4.1b.

What happens if my notification is not acceptable?

For reasons of confidentiality unacceptable notifications will be returned directly to you (unless we have your authority to deal with someone else on your behalf such as a financial advisor). We will be prioritising the notifications so they are returned to you (where appropriate) as quickly as possible.

What are the consequences of missing the deadline?

If you miss the deadline and you do not have a reasonable excuse for making a late application you will not have protection from the lifetime allowance charge.

Any benefits that you take (or are deemed to take under the tax legislation) worth more than the lifetime allowance will be liable to the lifetime allowance charge.

Where the excess over the lifetime allowance is taken as a lump sum the tax rate is 55%.

Where taken in pension form the rate of the lifetime allowance charge is 25%. Do not forget however that pensions at this level of funding are likely to trigger a 40% liability on the individual.

How long will I have to wait to find out if my notification is acceptable?

We will aim to notify you immediately where your form is unacceptable. If your form is acceptable then we will aim to tell you that within 15 working days.

Can I amend a notification after the deadline?

If you discover after 6 April 2009 that a notification you made before that date is incorrect you can amend it. You should do this as soon as possible. You will need to submit a new, fully completed APSS200 with the corrected information, completing question 1.6 to confirm the form is an amendment to your original notification and providing the reference number of your existing protection certificate.

Lutchmumun and others v DG of the Mauritius Revenue Authority [2008]

In 1991, the taxpayers obtained a provisional land conversion permit under the relevant national legislation, namely Sugar Industry Efficiency Act 1988 to convert 50 arpents of agricultural land.

On receipt of the permit, they entered into an informal agreement to purchase the land. In 1993, they purchased it by authentic deed jointly and in undivided rights. At the beginning of October 1993 the parceling of the land into 419 residential plots was approved by the authorities.

In October 1993, the taxpayers were served with a notice under s 6 of the Land Acquisition Act 1973 that it was proposed to acquire part of the taxpayers' land. The taxpayers made a claim for compensation under the 1973 Act.

In August 1995, the board of assessment awarded the taxpayers compensation, to be apportioned among them according to their respective shares, together with interest from the date of vesting. The result of that award was that the taxpayers received more per arpent than they had paid for it.

The Director General of the Mauritius Revenue Authority (the Revenue) decided that the sum received as compensation was taxable in the hands of the taxpayers as part of their gross income within the meaning of s 11(1)(g) of the ITA1974.

Under that provision a person's gross income included any sum or benefit, in money or money's worth, derived from the sale of any property or interest in property, where the property was acquired in the course of a business the main purpose of which is the acquisition and sale of immoveable property.

The taxpayers were assessed to income tax in respect of their shares of the profit that resulted from the compulsory acquisition of the excised land on behalf of the government. The assessments were made on 30 June 1999 for the year of assessment 1994–95, based on the taxpayers' income for the preceding year 1993–94. Their shares of the profit were included under the description "trade, business, profession" as part of their total gross income for that year. Their shares of the interest on the principal award were included in the amount of their gross income under the description "dividends and interest".

Appeal

The taxpayers appealed against the assessments contending that the amounts received for compulsory acquisition were not taxable.

In June 2002, the Tax Appeal Tribunal of Mauritius held that the compensation payment and the interest thereon were not taxable under s 11 of the 1974 Act.

It further held that it was established clearly by the evidence that the taxpayers had invested money in what could not be described otherwise than as a business venture with profit in mind.

The Revenue appealed against the determination of the tribunal to the Supreme Court.

In May 2005, the Supreme Court held that the compensation and the interest thereon were taxable as gross income and that the determination of the tribunal to contrary had been wrong.

It accordingly allowed the appeal.

As a result of reforms following the date of its determination, the tribunal was no longer in existence by the time the Supreme Court had allowed the appeal and the court could not remit the case to the tribunal for the assessments to be adjusted. In view of that, it decided to make no order, trusting that its pronouncement would serve as guidance to the parties. The taxpayers and the Revenue appealed to the Privy Council.

The issue arose as to whether the sum that had been award as compensation for the compulsory acquisition of the land was taxable as gross income or was a tax free capital sum because it had not been awarded in the normal course of the taxpayers' business.

The taxpayers' appeal would be dismissed. The Revenue's appeal would be allowed.

In the instant case, the Supreme Court had been correct in holding that compensation and the interest thereon were taxable as gross income and that the determination of the tribunal to contrary had been wrong. However, the Supreme Court had been wrong in holding that it followed from the fact that the tribunal was no longer in existence that no effective order could be made (see [18] of the judgment).

Accordingly, the determination of the tribunal would be set aside and the assessments would be affirmed.

Haskins v Revenue and Customs Commissioners SpC 726

In his self–assessment tax return for the tax year ending 5 April 2004, the appellant, a bookkeeper, disclosed a gross income in respect of his Sch D trade of £21,411, employment income of £17,722, from which it was asserted that tax of £3,898.84 had been deducted, and a net taxable profit of £8,280 following various deductions, including £1,800 for motor expenses, £4,000 in respect of a bad debt and £2,114 for "costs of sales".

HMRC wrote to the appellant indicating that they intended to investigate his return and requesting to see his business accounts, the records underlying those accounts and the identity of the employer by whom the asserted employment income had been paid.

During a meeting with HMRC the appellant admitted that his return was wrong and he disclosed a schedule of customer invoices in date order totalling £17,944, and a schedule indicating the gross and net receipts from his alleged employment with two companies.

HMRC had separate evidence that the appellant had not been recorded on the PAYE records as an employee of either of the companies to whom employment income had been paid, and those records had been completed and signed by the appellant's accountant.

After the meeting the accountant sent a revised profit and loss account indicating increased gross receipts of £22,148, increased "costs of sales" of £3,124, £1,585 for motor expenses, a revised bad debt claim of £2,500, miscellaneous expenses of £2,243, and a resultant net profit of £10,696.

However, the appellant subsequently stated that his gross receipts should in fact be £28,418 and his net profit was £16,978 after deductions for expenses—including motor expenses of £4,896 and "purchases" of £1,254—and for first year capital allowances of £4,896, a figure for which he had no written evidence, but which he recalled "from memory".

The appellant then claimed that he had no business records as all the paperwork had been handed over to his accountant, who was now seriously ill, and could therefore not be obtained.

HMRC made an assessment in which they took the gross turnover indicated by the schedule of invoices, namely £17,944, treated the employment income—which was calculated to be £12,400 on the basis of the actual cash figures received and was assumed to have been grossed up by the appellant to result in the higher figure originally claimed—as further gross receipts for Sch D purposes, and disallowed all the expenses and the claim for capital allowances, resulting in a figure of £30,344.

The appellant appealed.

Before the hearing the appellant requested a postponement on the basis he was trying to obtain a crucial document to establish he had been regarded as an employee by one or both of the relevant companies and that they had deducted tax from his employment income. HMRC opposed the application and the Special Commissioner issued an immediate direction that the appeal should proceed as arranged but that an adjournment would be granted during the hearing should further evidence emerge.

As a result the appellant did not attend the hearing but afterwards he delivered, without any explanation or comment, a copy of a form P60 in respect of his income from one of the two relevant companies showing his gross pay of £9,679.78, subject to a deduction of £2,129.38 in respect of PAYE tax and employee's primary Class 1 national insurance contributions.

The Special Commissioner found that there was a startling lack of reliable evidence relating to the income on the appellant's return for the period ending 5 April 2004 and that the appellant had advanced no satisfactory evidence to establish that the reconstructed assessment made by HMRC was wrong. In short the appellant, who was a bookkeeper, and who had been assisted or hindered by support from his accountant, had seemingly given new meaning to the expression about the "shoe–maker being worst shod".

HMRC had acted reasonably in taking the gross turnover as one of the lowest figures ever mentioned, namely the figure of £17,944 derived from the list of actual invoices, and adding in the alleged employment income at merely the net figure of £12,400 of cash actually received when there was no evidence that the appellant was an employee and when the figures of employment income were round figures only in their "net" rather than "gross" or "grossed–up" amounts.

HMRC had also acted reasonably in disallowing any deduction for expenses—the appellant had altogether failed to produce any evidence to sustain any claim to deduct anything, and the various utterly conflicting figures resulted in a total lack of confidence in anything said by him.

However, the assessment would be adjusted both to allow for a deduction for expenses of £3,000 on the basis it was natural that the appellant would have incurred some expenses, and HMRC had confirmed that they considered the figure reasonable, and to reduce the amount of employment income to that indicated in the copy P60, net of the PAYE tax and national insurance shown to have been deducted.

Whilst the evidence for concluding that the form was genuine was fairly slim, as there was a disparity in the figures—in that it did not contain any of the figures previously discussed—the amount of income therein should be accepted to have been paid as employment income.

Appeal allowed in part.

Another avoidance scheme shut down

Certain planning arrangements involve the use of a number of entities including both companies and trusts, some of which may be located offshore.

A key element of the structure is the creation of a contrived employment, the duties of which include entering into financial arrangements - e.g. stock lending - with another party.

During the course of the employment the individual will deliberately default with regard to one or more aspects of the financial arrangements.

This will trigger automatic damages payable by the individual to the counterparty to the lending.

The individual will have borrowed the money to pay the damages from another entity in the structure.

However, the individual will not in reality repay the borrowings and as a result suffers no genuine loss of money.

HMRC understand that the individuals who participate in these arrangements will claim that, under ITEPA 2003, ss 346 or 555, they are entitled to deduct the amount of the damages from their income on the grounds that the damages rank as a liability that was incurred when acting as employee.

The Government does not accept that these arrangements have the effect sought and will include appropriate countering legislation in Finance Bill 2009 to take effect from 12 January 2009 but will not apply to payments made before that date.

The proposed legislation will deny any deduction under ss 346 or 555 where the liability in respect of which the deduction would otherwise be due has been paid in connection with arrangements the main purpose, or one of the main purposes, of which is the avoidance of tax.

The new rule will not prevent a deduction being set off against the cost of insurance premiums paid for by the employer where the employer routinely takes out insurance policies whose sole purpose is to indemnify employees against employment related liabilities such as damages or legal costs relating to their jobs.

Similarly, a deduction will not be disallowed where the employer meets the cost of an uninsured employment-related liability incurred by an employee, so that the relief offsets the tax charge that would otherwise have applied.

Examples of how the new rule will work can be found in a technical note on HMRC's website.

Capital Gains Tax

Underwood v R&C Commissioners [2008] EWHC 108 (Ch)

On 16 July 1990, the taxpayer acquired a property for £1.4m. Shortly thereafter, the market for property of that type went into serious decline, such that by March 1993, it was professionally valued as having an open market value of £400,000.

By a contract dated 2 April 1993 (the 1993 contract), the taxpayer agreed to sell the property to R Ltd as beneficial owner with vacant possession, for £400,000.

During the year of assessment which ended three days later, the taxpayer had made substantial chargeable gains on other assets and, although that affected only the timing of the sale rather than the decision to sell, he hoped to crystallise a substantial loss upon performance of that contract.

In his tax return for the year ending 5 April 1995, he claimed a loss in relation to the property of around £1.174m. On the same day that the 1993 contract was made, the taxpayer and R Ltd entered into an option agreement by which R Ltd granted to the taxpayer the right to re–purchase the property. The amount payable upon exercise of the option was £400,000.

In the event, the 1993 contract did not complete as anticipated, and the date for completion was extended to 31 December 1994. By the end of September 1994, the property had substantially increased in value.

In the meantime, the 1993 contract had not been completed, and accordingly no part of the purchase price had been paid.

By November 1994, the taxpayer had decided, in order to ease his continuing financial difficulties, to sell the property to B Ltd for £600,000.

For that purpose, he needed to extricate the property from the 1993 contract. Following lengthy discussions with R Ltd, rather than simply exercising the option, the parties entered into a contract for the re–purchase of the property for £420,000 on 29 November 1994 (the 1994 contract). On the same day, the taxpayer exchanged contracts for the sale of the property to B Ltd for £600,000.

It was common ground that the 1994 contract was in substantially the same terms as would have arisen by operation of law had the option simply been exercised. The taxpayer, R Ltd, B Ltd and the mortgagees of the property all used the services of the same solicitor, C, who drafted all the relevant contracts. The parties left C to devise a sensible means of dealing with the consequence of there being simultaneously in existence contracts between the same parties for the sale and re–purchase of the same property for completion at substantially the same time, at prices £20,000 apart.

C concluded that, as legal title to the property had remained with the taxpayer throughout, he was able to execute just one transfer of the property to B Ltd.

The position as between the taxpayer and R Ltd was to be settled by a payment of £20,000 to R Ltd. The taxpayer completed the sale of the property to B Ltd for £600,000 on 30 November 2004.

Subsequently, the taxpayer appealed against two estimated assessments to capital gains tax for the years ending 5 April 1993 and 5 April 1995.

Principal issue

The principal issue before the Special Commissioners was whether the rights and obligations arising from the simultaneous existence of the 1993 and 1994 contracts gave rise to a disposal by the taxpayer of his beneficial interest in the property under the contract of sale, such that it should, pursuant to s 28 of the TCGA 1992 have been deemed to have been disposed of at the time of the contract of sale.

Commissioner’s view

The Special Commissioners accepted the taxpayer's analysis that the legal analysis of that factual matrix was that both the 1993 contract and the 1994 contract had been performed in full by way of set–off.

However, no beneficial interest in the property ever passed to R Ltd under the 1993 contract capable of constituting a disposal by the taxpayer and an acquisition by R Ltd within the meaning of s 28(1) of the 1992 Act.

The fact that the payments occurred simultaneously by way of set–off meant that there had never been a moment in time (or scintilla temporis) when the beneficial interest in the property had vested in R Ltd. The taxpayer appealed.

An issue arose as to whether the Special Commissioners' contractual performance by way of set–off analysis had been correct.

In the instant case, the set–off analysis was an artificial and fallacious construct. In reality all that had happened was that the two contracts were settled by payment of a £20,000 difference without any substantial performance of either of them. There was no performance of either contract and, therefore, there was no transfer of the beneficial interest in the property under either contract, or at all. Accordingly, there was no disposal of the property under the 1993 contract, and nothing upon which s 28(1) of the 1992 Act could bite so as to deem there to have been a disposal in the 1993 year of account.

The appeal would be dismissed.

Smith v Revenue and Customs Commissioners SpC 725

On 11 December 2002 the appellant realised a capital gain of £1.5 million upon the sale of company shares and decided to invest the money in second hand life insurance policies ("SHIPS").

As part of that strategy, on 23 January 2003 he purchased a SHIP from G for £4,139,560, and in respect of which he also paid commission of £60,000 to the bank, who held the policy for him, and £30,000 to his accountant.

On 31 January 2003 the policy matured and the appellant received £4,144,530, giving rise to a charge to income tax as a chargeable event gain of £244,530 under TA 1988 s 541.

In his self–assessment tax return for 2002–03 the appellant claimed a loss of £4,139,560 on the disposal of the policy set against the gain on the company shares, on the basis that the proceeds on maturity were taken into account in computing his income and therefore had to be excluded from the disposal consideration for capital gains tax by reason of TCGA 1992 s 37(1).

Page CG2 of the return showed the shares as a business asset and the taper rate as 25% but showed no tapered gains at col M because the loss had been set against the gain.

The return also showed income before reliefs and allowances of £51,540.08, together with the TA 1988 s 541 figure of £244,530.

Following an enquiry into the return, HMRC issued a closure notice disallowing the capital loss on the SHIP and increasing the tax due by £596,919.61 on three alternative grounds:

(1) the £4,144,560 was not as a matter of statutory interpretation "taken into account as a receipt in computing income" within TCGA 1992 s 37(1). The proceeds of the policy were an element in computing that chargeable gain but not in computing the appellant's income and s 37(1) did not encompass the process by which a chargeable event gain was treated as arising;

(2) the acquisition and disposal of the policy was part of a tax avoidance scheme and £4,144,560 was not "given by him … wholly or exclusively for the acquisition of the policy" within TCGA 1992 s 38(1)(a) because it was part of the total consideration for entering into the avoidance scheme which consideration involved additional sums of £60,000 and £30,000. The scheme was a totality and the £4,139,560 was part consideration for the whole;

(3) the loss was artificially generated as part of a tax avoidance scheme and did not give rise to an allowable loss on the *Ramsay* principle (see *WT Ramsay Ltd v IRC; Eilbeck (Inspector of Taxes) v Rawling* [1981] STC 174, [1982] AC 300).

The appellant appealed contending that:

(1) the gross proceeds of the policy was taken into account as a receipt in computing income because it was taken into account as a receipt in computing the chargeable event gain within TA 1988 s 541(1)(b);

(2) there was a real loss in the sense of the statute because TCGA 1992 s 37(1) excluded the element entering into the income tax computation. Capital gains tax was a technical tax which could produce results which differed from commercial reality

(3) the sum of £4,139,560 was given wholly and exclusively for the policy for the purposes of TCGA 1992 s 38(1). The purpose was to generate investment and any tax benefit was not fundamental, and the test was subjective and not objective;

(4) if the entire amount did not fall to be excluded, the £244,530 difference between the policy proceeds and the premium paid by G should be excluded being the sum stated in the chargeable event certificate.

Eight days after the hearing, Norris J delivered his judgment in *Drummond v Revenue and Customs Comrs* [2008] STC 2707 and both parties accepted that the decision, which was binding on the Special Commissioners, could not be distinguished from the instant case.

The Special Commissioners considered that TCGA 1992 s 37(1) only applied to the actual chargeable event gain charged to income tax, amounting to £244,530 in the present case. Furthermore, the sum attributable to the policy was “wholly and exclusively” for the acquisition for the purposes of TCGA 1992 s 38(1)(a). In addition, the Special Commissioners formally found that the purpose of purchasing G's policy was tax driven; it was not part of an investment strategy and the primary purpose was to obtain tax relief. Although the appellant was entitled to deduct the amount which was subject to income tax, the appeal against the denial of the full loss relief claimed failed. As the correct determination of the appellant's liability to tax had to take into account his entitlement to taper relief (which only applied after the deduction of allowable losses), the appeal would be adjourned for the parties to agree the adjustment to the self–assessment return; *Drummond v Revenue and Customs Comrs* [2008] STC 2707 applied.

Appeal adjourned.

CGT warning for holiday home vendors

The strengthening euro and the reduced price of property could combine to create a capital gains tax headache for British taxpayers who own foreign property, PKF has warned.

The company of accountants has also noted that people wanting to sell their overseas holiday homes and then reinvest the equity may find their situation to be especially problematic.

PKF director of personal tax Matt Coward explained that recent movement in sterling against the euro means that vendors might be forced to take ‘dramatic currency risks’.

He said that Britons ‘could face an unexpected capital gains tax liability if they sell an overseas property that they have owned for a couple of years’.

Even a euro-denominated loss due to a fall in property prices might give rise to a UK capital gains tax liability.

To illustrate his example, Mr Coward explained how a UK national who bought a Spanish property in January 2007 for €1.25m (then equal to £854,818) might sell this month for €1m (equal £966,744 in sterling).

Although there is a loss in euros, there is a profit in sterling of £111,926 on which the vendor will have to pay UK CGT of at least £18,419.

The position could be ‘particularly difficult’ if the vendor then reinvested all resulting equity in a new overseas property, because as he or she may then have difficulty finding the money to pay the British tax liability when it becomes payable in January 2010.

‘Even those who are aware they have a UK tax problem will often realise a smaller amount of post-tax equity from their properties than they may have expected,’ said Matt.

If the vendor were to leave the equity in a foreign currency bank account, he or she could face a ‘double hit’ if the value of sterling recovers before the UK tax is payable on any gain.

‘Unwitting failure by holiday home owners to report such gains will not be met with a sympathetic approach from HMRC,’ added Matt.

Fletcher v HMRC on debt capitalisations

The Special Commissioner in *Fletcher* (SpC 711) reached his decision in an unusual way.

After the hearing had finished, the Special Commissioner realised that he had overlooked a key Court of Appeal authority.

There was no need to call the parties back for further argument, because the point was beyond doubt. He decided the case in the taxpayer's favour and, in the decision, reprimanded himself for having overlooked the key authority at the hearing.

The facts

The taxpayer and her representative had originally subscribed for 400 ordinary shares each. In 2003, they had agreed with a venture capital fund that it would invest £250,000 for £150,000 preference shares and £100,000 A ordinary shares.

The fund's shares would carry preferential dividend rights, and would also rank ahead of the 800 ordinary shares held by the founding shareholders in the event of liquidation.

The shareholder-directors had also lent a total of some £115,000 to the company, at least £50,000 each.

The fund did not want its shares to rank behind these loans in the event of liquidation and so the shareholders capitalised £50,000 of the loans by the issue of £50,000 B ordinary shares, with rights that were arguably worthless.

The shareholders were indifferent as to whether their ordinary shares or their B ordinary shares would be next in line after the fund's shares.

The dispute

Following a negligible value claim, what was the base cost of the B shares?

Any cost other than nil would have created a capital loss.

Section 251(3) provides that, where property is acquired by a creditor in satisfaction of his debt, the creditor's base cost in that property is limited to its market value at the time of acquisition.

HMRC argued that, by virtue of TCGA 1992, s 251(3), the taxpayer had no base cost in these shares because the limited rights rendered them worthless.

The taxpayer's case was advanced by reference to valuation principles. It did not find favour with the Special Commissioner, who held that the shares were worth only £2,500 when issued.

During the hearing, the Special Commissioner had noted that the taxpayer's case would have been much stronger if the B ordinary shares had been taken up as a rights issue.

Had this been the case, the acquisition of those shares would have been treated as a reorganisation for tax purposes, involving neither a disposal of the ordinary shares nor an acquisition of the B ordinary shares.

All the taxpayer's shares would have been treated as a single shareholding. Her base cost in that shareholding would have been equal to the consideration she provided for it (both on the original acquisition and under the rights issue), unless the capitalisation constituted a non-arm's length bargain.

In that case the increase in base cost resulting from the rights issue would have been limited to the increase in value of the whole shareholding (TCGA 1992, s 128(2)).

The value of the B ordinary shares viewed in isolation would have been irrelevant.

Change of mind

The case which subsequently led the Special Commissioner to find in favour of the taxpayer was *Dunstan v Young, Austen and Young Ltd* [1989] STC 69. In his view, on the authority of this decision it was clear that the issue of B ordinary shares constituted a reorganisation for tax purposes even though it had not been structured as a rights issue.

In Young, the Court of Appeal held that an increase of share capital can be a reorganisation of that capital even if it does not come within the precise wording of what is now s 126(2)(a), provided the new shares were 'acquired by existing shareholders because they are existing shareholders and in proportion to their existing beneficial holdings'.

The decision

The Special Commissioner held that the issue of B ordinary shares had been 'in respect of and in proportion to' the taxpayer's existing holding and therefore fell within section 126(2)(a). As a question of fact, the issue of B ordinary shares had been in proportion to the ordinary shares.

The decision states that it had also been 'in respect of' the ordinary shares, because the taxpayer's existing shareholding made her indifferent to the rights attaching to the new shares.

The decision states that 'it is unarguable that the *Young* analysis applies in this case'.

The Special Commissioner also held that the value of the ordinary shares and the B ordinary shares, taken together, had been increased by £50,000 (the face value of the debt) as a result of the capitalisation.

As a result, the taxpayer's base cost in her shares was not restricted by TCGA 1992, s 128(2).

From an article by John Manis.

Lecture P517 (12.23 Minutes)

Inheritance Tax and Trusts

R&C Commissioners v Trustees of the Peter Clay Discretionary Trust

The taxpayer trust was constituted by a deed dated 5 December 1995. At the relevant time there were four trustees—two individuals (described as non–executive trustees) who claimed only limited fees (fixed in amount) for the time spent in preparing for and attending trustee meetings; a family trust company which made no charge; and an accountant (described as the "executive trustee") who was remunerated on a time basis for his service as a consultant to the firm of which he was formerly the senior partner.

The trusts had three different investment managers, each with its own custodian. Each investment manager was remunerated by a fee calculated by reference to the capital value of the funds under management.

An issue arose as to whether the trustees' expenses were to be treated as capital or income expenses for the purposes of s 686(2AA) of the ICTA 1988, the latter position holding tax reduction benefits.

The expenses in issue before the Special Commissioners fell into five categories

(i) trustees' fees

(ii) investment management fees

(iii) bank charges

(iv) custodian fees

(v) professional fees for accountancy and administration.

HMRC's view

HMRC had accepted that:

- an apportionment of bank charges, accountancy and other professional fees and custodian fees could properly be made so as to attribute part of the expense to capital and part to income
- the fees relating to the executive trustee could be attributed to income, not on the basis of fairness, but because some of the time spent could be clearly identified as relating to income based on hours spent.

However, HMRC resisted this approach in relation to the non-executive trustees.

Court of Appeal

The trustees appealed to the Court of Appeal on the issue of fees relating to the non-executive trustees and the investment management fees.

Arden LJ concluded that HMRC's approach to the executive trustee correctly reflected the legal position. That being so, there was no reason why the same approach could not be taken to the fixed fee paid to the non-executive trustees, assuming that a realistic estimate could be made of the time spent on capital and income matters respectively.

As to the investment management fees, Arden LJ agreed with the Special Commissioners that once the trustees had resolved to accumulate the income, the monies to be accumulated ought properly to be regarded as capital; so that the expenses incurred in connection with the investment of those monies could not be said to be chargeable to income.

Non–resident trusts—CGT rebasing election form RBE1

HMRC has made available Form RBE1 for a non–resident trust CGT rebasing election under FA 2008, Sch 7 para 126, in respect of trust assets held before 6 April 2008.

FA 2008, Sch 7 para 126 introduced a provision for trustees of non–resident trusts to make a CGT rebasing election in respect of trust assets held before 6 April 2008, to ensure that a non–UK domiciled beneficiary who receives a trust capital payment will not be taxed on the pre–6 April 2008 element of the chargeable gain.

HMRC has now made available the Form RBE1 on which an election must be made (www.hmrc.gov.uk/cnr/rbe1.pdf). The earliest date by which an election would need to be made is 31 January 2010, for relevant capital payments or transfers occurring during 2008/09.

HMRC has also updated its Residence and domicile FAQs on non–resident trusts, to include the question "On what form should a rebasing election be made?"

Revenue and Customs Comrs v Bower and other (executors of Bower (deceased)) [2009]

Section 160 of the ITA 1984 provides— "Except as otherwise provided by this Act, the value at any time of any property shall for the purposes of this Act be the price which the property might reasonably be expected to fetch if sold in the open market at that time; but that price shall not be assumed to be reduced on the ground that the whole property is to be placed on the market at one and the same time".

The settlor, aged 90 and in poor health, bought an estate planning bond from Axa in 2002. She paid £73,000 for the bond, which she transferred to trustees on the terms of a trust. Under its terms, she was entitled to monthly payments of just over £300 in her lifetime. Although the transfer was potentially an exempt transfer for the purposes of inheritance tax, she died very shortly after taking out the bond. The question arose as to the value of the transfer that she made, which was to be calculated by taking the price paid for the bond and subtracting from it the value of the right to a monthly payment. For inheritance tax purposes, the value of property for inheritance tax purposes was governed by s 160 of the 1984 Act. The Revenue and CustomsComrs (the Revenue) took the view that in the real world there would not have been a buyer for the right to the monthly payment given the settlor's age and state of health, and accordingly, a purely nominal figure should be attributed to the value of the rights in order to give effect to the statutory hypothesis that the sale must be assumed. Accordingly, it fixed on a figure of £250. The settlor's executors disputed that figure, and the matter came before the Special Commissioner for determination. The Special Commissioner accepted that in the real world the buyer of an interest like the settlor's right to a monthly income for her lifetime would either wish to lay off the mortality risk by buying back–to–back term insurance or would wish to minimise the mortality risk by pooling a number of such interests where the risks of each would have a self–cancelling effect. The Special Commissioner concluded that no buyer would be able to lay off the mortality risk by taking out term life insurance. So far as pooling was concerned, he decided that the possibility of pooling risks by buying more than one annuity was precluded by the statutory hypothesis which required a sale of the settlor's rights alone. Accordingly, the Special Commissioner found that the combination of the real world and the statutory hypothesis was that those who bought interests of that type in the real world would not have bought that particular interest. The Special Commissioner went on to consider whether the sale in the open market contemplated that a sale should take place in "some sort of conventional market manner", and decided that no such connotation was involved, and that he was entitled to consider other possible purchasers. In his decision, the Special Commissioner came to the conclusion that the right to the monthly payment was worth £4,200. The Revenue appealed.

The court ruled—the property should be assumed to have been capable of sale in "the open market". The property should be assumed to have been capable of sale in the open market, even if in fact it had been inherently unassignable or held subject to restrictions on sale. The question was what a purchaser in the open market would have paid to enjoy whatever rights attached to the property at the relevant date.

In asking whether the sale in the open market contemplated that a sale should take place in "some sort of conventional market manner", it was not at all clear that the Special Commissioner had appreciated that the hypothetical sale took place in the real world. He had not been wrong in saying that he had been entitled to consider other possible purchasers. There had to be an assumed buyer in order to give effect to the statutory hypothesis that the sale took place. However, although the Special Commissioner had been entitled to consider possible purchasers, he had not been entitled to invent them. The assumption of a buyer, in order to give effect to the statutory hypothesis, in addition said nothing about the price which the buyer was assumed to have paid. If in the real world an asset was worthless, the statutory hypothesis did not make it valuable. It was not lip service to the hypothesis in those circumstances to ascribe a nominal value to an asset. On the contrary, it was the necessary consequence of a finding of fact that an asset was not commercially, as opposed to legally, saleable coupled with the assumption that a sale should be assumed to have taken place. It followed that at that point in his decision the Special Commissioner had gone wrong in law. The Special Commissioner then went on to consider the price at which the hypothetical willing speculator would have bought the interest. The Special Commissioner had described his figure as being "little more than uninformed, but hopefully realistic, guesswork", thereby acknowledging that there had been no evidence before him about how a price payable by a speculator might be calculated. Nevertheless, he went on to produce what he described as "my calculation and valuation". The Special Commissioner's method of calculation and valuation was not one that had been put forward by anyone and not put by him to any of the witnesses or parties for comment. That in itself was a breach of the rules of natural justice. More importantly, it had not been based on the evidence before him. It had flowed from his erroneous conclusion that he had been required or entitled to populate the real market, in which the hypothetical sale took place, with hypothetical speculators who had not shared the characteristics of real buyers. The appeal would be allowed.

The Special Commissioner's decision had been erroneous in point of law.

Chancery Division Lewison J 5 November 2008

Tax planning points for unmarried couples

The inter-spouse exemption

We all know that, when married or in a civil partnership (and not separated), people are a couple for tax purposes and can benefit from:

- Inheritance tax inter-spouse exemption at IHTA 1984, s 18
- Capital gains tax spouse exemption offered in TCGA 1992, s 28
- Recent changes on transferable nil-rate bands for married couples and civil partnerships

At present, these are not available to unmarried couples but what is?

New assets

Where new assets are being acquired by a couple, they can be purchased in joint names at the outset, thereby ensuring that asset values are split equally to ensure that each person's inheritance tax nil-rate band can be utilised on death.

Transfers and equalisation

The situation is somewhat different where one partner comes to the relationship with substantial assets and the other with few.

Equalisation of estates would involve the gifting of assets from the 'richer' to the 'poorer' partner resulting in a potentially exempt transfer for inheritance tax purposes and a chargeable disposal for capital gains tax purposes.

The inheritance tax issue could be overcome by insuring the life of the donor for a term of seven years to ensure that funds would be available in the event of a premature death to settle any tax, or – if the gift is within the nil-rate band – to protect the value of that band.

Transfers on death

Assets passing on death are uplifted to market value whoever they pass to for capital gains tax purposes, so any inherent gain would be washed out.

Other transfers

One partner could transfer their home into joint names as tenants in common by holding the property on trust for the second partner.

By transferring a property into joint names, the couple may decide what proportion of the property (not necessarily equally) should be held on trust for the second partner.

Care needs to be taken here to ensure that they do not fall foul of the 'gifts with reservation of benefit' rules and so it is important to ensure that both partenrs pay their proper share of outgoings in respect of the property.

Also watch out for any stamp duty land tax implications in respect of the transfers of properties to consider.

Use of insurance

Where the couple's assets are significantly above the value of their nil-rate bands, life assurance could be considered on a joint life, first death basis to ensure that on the earlier death there will be sufficient funds to pay the inheritance tax due on assets passing to the unmarried survivor.

A policy of this type would need to be written in trust to ensure that the proceeds on death fall outside of the estate of the deceased.

By making this simple arrangement it is possible to ensure that the survivor is be able to take hold of the assets without the need to take a mortgage on their home or even possibly having to vacate the home to pay the inheritance tax due.

Immediate post-death interests

Whilst the use of a life interest trust for a surviving partner will not give IHT protection at the time of the donor's death, it could be considered useful in protecting the assets for the 'blood line' whilst also ensuring that the surviving partner continues to have access to funds/use of property, during their lifetime.

For married couples/civil partners the transfer of assets on death to a life interest trust for the survivor would be exempt from inheritance tax and only become chargeable on the later death of the life tenant when the value would be aggregated with his or her free estate. Hence there is one 'hit' of inheritance tax only.

This would not be the case for unmarried partners, but any inheritance tax payable at the time of the donor's death could be covered by life assurance.

On the death of the survivor, inheritance tax would again become due – a double hit – but the cost may be justifiable to the couple because it gives short term protection to the surviving partner (income/use of assets) and long term protection to the children from the first relationship as the assets will pass to them on the death of the life tenant.

Business property relief

An unmarried couple could take advantage of business property relief if their circumstances allow by organising their affairs to obtain relief twice.

This technique is commonly used for married couples, but I fear is sometimes overlooked for others.

The final resort

Why not marry or form a civil partnership and defeat the Exchequer? By marrying before death and ensuring that wills are redrafted (they will be revoked by marriage), any couple can ensure that their affairs are organised to fully escape inheritance tax on the first death.

Indeed, a second advantage could be gained where one of the couple is terminally ill in that assets could be transferred tax free to that individual.

On death, assets would pass back to the survivor, again tax free, and with the added benefit of rebasing to market value for capital gains tax purposes. Naturally, such a suggestion would have to be made with great tact and understanding.

From an article by Penny Bates

Lecture P516 (10.03 Minutes)

Interaction of chargeable lifetime gifts & PETs

Gift of business assets (Holdover)(s165 TCGA 1992)

Up until 13 March 1989 there was a general relief for gifts of any asset. This was replaced by a requirement that the asset concerned was a "business asset". The relief applies where the transferor (individual or trustee) makes a disposal other than at arms length to a transferee, and the two parties make a joint claim for the gain to be held over. Where the transferee are the trustees of a settlement only the settlor is required to sign the claim.

An asset is eligible for hold over relief if either

- it is, or is an interest in, an asset used for the purposes of a trade, profession or vocation carried on by the transferor, his 'personal company' or a member of a **'trading group'** of which the 'holding company' is his personal company), or
- it consists of shares or securities of a **'trading company'**, or of the holding company of a **trading group**, where either the shares etc. are not listed on a recognised stock exchange or the trading company or holding company is the transferor's personal company.

For these purposes, an individual's '*personal company*' is a company the voting rights in which are 'exercisable', as to not less than 5%, by that individual.

For 2003/04 onwards, ***'trading group'***, ***'holding company'*** and ***'trading company'*** have the same meanings for these purposes as they do for the purposes of taper relief and entrepreneurs' relief (S 165A TCGA). For 2002/03 and earlier years, they had the same meanings as for the purposes of retirement relief.

Hold over relief is no longer available where the disposal is a transfer of shares or securities after 8 November 1999, and the transferee is a company. (For disposals between 6 April 2003 and 20 October 2003 this anti-avoidance measure was inadvertently repealed but reinstated by Finance Act 2004)

Where the disposal is at an undervalue and some consideration is received by the transferor, the amount of consideration received that exceeds the original cost of the asset cannot be held over but is chargeable (less entrepreneurs' relief) on the transferor.

To the extent that the gain is held over and not chargeable on the transferor entrepreneurs' relief is lost and the " clock" is restarted with reference to the period of ownership of the transferee. Thus it would take at least a year to get back to full relief.

Gifts on which there is an immediate IHT charge (s260 TCGA)

This provision provides for the resulting gain on the transfer of **any asset** to be held over in circumstances where there is an immediate charge to inheritance tax. The most common example is where the transfer is to or out of a discretionary trust although Finance Act 2006 has extended this to most lifetime transfers of assets to trust, including A&M settlements and interest in possession trusts, previously treated as PETs. (The only exception now would be transfers to a trust for a disabled person).

Note that the relief is still available where no inheritance liability results, for example where the value transferred falls within the nil rate band as IHT is still technically chargeable but at 0%.

Self settlement anti-avoidance

As a result of changes in Finance Act 2004, announced in the 2003 pre-Budget Report and taking effect from 10 December 2003, no hold over is available where the settlor has an interest in a trust to which an asset is transferred so a gain would crystallise upon the transfer to the trust. This has effectively blocked the use of a self-settlement to eliminate "tainted taper" where for example a shareholding did not qualify for business asset taper during the period 6 April 1998 to 5 April 2000.

A further measure bites where the settlor, or spouse, acquires an interest in the trust at any time in the six years following the year in which the asset was settled. Where the original hold over was on or after 10 December 2003 there will now be a clawback of any hold over relief claimed in the year in which the settlor acquires the interest.

Note that Finance Act 2006 extended the definition of settlor interested trusts to include trusts for the benefit of minor (U18) unmarried children.

Principal Private Residence Exemption

The principal private residence exemption can apply to a gain accruing to a trustee on the disposal of a residence, which is settled property, where during the period of ownership of the trustee the dwelling house or part of the dwelling house has been used as the only or main residence of a person entitled to occupy it under the terms of the settlement.

By extra statutory concession (number D5) relief is also given where the residence is occupied by permission of the trustees and the individual concerned is entitled to the whole of the income from the residence or from the proceeds of its sale.

Finally, where there is a choice of houses that should be treated as exempt, the usual election has to be made jointly by the trustees and the person entitled to occupy the house.

This relief has been severely restricted from 10 December 2003 by legislation that will be included within the Finance Act 2004 (as outlined above).

Some Basics of Inheritance Tax

a) Gifts made between individuals during their lifetime may be considered to be exempt from IHT as they are potentially exempt transfers (PETs).

b) Gifts made within seven years of death will be included within an individual's estate on death and may well be charged at 40% (see rates below) although after surviving three years there is a taper relief available (see below).

c) The use of trusts allows the beneficial ownership to be separated from the legal ownership allowing tax efficient gifts to be made to people such as children.

d) Gifts into many commonly used family trusts were also PETS until March 2006,namely:

   i) Accumulation and Maintenance Trusts

   ii) Life tenant Trusts (interest in possession Trusts) and certain transfers out of these Trusts.

e) Now all lifetime gifts into trust, with few exceptions, are treated like Discretionary Trusts (relevant property (see part B below) are not subject to the PET regime and therefore lead to immediate Inheritance Tax charges in some circumstances.

f) Where a donor reserves a benefit in any assets gifted, they are still treated as having a beneficial interest in the asset on death.

g) IHT is always charged on the diminution of value principle.

Rates etc

Since April 2008, IHT has been chargeable as follows:

Chargeable Transfers Gross	**Rates on Gross**
0 - £312,000	Nil
Excess	40%

Generally the above rates apply on the death of an individual. Where a lifetime gift is chargeable generally this will be at half the rates outlined above (i.e. 20%). This first band is generally called the "nil rate band" up to £312,000.

The 2007 Act provides certainty of the available inheritance tax nil rate band for more than one year ahead. Section 4 increases the nil rate band to £350,000 in 2010/11 and confirms that the rate of IHT will remain at 40%.

The FA 2006 set the bands for 2008/09 and 2009/10 at £312,000 and £325,000 respectively.

Where an individual dies then the above rates apply to any gifts made within seven years (although of course they may fall within the nil rate band, or straddle it). The tax calculated will then be subject to taper relief as follows:

Years Before Death	**% of Tax Charged**
0 – 3	100
3 – 4	80
4 – 5	60
5 – 6	40
6 – 7	20

The interaction between these concepts is complex and is best illustrated by an example.

Mr A is a relatively wealthy individual. He is a widower. His wife died more than 2 years ago utilising her nil band (as was usual then). He has made or makes the following gifts etc:

i) in 1995, he gives £75,000 to his son (but in a discretionary trust

ii) in 1999, he makes another gift of £325,000 to his daughter

iii) in 2004, he dies leaving an estate of £450,000

No IHT or CTT is due during his lifetime on the above gifts (annual exemptions have been utilised on the first day of each year by the appropriate small gifts).

On death, tax will be due on both the failed PET (payable by his daughter) and the estate held at death as follows:

a) Failed PET:

Gift	325,000
Gifts in previous 7 years	75,000
	400,000
Nil bank	255,000
Chargeable on Death	145,000

Tax @ 40%	58,000
Less taper relief @ 40%	23,200
Payable	£34,800

b) On his estate:

Estate at Death		450,000
Gifts in last 7 years		325,000
		775,000
Less nil band		255,000
		520,000
Tax @ 40%		208,000
Less tax on PET (as recalculated)		
Gift	325,000	
Nil Band	255,000	
@ 40%	70,000	28,000
Tax due on Estate (subject to planning)		£180,000

This example illustrates the 14 year window for Capital Tax planning.

The gift in 1986, some 8/9 years prior to the death clearly effects the total tax "take" at death. This indicates a general principle of staging Capital Tax planning in 8 yearly tranches.

Article by Bob Truncheon

Lecture P518 (15.56 Minutes)

Administration

Wilson v Revenue and Customs Commissioners SpC 724

The taxpayer submitted his self–assessment tax return for the year 2004/05 claiming a capital gains tax loss of £2m following the redemption of capital redemption bonds that year.

HMRC extracted the figures from the return and entered them manually on the computer, but subsequently lost the original return.

The taxpayer failed to produce a copy of the tax return when requested and so HMRC issued a notice under TMA 1970 s 20 requiring him to deliver a copy of the return.

The taxpayer's accountant replied contending that the tax return was not relevant to the liability or the amount of liability which existed independently of the return.

As the taxpayer still failed to produce a copy of the return, HMRC issued a summons for a penalty under TMA 1970 s 98(1)(b) for failure to comply with the notice, and requested the maximum penalty of £300. The taxpayer did not appear at the hearing.

The Special Commissioner determined the penalty in the sum of £300, as the return contained information relevant to the taxpayer's tax liability and the default had continued for a year without any proper explanation apart from the accountant's letter.

The maximum penalty was very small compared with the loss which was potentially in issue, and the fact that the Revenue received the original return which they could not locate did not prevent them from requiring a copy of the return.

Order accordingly.

Working together

Online filing

Updated online advice for agents and a table showing the most common reasons for rejection of SA returns filed online with some workarounds is also available. (N.B. HMRC say that these are sanctioned workarounds and no compliance action will be taken for an ‘incorrect return’ created by applying the workaround.

However, if an agent feels unable to apply the workaround, HMRC will accept a paper return with a reasonable excuse claim.)

Business payment support service

Guidance for agents about using this new service, which is designed to help businesses that are having difficulty paying their tax, is available online.

Unique taxpayer references

If a unique taxpayer reference (UTR) is needed urgently to meet the 31 January self assessment filing deadline, there is a new fast-track process, which aims to provide these within five days.

(N.B. this service is only available to people who were self-employed during 2007-08 and who have not yet registered and received a UTR. UTRs for partners can be obtained via this fast-track process until the end of January 2009.)

Agents should also remember that Statement of Practice 1/05 enables income, expenses, and/or payments up to set limits to be notified to a contact centre by phone without the need to file a self assessment tax return.

Agent-dedicated lines

All HMRC contact centres now have these lines (ADLs) for agents who wish to discuss a client's personal self assessment tax affairs, partnership matters, PAYE, and tax credit claims.

Agent authorisation (64-8)

In urgent cases, agents can apply for authorisation by fax or by telephone; most commonly to enable a client's affairs to be discussed to meet the 31 January filing deadline.

Where an agent has already completed and returned a form 64-8 which has yet to be processed and it can be shown that there is an urgent need to discuss the client's tax affairs with HMRC, the agent can use the fax service for exceptional circumstances.

To use this service, the tax adviser should call the agent-dedicated line relevant to the client.

The agent will then need to be prepared to fax a replacement form 64-8, together with HMRC correspondence to the client. This additional verification is necessary to protect the client's security and privacy.

If the criteria for this service are met, HMRC say that they will aim to have the faxed authorisation in place within 24 hours of receipt.

However, agents must send another signed 64-8 – clearly marked as a replacement – to the central agent authorisation team to ensure that a full written authority will be processed and complete for future use.

If an agent has an urgent query and the client is present, he can authorise the agent over the telephone for the purposes of a single telephone conversation with HMRC.

Again, the agent should call the ADL that covers the client. HMRC state that they should then be able to discuss the client's affairs with the agent – for this occasion only – provided that:

- the identity of the customer can be satisfactorily verified using their normal security checks;
- the customer can confirm that he is providing consent for HMRC to disclose information to a named third party.

This facility is only available where HMRC have the ability to record calls for security purposes, so it is very important to use the client's agent dedicated line.

Again, the full authorisation process (either online or on paper form 64-8) should then be completed to ensure future transactions can be handled more easily.

Clients' account information sheets

Working Together 33 explains that HMRC will not be issuing clients' account information sheets (SA327) this year because of data security changes and requirements. HMRC appreciate that this decision was not helpful at this time of year when some agents find them to be a useful summary of clients' affairs.

HMRC advise that statements (SA300) will still be issued to all SA taxpayers where the return has been processed by early December.

Where the return was filed on paper by 31 October, but processed after early December, the normal tax calculation statement (SA302) will be produced ahead of the 31 January payment date.

Customers will receive a payslip either with SA300 or attached to SA309-type payment reminder.

Payslips

HMRC understand that agents may have difficulty obtaining the original payslip to send with a client's tax payment.

A 'pro-forma' payslip is now available to download via the HMRC website to help agents in these circumstances.

While it is not pre-populated with specific client details it will ensure that all information necessary to process the payment quickly is captured.

Extension of HMRC business clearances

At Pre-Budget Report 2007, as part of the review of links with Large Business, HMRC announced that from April 2008 HM Revenue & Customs (HMRC) would provide business with their view of the tax consequences of significant commercial issues wherever there is uncertainty, regardless of when the legislation was enacted. They also committed to responding to clearance applications within 28 days as the norm.

On 1 May 2008, HMRC commenced a six month trial extension of the service to business owners in relation to inheritance tax business property relief where there was a significant commercial issue or transaction of the business itself.

On 26 January 2009 HMRC announced that the inheritance tax business property relief clearance service for business owners will continue and will include an extension to the scope of the service

Please see the guidance on the clearances process and how to apply. (http://www.hmrc.gov.uk/cap/clearanceiht.htm)

As with other clearances HMRC will:

- remove the four Finance Act restrictions that inheritance tax clearance applications are subject to under Code of Practice 10 (COP10) where the application relates to the availability of business property relief
- expect applicants to demonstrate the commercial significance of the transaction that causes genuine uncertainty
- expect them to identify what aspect of the law or HMRC practice they consider to be uncertain
- respond within 28 calendar days, as the norm

Extension

From 26 January 2009 HMRC will also provide their view of the tax consequences of a transfer of value that involves a change of ownership of a business where this transfer, leaving aside the application of business property relief, would result in an immediate inheritance tax charge and provided that the other conditions are met. Clearances in these change of ownership cases will remain valid for a limited period of six months.

An applicant who has previously had an application rejected because it fell outside the scope of the trial service, but the circumstances are such that it would be included in the scope of the extended service, may request a review of the original application.

Other guidance on information and advice

COP10 and VAT Notice 700/6 will remain in place for our customers who are not covered by the new clearances process to provide guidance on how to seek information and advice from HMRC. We will be reviewing these documents over the next year to provide more consistent guidance on the information and advice available to our customers.

HM Revenue and Customs Notice, 26/01/2009

Dedicated tax unit for highest earners

Thousands of wealthy taxpayers are to be given their own dedicated section within HMRC.

The Revenue says that the soon-to-launched High Net-Worth Unit is part of an effort to ‘ensure an integrated and consistent approach’ to the tax affairs of the rich.

The unit will aim to develop ‘a better understanding’ of people within the targeted taxpayers, and it will to strive form better relationships with top-earners’ agents.

The unit is expected to serve in the region of 5,000 of HMRC’s ‘most wealthy and complex customers’: about 0.2% of all British taxpayers.

It will maintain ‘close links’ with other specialist units across the Revenue to secure their input when appropriate, while making use staff currently working in the department’s Complex Personal Returns teams.

The technical director of the Low Incomes Tax Reform Group, Robin Williamson, said that it would be ‘very nice’ if the Revenue were to open a unit dedicated to the affairs of low-income taxpayers, who are ‘potentially the most compliant’.

Mr Williamson went on to point out that low-earners are usually unrepresented in their tax affairs and therefore rely on the taxman for all advice and information.

Partnership filing dates—individual and corporate partners

HMRC has published guidance on partnership tax return filing dates for 2007–08, including changed dates for mixed and CT partnerships from 2008–09.

All partnerships are required to complete and file a partnership tax return to aid the assessment of the members of the partnership, including any corporate members. The filing dates for a completed partnership return accommodate both individual and corporate partners.

<u>Partnerships consisting entirely of individuals</u>

Where a partnership return is required in connection with a partnership that consists entirely of individuals, the filing date will be the same as the filing date for the individuals' personal returns—

- If the notice to file a partnership return for 2007–08 was issued at the normal time (no later than 31 July 2008), the filing date for a non–electronic (paper) return will be 31 October 2008 and the filing date for an electronic return will be 31 January 2009.

- If the notice to file was issued after 31 July but on or before 31 October 2008, the filing date for a paper return will be three months from the date of the notice and 31 January 2009 for an electronic return.

- If the notice to file was issued after 31 October 2008, the filing date for paper and electronic returns will be three months from the date of the notice.

<u>Partnerships with individual and company members (“mixed partnerships”)</u>

Where a partnership includes one or more individuals and one or more companies, the filing date for the partnership return will not be earlier than the filing date for individuals' personal returns and may be later depending on the relevant period for the company members.

The relevant period is the period in respect of which the partnership return is required. The relevant period will generally be the period or periods to which the partnership makes up accounts and will end on the accounting date(s) of the partnership ending in the tax year.

HMRC accepts that the relevant period will be the same as the tax year—

– where the partnership makes up accounts to 5 April

– where there are no partnership accounts ending in the tax year

– for investment partnerships that do not carry on a trade or profession.

Where the relevant period for a mixed partnership began before 6 April 2007, the filing date whether for a non–electronic (paper) return or an electronic return cannot be earlier than the first anniversary of the end of the relevant period.

Where the relevant period for a mixed partnership began on or after 6 April 2007, the filing date for a non–electronic (paper) return must not be earlier than the end of the period of nine months beginning at the end of the relevant period. The filing date for an electronic return must not be earlier than the first anniversary of the end of the relevant period.

In all cases, the filing date must be after the end of the period of three months beginning with the date of the notice to file.

Partnerships consisting entirely of companies ("CT partnerships")

The filing date will depend on the relevant period which is the period in respect of which the partnership return is required. The relevant period will generally be the period or periods to which the partnership makes up accounts and will end on the accounting date(s) of the partnership ending in the tax year.

HMRC accepts that the relevant period for company partners will be the same as the tax year—

– where the partnership makes up accounts to 5 April

– where there are no partnership accounts ending in the tax year

– for investment partnerships that do not carry on a trade or profession.

Where the relevant period for a CT partnership began before 6 April 2007, the filing date cannot be earlier than the first anniversary of the end of the relevant period.

Where the relevant period for a CT partnership began on or after 6 April 2007, the filing date for a non–electronic (paper) return must not be earlier than the end of the period of nine months beginning at the end of the relevant period. The filing date for an electronic return must not be earlier than the first anniversary of the end of the relevant period.

In practice, HMRC uses the inherent flexibility of the legislation to set the filing date on the same basis as partnerships with individual and company members. This means that a CT partnership will always have at least the same time as individuals to file the partnership return.

In all cases, the filing date must be after the end of the period of three months beginning with the date of the notice to file.

Mixed and CT partnerships—filing dates for the partnership return for 2007–08

HMRC has published guidance about the filing dates that apply to the 2007–08 partnership return where at least one partner is a company in the self–assessment area of its website (www.hmrc.gov.uk/sa/parts–partners.htm). This guidance explains that the nominated partner must deliver the completed partnership tax return within 9 months of the end of the tax year for a non–electronic (paper) return and within 12 months of the end of the tax year for an electronic return. This gives filing dates of 5 January 2009 (paper) and 5 April 2009 (electronic).

However, where the relevant period began before 6 April 2007, the filing date must not be earlier than the first anniversary of the relevant period. Therefore, a paper partnership return for a relevant period beginning before 6 April 2007 will be on time provided that it is delivered on or before the later of 5 January 2009 or 12 months from the end of the relevant period.

Mixed and CT partnerships—filing dates for partnership returns for 2008–09 onwards

For partnership returns for 2008–09 onwards, the filing date will be—

– relevant periods ending on or between 6 April and 31 January, the filing date for individuals' personal returns and

– relevant periods ending on or between 1 February and 5 April, 9 months from the end of the relevant period for non–electronic (paper) returns and the first anniversary of the end of the relevant period for electronic returns.

2007–08 Examples of filing dates for partnership returns—mixed and CT partnerships

Non–electronic (paper) returns

Relevant period	*Extended filing date*	*12 months*	*Filing date*
Year to 30 June 2007	5 January 2009	30 June 2008	5 January 2009
Year to 31 December 2007	5 January 2009	31 December 2008	5 January 2009
Year to 31 March 2008	5 January 2009	31 March 2009	31 March 2009

Electronic returns

Relevant period	*Extended filing date*	*12 months*	*Filing date*
Year to 30 June 2007	5 April 2009	30 June 2008	5 April 2009
Year to 31 December 2007	5 April 2009	31 December 2008	5 April 2009
Year to 31 March 2008	5 April 2009	31 March 2009	5 April 2009

2008–09 onwards–Examples of filing dates for partnership returns—mixed and CT partnerships

Non–electronic (paper) returns

Relevant period	*Individual*	*9 months*	*Filing date*
Year to 30 June 2008	31 October 2009	30 April 2009	31 October 2009
Year to 31 December 2008	31 October 2009	30 September 2009	31 October 2009
Year to 31 March 2009	31 October 2009	31 December 2009	31 December 2009

Electronic returns

Relevant period	*Individual*	*12 months*	*Filing date*
Year to 30 June 2008	31 January 2010	30 June 2009	31 January 2010
Year to 31 December 2008	31 January 2010	31 December 2009	31 January 2010
Year to 31 March 2009	31 January 2010	31 March 2010	31 March 2010

HMRC press release 14 January 2009

Lecture P519 (11.47 Minutes)

VAT repayments for golf clubs on green fees

Sporting services provided by eligible/non-profit making bodies

Under Schedule 9, Group 10 VAT exemption applies to the supply of services closely linked with and essential to sport or physical recreation supplied to individuals taking part in the activity where the supplies are made by

- an 'eligible body' having a membership scheme to those of its members who are granted membership for a period of three months or more; and
- an 'eligible body' which does not run a membership scheme (eg a charity).

An eligible body means a non-profit making body which

- cannot distribute any profit it makes otherwise than to another non-profit making body or its own members on winding up or dissolution;
- (except on winding up or dissolution) applies any profits it makes from supplies exempted by these provisions *either* to maintain or improve the facilities made available in connection with those supplies *or* for the purposes of a non-profit making body; and
- is not subject to 'commercial influence'.

To decide whether a body is non-profit making, it is necessary to look at its constitution, its activities and its use of funds to determine whether it was established with a purpose, intention or motive which excluded profit making. A non-distribution clause in the constitution of an organisation does not, in itself, answer this question.

If the organisation is a company limited by shares, HMRC have accepted that

(*a*) the non-distribution condition will be satisfied by the passing of a resolution to

- delete, if appropriate *Table A, Arts 102–108* (dividend arrangements) and *Art 110* (capitalisation of profits); and
- adopt a new Article preventing distributions by way of dividend, bonus and any other means; and

(*b*) adoption of *Art 117* on winding up fulfills the winding-up criterion.

(VAT Notice 701/45/02, paras 4.2, 4.3).

Following the decisions in *Messenger Leisure Developments Ltd v R & C Commrs, CA [2005] STC 1078 (TVC 24.31)* HMRC take the view that any company which is precluded from distributing profit, but whose function is nevertheless to create VAT exemption in the context of a wider commercial undertaking, is not a non-profit making body for VAT purposes. It follows that such a company is not entitled to claim the VAT exemption which is directed at such bodies. (Business Brief 22/05).

A body is considered to be subject to commercial influence in relation to any supply which would otherwise be exempt under these provisions (the '*sports supply*') if (and only if), there is a time in 'the relevant period' when

- a person 'associated with the body' made a 'relevant supply' to it; or

- a person 'associated with the body' received an emolument from it determined at least in part by reference to the body's profits or gross income; or

- an arrangement existed for a relevant supply to be made or emolument to be received after the

Individuals qualifying as members of a membership body

Where a body has a membership scheme, exemption applies to services supplied to a *playing* 'individual' granted membership for a period of three months or more (including life membership). Where an individual becomes a member less than three months before the end of the club's subscription period and pays less than three months' subscription, the subscription can still be exempt provided the grant of membership is for not less than three months.

Canterbury Hockey Club

The ECJ have recently given their decision in the case of Canterbury Hockey Club. Whilst the case concerns affiliation fees the decision has created doubt in respect of certain elements of the UK law within Schedule 9, Group 10. This may have very positive implications for golf clubs.

As mentioned above, payments made by individuals to eligible bodies in respect of sporting services are exempt from VAT. However, Customs did not believe that exemption extends to payments of affiliation fees by clubs to national associations. The club's affiliation fee was not associated closely enough with sporting supplies to an individual. The club was not a "person taking part in sport", and it could not (as the Tribunal held, on appeal) be treated as "transparent" (the true supply being made for the benefit of the individual club members).

The High Court did not believe that the clubs should be regarded as transparent, but referred questions to the ECJ to find out if "persons taking part in sport" could be taken to include corporations and unincorporated associations.

The ECJ has now ruled that:

> "*Article 13A(1)(m) 6th Directive … is to be interpreted as meaning that, in the context of persons taking part in sport, it includes services supplied to corporate persons and to unincorporated associations, provided that – which it is for the national court to establish – those services are closely linked and essential to sport, that they are supplied by non-profit-making organisations and that their true beneficiaries are persons taking part in sport.*
>
> *The expression 'certain services closely linked to sport', in Article 13A(1)(m) 6th Directive does not allow the Member States to limit the exemption under that provision by reference to the recipients of the services in question.*"

It is not clear whether HMRC will concede the case on that basis, or whether the High Court will have to determine the issue which the ECJ says is its prerogative.

How does Canterbury Hockey Club affect golf clubs?

The UK exemption has meant that members owned golf clubs are partially exempt. The members subscriptions are exempt and the fees guests pay to play the course (green fees) are standard rated.

However the ECJ comment…

> *The expression 'certain services closely linked to sport', in Article 13A(1)(m) 6th Directive does not allow the Member States to limit the exemption under that provision by reference to the recipients of the services in question.*"

…could imply that green fees paid by non members may be exempt. The UK law currently excludes this income from the exemption and golf clubs have been accounting for the standard rate of VAT on this income. The golf club would have to be an eligible body but the majority of golf clubs in the UK would meet this definition.

Golf clubs have therefore started to consider submitting a claim for the repayment of the standard rated VAT that they paid over in "error" on their green fee income.

It is unlikely that HMRC will look to apply any unjust enrichment argument as these clubs are eligible bodies and any repayment would be reinvested in the clubs facilities which can then be enjoyed by all.

In reclassifying their taxable green fees as exempt there will be a reduction in the input tax that the golf club is allowed to recover. Advisors will need to re work the partial exemption calculations to ensure that a claim is beneficial to the club.

How far can they go back?

Claims are subject to the three year cap in the normal way. Any claim for overpaid output tax in respect of a particular quarter must be submitted within three years of the due date for that quarters return. For example the return to 31 March 2006 has a claim cap of 30 April 2009.

It should also be noted that clubs can go back further following the cases of Fleming and Condé Nast.

Finance Act 2008 provided for a transitional period, ending on 31 March 2009, during which businesses may submit claims for:

- output tax overpaid before 4 December 1996, and
- input tax incurred prior to 1 May 1997 and not claimed.

This measure follows the House of Lords judgements in Fleming and Condé Nast to the effect that the three-year cap on input tax claims (introduced with effect from 1 May 1997) was ineffective since no transitional period had been provided. The Commissioners consider that the judgement applies equally to the three-year cap on claims for overpaid output tax, introduced with effect from 4 December 1996.

Technically this means clubs could go back to 1973 although there is doubt as to whether this would be the case for golf clubs. Some of the larger firms are advising their clients to cap the "transitional" claim to 1990 whilst others are going back to 1973. The difference in opinion seems to arise in respect of the effective implementation date of the sporting exemption. If we adopted the more prudent view, a claim from 1990 to 1996 and then 2006 to 2009 will produce significant repayments for many clubs in any event.

Conclusion

Repayments are by no means guaranteed as the Canterbury Hockey Club case was about affiliation fees rather than green fees. The ECJs comments did however seem clear and it would be reasonable to expect a golf club case to be taken before the Tribunal in the near future. Golf clubs wishing to submit claims prior to 1996 will need to ensure these are submitted before 31 March 2009.

Where detailed records are not available HMRC are accepting reasonableness calculations for these so called Fleming claims.

Lecture P520 (16.09 Minutes)

Business Tax

Review of losses for unincorporated businesses

Introduction

When a sole trader makes a loss, the trading income assessment will be nil.

So assuming a loss has arisen in the year ended 31 December 2008, under the CYB rules this loss will be treated as a loss of the tax year 2008/09. The trading income assessment for 2008/09 will be nil.

The trader may choose how the loss should be relieved by making an appropriate loss claim.

"Current year" loss relief under Section 64

Under s.64 ITA 2007, losses may be set against total income (less any deductible payments, but before personal allowances.

The loss can be set against the net ***income of the year of loss and/or the preceding year.*** *Loss relief is only available if the business is being run on a commercial basis with a view to realising a profit.*

The two claims are independent and consequently we could make either or both claims in any order we like.

No partial claims are permitted. A taxpayer must either utilise all of the available loss or relieve all of the available income. Where a claim has been made and it is large enough, it could reduce net income to nil which will mean wasting some personal allowances.

Loss Planning

With these loss options, it is important to effectively plan the use of a loss. When deciding how best to relieve a loss, the following factors must be considered:

1) Marginal rates of tax at which the loss will be relieved.
2) Loss of personal allowances.
3) Timing of relief - earlier rather than later

Extension to capital gains

Where a person claiming relief for a trade loss against net income (s.64) is unable to make full use of that loss, he may make use of the balance as an allowable loss for the purposes of capital gains tax under s.71 ITA 2007.

Losses under s.71 are used after current year capital losses but before any capital losses brought forward from previous years. This relief is under s.261B TCGA 1992.

If a loss arises in the tax year 2008/09, first we can set this loss against the net income of 2008/09 and/or 2007/08. A s.71 claim allows us to extend this to capital gains. We can therefore extend the 2008/09 s.64 claim to cover capital gains in that year and/or do the same for 2007/08.

We have to make the s.64 claim before we can extend to gains. This will inevitably mean the wastage of personal allowance in this year as net income will have been reduced to zero before we can progress to the s.71 claim.

The s.71 ITA 2007 relief will be the lower of:

a) remaining loss after the s.64 claim; and
b) net gains in the tax year, less capital losses brought forward.

Once the relevant maximum has been calculated, trading losses of this amount must be set against gains in the year. It is therefore possible that a s.71 claim could lead to a wastage of both personal allowances and all or part of the CGT annual exemption.

Carry forward of losses under Section 83

The carry forward of losses is given under s.83 ITA 2007. Losses may be carried forward and set against future profits of the same trade.

A claim to carry forward trade losses will be made when a loss is not relieved against other net income or against capital gains.

For example, a carry forward claim may be made after a s.64 claim has been made, or if no claim has been made under S.64 at all.

S.83 loss relief is often a "last resort" as it delays relief for losses. Once a s.83 loss has been made the carried forward loss must be set off against the next available trading income.

Loss relief claims

Loss relief claims under s.64 must be submitted to HMRC by 31 January 22 months following the end of the tax year of the loss. If a loss arose in tax year 2008/09, the claim must be submitted by 31 January 2011.

There is no time limit specified in the legislation for s.71 ITA 2007 claims, but as the effect of the s.71 claim is to extend the s.64 claim, the 22 month time limit should be adhered to.

Additional rules

No loss relief is available unless the trade is being carried on commercially with a view to the realisation of profits.

If the trade is one of farming or market gardening, general loss relief is denied under s.64 if losses (before capital allowances) have been made in each of the previous 5 tax years. In this case, subsequent losses can only be carried forward against trade profits under s.83.

Affected losses

Finance Act 2008 introduced new rules restricting loss relief where an individual carries on a trade on a part-time basis.

With effect from 12 March 2008, if in a tax year an individual carries on a trade in a "non-active" capacity and he makes a loss from that trade in that year the loss is an "affected loss", the use of which is restricted.

"Affected losses" can only be set against net income or capital gains up to the "£25,000 cap" for the year. Any excess losses can only be carried forward against future trading profits under s.83.

An individual carries on a trade in a "non-active" capacity if he **does not devote a significant amount of time** to the trade during the year. "Significant" is defined as an average of at least 10 hours a week.

These rules do not affect the carry forward of trade losses.

Opening year losses

In the opening years of a trade, a special loss relief is available known as early trade losses relief.

This applies to all losses sustained in the first 4 tax years of trading.

If a trade commences on 1 January 2007 (i.e. in the tax year 2006/07) the special loss relief will be available in respect of losses sustained in 2006/07, 2007/08, 2008/09 and 2009/10. These rules are contained in sections 72-74 ITA 2007.

Overlap losses

Where a trader chooses a year end other than 5 April (or 31 March), overlap profit arises under the CYB opening year rules.

However, HMRC does not permit double-counting of losses. Consequently there is no such thing as an "overlap loss".

Where the basis periods overlap, a loss must be recognised only in the earlier of the two periods.

Any double counting of a loss is stripped out.

A **claim** under s.72 ITA 2007 must be made **by 31 January, 22 months following the end** of the tax year of the loss. For example, for a loss in tax year 2009/10 a claim should be made by 31 January 2012. This is the same time limit as applies in respect of s.64 losses. Unfortunately there is **no s.71/s.261B TCGA 1992 equivalent claim in respect of s.72** and consequently no extension can be made in respect of capital gains for those years.

Closing Year Losses

When a trader ceases trading, terminal loss relief is available under s.89 which allows a loss to be deducted from trading profits in the tax year of cessation and to be carried back to the 3 preceding tax years, taking later years first.

The losses are set against profits of the trade. It is not a net income claim - relief is only against trading income.

Computing a terminal loss

When computing the terminal loss, the terminal loss period is usually the last 12 months of trading.

This is not necessarily the same as the loss in the final accounting period, because cessation accounts are rarely exactly 12 months long.

The terminal loss is calculated on a tax year basis.

So where a trader has been drawing accounts to 31 December and he ceases trading on 30 June 2009 the terminal loss is calculated as:

Final tax year (6 April 2009 – 30 June 2009)	X
Preceding tax year (1 July 2008 – 5 April 2009)	X
Loss of final twelve months	X

If there is no loss in the preceding tax year – for example if the results for the period July 2008 to April 2009 give a profit – this profit can be ignored.

The terminal loss will also include the relief for overlap profits brought forward. Overlap profits are deducted from any profits in the final tax year of trade. By the same principle, any overlap profits will increase a terminal loss. Therefore having calculated overlap profits, they are added to any losses arising in the final tax year.

Losses remaining at incorporation

The transfer of the trade into the company will mean that the sole trader has ceased to trade and as a result losses cannot be carried forward under s.83 - losses can only be carried forward and set against future profits of the same trade.

Where the trade in which the loss was incurred is transferred to a company, the loss can be carried forward by the individual and deducted from their income derived from that company.

Therefore under s.86 the former sole trader may set these losses against the salary and dividends he receives from the company.

S.86 may be claimed provided that the:

- business was transferred to a company and the consideration paid was "solely or mainly" in shares. "Mainly" in this context is taken to be at least 80%; and
- Shares owned throughout the whole of the tax year in which the loss relief is claimed.

Lecture B516 (12.58 Minutes)

Extension of trading loss carry-backs

The Government plan to introduce legislation in the next Finance Bill to provide a temporary extension to the trading loss relief rules for companies and unincorporated businesses.

The position is as follows:

1. For companies, the existing rules allow trading losses of an ongoing business to be carried back for one year under S393A ICTA 1988. The new relief will apply to losses of accounting periods ended between 24 November 2008 and 23 November 2009 (inclusive) and will permit a carry-back against total profits of the three years preceding the year of the loss, with losses being set against the profits of more recent years before being carried back to earlier years.
2. Where an unincorporated business makes a trading loss, a claim can be made under S64 ITA 2007 to set that loss against the taxpayer's total income for the tax year in which the loss-making period ended and for the previous year. In the case of losses arising in a period ended in 2008/09, it is proposed to provide an additional relief which will allow unrelieved losses to be carried back and set against profits of the same trade for 2006/07 and 2005/06 in that order.

It should be noted that the available profits for the extended loss carry-back are total profits in the case of companies, whereas, for unincorporated businesses, the relief is only given against profits of the same trade.

The amount of any loss which can be carried back to the immediately preceding year remains unlimited, but the further carry-back to the two earlier years is restricted to an overall maximum of £50,000. If the loss-making period is for less than 12 months, the £50,000 cap is reduced pro rata.

This extension will also apply to the losses of a furnished holiday letting business.

Clearly, by a judicious choice of accounting dates, it would be possible for, say, a company to have two loss-making accounting periods ended within the relevant 12-month qualifying period. In that case, not only is the £50,000 cap reduced pro rata for the shorter period but the total extended loss relief across both periods is limited to £50,000, even if the available losses are greater.

Where a loss-making company is part of a group, there are no special amendments to the group relief legislation.

One interesting planning point for unincorporated businesses is that a sole trader does not need to have claimed loss relief under S64 ITA 2007 before taking advantage of the extended carry-back. This will allow an individual who only has a modest amount of income from other sources to avoid wasting his personal reliefs for the year of the loss – something which has hitherto always been a problem because of the all-or-nothing nature of the existing S64 ITA 2007 rules.

The time limit for making an extended carry-back claim is:

(i) in the case of a company, two years from the end of the accounting period in which the loss arose; and

(ii) in the case of an unincorporated business, 31 January 2011.

LexisNexis® Tolley

Illustration

Edward is an established trader with a 31 December year end. His recent adjusted results have been:

		£
2005	Profit	78,000
2006	Profit	35,000
2007	Profit	20,000
2008	Loss	(100,000)

Edward has fees from a non-executive directorship totalling £6,000 per annum.

On the assumption that Edward does not make a claim under S64 ITA 2007 for 2008/09 (his director's fees will be covered by his personal allowance for that year), his loss of £100,000 will be relieved as follows:

2007/08

	£
Trading profit	20,000
Director's fees	6,000
	26,000
Less: Loss relief	26,000
	£Nil

2006/07

	£
Trading profit	35,000
Less: Loss relief	35,000
	–
Director's fees	6,000
	£6,000

2005/06

	£
Trading profit	78,000
Less: Loss relief (restricted)	15,000
	63,000
Director's fees	6,000
	£69,000

The balance of Edward's loss (£100,000 – £26,000 – £35,000 – £15,000 = £24,000) is carried forward for offset against future profits from the same trade under S83 ITA 2007.

Article by Robert Jamieson

Lecture B517 (17.42 Minutes)

Capital allowances FA 2008 changes

This Brief seeks comments on draft revisions to HMRC's Capital Allowances Manual to reflect changes made by FA 2008. Comments on the draft should be made by 10 February 2009. The Brief also gives clarification on—the capital allowances treatment of slurry storage facilities; and the application of section 35 CAA 2001 to university halls of residence and similar facilities.

The new guidance on all these matters will be incorporated into the published Capital Allowances Manual in 2009.

Draft guidance on the Finance Act 2008 changes

Finance Act 2008 made a number of changes to the Capital Allowances Act 2001. The main changes were—

– The introduction of a new Annual Investment Allowance (AIA), which is effectively a 100%allowance for business expenditure on plant and machinery (apart from cars) of up to £50,000 a year. The AIA applies to businesses regardless of size, and replaced the previous 40%or 50%first–year allowances for small and medium–sized businesses.

– The introduction of a new writing–down allowance (a "small pools allowance"), allowing historic and future pools of plant and machinery expenditure of £1,000 or less to be written–off immediately.

– Changes to the rates of capital allowances on plant and machinery from 25%to 20%for the main pool, and from 6%to 10%for long–life assets in the new special rate pool.

– The introduction of a new classification of "integral features" of a building to apply to new and replacement expenditure, and which will attract 10%allowances in the new special rate pool.

– The phased withdrawal of industrial and agricultural buildings allowances by 2011.

– New payable tax credits for businesses that make losses attributable to investment in environmentally beneficial plant and machinery.

HMRC undertook to release the draft guidance on the changes for comment before the Capital Allowances Manual (CAM) was updated to reflect the changes.

The draft guidance is now available for comment and consists of—

– new material

– existing material revised to reflect the changes

We also intend to make a number of minor consequential changes to the CAM, but it is not intended to seek comment on these changes. In the main, the minor consequential changes are simply changes to the percentage rate of writing–down allowances and so on, where these are used in examples or appear in text elsewhere in the CAM.

The draft guidance for the new and rewritten material can be found at www.hmrc.gov.uk/briefs/company–tax/cam–draft–guidance.pdf.

Any comments on the draft guidance should be made on or before 10 February 2009.

The capital allowances treatment of slurry storage facilities

The Nitrate Pollutions Prevention Regulations come into force on 1 January 2009. In October 2008, the Department for Environment, Food and Rural Affairs (DEFRA) launched a national package of advice and support for farmers preparing for the new regulations. Following this launch, HMRC have been asked to clarify their approach to capital allowances claims on slurry storage facilities.

The Nitrate Pollutions Prevention Regulations update the UK's implementation of the 1991 EU Nitrates Directive, which guides the use of fertilizers in Nitrate Vulnerable Zones. The Directive requires there to be guidelines on the timing and quantity of the land application of fertilizers. In part, this necessitates the storing of slurry prior to its application. This Directive has raised the profile and importance of this issue, but farmers may, of course, need to store slurry for reasons unconnected with the Directive.

What is slurry storage?

The storage of slurry in England and Wales is dictated by The Control of Pollution (Silage, Slurry and Agricultural Fuel Oil) Regulations 1991. There is separate, but broadly similar, legislation in Scotland and Northern Ireland. Using the England and Wales legislation by way of general illustration, this defines a slurry storage system as including—

– a slurry storage tank, whether above or below ground

– any reception pit and any effluent tank used in connection with the slurry storage tank

– any channels and pipes used in connection with the slurry storage tank, and reception pit or any effluent tank

“Slurry storage tank” includes a lagoon, pit (other than a reception pit) or tower used for the storage of slurry.

The capital allowances position

Our view is that slurry storage systems located anywhere in the UK, which are used for the temporary storage of slurry, qualify as plant or machinery for the purposes of the capital allowances legislation.

However, any building or structure which is part of a slurry storage facility does not qualify because it is specifically excluded by S21 CAA 2001 and does not constitute plant or machinery.

See, for example, the case of *Attwood v Anduff Car Wash Ltd* 69 TC 575, in which it was held that the structure housing a car wash was not part of a single item of plant and machinery. Justice Carnwath explained that—”It remains necessary to apply the premises test in order to identify and exclude those parts of the complex which function simply as premises, and which are therefore not plant.”

For example, a slurry storage facility at a farm may include the following components—

– an above ground circular store

– a reception pit

– an open sided shed which provides shelter to the tank, preventing rainwater from falling into the store–the circular store is situated inside the shed

In this example the circular store and the reception pit are plant or machinery and qualify for capital allowances. Any channels or pipes associated with them also qualify. However, the shed is a structure and is therefore specifically excluded from being plant or machinery.

Officers of HMRC should, in general, accept claims for plant and machinery allowances in respect of slurry storage systems. Enquiries should be limited to significant claims for systems which appear to differ from the components described above, or facilities which include buildings or structures.

Annual Investment Allowance (AIA)

As slurry storage systems may generally be accepted as plant and machinery, business expenditure on them will qualify for plant and machinery capital allowances, including the new AIA. The AIA is, effectively, a 100%first–year allowance, capped at £50,000 a year, for business expenditure incurred on or after 1 April 2008 (Corporation Tax) or 6 April 2008 (Income Tax) on plant and machinery (other than cars).

University halls of residence and similar facilities—Application of section 35 CAA 2001

This Revenue & Customs Brief also clarifies our view on the application of CAA01/S35 (no capital allowances for plant and machinery used in a dwelling house) to university halls of residence and similar facilities.

There is no definition of dwelling house in CAA01/S35 but guidance at CA11520 sets out our view on its meaning. It states that, amongst other types of accommodation, university halls of residence are not dwelling houses.

We recognise that the provision of student accommodation has evolved since expressing our view in CA11520 and so we will be updating our guidance to reflect this.

We consider that "communal" areas are not dwelling houses. Areas to which tenants do not have access are also not dwelling houses. However, all other areas are dwelling houses.

Example

A student accommodation block has three floors, each with ten en–suite "study bedrooms" that are individually lockable. Each floor also has a kitchen and TV room which are for the use of the ten occupants. The building has air–conditioning equipment located in the attic and a boiler located in the basement–only maintenance personnel have access to these areas.

In this example the kitchen and TV room are communal areas and not dwelling houses. The stairs and corridors which give access to other areas are also communal and are not dwelling houses. Tenants do not have access to the roof and attic and so they are not dwelling houses. However, the individual study bedrooms are dwelling houses.

This view extends to other types of multiple occupancy accommodation, such as those provided to key workers.

There are several references to dwelling houses in CAA2001. The term appears in Part 2 (plant and machinery allowances), Part 3 (industrial buildings allowance) and Part 10 (assured tenancy allowances). Our view of dwelling houses applies throughout the Capital Allowances Act.

Our guidance will be updated to reflect the above.

Business entertaining

Legislation

Legislation disallows all business entertaining (ITTOIA 2005, s 45).

Business entertainment includes hospitality and that includes food and drinks.

Section 46 then lists two exceptions to this general rule.

1. Businesses such as hotels, where entertainment is provided in the ordinary course of the trade, and free or subsidised entertainment is provided to advertise the business.
2. Tax deduction for entertaining employees. Note that there is no monetary limit to the employee entertaining deduction. The £150 allowance applies only to the employee taxable benefit charge.

HMRC's guidance

HMRC's guidance in their *Business Income Manual* starts at paragraph BIM45000 and continues on a seemingly endless number of subsequent pages.

The manual gives a useful guide to HMRC practice but cannot be relied on in court.

Incidental

A practical problem with the legislation is the inclusion of the ubiquitous word 'incidental'.

BIM45025 states that refreshments provided at a press conference, product promotion, or annual general meeting will not be regarded as entertainment if the primary purpose of the event is not the provision of entertainment.

So, a firm of accountants may organise a meeting to explain the provisions of the latest Finance Act to their clients. If the partners hire facilities at a local venue, to include the provision of coffee and nibbles, it may be clear that the purpose of the event is to promote the firm and expertise of the tax department to clients as well as updating audit and other staff with current tax changes.

Both the advertising and promotion element and staff education would be allowable, and it should also be clear that the food and drink is an incidental cost that will be allowable.

If, however, the same event is held in the firm's meeting room, the main cost of the event may be the food and drink.

The partners may think that the food and drink is only incidental, but the Inspector may have other ideas. In this case, the Inspector should be referred to the HMRC manual where the examples refer to primary purpose rather than main cost (see paragraph BIM45025).

VAT and entertaining

Disallowed entertaining should include the associated VAT.

The VAT treatment closely follows the income tax treatment in that VAT suffered on supplies of business entertaining is not allowed (SI 1992/3222, Art 5(1)).

For VAT, the definition of business entertaining excludes entertaining employees and directors.

Again, the ubiquitous word incidental reappears to allow VAT on incidental entertaining (Art 5(3)).

Unfortunately for anyone trying to advise on VAT with any certainty, there are so many tribunal decisions that, for every decision found in one direction, there will be a decision in the other direction based on very similar facts.

The general advice seems to be that if it is possible to separate out the cost of food and drink and other non-employee entertaining, the entertaining will not be incidental and the VAT should not be reclaimed; it is only incidental if it is too small to quantify.

VAT re Subsistence and staff entertaining

VAT suffered on subsistence and staff entertaining expenses is reclaimable.

The general guide, VAT Notice 700 (April 2002 edition), at paragraph 12.1 provides a chart and guidance on claiming for meals, hotel accommodation, and staff entertaining.

It explains that a VAT deduction for all meals provided to employees is allowable, but for sole proprietors, partners and directors, the VAT deduction is limited to meals incurred on business trips away from the normal place of work.

Including company directors with sole proprietors and partners does not seem to comply with the legislation. The legislation makes no distinction between meals provided to employees and meals provided to directors; Article 5(3) of SI 1992/3222 specifically includes company directors and managers as employees.

Subsistence for employees

As a general rule, any meals within the vicinity of either home or normal business premises will not qualify as a tax deduction.

Food and drink is allowable when associated with accommodation and business travel to a temporary workplace that is not located at or near the normal place of work or near home. A temporary workplace can last for as long as 24 months.

Examples are given in the HMRC manual that covers every imaginable situation.

The expense of taking a client out to lunch would not be allowed even if it involves a taxi ride to the restaurant. Nor would the cost of the taxi ride be allowable as it is incidental to the main purpose of entertaining the client.

Travel and subsistence for the self-employed

The general rule is that the expense must be wholly and exclusively for business, but does not have to be incurred necessarily (ITTOIA 2005, s 34).

Business travel

This is generally allowed, following the decision in *Horton v Young* 47 TC 60. In this case, home to work travel was allowed for a self-employed bricklayer working at various temporary sites in the vicinity of his home. Home to work travel is not allowable for normal commuting such as travel to an office, shop or business premises.

A barrister is not allowed a claim for travel to his chambers, but if attending a court away from chambers, both the travel to and from the court would be allowable, so too would accommodation that might be required for a longer court case.

Subsistence

The cost of meals is more of a problem as there is a duality of purpose where in *Caillebotte v Quinn* ‘the taxpayer ate to live, not to work’. The expense failed the wholly and exclusively test.

Business Income Manual at BIM37670 says that, in practice, reasonable costs can be claimed for accommodation and subsistence for itinerant traders, such as commercial travellers and for occasional business journeys outside the normal pattern.

HMRC have also published proposed legislation for consultation purposes that, in essence, provides the same tax deduction provisions as that given to employees.

The client lunch – employees / directors

If a client takes his accountant out to lunch, is the cost of the meal tax deductible?

If the client providing the lunch is a director or company employee, there are two aspects to the question:

- Is it a tax-deductible expense of the company?
- Is it a taxable benefit for the director/employee?

Sole directors/employees

There are several small companies where there are no employees other than the one director or, more usually, husband and wife directors, and I am the company secretary.

For such cases, the lunch will be open to all employees and the lunch or several lunches will be within the £150 allowance.

The cost will be an allowable deduction for the company, providing it is an annual event.

There will be no benefit charges on the directors.

Other directors/employees

For other directors, the normal rule is that entertaining should be included on their form P11D, but they can make a claim for the cost of the entertaining as an allowable expense.

There will be no tax charge on the director, but the company will not normally be able to claim the cost as a deduction, and the entertaining should be written back in the tax computation.

However, following *CCE v Kilroy Television Company Ltd*, if the advice given by the accountant in the course of the lunch is sufficiently valuable then the company can claim the expense as a deduction because it will not be entertaining under the quid pro quo principle.

The client lunch – self employed

For a self-employed client, a working lunch might be to discuss the accounts, the return and the tax liability. The cost of the accountant's lunch will be allowable under the general rule of wholly and exclusively for business.

It is more difficult to justify the meal for the self-employed client, who eats to live rather than eats to work. Perhaps there is a let-out if the meal is an ancillary object to the purpose of the meeting, but this is a bit of a long shot.

From an article by Noel Sharland

Castle Construction (Chesterfield) Ltd

This was not an IR35 case regarding status, instead it determined whether individual workers of a construction company were employees or self-employed subcontractors. It was not a test case, but a case decided on its own facts.

The background

HMRC had instituted an employer compliance review in 1999-2000, and the company held correspondence dated in 2002 which confirmed that the department agreed the workers involved were self employed.

HMRC carried out another review and in June 2006 said that all workers were employees, and they proposed to issue determinations on the company.

When the company informed the workers of the proposed determination, 130 workers walked out immediately, and another 70 signified their intention of doing so on the following Monday.

The actions of HMRC therefore threatened some existing contracts and the long-term viability of the company.

The facts

Castle Construction is a construction company that supplies services to main house building and commercial building contractors such as Wimpey, Barratt etc. It provides mainly bricklayers and scaffolders to work on the sites of the main contractor; 321 of such workers were involved in the appeal.

The company has a small head office staff, all of whom are correctly taxed as employees, as are some quantity surveyors, trainee bricklayers and 'novices', i.e. newly qualified bricklayers.

The point at issue

As the company had deducted tax at either 18% or 20% under the scheme when paying workers, the matter at issue was Class 1 National Insurance.

HMRC would collect both primary and secondary contributions if the department won the appeal. It was recognised that, in such circumstances, the company would be unable to claw back past tax and National Insurance contributions from current and former workers. Winning the appeal was therefore vital if the company were to stay in business.

The contract for services

The contract for services between the company and each worker was fairly brief and had not been signed by all workers. However, all workers had provided construction industry scheme certificates to the company.

It was explained that bricklayers were not paid for the number of bricks laid on a site, because it was impossible to determine the number of bricks laid by each worker, when a whole group of bricklayers were working on the same site.

Each worker was paid at a higher rate per hour to take into account that they were not paid when rain or frost prevented work.

They were also not paid for holidays, illness or other absence reasons.

However, workers did not need to ask anyone for time off.

Workers provided their own basic tools, which could cost between £500 and £1,000, and paid for transport to and from each site.

They also had to provide 'hard hats' and visibility jackets. They had to pay for any trade courses attended.

Relevant tests

There was an absence of mutuality of obligation in the work agreement. Workers could leave, work for another firm and then return.

Applying the tests set out in *Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* 1 All ER 433:

- The worker works for one employer. This did not occur in the current case.
- The worker accepts control. There was little evidence of control in Castle. A trained bricklayer did not need to be told how to lay bricks.
- Other provisions that made the engagement a contract of service. Most of these were absent in the current case.
- Substitution. The clause in the contract in this case was worthless.
- Being in business on one's own account. The Special Commissioner observed that 'brickies' have a real sense of trade.
- The intention of the parties. This was clear from the terms of the contract.

There was an additional test. This was the 'overall picture'. Applying this to the current case it was submitted that all 'brickies' are normally self employed.

The decision

The Special Commissioner decided that 314 of the company's workers who were involved in the appeal were self employed.

Six fork lift drivers and one lorry driver who operated expensive equipment owned by the company were determined to be employees, but only for future years.

From an article by John Newth

Lecture B519 (9.27 Minutes)

Corporation Tax

Two new tax proposals announced for Finance Bill 2009

The proposed changes are—

1 An amendment to paragraph 1(3) of Schedule 18 ICTA 1988, to ensure that preference shares that carry a right to dividend of a fixed amount or at a fixed percentage of the nominal value of the shares, but that give the issuer the right to pay a smaller dividend in certain circumstances are not disqualified from being treated in the same way as "Fixed Rate Preference Shares" for the purposes of the tax group rules solely due to this feature.

2 Amending the currency rules in sections 92 to 92E Finance Act 1993 so that companies having functional currencies other than sterling carry forward any unused losses to offset future profits in their functional currencies instead of sterling.

Amendment to paragraph 1(3) Schedule18 ICTA 1988

Companies are treated as members of the same group for corporation tax purposes where one is a 75% subsidiary of the other or both are 75% subsidiaries of a third company. To meet the 75% test, the parent company must hold 75% of the ordinary share capital, but also must—

- be entitled to 75% or more of any profits available for distribution to equity holders
- and be entitled to 75% or more of the assets available to equity holders were the subsidiary to be wound–up

Paragraph 1 Schedule 18 defines an "equity holder" of a company as being any person who

- holds ordinary shares in a company
- or is a loan creditor of the company where the loan is not a normal commercial loan

This proposed amendment relates to the first condition.

"Ordinary shares" are defined as any shares other than "Fixed Rate Preference Shares". To qualify as fixed rate preference shares within paragraph 1(3)(c) shares must not carry a right to a dividend other than a fixed amount or at a fixed percentage rate of the nominal value of the shares.

In order to qualify as Tier 1 capital for regulatory purposes banks must issue preference shares that are "non–cumulative". This means that these shares do not carry a right to a dividend where paying one would risk breaching the bank's capital requirements

These shares do not qualify as fixed rate preference shares as defined for tax purposes as the dividend is not fixed. It may, depending upon the reserves available, be at a rate below the quoted coupon rate down to zero. Therefore the present tax rules treat holders of such shares as if they were equity holders in the company.

As a result banking groups seeking to boost their capital base in the present financial market conditions may no longer form a group for tax purposes. This can trigger various tax charges and cause restrictions going forward on the surrender of group relief.

Although the issue has come to light with regard to the financial sector, the Government believes that holders of preference shares issued in this form by any company should not be considered equity holders in the business.

Therefore the Government proposes to change the rules for accounting periods beginning on or after 1 January 2008, in respect of all shares in issue. This change will ensure that preference shares which would qualify as fixed rate preference shares but for the issuer having the right to pay a lower dividend or no dividend in any accounting period in certain defined circumstances (including where doing so would breach regulatory requirements) shall be treated in the same way as fixed rate preference shares for tax grouping purposes.

Companies will have the right to elect for the changes to apply to new share issues only.

Amendment to Sections 92–92E Finance Act 1993

Companies are required for corporation tax purposes to compute their profits or losses in their functional currency.

Functional currency is defined in section 92E(3) as “the currency of primary economic environment in which the company operates.”

Where a company's functional currency is a foreign currency the rules require the company to convert the profits or losses for an accounting period into sterling at the “appropriate exchange rate” (normally the average for the period).

Where the company has made a profit corporation tax is charged on the sterling equivalent.

Where the company has made a loss, any losses not otherwise utilised must be carried forward in sterling and offset against future profits.

As the exchange rates between sterling and the foreign currency for the period in which the loss was incurred and the period in which the loss is utilised are likely to be different, the loss as measured in the foreign currency may not offset the same measure of foreign profits in the future period. Thus both the companies and the Exchequer are exposed to exchange risk.

The present financial climate has brought this issue into sharp focus, and it is an issue of particular concern to foreign banks trading in the UK.

The Government therefore proposes to change the rules so that any unused losses at the start of a company's first accounting period beginning on or after 1 January 2008 will be converted into its functional currency at the spot rate for the start of the period and carried forward in its functional currency. All future losses will be carried forward in the company's functional currency.

Companies will have the right to elect that the change only applies to future losses.

R&C Brief 59/08 Capital Gains degrouping charge

This Brief outlines HMRC's view of what it means to be “associated companies” for the purposes of the exception to the degrouping charge, following the Court of Appeal decision in Johnston Publishing [2008] STC 3116.

Background

The case of Johnston Publishing (North) Ltd versus HMRC concerns the degrouping charge which may arise when a company leaves a group of companies at a time when it owns an asset that had been acquired from a fellow group company (Section 179 Taxation of Chargeable Gains Act 1992).

The Court of Appeal decision confirmed our view of the exception to the degrouping charge for “associated companies” in Section 179(2)—the transferor and transferee company are required to be “associated” at the time of the intra–group transfer as well as at the time they leave the group.

Now that the Court of Appeal decision is final, we have received enquiries about how this decision affects its view of what it means to be “associated companies” for the purposes of the exception.

What it means to be “associated companies” ?

The question of what may constitute “two or more companies (that) by themselves form a group of companies” for the purposes of Section 179(10) was not directly in point in the Johnston case and was not fully explored.

It is necessary to refer back to the basic definition of a capital gains group at Section 170 TCGA when considering whether any company(ies) other than the transferor and transferee must be present in the “sub–group” of companies at the time that it leaves the group. We also consider that the question of whether companies are associated arises in respect of each potential degrouping charge and that regard must be had to the use of the words “by themselves” in Section 179(10). Therefore, in this context, the “sub–group” in point would comprise the minimum number of companies necessary to establish the required group relationship.

Thus, as noted in the decision, if transferor A and transferee B can only be considered to form a group by reference to some other company C at the time of the transfer then A, B and C must also form a group at the time they leave. That is the "sub–group" to be considered.

This situation will arise, for example, where A and B are sibling subsidiaries of C.

We take the view that the use of the words "by themselves" in Section 179(10) means that the presence, or absence, of any company(ies) other than A, B and such other companies that are required to identify a group relationship between A and B would not prevent S179(2) applying.

Example

- P is principal company of a capital gains group.
- Q is one of its 100% subsidiaries.
- Q has a 100% subsidiary R which in turn has two 100% subsidiaries A and B.
- A also has an 80% subsidiary S.
- A transfers an asset to B; Section 171 means no gain or loss arises.
- Later, R is liquidated and its shareholdings passed up to Q.
- S is then transferred elsewhere in the group.
- B then acquires a new 100% subsidiary, T.

If P sells Q, along with its subsidiaries at the time, to a third party then we would consider that there will be no degrouping charge in respect of the asset transferred from A to B. This is because Q, A and B formed a group of companies by themselves when the asset transfer took place (A and B were both 100% indirect subsidiaries of Q) and at the time when P left the main group (A and B were both 100% direct subsidiaries of Q).

Diagram available to view on HMRC website at www.hmrc.gov.uk/briefs/cgt/brief5908.htm

Section 170(2) defines a group by reference to a principal company and its 75% subsidiaries and Section 170(10) provides that a group remains the same while the principal company remains the same. Applying these to the provision at Section 179(10), we would expect the sub–group to remain defined by reference to the same company from the time of the asset transfer to the time the companies leave the group.

We will update page 45,456 of the Capital Gains Manual to state that the view expressed there has been confirmed by the Court of Appeal. Our interpretation of what it means to be "associated companies" will also be added to the manual.

Amending tax on late–paid interest between connected companies

HMRC has published a draft Schedule for Finance Bill 2009 which would disapply the late–interest rule in relation to connected companies, except where two specified conditions apply.

The draft legislation would amend the late–interest rule (currently in paragraph 2 Schedule 9 FA 1996), and the similar equivalent rule on deeply discounted securities (currently in paragraph 17 Schedule 9 FA 1996) in the rewritten legislation in the proposed Corporation Tax Act, which is due to come into force from 1 April 2009.

The draft legislation can be summarised as follows.

- The late–interest rule in relation to connected companies (currently paragraph 2(1A)) and "major–interest" companies (currently paragraph 2(1C)) would be disapplied except where either of the two following conditions apply.
- The first condition is that the creditor company is not resident in a "qualifying territory". The meaning of "qualifying territory" would be derived from paragraph 5E of Schedule 28AA to ICTA 1988. A list of qualifying territories can be found in the HMRC International Manual at INTM432112.
- The second condition is that the debtor company is party to an arrangement, the purpose of which is to secure a deduction for the UK debtor company with no corresponding

credit brought in for tax purposes either under the loan relationships rules or under an equivalent foreign tax rule.

- Where either condition applies, the debtor company would get relief for interest payable but unpaid 12 months after the end of the accounting period in which it accrues, when it is paid.
- In the majority of cases, therefore, a debtor company would be allowed a deduction for interest payable to a connected creditor company under normal loan relationships principles. A "paid basis" would only apply where the creditor company is resident in a small number of "non–qualifying territories", or where the debtor is party to an avoidance scheme. In neither scenario would the debtor company lose its deduction for interest payable to the connected creditor, although there would be a timing difference.
- The same principle would apply in relation to debits arising to a debtor company on a deeply discounted security issued to a connected creditor company.
- The same principle would apply to late interest payable to a participator (the rule currently in paragraph 2(1B)), where the participator is a company that also falls within the definition of a connected company or a "major interest" company.

Commencement and transitional arrangements

The legislation would have effect for accounting periods beginning on or after 1 April 2009. A company would be able to elect for the current basis to continue to apply for the first accounting period beginning on or after 1 April 2009.

No special rules are prescribed for interest accruing but unpaid in accounting periods beginning before 1 April 2009.

Debits disallowed under the rule as it currently stands will be deductible in accordance with the rules as they stood before the amendments to the legislation, that is, when the interest is paid.

Where amounts should have been disallowed in earlier periods but were not, either because returns were accepted without challenge, or because of the decision set out in Revenue and Customs Brief 33/08 not to pursue points relating to paragraph 2 for currently open periods, no adjustments will be needed in relation to those earlier periods.

CT enquiry still open

HMRC opened an enquiry into the taxpayer company's corporation tax returns for the years ending 31 October 1999 to 2002. They considered that deductions in the company's trading accounts in respect of licence fees were in fact annual payments on which income tax should have been deducted and issued assessments accordingly. HMRC also issued Regulation 80 determinations on the ground that if they were not annual payments, they were Schedule E emoluments.

The company applied for a closure notice. HMRC refused on the ground that the appeals were still outstanding and the enquiry depended on their outcome.

The Special Commissioner found that the corporation tax enquiry depended on the result of the appeals and that it was therefore reasonable for HMRC not to give closure notice while they were still to be determined.

The taxpayer's application for closure notice was dismissed.

ECL Solutions Ltd (SpC 721)

Value Added Tax

Attribution of input tax

In *Royal Bank of Scotland Group plc v Revenue and Customs Commissioners* (Case C-488/07), the claimant carried on the business of banking and financial services.

The claimant reached agreement with HMRC to identify “residual input tax” which could not be wholly attributed either to taxable or to exempt supplies.

The agreement included parameters for agreeing a special method for each sector of the claimant's business.

It also provided that where recovery was to be based on a calculated percentage, that percentage would be rounded up to two decimal places.

The claimant challenged the rounding-up provision, as contrary to Articles 17 and 19 of the Sixth VAT Directive.

The question for the ECJ was whether member states should apply the rounding-up rule in Article 19(1) to the next whole number.

The ECJ ruled that member states were not required to apply the rounding rule in Article 19(1) in such cases.

Mechanised Cash Bingo and gaming machine takings

This Brief confirms that HMRC is appealing the VAT Tribunal decisions involving the Rank Group (V20688 and V20777) to the High Court. These cases concern the VAT liability of Mechanised Cash Bingo and gaming machine takings.

Background

In a decision dated 27 May 2008 (V20688) the Tribunal decided that the VAT treatment of MCB provided by Rank was in breach of fiscal neutrality and consequently these supplies should be exempt from VAT.

In a further interim decision dated 19 August 2008 (V20777), the Tribunal found that there had been a prima facie breach of fiscal neutrality in the VAT treatment of Rank's gaming machine takings and that these should have been treated as being exempt from VAT before 6 December 2005, when UK law was changed to make all gaming machine takings taxable. A second Tribunal hearing to hear further aspects of this issue is to be held in October 2009.

HM Revenue & Customs (HMRC) has appealed against both decisions and the High Court hearings are expected to be held in March or April 2009.

Implications

VAT—Our view of the law remains unchanged in that VAT is and always has been properly due on supplies of MCB and on the takings of gaming machines. Therefore, businesses should continue to account for VAT on such supplies.

VAT Tribunal decisions are only binding on the specific case heard, as it is only the facts of that specific case that are considered in full. In line with HMRC's normal policy, as we continue to maintain that our view of the law is correct, no other businesses are affected by the decisions and therefore no claims for alleged overpayments of VAT by other operators can be considered until the conclusion of this litigation.

Bingo Duty—In order to protect our position in law, “protective assessments” of bingo duty will be raised to safeguard revenue. These assessments will be issued to reflect the fact that if there is no VAT to deduct from bingo receipts, then additional bingo duty is due These assessments will not be enforced unless HMRC loses on the substantive VAT liability issue.

Michael John Bracegirdle 20889

Mr Bracegirdle carried out building work at his home–the demolition of existing outbuildings and the erection of an indoor swimming pool, garages, a flat and ancillary accommodation such as store-rooms and utilities; an existing door between the original house and the new building was blocked. The entire structure now sits around a courtyard which has one driveway for access.

The planning permission prohibited separate use of the new accommodation but arguably permitted separate disposal.

On the facts the Tribunal held that the work amounted to an extension of the original building, which would be standard-rated except to the extent that a new dwelling was created. The flat would be a new dwelling if "the separate use, or disposal of the dwelling is not prohibited by the term of any covenant, statutory planning consent or similar provision"—see VAT Act 1994, Sch 8, Group 5, Item 2 and Note 2(c).

The Tribunal held that the flat would not be a dwelling if either the separate use or the separate disposal of the flat were prohibited by the planning permission. It said–

"Note 2(c) is worded "the separate use, or disposal" with a comma after "use" and the use of the word "or" and not "and". On an ordinary reading of those words, the conclusion is inevitable that works will not be zero-rated if either separate use or disposal is prohibited."

Separate use was prohibited by the planning permission, so it was not necessary to decide whether separate disposal was prohibited, since the appeal had to fail in any case.

Latvia latest to increase VAT

Latvia has become the latest EU country to increase VAT in an effort make up budgetary shortfalls caused by the deepening financial crisis.

The Latvian government has announced a 3% increase to 21% from this month.

This follows Lithuania's increase last month and Ireland's increase in October.

Richard Asquith of VAT global compliance services at accountants TMF said: 'It seems the UK may be going it alone with its strategy to cut VAT to stimulate the economy out of a recession.

The prospect of colossal budget deficits and demands from buyers of government debt mean that much of the rest of the EU is headed the other way.

'We expect others to increase over the next few months.'

VAT online

This should be the year in which businesses seriously consider filing their VAT returns online, according to independent VAT consultant Neil Warren.

It will be compulsory for firms with an annual turnover of more than £100,000 to file online after April 2010, a measure that is expected to immediately increase the 14% filing figure to at least 65%.

It will also be a requirement for newly registered businesses to submit returns online and pay VAT by electronic means from the same date.

So, 2009 is an ideal opportunity to prepare for compulsory filing, said Mr Warren.

He remarked: 'I was quite surprised to learn that only 14% of VAT returns were filed online for the eight-month period up to 30 November.

'This is a very low figure considering the convenience and cash flow benefits. A business filing its return online can get up to 12 extra days to pay the VAT it owes compared to the traditional paper return and cheque method.'

Neil also pointed out that HMRC withdrew prepaid business reply envelopes from 1 October 2008, a measure that will save the department £8 million a year.

He added: ‘It sounds very basic, but I am sure situations will arise where a business reply envelope is posted with a second class stamp instead of a first class stamp, or no stamp at all, creating a default surcharge problem when the return arrives late.

'This risk can be avoided by online filing.'

Independent Thinking Ltd 20884

The appellant provides consultancy services and related material in the field of thinking skills, providing courses and material to schools, businesses and other organisations designed to help them think creatively, or to equip teachers or leaders to encourage a creative thinking approach in their pupils or workforce. The appellant purchased an ocean-going yacht and incurred substantial expenditure in making it seaworthy. The appellant reclaimed the VAT element of that expenditure and HMRC later made an assessment to recover what it considered to be overclaimed input tax. In HMRC's view none of the expenditure was on goods or services to be used by the appellant in the course of its business.

The appellant relied on three separate arguments. The first was that it had purchased the yacht to give itself a suitable environment for creative thinking. However, even though the Tribunal accepted that the yacht was not purchased for the recreational purposes of the appellant's owner, the appellant had failed to show a direct link between the expenditure and the purposes of the appellant's business. The flaw in the appellant's argument was that whilst the yacht might indeed provide a creative space, it was entirely arbitrary whether any ideas which came to the appellant's personnel did so while the yacht was being used as a thinking space or, indeed, whether such ideas were of any use to the appellant's business.

Secondly, the appellant argued that the yacht was to be used in a specific business venture–round-Britain cruises. It was not relevant that the appellant had failed to get that venture off the ground, because the concept had not been developed until after the yacht had been purchased and the refurbishment expenditure incurred. Thus the expenditure in question could not have been incurred for that specific business purpose, since the business purpose did not exist at the time.

Finally, the appellant alleged that it had used the yacht as an office. HMRC had calculated an alternative assessment on the basis that the Tribunal accepted this as fact. However, there was no evidence of use as an office and the Tribunal held that the appellant had failed to make out its case.

The appeal was dismissed.

Loyalty Management brief

This brief clarifies that Redeemers in the Nectar scheme who are not correctly treating the supplies in accordance with the guidance set out in Revenue & Customs Brief 46/08 must now do so from 17 September 2008.

In October 2007 HM Revenue & Customs (HMRC) lost the Loyalty Management (UK) Ltd [2007] All ER (D) 66 (Oct) (LMUK) case C3/2006/1560, concerning the VAT treatment of payments for Nectar scheme rewards, in the Court of Appeal. The Court of Appeal decided that the payments made by LMUK to Nectar scheme “Redeemers”, known as “service charges”, were for taxable supplies of “redemption services” by the Redeemer to LMUK. LMUK is entitled to claim input tax on the amounts it has paid to Redeemers, so long as that decision remains in effect.

We were granted leave to appeal to the House of Lords, which have referred the matter, as well as the appeal in Baxi Group Ltd, to the European Court of Justice without full hearing. Our position, pending the resolution of the litigation, was set out in Revenue & Customs Brief 46/08 issued on 17 September 2008, and included guidance to Redeemers, that they should treat the service charges as consideration for supplies by them to LMUK, and so issue tax invoices to LMUK for VAT on these amounts. They may submit protective claims, if appropriate, in case we succeed in the litigation in the end.

This brief clarifies that Redeemers in the Nectar scheme who are not correctly treating the supplies in accordance with the guidance set out in Revenue & Customs Brief 46/08 must now do so from 17 September 2008, which is the date that the brief took effect. Any guidance given to any Redeemer prior to that date, which was different to the guidance in that brief, is withdrawn from the date of Revenue & Customs Brief 46/08.

The treatment advised in that brief will continue in effect until further notice.For further help or advice, please contact the National Advice Service on Tel 0845 010 9000 or 0845 000 0200 (text phone).

Loft conversion case

A1 claimed to be a project manager which organised loft conversions on behalf of clients. As such, the only supplies made by A1 were said to be of project management. HMRC argued that A1 supplied loft conversions and so was liable to account for VAT in respect of the total charge for each job, not just the project management element as claimed. The VAT in dispute totalled more than £1.2 million between the two appellants (which carried on the business in succession).

The theory was that A1 would visit a client and propose a total figure for the conversion. A1 would offer to manage the project, which would involve finding several contractors to do the various tasks required to complete the job. In order that the contractors would make supplies to the client, rather than making supplies to A1, it was necessary that A1 should act as the client's agent in appointing each contractor. However, whilst the documentation as between A1 and the contractors may have reflected this position, it was more doubtful whether the documentation between A1 and the client did so. In any case, and more importantly, the Tribunal agreed with HMRC that A1 could not act as agent for the client for these purposes unless the client understood that A1 was acting as agent—that could not be implicit but must be clearly understood by the client. The evidence was that the clients did not understand that they were supposed to have appointed A1 as their agent, so the appeal could not succeed.

A1 Lofts Ltd and A1 Loft Conversions Ltd 20888

The VAT package

The changes

The Commission has proposed to change the rules on supply of services, and political agreement has been obtained to press ahead with these changes with effect in 2010 (the date for the implementation of the so-called “VAT package” which will change a number of international supply rules). This means that:

- from 1 January 2010, most supplies of services from business to business will move to “where the customer is established”, with exceptions for services which will be situated where consumption takes place (restaurant and catering services, the hiring of means of transport, cultural, sporting, scientific and educational services);
- business to consumer services will remain situated where the supplier belongs, but there will be exceptions for those services listed above;
- from 1 January 2015, supplies of telecoms, broadcasting and electronic services to consumers will move to “where the customer belongs”, with a “one-stop shop” electronic reporting system whereby the supplier will charge the VAT rates of the country of consumption and the revenue will be passed on to the customer’s country (with some retention by the country of the supplier from 2015 to 2018);

- from 1 January 2010, the present paper-based 8th Directive refund procedure will be replaced with a fully electronic procedure which will be quicker and more certain (interest will also be paid on late refunds).

Given that the list of exceptions to the reverse charge appears to be very similar to the current list of exceptions, the main effect appears to be to change the "default" result from "basic rule" to "reverse charge" – in which case unspecified management services will become a reverse charge service rather than a basic rule service. Call centre services might also be affected.

The new system for dealing with overseas VAT appears to require a separate return to the trader's own state authorities instead of a claim from the authorities in the state where the VAT was incurred. The procedure will apparently still be separate from the main domestic VAT return, but the domestic authorities will be responsible for paying the claim to the trader and recovering the money from the other state.

Revenue & Customs Brief 53/08 VAT: EC Sales Lists

On 22 October 2008 HMRC published R&C Brief 53/08. This Brief publicised a new requirement that businesses provide them with EC Sales Lists for certain taxable supplies of services from 1 January 2010. This requirement affects all UK businesses that make taxable supplies of services to business customers in other EU countries where the customer is required to account for VAT under the reverse charge procedure.

Currently EC Sales Lists are only required for B2B intra-EC supplies of goods. However, from 1 January 2010 EC Sales lists will also be required for intra-EC taxable supplies of services to which the reverse charge applies. They will not be required for:

- supplies which are exempt from VAT according to the rules in the Member State where the supply takes place
- B2B supplies where the recipient is not VAT registered
- B2C supplies

The object of the Brief was to ensure that UK businesses were fully aware of this requirement so that they can start considering what arrangements or systems they may need to put in place to gather the information needed to complete EC Sales Lists, particularly if these are, or will need to be, electronic systems that will require change. When the Brief was published HMRC anticipated using the same form that is used for reporting goods (VAT 101) and to require the following:

- country code
- customer's VAT Registration Number
- total value of supplies in sterling
- an indicator will also be required to identify services

Under the VAT Package legislation that was adopted in February, from 1 January 2010 businesses will have to submit EC Sales Lists for taxable supplies of services subject to the reverse charge on a quarterly basis. However, Member States were discussing a European Commission anti-fraud proposal which includes a provision that from 1 January 2010 all EC Sales Lists should be submitted on a monthly basis. HMRC received a number of comments from UK businesses objecting to the introduction of a monthly requirement in respect of supplies of services.

R&C Brief 2/2009 VAT package and anti-fraud measures implementation update

On 16 December 2008, the EU Council adopted a Directive 2008/117/EC and a Regulation (37/2009) relating to EC Sales Lists (ESLs) and the time of supply of services subject to the reverse charge.

The implementation date for these new measures is 1 January 2010. On 26 January 2009 HMRC published R&C Brief 2/2009 which gives some information about how these measures will be implemented in the United Kingdom. It should be read in conjunction with Revenue & Customs Brief 53/08.

The main changes relate to the submission of ESLs. In principle, the new Directive provides that these should normally be submitted monthly, but it allows Member States to offer their businesses certain options.

The United Kingdom intends to implement these as follows:

- ESLs relating to services may be submitted quarterly, relating to calendar quarters.
- From 1 January 2010, ESLs relating to goods may be submitted quarterly, relating to calendar quarters, provided that the value (excluding VAT) of supplies of goods to other Member States has not exceeded £70,000 in any of the previous 4 quarters.
- A business entitled to submit quarterly ESLs for goods can continue to do so unless the value of supplies of goods to other Member States exceeds £70,000 (excluding VAT) per quarter from 1 January 2010 to 31 December 2011 or £35,000 (excluding VAT) per quarter from 1 January 2012 onwards.
- If a business exceeds the quarterly goods threshold by the end of the first or second month in a quarter, an ESL must be submitted at the end of that month, covering the month or months in that quarter. Lists must be submitted monthly from then.
- Once a business is on a monthly cycle, because it has exceeded the threshold in any quarter, it must continue to submit monthly ESLs for goods until the value of its intra-Community trade in goods has been below the threshold for five consecutive quarters – it may then revert to quarterly submission if its trade remains below the threshold.
- A business required to submit monthly ESLs relating to goods may still submit ESLs relating to services quarterly.
- Any business may submit ESLs for goods and/or services monthly, if it wishes.

The other change to ESLs is that the time, within which both UK businesses and then HM Revenue & Customs (HMRC) must carry out their respective ESL obligations, has been reduced from three months to one. HMRC intend to discuss this issue with business to explore how implementation can balance the needs of business and HMRC. Their current thinking is that businesses that submit paper ESLs would have 14 days from the end of the (last) month to do so. This period would be extended to 21 days for electronic submission of ESLs.

Finally, the Directive makes changes to the time of supply of services rules for services supplied to businesses in another Member State where the customer has to account for VAT under the 'reverse charge'. The changes are:

- the time of supply of such services will be the earlier of when the service is completed or when payment is made.
- for continuous supplies of services, the time of supply will be linked to the end of each billing or payment period, but where no invoice or other accounting document is issued or payment made during the year, the time of supply will be the end of each calendar year.

These changes will determine not only when the customer has to account for VAT under the reverse charge when the service is received from a supplier in another Member State, but also when a supplier is required to include the transaction on an ESL.

HMRC intend to discuss implementation of the new time of supply rules with businesses, to understand their current accounting practices and their concerns about the changes likely to be needed. Their objective in implementing the rules will be to do so in a way which is as easy as possible for businesses to apply, and minimises additional burdens, while remaining consistent with the provisions of the Directive.

Lecture B519 (18.30 Minutes)

Latest issues with the VAT flat rate scheme

This lecture reviews the changes to the flat rate scheme announced in the Pre-Budget Report in November, and also a number of other issues which have arisen in the last year on which HMRC clarification has been sought.

Pre-Budget Report changes

Flat rate scheme entry and exit

The Pre-Budget Report included the announcement of clarification and simplification of the requirements for traders entering and leaving the flat rate scheme. These are:

- using only taxable turnover, rather than all turnover, when considering the £150,000 (VAT-exclusive) threshold for entering the scheme;
- using the figure the trader calculates for the VAT return (cash basis or invoice basis) in determining the £225,000 (VAT-inclusive) threshold for having to leave the scheme.

The problem with the exit test was highlighted earlier in 2008when HMRC confirmed that the invoiced figure should be used, even if the trader prepared VAT returns on a cash basis. This could lead to the peculiar result that the trader has to leave the scheme even though the VAT return shows a figure below £225,000 in Box 6.

A curiosity of the new scheme (which will be further clarified by later issue of regulations and a revised Notice) is that a trader could simultaneously be eligible to join the scheme and required to leave. HMRC point out that a trader with so much exempt turnover would probably not wish to join the flat rate scheme because the flat rate would apply to that income.

PBRN 25

Flat rate scheme and the change of rate

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 (rules described in a previous lecture on the standard rate change on 1 December 2008) 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

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"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".

HMRC's further guidance on the change of rate, issued on 1 December 2008, contained the following guidance on the flat rate scheme:

Flat Rate Scheme and the change in the standard rate

1. I'm on the Flat Rate Scheme. Why hasn't my rate fallen by 2.5%?

The flat rates as a whole have been correctly adjusted to take account of the 2.5% reduction in the standard rate, but this doesn't mean that each of the flat rate amounts falls by 2.5%. There are two reasons for this.

Firstly, the flat rate takes account not only of the VAT payable on sales, but also a number of other factors including the amount of VAT reclaimable on purchases and expenses and the level of VAT inclusive turnover. And because businesses are not the same - different types of business have different patterns of input and outputs - it is necessary to have different flat rates for different types of business.

Secondly, the flat rates are also reviewed annually to ensure that they reflect the net VAT paid by small businesses that do not use the flat rate scheme. This avoids distortion of competition between flat rate users and small businesses that opt not to use the Flat Rate Scheme.

2. My rate hasn't changed. Why?

There are a few types of business whose rates have remained unchanged – this reflects the combined effect of the standard rate reduction and the review of rates referred to above. Those flat rates that have remained the same would have needed to go up had the standard rate of VAT remained at 17.5%

3. Have any rates gone up?

No rates have gone up.

The changes introduced in the PBR cut the flat rate for the overwhelming majority of businesses – 50 out of 55 of the flat rate scheme categories have been reduced.

4. I no longer wish to use the flat rate scheme following these changes

We would normally expect you to apply for and leave the scheme at the end of an accounting period. Businesses can leave the scheme and account for VAT in the normal way by notifying HMRC in writing and we will notify you of the date you have left the scheme.

HMRC Press Release 1 December 2008

Issues for clarification

The following issues arising from the practical application have been put to HMRC for clarification. Although no formal response has been published yet, HMRC's comments are given below and can be taken as indicative of how HMRC view each problem.

Buy-to-let income – included or excluded from flat rate scheme?

Example

John is a management consultant in Peterborough earning £100,000 per year excluding VAT. He is VAT registered as a sole trader and uses the flat rate scheme. He also owns a flat in London, which earns him rental income of £12,000 per year. The income and expenditure on the flat is kept totally separate (different bank account etc) from the consultancy income. Does he apply the flat rate percentage (11% for management consultants) to £115,000 (£100,000 plus VAT) or £127,000 (ie including rental income)?

The issues

VAT Notice 733 (para. 6.3) confirms that 'private income, for example income from shares' and 'non-business income' is excluded from the flat rate scheme calculation. However, Notice 733 is silent on the specific issue of dealing with buy-to-let income.

This silence has therefore created two schools of thought among practitioners:

- buy-to-let income is also private income – but a return from investing in property rather than in shares. It should therefore be excluded from the FRS – unless it is income generated from the business premises e.g. as per para. 10.1 of Notice 733 which advises retailers to include 'rent from a flat above the shop'.
- EU law (Directive 2006/112/EC, Art 9(1)) indicates that rental income is included within the definition of 'economic activity' i.e. it should be included as business income within the FRS if earned through the same legal entity i.e. sole trader in above example.

Our understanding from talking to practitioners is that buy-to-let income is being generally excluded from FRS calculations as private/non-business income, which is logical when the simplification aims of the scheme are considered, and we have no examples of HMRC visiting officers challenging this approach.

It is well known that the flat rate percentages are derived from analysis of the average mix of supplies made by different types of business. Where by chance a single taxable person (most commonly a sole trader) happens to have a buy-to-let rental property, this would not have been taken into account in HMRC's calculation of the appropriate percentage for the trade sector, and would distort the resulting VAT accounted for. The simplest solution would be to exclude from the FRS rental income which is unconnected with the main trade, even if the "taxable person" is the same.

It would be relatively easy for users of the FRS to avoid the problem, if a problem exists, by entering into a business-splitting arrangement (e.g. putting the rental property into the joint names of husband and wife). This would hardly be "artificial" business splitting. Given that the objective of the FRS is to simplify the VAT affairs of small businesses, it would seem more sensible to remove the distortive problem altogether rather than making it necessary for those affected to enter into complex arrangements to solve the problem.

HMRC response

Rental income is generally business income and would be subject to the FRS if received by the same legal person as the VAT-registered trader. It would be very unlikely, perhaps impossible, to invoke the business splitting provisions if a trader separated the rental income from the VATable trade. However, a trader who was unaware of the disadvantageous treatment and remained within the FRS could expect to be assessed to flat rate VAT on the last three years' worth of rental income if the situation came to HMRC's attention.

Bank interest received – included or excluded from flat rate scheme?

Example

John Ltd trades as a management consultancy company with sales of £100,000 per annum. In addition, the company receives £2,000 bank interest per year because John the director retains a high bank balance in the company account to meet potential business liabilities in the uncertain economic climate. The company also received interest of £500 this year from HMRC for early payment of its corporation tax.

Does the director apply the flat rate percentage (11% for management consultants) to £115,000 (£100,000 plus VAT), £117,000 (ie including bank interest) or £117,500?

The issues

The FRS percentages are intended to reflect the VAT that would be payable within normal accounting for a typical business in the same trade category. It is the policy of HMRC that the scheme should be tax neutral.

Para.3.3 of notice 733 confirms that the test of 'total income' to see if a business is eligible to use FRS should include 'bank interest on a business account, rent, lottery income' but there is no indication at section 6.3 that all these sources should be included in the actual calculation to work out the amount of VAT payable within the scheme.

With normal VAT accounting (i.e. output tax less input tax), a cash rich business and a business operating an overdraft would not pay different amounts of VAT – even if it counted as an exempt supply, any bank interest earned by the cash rich business would be disregarded under SI 1995/2518 reg.101(3)(b) as far as partial exemption is concerned i.e. not affecting the amount of input tax that

could be claimed. There is therefore no logical reason for the cash position of the business – interest-earning or interest-paying – to affect the flat rate VAT liability.

It is questionable whether bank interest received by a trading business on the cash it earns on its trade is really "business income" for VAT at all. When a small company deposits takings in the bank, is it really "making a supply of finance" to the bank for consideration in interest? The same transaction can be regarded as a supply on one side but not on the other: see the Tribunal's decision in Willis Pension Trustees Ltd (VTD 19183) concerning foreign exchange transactions. The small company is a customer of the bank, not a supplier of the bank.

It would be even more ludicrous to suggest that a company paying its corporation tax early was "supplying finance" to HMRC and being paid exempt consideration in respect of it. However, it would not be logical to treat interest on a bank account and interest credited by HMRC differently: if only bank interest was subject to FRS, this would appear to breach 'fiscal neutrality' because there would be a fiscal distortion in favour of paying HMRC early instead of leaving the money to earn interest in the company's deposit account.

The other point is that a sole trader or partnership entity appears to have an advantage over a limited company because they can transfer money (increase in drawings) to private bank accounts, which are then excluded from FRS as 'private income'. It would appear that the current procedures could only possibly capture bank interest for sole traders and partnerships on business bank accounts. However, a limited company does not have this option because of legal and tax issues on extractions of money by the shareholders/directors. In the current economic climate, a prudent company will not want to run down its resources by extracting cash, but it may be forced to do so if the FRS is found to apply to interest.

HMRC response

HMRC Finance Policy regard interest received on a business bank account as consideration for an exempt supply. HMRC acknowledge that there might be a distinction between interest paid by a bank (which they regard as consideration for a supply) and statutory interest paid by HMRC, but they do not see this as engaging the principles of fiscal distortion.

Sale of capital assets on which no input tax was recovered or recoverable

Example

David Ltd is a small company using the FRS. It purchased a new computer for £3,000 incl. VAT and made a claim for input tax outside the FRS. Its directors know that if they sell the computer they must account for output tax at the standard rate rather than using the FRS.

The company has also purchased a car for use in the business. No input tax would in any case be deductible because of the availability of the car for private use, and a sale of the car would therefore be exempt within VATA 1994 Sch.9 Group 14. There is nothing to exclude the sale of the car from a charge under the FRS: Notice 733 at para.6.2 tells traders to include "supplies of capital expenditure goods, unless they are supplies on which VAT has to be calculated outside the flat rate scheme in accordance with paragraph 15.9".

The issues

The flat rate percentages are supposed to reflect the receipt of some exempt income by the trades described in the table; they are expressly described by HMRC as allowing for regular expenditure but potentially distorted by capital expenditure, hence the special rules for purchases and sales of VATable items costing £2,000 and more. The rules do not exclude supplies which would be exempt – this appears simply to be an oversight, as there is no logical reason for it.

Sales of buy-to-let properties

Combining this issue with the first problem identified above, what if a buy-to-let property is sold (exempt income)? Presumably this should also be excluded from the FRS calculation because it would give such a distortive result, but this is not made clear in the guidance. The application of a 13% FRS percentage to the sale of a £500,000 investment flat could bankrupt the taxpayer.

HMRC response

HMRC believe that the setting of the flat rates should take into account the average amount of such sales by traders in each sector (the same comment applied to the receipt of bank interest). This relies

on those eligible traders who are not in the scheme (whose statistics are used to set the rates) putting all such supplies in Box 6 of their returns, so that HMRC can "see" them.

On a sale of a buy-to-let property, HMRC accepted that this would constitute "exceptional circumstances" which would lead them to agree to retrospective removal from the flat rate scheme. That would avoid the problem on the buy-to-let property, but it would require "normal accounting" for at least a year following the removal from the FRS. HMRC did not believe that it would be appropriate simply to leave the sale out and continue within the FRS.

Comment

The point was made to HMRC that many "normal accounting" traders would not put sales of cars or receipts of interest income in box 6, because there was no reason to do so. The flat rate would therefore be set on the basis of statistics which omitted such receipts, and it would therefore be logical to exclude such receipts from a charge under the scheme, possibly by including a measure similar to the exclusion of incidental income in the calculations of partial exemption percentages. HMRC did not accept this argument.

Does the inclusion of goods sold to business in other EU countries create double taxation?

Example

Pens Ltd manufactures pens in the UK, and one of its customers is a VAT registered wholesaler in Italy. It does not charge VAT to the Italian wholesaler – the latter accounts for acquisition tax in Box 2 of its own VAT return. Pens Ltd uses FRS. In this situation, output tax is being declared on the goods by both the Italian customer and by Pens Ltd through the FRS.

The issues

Income received by a UK business from Schedule 5 services provided to EU business customers where the place of supply is outside the UK are excluded from FRS (outside the scope of UK VAT). This seems reasonable because, in most cases, the customer will account for output tax on their VAT return i.e. under the reverse charge.

However, the same exclusion does not apply to the sale of goods to EU business customers, as the income is included within FRS. Many taxpayers and advisers are not aware of this anomaly – many assume that the income is outside the scope of FRS because the customer is accounting for output tax.

There is no logical or policy reason for the different treatment of goods and services: it is the result of the technical difference in the way in which the rules apply to non-FRS traders ("UK supply but ZR" vs. "outside the scope with recovery").

There is a reason for the express inclusion of acquisitions as chargeable in Box 2 at the standard rate even for a FRS trader – otherwise the FRS trader would be able to source goods from elsewhere in the EU without suffering the input tax that would be blocked under the FRS in the UK. The exclusion of reverse charges on services bought in from abroad is as illogical (but favourable) as the inclusion of despatches in the FRS charge.

The guidance does at least point out that a trader who exports or despatches more goods than the average for the trade sector (which has been used to determine the applicable FRS percentage) may be at a disadvantage if they use the scheme. However, there seems to be a simple solution for this. Given that EU law does not allow VAT to be applied twice on the same supply, and despatches must be evidenced by the provision of a VRN from another member state and the appropriate transport documentation, could not despatches be taken out of the FRS?

HMRC response

HMRC did not regard this as a problem, particularly given the "upfront warning" in Notice 733. Flat rate VAT is accounted for to HMRC, not charged to the customer, so the treatment does not violate the Directive's exemption of intra-state supplies.

Do proposed entry and exit levels for scheme from 1 April 2009 create an overlap problem?

Example

Susan operates an ice cream and chocolate stall at the local market, earning annual sales of £140,000 per annum (£161,000 including VAT). Her only input tax is on the stock she buys for resale

(£70,000 plus VAT) so she decides to use the FRS (2% rate for 'retailing food, confectionery' etc). She also trades as an insurance broker earning exempt commissions of £100,000 per year. Her total income of £261,000 exceeds the proposed exit level for the FRS (total income including VAT exceeds £225,000) but is lower than the entry level (taxable turnover is less than £150,000). Can she join the scheme?

The issues

As a general point, not many businesses with high exempt income will want to join the FRS because the relevant flat rate percentage needs to be applied to both zero-rated and exempt income as a condition of the scheme. But the rates for certain business structures are so favourable that participation in the scheme could still produce a good result, even if the relevant percentage is applied to a high exempt income figure – as illustrated by the above example where use of the scheme saves the taxpayer £5,280 per annum.

HMRC response

HMRC regard this situation as very unlikely to arise in practice, because for the great majority of such traders the disadvantage of accounting for FRS VAT on their exempt turnover would outweigh any possible advantage of being in the scheme. They do not propose to amend the regulations in any way.

Presumably, therefore, a trader who did find an advantage in the scheme could join it for a year before being required to leave.

New FRS entry and exit tests to be allowed retrospectively?

Example

ABC Ltd uses the FRS and the cash based method of turnover. It also uses the annual accounting scheme. For year-ending 31 March 2008, it had invoiced taxable sales of £250,000 including VAT but only included £220,000 on its annual VAT return because it had a closing debtor figure of £30,000 including VAT (there were no opening debtors). Has the company exceeded the exit level for the FRS?

The issue

The answer to the above question, given by Policy to Mike Thexton earlier this year, was that the company had exceeded the limit because the "income" test for this purpose had to include all invoiced sales rather than just the figure used to calculate the FRS tax due. Policy's answer was contrary to the answer given by two respondents to "Readers' Queries" in Taxation magazine, both of whom thought that the figure used to calculate the tax would be the correct one for the exit test.

HMRC's internal guidance at FRS4400 appeared to support the respondents to Taxation magazine because it refers to the figure 'most readily to hand' when considering the FRS exit levels. This can only be the figure that has been entered on the VAT return submitted by a business. PBRN25 acknowledges this problem because para. (7) confirms that 'income for this purpose is not defined in the legislation'.

PBRN25 was therefore very welcome because it clarified that the above company will, from 1 April 2009, base the exit test on the sales value that is included in Box 6 of its VAT return. This approach is consistent with the 'tax simplification' aim of FRS – the company will only need one figure for income, the one on which it will pay tax – and clarifies the confusion that previously existed.

However, in view of the ambiguity that existed up to 31 March 2009, it is suggested that the new interpretation should be treated as a clarification of the existing rule rather than as a change to the rules. This would allow the business described in the example to remain within the FRS after 31 March 2008, rather than having to leave the scheme. As many businesses are suffering a downturn in turnover at present, it is likely that those which would have breached the exit conditions in the last year will find that this was a "blip" or one-off, and they will not exceed the exit conditions in the current year – allowing the retrospective application of this clarification would permit them to continue to enjoy the benefits of the simplification of VAT under the FRS.

HMRC response

As the present version of the law does not define "income", it has to be interpreted in accordance with its normal meaning. That would be the invoiced amount, not the received amount. The new

measure is therefore a change in the law, not a clarification, and it will only apply from 1 April 2009. The business described in the example cannot re-enter the FRS until 1 June 2009 at the earliest, when it will have to qualify again on the basis of turnover in the preceding 12 months not exceeding £150,000.

Clarification on VAT return entries

Example

ABC Ltd received income of £30,000 plus £4,500 VAT for period ended 31 March 2009 – it uses the FRS and cash based method of turnover. Its VAT payment for the quarter under FRS is £3,450. What value does it include in Box 6?

The issue

VAT Notice 733 (para.7.5) confirms that a taxpayer should include the gross value of his sales in Box 6 i.e. £34,500. But the reverse of the VAT100 return form states that the Box 6 figure should exclude VAT i.e. £30,000 – which is correct?

If a VAT-exclusive figure is to be used, is the VAT exclusive figure for a scheme user classed as £30,000 or £31,050 (latter figure being gross sales minus VAT payable within scheme)?

HMRC response

Although the back of the return form still only contains instructions for “normal traders”, there is a note at the top of the front of the form telling FRS traders to read the notice before filling in the form. This is as much help as FRS traders are likely to get. When online filing will apply to far more traders (in April 2010), it is hoped that the system will provide clearer instructions and help.

Second issue

VAT Notice 733 (para.7.5) states that Box 4 will generally be “none” unless there is a claim for input tax on capital goods expenditure of £2,000 gross, or an exceptional claim for goods on hand at registration. This ignores the possibility of bad debt relief, which is described later in the Notice and which presumably must be entered in Box 4.

It appears that Box 7 is supposed to relate to the figure in Box 4, but this could also be clarified where there are bad debts.

HMRC response

This was noted for possible inclusion in guidance.

Article by Mike Thexton

Lecture B520 (25.52 Minutes)