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# Form P11D

## Quick reminder – recent changes

**QUALEC's**

This term stands for a "qualifying low emissions car", which attracts a benefit in kind at a rate of 10%. The level of low emissions has been set for 2008-09 at 120 g/km. (Many of these cars also attract a 100% first year allowance when purchased new). Electrically propelled vehicles are not qualifying low emissions cars, irrespective of their emissions figure. No reduction below 10% for these vehicles will be permitted. Emissions figures are not rounded down for the purposes of determining whether a car is a low emissions car. Diesel cars will still be subject to the 3% addition, and will therefore be taxed at 13% of list price.

The lowest emissions rate, which attracts tax at 15% of list price reduced to 135g/km of $CO_2$ in 2008-09. This will produce a 1% of list price increase in benefit in kind for most drivers, meaning that benefit increase by between 0% and 6.7%.

**Fuel benefit scale charge**

The fuel benefit scale charge increased to £16,900 for 2008/09. This is multiplied by the percentage used for the provision of the car, as adjusted for diesel or low emission cars.

**New category – Fuel type G**

This new category commences from 2008/09 and applies to cars adapted to run on E85 fuel, which is an 85% biofuel (unleaded petrol and 85% bioethanol) mix. The cars attract a discount of 2% in the calculation of benefit in kind from 6 April 2008.

**Mobile telephones**

A single mobile phone provided by the company on which an employee can make private calls is tax free. If the phone is in the name of the employee this exemption does not apply, and the amounts paid must be apportioned between business and private use, remembering that the basic airtime charge will always be private if the phone is in the name of the employee.

If an employee has a second phone in the company name this is fully taxable – although employees may choose which is the benefit phone for the year. At present BlackBerrys and other PDA's are regarded as computers, but you should bear in mind that with advances in telephone technology this could change.

<u>Details : Computing the benefit in kind : HMRC manual</u>

The employee will be taxable on the full cost of the provision of the phone, which may include a benefit for the handset cost at 20% of the cost. The bills paid on a taxable phone will give rise to a benefit in kind, but some apportionment of the bill may be possible for business calls, when billed over and above the line rental charges.

The following example is provided, and although in connection with an employee provided phone, is quoted in other parts of the manual.

"EIM 32951. A construction engineer often works out of the office on construction sites. She uses a mobile phone so that she can keep in touch with the office. The phone is mainly used for business calls.

The tariff for the mobile phone includes up to 10 minutes of free calls each month. In one month she pays £22, which is the rental charge only, because her total calls, all of which were business calls, amounted to 8 minutes. No deduction can be permitted because no expense has been incurred in making the business calls.

The following month she pays £28, which is £22 for rental and £6 for calls. Calls that are charged are paid for at a rate of 20p per minute. In the month she made calls totalling 40 minutes, of which 30 minutes were for business and 10 minutes were private. A deduction should be permitted for the cost of business calls. The amount that can be deducted is £4.50, which is 75% of the call charges, because 75% of the total call time was made up of business calls."

**Computers with private use**

Where an employee is provided with a computer which is also available for private use, there will not normally be a benefit in kind on any private use. The situations where this might arise are for laptop computers which the employee takes home at night and where the employer has equipped the employee's home office with computer equipment on the basis that the employee works from home on occasions.

The statutory test is that the private use of the computer is insignificant, but this test is amplified by the guidance in the Employment Income Manual. HMRC provided a new interpretation of "insignificant" in the employment income manual in connection with facilities provided for the performance of the duties, and used to an insignificant extent for private purposes, which private use is on this basis not taxable as a benefit in kind in 2006 when the computer exemption was withdrawn.

This is particularly applicable to the provision of computers but also applies to the provision of broadband internet connection which is treated in the same way. Essentially the new interpretation in EIM21613 allows the employer to make a decision on how significant the private use is by ignoring the hours used and by taking a view about the provision of the computer and its necessity to the employee in performing the duties. It is in this context that significance of private use is measured. The following example is provided which makes understanding the new interpretation easier :

"Employers are not expected to keep detailed records of every instance of actual private use in order to substantiate a claim for exemption. The "not significant" condition should not be decided purely on the absolute time spent on different uses of the equipment or services provided. It should be considered in the context of the employee's duties and the necessity for the employee to have the equipment or services provided in order to carry out the duties of the employment.

For example, where a computer is provided by an employer because it is necessary for an employee to be able to carry out the duties of the employment either at home, or whilst travelling or at work, it is highly unlikely that any private use made of that equipment will be significant when compared with the business need for providing the computer in the first place. In these circumstances section 316 will apply and no tax charge will arise."

**Internet access**

As a result of the changes to the computer exemption, new guidance was also issued about the provision of internet access by the employer at the employee's home. This was revised during 2008. The guidance now says :

Where an employer provides for Internet access (on a company contract) at the employee's home solely for work purposes, under a package where there is no separate billing or record of access calls, and no breakdown is possible between work and private calls, where private use is not significant (and private use does not affect the cost of the package) the costs of connection are exempt from tax under Section 316.

For tax purposes the cost of providing the telephone line to connect to the Internet is a separate matter from the contract between the ISP and the employer or employee. The treatment of the telephone line rental and call charges depends on who has contracted with the provider of the telephone line.

Where an employee is the subscriber for Internet access to his or her home, and the employer reimburses the employee for these costs, there is no scope for the exemption in Section 316 to apply, as the employer is not providing a benefit. Reimbursements are taxable as expenses payments. If the employee can show that some or all of the Internet costs related to use wholly, exclusively and necessarily in the performance of his duties, he may be entitled to a deduction under Section 336 ITEPA 2003.

Where an Internet package, such as for Broadband access, provides unlimited access and no separate billing procedures to separate business use from private use, it is not possible for an employee to identify the business part of the cost. Consequently the position for these packages is the same as for similar mobile phone packages. If there is no identifiable cost that is wholly and exclusively for business use, no deduction will be due.

There is also guidance for employers about reimbursing internet access charges under the homeworking rules in Section 316A. This makes it clear that the payment of broadband bills for employees will only be regarded as additional costs incurred because of homeworking when the employee was not already paying for internet connection, or when the broadband speed had to be upgraded at additional cost because the employee was working from home. Only the additional costs incurred can be exempt under Section 316A. (EIM01475).

**Employee subscriptions to broadband**

EIM21617 says that when an employer reimburses employee for the cost of subscriptions to an ISP for internet access to his or her home, s 316 ITEPA 2003– "Exemption for accommodation, supplies and services used in employment duties" **does not** apply, as "the employer is not providing a benefit".

The amended guidance (dated 30 July 2007) now continues as follows :

*"But where a payment is made by an employer to reimburse an employee for reasonable **additional** costs (EIM01476) incurred whilst working at home under homeworking arrangements (EIM01472), the payments may be exempt under Section 316A ITEPA.*

**Fuel only advisory rates – effective 1 January 2009**

These rates were announced on 30 November in accordance with previously published practice, giving employers a minimum of one month's notice to implement the new rates. General comment about the use of the advisor fuel only rates is in chapter 5 of these notes. The rates are based on fuel prices of 93.1p per litre for petrol and 107.3 for diesel.

**Table : new rates effective 1 January 2009, old rates effective 1 August to 31 December 2008**

| | **Petrol** | | **Diesel** | | **LPG** | |
|---|---|---|---|---|---|---|
| **Engine capacity** | **Old** | **New** | **Old** | **New** | **Old** | **New** |
| Up to 1400 cc | 12 | 10 | 13 | 11 | 7 | 7 |
| 1400 – 2000 cc | 15 | 12 | 13 | 11 | 9 | 9 |
| Over 2000 cc | 21 | 17 | 17 | 14 | 13 | 12 |

**Beneficial loan rate**

The rate applying to beneficial loans is 6.25% with effect from 6 April 2008 to 28 February 2009. From 1 March 2009 the rate is 4.75%.

**Late night taxis home**

January 2008 saw the publication of revised guidance on the subject of the provision of taxi transport home for employees after they had worked late. The guidance was issued in draft in late 2007 and finalised and issued in early January 2008. The guidance was further amplified in December 2008 by

the addition of page EIM10210 which links the taxis provisions to the car sharing provisions, making it clear that providing a taxi home when car sharing arrangements break down due to unforeseen circumstances counts towards the 60 journeys limit.

The guidance (at EIM 21831) provides an exemption from benefit in kind for employees who are provided with a taxi home after work, only if the following conditions are met each time the employee is provided with a taxi home:

- all four late night working conditions are satisfied; **and**
- the number of such journeys for which a taxi has been provided for that employee in the tax year is no more than 60.

The late night working conditions

All of these must be satisfied every time for the exemption to be available :

- the employee is required to work later than usual **and** until at least 9pm
- this occurs irregularly, and
- by the time the employee ceases work
  - either public transport has ceased, or
  - it would not be reasonable to expect the employee to use public transport, and
- the transport is by taxi or similar road transport.

The first three terms are the subject of further detailed guidance. Some good examples were added to this guidance in December 2008 at EIM21832.

Taxis : failure of car sharing arrangements

A taxi may also be provided to staff where car sharing arrangements fail due to unforeseen circumstances. New guidance was issued in December 2008 to explain that this means when the car sharing arrangements break down during the working day – either by the breakdown of the car or by the employee who is due to drive being called away to work at another site or goes home ill. Where the unavailability of the car share was known before the journey to work the change is not considered to be unforeseen and any taxi which is paid for by the employer will be regarded as a benefit in kind or taxable expense payment, depending on the method by which the provision is made.

Taxable taxis

Where the terms of the exemption are not met, the taxi fare will be taxable, either as a taxable expense payment or as a benefit in kind where there is a contract with the employer to provide taxis. New guidance has been added to explain this at EIM10220. The manual also observes that taxi fares would be covered by a PSA arrangement if the employer so chose, as a "minor item".

**Revised guidance – the provision of travel cards**

Where an employer pays for business journeys by providing a travel card for the employee there is a potential benefit in kind, as the card would then be available for the employee to use for private journeys in addition to the business journeys. However, new guidance (EIM 16065) issued in July 2007 indicates that the benefit in kind will be reduced by a deduction for business use as follows :

The employee is entitled to a deduction under s362 equal to the lesser of :

- the total cost of the individual business journeys undertaken with the travel card (if paid for singly), and
- the cost of the travel card.

Consequently if the cost of individual journeys (if paid singly) exceeds the cost of the travel card, only the cost of the travel card can be allowed as a deduction This ensures that the employee is not

penalised simply because the employer has chosen to pay for his/her business travel in the most economical way.

**New arrangements : provision of cars in the motor trade**

Where employees in the motor trade are provided with a car by their employer the car is still subject to the benefit in kind rules. However when salesmen or service staff are provided with a car it is frequently the case that the model and therefore the list price and emissions will change frequently through the year, particularly when the employee takes a demonstrator or courtesy car home at night to facilitate an early customer call the next morning.

Generally speaking the employer should record each vehicle and calculate the benefit in kind accordingly, but this is impractical, so the calculation of the benefit in kind has normally been subject to local agreement. HMRC has now produced guidance in the Employment Income Manual which sets out a new **mandatory** averaging scheme to apply from 2009/10. This is covered in pages EIM23650 onwards.

**Subsistence expenses**

Employers are permitted to use a sampling basis to establish scale rate payments for employees in relation to subsistence expenses; details of this procedure are in EIM05200 et seq.

Where staff travel abroad the use of FCO benchmark scale rates is permitted, to avoid the need to amass receipts and translate currency expenditure into sterling. Full guidance on the use of scale rates for foreign travel is at EIM05250 and related pages. This guidance was first published in December 2007 and was updated in February 2008 and December 2008.

**Medical checkups paid for by the employer**

In general terms a medical check up provided by the employer for employees is not a taxable benefit, but is taxable when provided to members of the employee's family.

A long standing concession was implemented into law in August 2007. The guidance on this area was not updated at the time, and HMRC has also been in discussion with a number of employers who provided medical checkups which were exempt under the concession but now fall outside the new statutory exemption. As this is quite a complex area, the details from the guidance in EIM21765 follow :

Section 210 ITEPA and S.I. 2007 No. 2090

"The paragraph above describes a long standing non-statutory HMRC practice. From 14 August 2007 this practice was replaced by a statutory exemption (S.I. 2007/2090) under regulations laid under Section 210 ITEPA to exempt from charge minor benefits. But see below for details of announcements made by HMRC in October 2007 and March 2008.

Under the terms of the Statutory Instrument, if an employer provides for an employee up to one health screening and/or medical check-up per year, the cost of provision is exempt from charge as an employment-related benefit as long as

- the health screening is generally available to all employees, and/or
- the medical check-up is generally available to all employees, or to all employees identified in a previous screening as needing a check-up.

Not all employees have to take up the option to undergo health screening and/or a medical check-up, but all employees must have the opportunity to do so. There is no requirement that all employees should receive the same screening and/or check-up, or that the screening/check-op should be made available at the same intervals for all employees.

"Health screening" refers to an assessment to identify employees who might be at risk of ill health. "Medical check-up" refers to a physical examination of an employee by a health professional which is limited to determining the employee's state of health.

If the screening and/or the check-up results in the employee being provided with medical treatment, the exemption does not apply to any treatment that is subsequently made available.

The exemption applies from 2007/08. Where screening and/or check-ups took place between 6 April and 13 August 2007, on the basis of the previous guidance at EIM21765, HMRC accepts they were exempt from tax even if at that time the check-ups or health screening weren't generally made available to all employees. Consequently the requirement that screening and/or check-ups should be available to all employees took effect from 14 August 2007 and not from 6 April 2007.

<u>No tax or NICs liability for 2007/08 or for 2008/09</u>

Following a number of representations, HMRC was concerned that some existing health schemes could be affected by the new regulations in a way that was not envisaged when the regulations were laid. HMRC wanted to discuss the issues arising from the regulations with employers and their representatives to find a way forward that meets the needs of HMRC and employers.

Consequently on 15 October 2007 HMRC announced that for 2007/08 it will not seek to collect tax and NICs in respect of health screening and/or medical check-ups, if there would have been no tax or NICs payable on the basis of the non statutory treatment in force before 14 August 2007.

HMRC announced in March 2008 that it was still considering the many responses received on this issue and would announce the outcome of those deliberations as soon as possible. In the meantime HMRC extended the concession not to collect tax that is due as a result of these regulations to cover the 08/09 tax year**."**

**Canteen arrangements**

Section 317 ITEPA 2003 provides an exemption for meals provided in a canteen which is open to employees generally, and to meals on the employer's premises which are available to all staff. There are several pages of guidance on the application of this benefit exemption in EIM21670 and the following pages. However, this was updated by the issue of an additional page in mid 2008 identifying some arrangements to which Section 317 does not apply.

<u>"EIM21675 – Particular benefits: canteen arrangements that are chargeable to income tax</u>

<u>Section 317 ITEPA 2003</u>

HMRC has become aware of certain commercially marketed arrangement that do not fall within the Section 317 exemption. Scheme details vary but some of the following features may be seen:

- the employer makes money or value available to participating employees. This is used by employees to purchase food and drink in the workplace
- each participating employee has an account or "purse" in which the money or value is held
- the account or purse may exist in the accounting system that supports the canteen or on smart cards held by the employees
- money or value is credited to an account or "purse" on a daily, weekly or monthly basis
- Employees may add money or value to the account from their own taxed income. "Top ups" are used to purchase food and drinks when amounts credited by the employer are exhausted
- Money or value can be used to obtain food and drinks from a range of restaurants, coffee shops and vending machines in the workplace. The retail outlets link into a common accounting/tracking system
- Tills and vending machines in the workplace require the provision of a card or the entry of a PIN to enable employees to access and draw on funds in their accounts
- Arrangements may be linked to salary sacrifice. Employers deposit matching amounts into the canteen account or purse. Once funds are exhausted, "top-ups" may be used to fund consumption until the next employer deposit is made

Analysis
These schemes are not within the Section 317 exemption. Canteen arrangements that provide employees with money or value do not provide "…free or subsidised meals…" within the meaning the meaning of Section 317. These arrangements simply place funds at the disposal of participating employees. They can spend the funds as they like, within the limitations they have agreed to. The provision of money or value is taxable as earnings within the definition provided by Section 62,

Tax and NICs consequences
Employers should treat amounts credited to canteen accounts as earnings for the purposes of PAYE and Class 1 NICs"

**Employer provided vans**

Where a van is provided to an employee for both business and private travel, there is no charge to tax if the restricted private use condition is met in relation to the van for the year. Drivers who have unrestricted use of a company van are taxable on a benefit in kind of £3,000; there is a further taxable benefit of £500 if free fuel is provided for private motoring. This will normally be chargeable if the van accrues a benefit in kind and fuel is provided in the van, unless the driver is required to and actually does make good the cost of fuel used privately.

The restricted private use condition is met for a tax year if :

(a) the commuter use requirement is satisfied throughout the year (or the part of the year on which it is available to the employee) or the extent to which it is not satisfied during that period is insignificant, and
(b) the business travel requirement is satisfied throughout the year (or the part of the year on which it is available to the employee).

The commuter use requirement is satisfied at any time if :

(a) the terms on which the van is available to the employee at the time prohibit its private use otherwise than for the purposes of ordinary commuting or travel between two places that is for practical purposes substantially ordinary commuting, and
(b) neither the employee nor a member of the employee's family or household makes private use of the van at the time otherwise than for those purposes.

The business travel requirement is satisfied at a time if the van is available to the employee at the time mainly for use for the purposes of the employee's business travel.

The tax charge will be excluded if the employee only uses the van for home to work travel, or the private use is insignificant. The interpretation of insignificant is give as "too small or unimportant to be worth consideration" and examples give of insignificant use are :

- An employee who :
    - takes an old mattress or other rubbish to the tip once or twice a year
    - regularly makes a slight detour to stop at a newsagent on the way to work
    - calls at the dentist on his way home.

Examples of use which is NOT insignificant include the following :

- An employee who :
    - uses the van to do the supermarket shopping each week
    - takes the van away on a week's holiday
    - uses the van outside of work for social activities.

Drivers of emergency vehicles are exempt form the benefit in kind, subject to meeting strict conditions. These are explained at EIM 23047.

Double cab pick ups are treated as vans if the load weight exceeds one tonne. The addition of a hard top reduces the load weight by a deemed 45kg.

**More information :** HMRC web area on vans, including guidance for both employers and employees is at http://www.hmrc.gov.uk/vans/

**Expenses while working from home**

Tax Bulletin 79 includes a detailed article regarding tax relief for employees on expenses incurred when working from home. The article provides guidance both on the circumstances under which an employee will be able to claim tax relief on expenses incurred while working at home, and the types of expenses which will and will not attract tax relief. The article indicates that in the absence of additional evidence demonstrating a higher level of expenditure, HMRC will accept a claim of £3 (increased for 2008-09 from £2) per week in respect of heat, light and other expenses, with an additional claim possible for the business units of telephone calls. Under no circumstances can rent, council tax or mortgage interest be claimed.

Only those employees required to work from home can make any claim at all under Section 336 ITEPA 2004. The new guidance sets out four conditions which all need to apply to allow an employee to make a claim :

- the duties that the employee performs at home are substantive duties of the employment. "Substantive duties" are duties that an employee has to carry out and that represent all or part of the central duties of the employment (this condition is unchanged),
- those duties cannot be performed without the use of appropriate facilities,
- no such appropriate facilities are available to the employee on the employer's premises (or the nature of the job requires the employee to live so far from the employer's premises that it is unreasonable to expect him or her to travel to those premises on a daily basis),
- at no time either before or after the contract is drawn up is the employee able to choose between working at the employer's premises or elsewhere.

Where a contract of employment includes a term requiring the employee to work form home, this will not change the right of claim where this is a reflection of the employee's choice rather than an objective requirement of the duties. In practice, the third and fourth of these conditions are the most likely to cause disagreement.

Once an employee can make a claim, he will be able to claim in respect of the following expenses, incurred wholly, exclusively and necessarily in the performance of the duties :

- the additional unit costs of gas and electricity consumed while a room is being used for work,
- the metered cost of water used "in the performance of the duties" (if any),
- the unit costs of business telephone calls (including "dial up" Internet access).

Employees will not be permitted to claim for any of the following expenses :

- Council tax/rates (this is a change to the practice set out in EIM32815),
- Rent (this is a change to the practice set out in EIM32815),
- Water rates,
- Mortgage repayments/endowment premiums,
- Household insurance premiums.

Unless the employee can demonstrate clearly that the expenses open for claim exceed that amount, the sum of £3 per week plus telephone costs will be allowed, and no more. No proof of the £3 per week will be necessary, once the employee has shown that he will qualify for relief.

**More Information :** More information is in Tax Bulletin 79 at http://www.hmrc.gov.uk/bulletins/tb79.htm

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**Approved mileage allowance payments**

A new system of mileage payments in respect of business use of a privately owned car commenced on 6 April 2002. The new system replaced any alternative arrangements that employers have in place in respect of taxing or reporting such payments. The new system is now fully in place, the NIC having been legislated for to bring it in line with the tax treatment.

Record keeping

Provided payments made to employees are not more that the approved mileage rates, no benefit in kind will need to be reported on form P11D, and the payments are not reported in any way. However, Employers' Bulletin 9 indicates that HMRC expect the employer to record (in respect of each payment) the amounts paid *" and the business journeys they are for."* This advisory statement indicates that there is an expectation that every journey should be identifiable, not just a total monthly mileage amount.

National Insurance Contributions

The higher rate of mileage applies for NIC purposes (as in the past) so that 40p per mile can be paid in respect of all miles before a liability to Class 1 NIC arises. Once this amount has been exceeded, the amounts paid must be included in gross pay and NIC calculated on the total amounts paid in the month.

Table : Approved Mileage Allowance Payments

| | **Per mile** |
|---|---|
| **Cars and vans** | |
| First 10,000 miles | 40p |
| All miles in excess | 25p |
| | |
| **Motorcycles** | 24p |
| | |
| **Bicycles** | 20p |

Passenger rate

This rate works differently in that although employers can pay this rate per mile tax free, the employee has no right to claim a tax deduction for the amount if not paid by the employer. Where the driver takes other employees in his car on a business journey the employer will be permitted to pay an additional 5p per mile tax free for each passenger carried.

Motor Insurance

Issue 9 of the Employers' Bulletin reminds employers that they should advise employees to check that the mileage payments they receive (and in particular the passenger rate) do not infringe their motor insurance.

**Tax treatment of termination and redundancy payments**

Under the special legislation in ITEPA 2003, ss 401–416 (previously in ICTA 1988, s 148), payments and other benefits 'received' in connection with the termination of a person's office or employment, and not otherwise chargeable to income tax, are chargeable to tax as employment income if and to the extent that they amount in aggregate to more than £30,000.

The charge is as employment income for the tax year in which the payment or benefit is received. For these purposes, a cash benefit is treated as 'received' when payment is made (including any payment on account) or when the recipient becomes entitled to require such payment. A non-cash benefit is treated as 'received' when it is used or enjoyed.

A benefit includes anything which would be taxable earnings from the office or employment.

The charge applies to payments and other benefits received directly or indirectly, in consideration or in consequence of, or otherwise in connection with, the termination, by the employee himself, by a spouse (or, from 5 December 2005, civil partner), other relative or other dependant of his. Where an individual suffered constructive dismissal on grounds of discrimination, the amount awarded by a tribunal was within the charge to the extent that it related to loss of income but not to the extent that it covered injury to.

Where a payment or benefit could fall to be taxed under both these provisions and the benefits code, the benefits code takes priority after 5 April 2003.

The amount of a non-cash benefit is normally its cash equivalent as determined under the benefits code as applied, with the necessary modifications (including a modified version of the rules for valuing the benefit of living accommodation) by ITEPA 2003, s 415. If, however, a greater figure would thus result, the benefit is the amount of earnings it would give rise to if received by an employee for duties of the employment (money's worth), thus bringing into charge any appreciation in the value of an asset since its acquisition by the person providing it.

Where the cash equivalent of a beneficial loan is charged under these provisions for any tax year, the taxpayer is treated as having paid interest for that year of an amount equal to that brought into charge (but not to the extent that the amount otherwise chargeable is covered by the £30,000 threshold); general principles then apply to determine whether such notional interest is allowable for tax purposes.

A statutory redundancy payment under Employment Rights Act 1996 (or NI equivalent) is specifically brought within these provisions.

*P11d notes prepared by Rebecca Benneyworth*

# Personal Tax

## Termination payments

### Analysis of the payment

Three stage analysis is required:

1. Is it taxable as employment income? – Section 6 ITEPA2003 but with exemption of statutory redundancy payments
2. If not, is it taxed under Section 394 relating to an employer-financed retirement benefits scheme? (i.e. not a registered scheme and formerly known as a non-approved retirement benefits scheme)
3. If not, is it taxable under Section 401, subject to various reliefs including exemption of the first £30,000 under Section 403?

### Non-cash benefits received on and after termination

Section 415 ITEPA2003 serves to tax these by reference to the cash equivalent, with Section 415(6) ensuring that the benefits code applies to the former employer as well as the current employer.

Cash benefits from an EFRBS, in the form of a lump-sum or pension, are of course taxed as income. So are non-cash benefits, with the tax charge being on the greater of (a) its money's worth, or (b) its "cash equivalent" under the benefits code.

The following non-cash benefits are all exempt for retired former employees, mainly mirroring the exemption applying to existing employees and with the same conditions applying:

- continued provision of accommodation and related expenses
- welfare counselling
- recreational benefits
- annual parties and similar functions
- equipment for disabled former employees
- advice on writing of wills
- other benefits where cost is less than £100 in total per tax year

### Section 401 exemptions

1. There is full exemption under Section 406 where a payment is made in connection with termination of the employment by death of the employee or on account of his/her injury or disability. Under IRSP 10/81 disability covers not only a condition resulting from a sudden affliction, but also continuing incapacity to perform the duties of the employment arising out of the culmination of a process of deterioration of physical or mental health caused by chronic illness.
2. There is also full exemption where foreign service applied, defined as:
    - 75% of whole period of service up to the date of the termination: or
    - if whole period of service exceeded 10 years, the whole of the last 10 years; or
    - if whole period of service exceeded 20 years, 50% or more of that period including any 10 of the last 20 years.

### Determining the character of the termination payment

If required to work his notice, clearly the payments flow from the employment contract and are taxable as such.

The same position applies where the employee is placed on "garden leave". PAYE and NIC applies in the normal way.

Where termination is without notice and a PILON is paid, it is taxable under Section 6 where there is a clause in the employment contract and payment is made pursuant to that clause. HMRC often consider the same tax treatment applies where the employer's practice is to pay a PILON and therefore the employee could expect it, such that it becomes contractual in law. However, their stance seems to have relaxed somewhat following *para EIM12979* of the *Employment Income Manual* as under (words in bold are from HMRC):

- Where employer and employee agree to terminate without proper notice and the employer pays a PILON, if this is done **before termination is in prospect** it is simply a variation in the terms of employment. The PILON is then within the Section 62 ITEPA2003 definition of "earnings" and therefore taxable as employment income under Section 6.
- If it is done **only** as part of the process of termination, the PILON is not from the employment but instead it is from the agreed terms for its destruction. It is therefore taxed under Section 401, with the £30,000 exemption and no NIC.

There is often a conflict between employer and employee with the establishment of a PILON clause. The former may wish to include it so as to be able to terminate without a breach of contract, thereby not compromising its ability to enforce any post-employment restrictive covenants under the employment contract, whereas the employee may wish to safeguard the £30,000 exemption.

**Ex-gratia payment**

1. This is an area treated with great suspicion by HMRC. Quite apart from a possible attack as being a payment under a non-approved retirement benefits scheme, HMRC will look to see the reason behind the payment.
2. Success (in terms of exemption of the first £30,000) is most likely where the employer wishes to pay more than the amount which will be regarded by the Courts as appropriate in compensation. Depending on the length of service and seniority, pay-offs for directors in established firms are generally equivalent to between one and two years' net salary, so it is only where a greater pay-off is to be made that there is likely to be a problem although ordinarily account would be taken of a discount to reflect acceleration of the compensation; the prospect of the individual obtaining new employment; and a reduction to take into account the tax exemption of the first £30,000
3. If the employee has no legal entitlement (which he will not have if he resigned or received the proper period of notice) the whole of any payment is ex-gratia.
4. Great care is needed in the wording of the minutes of a directors meeting, so as to ensure the payment could not be regarded as a reward for past service.
5. The *Resolute Management Services* case (see below) suggests that particular wording could be used to safeguard the £30,000 exemption on an ex-gratia payment.

**Resolute Management Services Litd v HMRC; Haderlain v HMRC SpC710**

1. In 1996 the company was formed as part of the Lloyd's reconstruction and renewal plan to reinsure various long-tail liabilities of Lloyd's and it was set up with the intention of "working itself out of business".
2. In November 1996 H, a US national, was employed by the company as director of human resources. Once it achieved its business objectives the company began to downsize and H's job changed from managing high volume staff recruitment and establishing human resources policies for the business to managing a planned headcount reduction programme over a five year period. Thus, by 2004 H's role was very different from her original role and realising that her task had been accomplished she formally resigned on 21 July 2004. In so doing she forfeited her potential redundancy benefit, assessed to be £152,300, and outstanding long-term incentive plan awards, amounting to £122,500, she would have received had she remained.
3. Whilst there was no provision in her employment contract under which she was entitled to an ex gratia payment, the CEO of the company decided to make her an ex gratia payment of £150,000 to compensate her for the benefits she was giving up as a result of her resignation and to recognize that she was doing the "right thing" by the company. H left the company on 17 September 2004 and returned to California. On 19 November 2004 the company

made the ex gratia payment into her American bank account. The company deducted tax at the basic rate of 22 per cent from £120,000 of the payment.

4. HMRC contended that the ex gratia payment was chargeable to tax as general income from the employment under ITEPA 2003 s 62(2)(b). The company argued that the ex gratia payment was not chargeable under s 62 but only under ITEPA 2003 s 401 as a payment in connection with the termination of H's employment and that on that basis it had deducted and accounted for the correct amount of tax.

5. H submitted that (a) she was not employed by the company when the payment was made and she had no contractual or other legal entitlement to it and had the company refused to pay it there would have been no formal recourse open to her. Furthermore the payment was not paid in connection with the termination of her employment. It was a straightforward personal gift—made because she had "done the right thing" by the company in resigning—and not chargeable to tax at all; or, in the alternative, (b) if it was a termination payment within s 401, it was not subject to UK income tax because it was not "salaries, wages, and other similar remuneration derived by a resident of a Contracting State in respect of an employment" within the UK/USA Double Taxation Convention 2001, art 14; thus the payment could only be "other income" within art 22 and therefore taxable only in the USA.

6. The Special Commissioner found that the ex gratia payment was not earnings for the purposes of ITEPA 2003 s 62 as it was paid in recognition of the fact that H had "done the right thing" in resigning her position as human resources director with the company. On the facts the ex gratia payment was truly ex gratia. H had no contractual entitlement to it and she did nothing to earn it in the conventional sense. Whilst it was true that the company would not have paid it had she not chosen to resign her position, it was not paid in return for that resignation. However, a gratuity or gift was not removed from charge to tax as employment income by that fact alone. It was possible that had there been no financial cost to H's decision to resign voluntarily the company CEO would not have thought of making the ex gratia payment. Although companies did not usually pay gratuities to employees who chose to leave voluntarily, they might do to recognise the personal qualities that an employee had exhibited in the course of that employment. When judges referred in that context to the payment being for "something else" they did not necessarily have in mind payment for some other (non-employment) service or asset. It might be an intangible personal quality of the individual concerned—loyalty, good humour, for being a good team player—that contributed significantly to the success of the business and therefore were appropriately recognised gratuitously. However, a payment did not lose its character as earnings because it was paid to recognise the personal qualities that the employee had exhibited in the course of rendering services. The payment remained earnings for employment services even if it purported to be for rendering the services with a smile. That was not the case, however, when the personal quality involved was recognising that the time had come to leave. H had recognised that her job was done and that she should move on to other things. The payment was made for "doing the right thing" by the company and resigning voluntarily; it was not in respect of any service that H had rendered or that she was obliged (but for short notice) to render.

7. The Special Commissioner found that the ex gratia payment was a termination payment within ITEPA 2003 s 401. The language of sub-s (1) was cast in the widest terms designed to catch any payment or benefit received "directly or indirectly … in consequence of, or otherwise in connection with" the termination of H's employment. The payment might have been gratuitous and for "doing the right thing" but the right thing was resigning her employment. Accordingly the payment was in consequence of or in connection with the termination of her employment.

8. Although only of relevance to this particular case, the Special Commissioner also found that the ex gratia payment was not within the scope of the UK/US Double Taxation Convention 200, art 14. As the ex gratia payment was a gift "for doing the right thing" it did not fall within the ordinary meaning of the words "salaries, wages and other similar remuneration".

*Article by Gerry Hart*

**Lecture P526 (11.41 Minutes)**

## Car averaging: new arrangements from 6 April 2009

### The revision

The original version required employers to identify the cars available to their employees for private use at each location, to allocate those cars to groups and then to calculate the average car in each group from the cars in each location.

Instead of requiring that this be done location by location, employers can instead calculate the average using all the cars identified at Step 1 (EIM23656) on a national basis (or regional, if they are so organised and prefer this option) rather than at each location.

It will still be necessary for such groups to identify how many cars in each group are at which location because this affects the cars actually available to employees at that location.

### EIM23650 - Car benefit: employees in the motor industry: when is there a car benefit charge?

All employees chargeable to car benefit are subject to exactly the same legislation.

However, HMRC recognises that problems arise in applying the law strictly for:

1. Test and experimental cars (EIM23651)

2. Demonstrator and courtesy cars: is there a benefit charge at all? (EIM23652)

3. Employees with frequent changes of car ("averaging", EIM23653 onwards)

### EIM23651 - Test and experimental cars

Test engineers in both the motor industry and the components industry are often required, as part of their jobs, to test cars under various driving conditions. For certain types of test such as cold starting, the only practical way of conducting them is for the engineers concerned to use the cars for private journeys and to report on their performance.

HMRC will not apply car benefit where the primary use of the car is for testing and any private use is clearly subsidiary to that testing.

### EIM23652 - Demonstrator and courtesy cars

Where, as part of the normal duties, a director, car salesperson or demonstrator takes a car home for the express purpose of calling on a prospective customer, or servicing staff take a car home overnight as part of a collection and delivery arrangement with a customer, the car will not on that account alone be treated as available for private use. In essence, the whole journey is for a genuine business purpose.

### EIM23653 - Employees with frequent changes of car

It is common practice, both in motor manufacturing and the retail car sales industry (both new and used), for an employee to have the contractual right to take a car, but not a particular car, home. This is also true of employees in the same contractual position in the daily car rental business and to some employees of fleet operators.

Applied strictly, the system for charging car benefits based on price and $CO_2$ emissions could mean a considerable amount of record keeping and administrative work where there are **very** frequent changes of car. HMRC recognises the need for administrative simplicity in such cases and has therefore always made arrangements to accommodate these administrative difficulties within the terms of the car benefit legislation.

These arrangements are applied solely for the purpose of simplifying the calculation of the amount of the car benefit charge and are not intended to result in a lower or higher tax charge for the employees involved.

### Employees' rights

Note that employees affected by these arrangements are entitled to have their car benefit computed under the statutory arrangements on the basis of the particular cars made available to them throughout the year should they so wish.

However, the employee will be individually responsible for providing evidence of the cars actually made available to them each day, as their employer is not required to keep such records under these arrangements.

**EIM23655 – Outline of averaging process**

The following pages describe how the averaging process operates in practice:

- Averaging Step 1: identify cars to be averaged (EIM23656)
- Cars without a CO2 emissions figure: EIM23657
- Averaging Step 2: separate the cars into groups (EIM23658)
- Averaging Step 3: calculate the average price of the notional car in each group (EIM23659)
- Averaging Step 4: calculate the average CO2 emissions and appropriate percentage of the notional car in each group (EIM23660)
- Averaging Step 5: determine the benefit charge for the notional car in each group (EIM23661)
- Averaging Step 6: identify employees within these arrangements (EIM23662)
- Averaging Step 7: allocate those employees to groups (EIM23663).

**STEP 1: identify cars to be averaged**

Each business records the cars actually available to employees for private use on the night of 5/6 April in the tax year.

**STEP 2: separate the cars into groups**

From 6 April 2009, the next step is to separate the cars identified at Step 1 into groups. The groups are local, regional or national as determined at Step 1.

**Daily rental businesses**

For rental businesses, they already group the vehicles they make available for hire for commercial reasons. These form the basis for averaging, using the prices determined at Step 1.

For other qualifying businesses, their groups are determined solely by price, as follows:

| Group | Price from | Price to |
|---|---|---|
| 1 | £0.00 | £8,999.99 |
| 2 | £9,000.00 | £11,999.99 |
| 3 | £12,000.00 | £16,999.99 |
| 4 | £17,000.00 | £22,999.99 |
| 5 | £23,000.00 | £34,999.99 |
| 6 | £35,000.00 | £49,999.99 |
| 7 | £50,000.00 | £64,999.99 |
| 8 | £65,000.00 | £79,999.99 |
| 9 | £80,000.00 | upwards |

**STEP 3: Calculate the average price for the notional car in each group**

This is achieved using this process:

- take the uncapped price of each car in the group, as determined at Step 1 (EIM23656)
- add these together and divide by the number of cars in the group
- restrict the result to £80,000 if, exceptionally, this is necessary
- the result is the price for the notional car in that group.

Daily rental businesses will also need to calculate the average price of the cars in their fleet which are

**STEP 4A: average CO2 emissions for the notional car in each group**

This is achieved using this process:

- ignore any cars in a group which do not have a CO2 emissions figure
- add the CO2 emissions figure of each other car in the group, as determined at Step 1
- add 15 for each diesel car in the group to which the diesel supplement applies
- for cars which are not QUALECs
- deduct 15 for each hybrid
- deduct 10 for each bi-fuel car or car manufactured to run on E85
- now bring any cars which do not have a CO2 emissions figure back into the calculation by adding the figure obtained from EIM23657
- divide the result by the number of cars in the group

The result is the CO2 emissions figure for the notional car in that group (round down to the next integer).

**STEP 4B: find the appropriate percentage for the notional car**

Because the effect of all fuels other than petrol has been taken into account in the above calculation, the notional car is deemed to run on petrol.

The appropriate percentage for the year is therefore determined using the ready reckoner at EIM23410 without the need for any further adjustments.

**STEP 5: Calculate the car benefit charge for the notional car in each group**

For the notional car in each group, multiply the average price as determined at Step 3 by the appropriate percentage as determined at Step 4.

**Example**

There is an example of Steps 1 to 5 at EIM23664.

**STEP 6: identify qualifying employees**

On 6 April in each tax year, the employer lists employees at each location who qualify as described above.

**STEP 7: allocate qualifying employees to car groups**

The employer simply allocates each member of staff to a group, thus determining which cars are available to them. This may be done on an individual basis or by job type (e.g. sales executive, service manager). The number of employees at a location allocated to a group may not exceed the number of cars in that group at that location, but all groups at a location must be populated with employees because those groups only contain cars which are available to employees for private use.

An employee joining during the year is allocated to the appropriate group from the date on which they are first entitled to use a grouped car.

An employee leaving during the year: a P46(car) is completed showing that the car has been withdrawn and the date of leaving goes onto their final P11D.

An employee who changes their job during the year may move up or down a group.

**Employee uses car of a different group**

The normal rule is that an employee must use a car of the group to which they are allocated. However, there will inevitably be occasions when this is not possible.

The rules for replacement cars at EIM23502 (www.hmrc.gov.uk/manuals/eimanual/EIM23502.htm) are adapted to this situation. No charge will be made for the replacement car (whether of a higher or lower group) if

- it is not materially better than the normal (i.e. notional) car, or
- it is not made available under an arrangement of which the main purpose, or one of the main purposes, is to provide the employee with the benefit of a car that is materially better than a car of the group to which they are allocated.

**Only one car in a group**

As long as the employee works in the kinds of business described at EIM23653 and does not have a car allocated to them, so qualifying to be allocated to a group, we allow employers to use these simplified arrangements even though there is only one car in a group. Doing so has two advantages:

- it allows all qualifying employees to be treated in the same way, and
- it relieves that employer of the need to complete forms P46(car) when the car is changed.

**Procedures and record-keeping**

Employers will need to keep the following records about the cars:

- cars available to employees for private use on 6 April in each tax year
- price for each car, i.e. list price plus accessories, including VAT
- CO2 emissions and fuel for each car
- the groups to which the cars were allocated
- the number of cars in each group at each location
- the car benefit charge for each group and how this was calculated

and these about the employees:

- list of employees entitled to use those cars in the tax year
- group to which each employee is allocated
- why that employee (or group of employees) was allocated to that group
- dates on which new employees join or current employees leave
- any employee who changes group in a year, with the date of change

Failure to do so may result in HMRC taking action to recover car (and, if appropriate, car fuel benefit) on the statutory basis, both for future and past years.

**Form P11D**

Form P11D should be completed annually with the relevant details for each employee. It will only be necessary to report two cars for an employee where that employee changes groups in the year.

**Form P46(car)**

Forms P46(Car) will only be necessary when an employee joins or leaves the employment. No form will be necessary if an employee changes groups, whether in year or between years.

### Car fuel benefit

The car fuel benefit legislation applies to employees with cars subject to averaging as it does to all others.

## Employment related securities - Gray's Timber Products Ltd

### The Facts in Outline

In December 1999 Mr G, the managing director of Gray's Timber Products Ltd, acquired 14,465 ordinary shares in its parent company (Gray's Group Ltd) by reason of employment.

At the time of acquiring the shares Mr G, Gray's Group Ltd and certain other holders of Gray's Group Ltd's share capital entered into a shareholders' agreement. Clause 4 of the shareholders' agreement provided in the event of a sale of Gray's Group Ltd after two years, Mr G was to receive from Gray's Group Ltd or from the purchaser a formula price described, broadly, as a one-third share in the value by which Gray's Group Ltd had increased from the date of his initial share acquisition to the date of the disposal.

This 'ratchet' evidently gave Mr G a much larger share of the sale proceeds than that to which he would have been entitled on a pro rata basis under Gray's Group Ltd's articles of association (Mr G held only about 6.5% of Gray's Group Ltd's ordinary share capital).

In November 2003 (more than two years after the shareholders' agreement was entered into), the entire share capital of Gray's Group Ltd was sold to an unconnected third party, Jewson Ltd. In accordance with the ratchet, Mr G received £1,451,172 for his shares. He would only have received £391,485 on a pro rata basis under Gray's Group Ltd's articles of association, so his actual sale proceeds exceeded his pro rata entitlement by £1,059,687.

### Applicable Law

HMRC took the view that the sale by Mr G was liable to income tax under Chapter 3D of Part 7 in respect of his excess sale proceeds of £1,059,687. Accordingly, HMRC assessed the taxpayer company to income tax under PAYE in respect of that amount.

Chapter 3D applies where an employee disposes of shares acquired by reason of employment for a consideration which exceeds the market value of the shares.

### The Decision of the Scottish Court of Session

By a majority verdict the Scottish Court of Session dismissed the taxpayer company's appeal. It decided that s 272 postulates a notional sale between a hypothetical willing vendor and a hypothetical willing purchaser (the personal characteristics of the actual vendor being ignored). The question is what the highest bidding hypothetical purchaser would be prepared to pay to acquire the rights attaching to, and running with, the shares, being the rights obtained on registration and provided for in the articles of association. Any personal rights which the actual vendor might in addition have acquired (particularly, but not only, as a reward for employment) are disregarded.

Mr G's shares were held to be identical to the other shares in Gray's Group Ltd. His right to sell at a ratcheted price did not affect the price which a hypothetical purchaser would be prepared to pay for his shares, because the right was specific and personal to him and non-assignable. Accordingly, Mr G had sold his shares for a price which exceeded their market value by £1,059,687 and that amount was liable to income tax under Chapter 3D.

### Implications of the Judgment of the Court of Session

***Personal rights conferred by articles of association or shareholders' agreements***

Would it have made any difference if the shareholders' agreement in *Gray's Timber Products Ltd* had been entered into by all of Gray's Group Ltd's shareholders? Indeed, would it have made any difference if Mr G's right to sell his shares at the ratcheted price had been contained in the articles

of association of Gray's Group Ltd? Surely not. In either case the right would still have been personal to Mr G and non-assignable. It would not have 'run' with the shares on a sale. The right would not be valuable to a hypothetical purchaser of the company, as it would still only be enforceable by Mr G.

***Non-personal rights conferred by articles of association or shareholders' agreements***

Clearly the decision in *Gray's Timber Products Ltd* would have been different if (i) the shares held by Mr G had been identified in Gray's Group Ltd's articles of association as a separate class of shares and (ii) the articles had provided for shares of that class to be sold at the ratcheted price. Such an intrinsic right would 'run' with the shares on a sale. It would be valuable to a hypothetical purchaser of the shares, as it would be enforceable by any holder of the shares.

Would the same apply if (i) the shareholders' agreement in *Gray's Timber Products Ltd* had been entered into by all of Gray's Group Ltd's shareholders and (ii) it had provided for Mr G's shares to be sold at the ratcheted price by whomsoever was the holder of those shares from time to time? It is clear from the decision in *Gray's Timber Products Ltd* that the concept of stepping into the actual vendor's shoes does not involve the hypothetical purchaser assuming the actual vendor's identity. But could it extend to treating the hypothetical purchaser as a subscriber to the shareholders' agreement, given that all the shares in the company are governed by that agreement? If so, the right to sell at the ratcheted price would 'run' with the shares on a sale and would be valuable to a hypothetical purchaser of the shares. Alternatively, if the shareholders' agreement had provided that no party was to dispose of his or her shares without first procuring that the purchaser became a party to the agreement, there would be a respectable argument that the right to sell at the ratcheted price would 'run' with the shares on a sale and would, therefore, be valuable to a hypothetical purchaser of the shares.

***Put options***

If an employer company grants to an employee an option to sell his or her shares in the employer company at an enhanced formula price, that would not normally have any effect on the market value of the shares. The put option would not 'run' with the shares on a sale and would not, therefore, be valuable to a hypothetical purchaser of the shares. However, if, under the law governing the shares or the option agreement, a purchaser of the shares would automatically benefit from the put option without additional cost to him or herself merely by virtue of acquiring the shares, the position might be different. Of course most put options do not 'run' with the shares (in the way that an easement might 'run' with land), unless they are embedded in the shares under the articles of association.

***Is* Gray's Timber Products Ltd *consistent with* Alexander v IRC*?***

In *Alexander v IRC* [1991] STC 112 Mrs Alexander was granted a long leasehold of the house in which she lived by her local authority under the 'right to buy' legislation in the Housing Act 1980. The price payable for the lease was at a substantial discount to market value. However, the full discount was repayable to the local authority if the tenant sold the property within one year and a diminishing part of it was repayable if the sale took place in the next four years. The obligation to make this repayment was contained in a covenant in the lease and was an encumbrance on the lease. Mrs Alexander died within one year of the grant of the lease and, in assessing the open market value of the lease for inheritance tax purposes, her executors argued, effectively applying the *Crossman* 'step in the shoes' concept, that the full amount of the discount should be deducted from what would otherwise be the market value of the property. The Court of Appeal also applied the 'step in the shoes' concept but held that account should only be taken of the negative value which the hypothetical purchaser in the open market would place on the repayment obligation and that this was less than the full amount of the discount.

*Alexander v IRC* decides that the hypothetical sale in the open market is not deemed to trigger the repayment obligation and that, because the hypothetical purchaser steps into Mrs Alexander's shoes, he or she is subject to the same repayment obligation as she was. The hypothetical sale in the open market is merely a mechanism for valuing property; there is no actual sale and, accordingly, only limited effect is given to what would be the actual consequences of a real sale.

In contrast, *Gray's Timber Products Ltd* decides that the hypothetical sale in the open market does not involve the hypothetical purchaser stepping into the actual vendor's shoes or assuming any personal characteristics of the actual vendor. On that basis, it could be argued that the hypothetical

sale is deemed to trigger Mrs Alexander's (or, rather, the hypothetical vendor's) repayment obligation (as a sale by her in the real world would have). If that is right, the repayment obligation would fall on Mrs Alexander (or on the hypothetical vendor), not on the hypothetical purchaser. That obligation could never fall on a *second-hand* purchaser of the lease and the hypothetical purchaser postulated by the market value test should be regarded as a second-hand purchaser. Accordingly, the hypothetical purchaser could safely offer to pay the full unrestricted value of the property (though, in the real world, he or she would ensure that the encumbrance on the lease was discharged out of the purchase price). Only the 'step in the shoes' concept would treat the hypothetical purchaser as a tenant who had purchased the lease from the local authority. There is, therefore, arguably a tension between *Alexander* and *Gray's Timber Products Ltd*.

**Conclusion**

The decision of the Court of Session in *Gray's Timber Products Ltd* has sensibly and severely restricted the scope of the concept of the hypothetical purchaser stepping into the shoes of the actual vendor. It does not involve the hypothetical purchaser assuming the identity of the actual vendor or any rights which are personal to the vendor.

But other points remain unclear. In particular, it would now be helpful to know whether the 'step in the shoes' concept has any application in a case where the asset being valued benefits from a right, or is subject to a restriction, which will inevitably fall away on the next actual sale of the asset (as in the case of the forfeitable discount in *Alexander*). If the hypothetical sale is a second-hand sale, it will be similar to the next actual sale and, consequently, the right or restriction (now spent) will be disregarded by the hypothetical purchaser in determining the price which he or she is prepared to pay for the asset. On the other hand, if the hypothetical purchaser steps into the actual vendor's shoes, the hypothetical sale will not displace the right or restriction and it will be necessary to ascertain whether it is personal to the actual vendor or would apply to any owner of the asset. If the latter, the hypothetical purchaser will take it into account in determining the price which he or she is prepared to pay for the asset.

*From an article by Nigel Doran*

## Non-UK domiciled individuals - planning before the end of the tax year

Fundamental changes were made to the UK taxation of **non-UK domiciled** individuals from 6 April 2008. There are planning steps and elections which should be considered.

The Finance Act 2008 introduced new tax rules for those individuals who are non-UK domiciled. While the implications of many of these rules still require further guidance, there is growing clarity as to what non-UK domiciled individuals/trustees should be doing with their personal assets or assets they control.

**General outline of the rules**

Individuals who are not domiciled or ordinarily resident in the UK may be taxed on certain types of foreign income and gains only when they are remitted to the UK (the remittance basis).

From 6 April 2008, individuals wishing to take advantage of the remittance basis will need to make a claim for the remittance basis to apply. It is often assumed that all persons will need to pay a £30,000 charge in order to claim the remittance basis, known as the remittance basis charge (RBC). This is not the case. The £30,000 RBC is only levied on those who have been UK resident for more than six out of the previous nine tax years. Therefore the £30,000 RBC will become due from the start of the seventh tax year of UK residence. Furthermore, it should be remembered that the decision to claim the remittance basis is an annual decision.

Another change from 6 April 2008 is that a claim for the remittance basis triggers the loss of personal income tax and capital gains tax allowances.

Where the person has no UK income or gains and is either under 18 or has been UK resident for less than seven out of the previous nine tax years, or where total unremitted income or gains fall below a de minimis limit of £2,000, the remittance basis of assessment may be enjoyed without requiring a remittance basis claim, and allowances may therefore be retained.

The new rules are complex and likely to cause significant complications for those to whom the new regime applies. However, the basic principle behind the rules is that income or gains which are used in any manner or form in the UK by, or for the benefit of a remittance basis taxpayer, their spouse, minor children or any other 'relevant person', or are bought to the UK by any structure for their benefit, will give rise to a tax liability. There is, however, still the potential to mitigate any tax liability by careful planning and structuring.

Many non-UK domiciled individuals took advantage of the pre-6 April 2008 planning window before the new regime came into play. However, there are still decisions to be made, in many cases before 6 April 2009.

**Should I pay the £30,000 RBC?**

The decision as to whether to pay the £30,000 RBC and take advantage of the remittance basis of taxation for 2008/09 may not need to be made until 31 January 2010 (the deadline for filing the 2008/09 UK tax return online), although advance consideration of the issues, and structuring of sources of income/gains is likely to be advantageous.

For some individuals it will be obvious that paying the £30,000 RBC and claiming the remittance basis will be beneficial. Similarly for others, the cost will clearly outweigh the benefits.

Where several family members are affected by the RBC it may be possible to use careful structuring to arrange funds so that they are held by only one family member, and not spread amongst them, to mitigate the RBC so that only one single payment will be required.

However, for those where the decision is not so clear-cut there are some steps which can be taken before 6 April 2009 which may impact on any decision which needs to be made.

**Nominating income and gains**

In order for people to be able to claim double taxation relief in another jurisdiction for the £30,000 RBC, this amount is treated as an advance tax charge on specified 'nominated income or gains'. The source of nominated income or gains must be specified on returns made and is then treated differently from other sources of income when determining the order in which amounts are remitted.

This is likely to lead to considerable practical difficulties, particularly if nominating a source which, at the time of nomination, is included in a bank account that pools various sources of income or gains. In this case, the entire pool will then be subject to the rules determining the order that income and gains are treated as remitted going forward.

For this reason, it may be prudent to consider setting up a new separate bank account prior to 6 April 2009 (or the start of a tax year next following that when a relevant offshore source arose) into which any nominated funds can be placed, thus protecting the other sources from tainting. Similarly, unless double tax relief is required, the restrictions placed on nominated income or gains going forward may mean that taxpayers choose to nominate only a small sum, rather than amount of income or gains that would give rise to a £30,000 tax liability, as permitted under the current rules.

**What about other planning?**

There is still planning that can be put in place prior to 5 April 2009 eg ring fencing of pre 5 April income and gains to ensure that these sources are not tainted by any income and gains arising after this date.

The use of investment products (including deferred interest bank accounts, offshore life bonds etc) may mitigate the impact of the new regime. There is still time to put such products in place for this tax year, or alternatively in preparation for the next tax year.

**Should an election be made in respect of foreign losses?**

Prior to 6 April 2008 losses generated on foreign assets by non-UK domiciled individuals could not be used to offset gains on foreign assets, due to the fact that the remittance basis of taxation was compulsory in respect of capital gains tax.

Under the new regime, this has changed. Where a claim for the remittance basis has been made, foreign losses for that year and for future years will be available if an additional election in respect of capital losses is made. Without such an election, any foreign capital losses generated by a non-UK domiciled individual will not be allowable losses for UK tax purposes in any tax year, regardless of whether the capital proceeds are remitted.

An election can be made at any time up until the fifth anniversary of 31 January next following the first year in which a remittance basis claim applies, and once made, is irrevocable.

There is a set order in which foreign capital losses are allowable for offset against gains, which, if the election is made, will also apply to UK losses. This means that the long-term effect of making an election and, therefore the decision as to whether to make the election at all should be considered carefully. Clearly in some situations the ability to set foreign losses against gains will result in a tax saving. For others, making the election could result in UK losses being wasted, as they could be set against foreign gains which are not to be remitted.

**What about implications for trustees of non-UK resident trusts?**

The new taxation rules extend to resident but non-UK domiciled beneficiaries of offshore trusts. Prior to 6 April 2008 gains arising to trustees of a non-UK resident trust established by a non-UK domiciled settlor may have been attributed to the beneficiaries of the trust in relation to capital payments made to them. However, where a capital payment was made to a non-UK domiciled beneficiary, no tax liability would arise in the UK.

From 6 April 2008, where a remittance basis claim is not made, nor a £30,000 RBC paid, as appropriate, UK resident non-UK domiciled beneficiaries may be taxable immediately on income or capital payments made to them from offshore trusts.

**Structure of the settlement**

The reduction in the rate of capital gains tax to 18% has created a planning opportunity for offshore trustees. Trustees should consider whether it would be beneficial to convert investments held in trust to those which would give rise to capital gains in the future rather than income generating investments. Beneficiaries to whom the gains are attributable would be taxable at 18%, increasing to a maximum of 28.8% if the gains are 'stockpiled' before a capital payment is made. This would be preferable to the income tax which would be payable at the highest rate, currently 40%.

**Rebasing election**

Offshore trustees have the option to make an irrevocable rebasing election which has the effect of revaluing all assets held by a settlement to their value at 5 April 2008. Once an election is in place, when gains are attributed to beneficiaries who are not UK domiciled at the time of the disposal, they are only taxed on the element of the gain arising since 6 April 2008.

The election must be made on or before 31 January following the first tax year in which either a capital payment is made to a beneficiary or part of the trust fund is transferred to a new settlement. If this deadline is overlooked the opportunity is missed.

Trustees with the opportunity to file a rebasing election should seek advice as to the consequences of making such an election, and whether an election would be appropriate. If no capital payment or transfer between trusts has been made in the year, the trustees may consider making a nominal capital payment before 6 April 2009 in order to trigger the requirement for the election (to be made before 31 January 2010) and ensure that it is not overlooked at a future date.

**Appointment of assets**

In view of the current market climate, many classes of asset have fallen in value since 5 April 2008. Provided a rebasing election has been made, as above, it may, therefore be the perfect time for trustees to appoint capital assets to UK resident but non-UK domiciled beneficiaries, without giving rise to a capital gains tax charge.

*Article by Francesca Lagerberg*

**Lecture P527 (10.20 Minutes)**

## Employees resident but not ordinarily resident in the UK

Section 25 and Schedule 7 Finance Act 2008 introduced changes to the remittance basis affecting the taxation of employment income where the employee is resident but not ordinarily resident in the United Kingdom. Amongst other issues, they introduced rules to determine the kind and amount of income or chargeable gains remitted to the United Kingdom where a transfer is made out of a mixed fund.

Statement of Practice 1/09 sets out how HMRC will treat transfers made from an offshore account holding only the income or gains relating to a single employment and the apportionment of earnings where an employee is taxed on the remittance basis.

Statement of Practice 5/84 is withdrawn and incorporated as part of this new statement of practice with effect from 6 April 2009.

*Transfers made from an offshore account holding only the income or gains relating to a single employment*

Sections 809Q ITA onwards set out rules to determine the kinds and amount of income or chargeable gains remitted to the United Kingdom from a fund containing more than one kind of income and capital, or income, or capital of more than one tax year. Such a fund is defined in sections 809Q and 809R as a "mixed fund". Where amounts are transferred to the United Kingdom out of a mixed fund, Section 809Q(3) requires that the individual's tax liability is calculated by reference to each individual transfer. This transfer by transfer approach is referred to below as the "mixed fund rule". This is a change to HMRC's previous practice, with respect to employees to whom SP5/84 applied, which was to allow the tax liability to be calculated by reference to the total amount transferred to the UK during the tax year as a whole.

In the circumstances outlined in this statement of practice, HMRC will accept that certain individuals who are resident but not ordinarily resident in the United Kingdom do not have to apply the mixed fund rule and can continue to calculate their tax liability by reference to the total amount transferred out of a mixed fund during the tax year as a whole, rather than by reference to individual transfers.

Employees who are resident but not ordinarily resident in the UK and who perform duties of an office or employment both inside and outside the UK, do not have to apply the mixed fund rule in respect of transfers from a particular account where—

- The mixed fund is an account held solely by the employee; and
- The account only contains employment income from a single employment plus—
- Any interest arising only on that account, and
- Any gains arising from foreign exchange transactions in respect of the funds in that account
- Any gains arising on employee share scheme related transactions
- Any proceeds from employee share scheme related transactions, not otherwise covered at paragraph 7, in respect of amounts paid by the employee in acquiring the shares.

The employment income from that employment may include—

- Employment income (subsection 809Q(4)(a))
- Relevant foreign earnings (subsection 809Q(4)(b))

– Foreign specific employment income (including termination payments and the proceeds from employee share schemes) (subsection 809Q(4)(c)), and

– Employment income subject to a foreign tax (subsection 809Q(4)(f)).

Employees who are resident but not ordinarily resident in the UK may also choose not to apply the mixed fund rule if the account contains only income or gains of a kind listed at paragraphs 6 and 7 above, but for more than one tax year. Where this is the case, the ordering rules at section 809Q(3) shall be applied – i.e. on a last in first out basis.

Where the employee applies this statement of practice, amounts transferred out of the account to the United Kingdom will be treated as comprising the kinds of income and gains in the order set out in section 809Q(4) for the tax year as a whole.

Accounts containing income or gains of more than one employment are not covered by this statement of practice.

Accounts containing income or gains of more than one individual are not covered by this statement of practice

*Apportionment of earnings*

Employees who are resident but not ordinarily resident in the United Kingdom are chargeable to United Kingdom tax under Sections 15 ITEPA on general earnings wherever received for duties performed in the United Kingdom. They are also chargeable under Section 26 ITEPA on general earnings for duties performed outside the United Kingdom but only to the extent that the earnings are remitted to the United Kingdom.

Where the duties of a single office or employment are performed both in and outside the United Kingdom, an apportionment is required to determine how much of the general earnings are attributable to the United Kingdom duties. Apportionment of general earnings is essentially a question of fact, but for many years HMRC has accepted time apportionment, based on the number of days worked abroad and in the United Kingdom, except where this would clearly be inappropriate. For example, in the case of an employee with 200 working days in the United Kingdom and 50 working days outside the United Kingdom, the proportion of general earnings attributable to United Kingdom duties would be 200/250. This practice does not, of course, apply where the charge arises under Section 15 ITEPA and relief is due under Part 5 Chapter 6 ITEPA (Deductions from seafarers' earnings).

Where an employee resident but not ordinarily resident in the United Kingdom performs the duties of a single office or employment both in and outside the United Kingdom and is remunerated wholly abroad, he is permitted, by a broad interpretation of the decision in the case of *Sterling Trust Ltd v CIR* (12 TC 868), to say that any remittances made to the United Kingdom are made primarily out of general earnings for that year in respect of duties performed in the United Kingdom assessable under Section 15, and only any balance out of general earnings chargeable under Section 26 on remittance.

However, where part of the general earnings are remitted to the United Kingdom, it was the practice of HMRC to regard the proportion of the earnings remitted to the United Kingdom, as being in respect of duties performed both in and outside the United Kingdom, and to treat that proportion of such earnings as were attributable to duties performed outside the United Kingdom as remitted to the United Kingdom for the purposes of Section 26.

The practice changed with effect from 6 April 1983 when HMRC introduced a simplified procedure for employees who—

– are resident but not ordinarily resident in the United Kingdom;

– perform duties of a single employment both in and outside the United Kingdom, so that they are potentially chargeable under both Sections 15 and 26 ITEPA 2003 in respect of general earnings from that employment; and

– receive part of their general earnings in the United Kingdom and part abroad.

In such cases, provided the general earnings chargeable under Section 15 are arrived at in a reasonable manner (i.e. in the absence of special facts, the proportion of the general earnings, including benefits in kind, relating to UK duties is arrived at on a time basis by reference to working days), HMRC is prepared to accept that a charge under Section 26 will arise only where the aggregate of general earnings remitted to the United Kingdom exceeds the amount chargeable under Section 15 for that year; and to restrict the charge under Section 26 to the excess of the aggregate over the charge under Section 15.

*Statement of Practice 1/09*

# Capital Gains Tax

## Entrepreneurs' relief and deceased person's estates

Given that entrepreneurs' relief has been available since 6 April 2008, clients and their advisers are now becoming more familiar with the operation of this important CGT relief, particularly as it affects individuals. However, what is the relief's position with regard to estates?

As far as the personal representatives of a deceased individual are concerned, it would appear that no entrepreneurs' relief can be claimed. This is because there is no facility in FA 2008 for personal representatives to make a claim for the relief on behalf of the deceased, despite the fact that he or she may have satisfied the relevant conditions up to the date of death (eg. by having held at least 5% of the ordinary share capital and voting power in a trading company of which he or she was an officer or employee).

Accordingly, one well-known commentator has announced that, in this context, the message for entrepreneurs' relief purposes is:

'Use it or lose it.'

However, this is not, strictly speaking, true, given that there may well be tax planning opportunities which can be turned to a person's advantage, especially where the administration of an estate is protracted. For example, where the estate has been in the course of administration for more than 12 months and it includes assets such as shares:

(i) which have increased in value since the date of death; and

(ii) which are likely to be sold (eg. because of a takeover bid),

it may well make sense to ensure that the shares are distributed to a legatee prior to their disposal.

**Illustration**

Tom has been a director of a family trading company for a number of years, owning 10% of the company's ordinary shares.

His father died on 1 June 2007 and Tom expects that, once the administration of the estate has been completed, he will inherit a further 60% of the company. There were legal disputes regarding aspects of the estate which have delayed matters, but these have now been resolved.

If Tom were to acquire a further 60% stake in the company and the company were then to be sold, any gain on the shares inherited could be reduced by entrepreneurs' relief because the company is already Tom's personal company (ie. ignoring the inheritance) and he is a director thereof.

At the point when Tom becomes entitled to the inherited shares, he will be deemed to have owned them since the death of his father. Any post-death growth in value will therefore be assessable on Tom who will be entitled to make a full entrepreneurs' relief claim.

However, if, in the above scenario, the administration of the estate simply continued and the shares were disposed of by the personal representatives in that capacity, an entrepreneurs' relief claim would not be competent.

*Article by Robert Jamieson*

**Lecture P528 (4.03Minutes)**

## Rebasing rules FA 2008 and Partnerships

HMRC Brief 9/2009 explains the CGT rebasing rules for disposals of partnership assets or changes in share of partnership assets from 2008–09 onwards. It applies only to non-corporate partners subject to capital gains tax, rather than corporation tax. HMRC intends its practice to be consistent with the previous treatment under SP1/89.

**Introduction**
The Revenue & Customs Brief is about assets held by a partnership on 31 March 1982. Assets held on that date are subject to special rules (the "rebasing" rules) when working out capital gains and losses.

The changes to Capital Gains Tax in Finance Act (FA) 2008 amended the rebasing rules. The changes apply to disposals of assets from the start of the 2008-09 tax year (6 April 2008). The Brief explains how the rebasing rules apply for people who dispose of partnership assets or who change their share of partnership assets from 2008-09 onwards.

The Brief applies only to partners whose capital gains are subject to Capital Gains Tax. The changes in FA 2008 do not apply to Corporation Tax and companies liable to Corporation Tax on their gains are not affected.

**Background**
Partnerships, including Scottish partnerships, are treated as transparent for Capital Gains Tax purposes. This means that any gains or losses accruing on disposals of partnership assets are chargeable on the partners rather than on the partnership itself. Partners are treated for this purpose as owning fractional interests in each of the partnership's assets. Disposals occur when the partnership disposes of an asset or when a partner's interest in an asset is reduced.

Statement of Practice D12 (SP D12) explains how gains or losses accruing on disposals of interests in partnership assets are to be computed.

Section 6 and Schedule 2 FA 2008 make rebasing of cost to 31 March 1982 compulsory for assets held at that date. The changes have effect only for the purposes of Capital Gains Tax. They do not apply for the purposes of Corporation Tax on chargeable gains.

**Rebasing rules for disposals before 6 April 2008**
The rebasing provisions for disposals before 6 April 2008 applied in respect of disposals on or after 6 April 1988 of assets held on 31 March 1982.

Assets held at 31 March 1982 were treated as if they had been acquired at their market value on that date so that gains or losses relating to changes in value before that date were not taken into account for Capital Gains Tax purposes. This approach was modified by the kink test which allowed for a comparison of the gain or loss based on the market value of the asset on 31 March 1982 with the gain or loss based on the actual cost before 31 March 1982. The lower of the gains was chargeable to Capital Gains Tax or the lower of the losses was allowable. If one computation resulted in a gain and the other in a loss, the person making the disposal was treated as realising neither a gain nor a loss.

A person could opt out of the kink test by electing under section 35 (5) Taxation of Chargeable Gains Act (TCGA) 1992 to have gains or losses computed as if all of their assets held on 31 March 1982 had been acquired at their market value on that date.

Section 35 (7) TCGA 1992 required separate rebasing elections to be made by a person who held assets in more than one capacity. For example, an election made by an individual in respect of personal assets would not cover interests in partnership assets held by that individual in his or her capacity as a partner.

There were special rules for arriving at the expenditure allowable in computing the gain on the disposal of an asset which had been acquired since 31 March 1982 by way of a statutory "no gain/no loss transfer" (a disposal which is treated for Capital Gains Tax purposes as resulting in neither a gain nor a loss for the person making the disposal) or an unbroken series of such transfers. The gain was computed as if the person making the disposal had owned the asset at 31 March 1982.

**Rebasing rules for disposals on or after 6 April 2008**

Section 6 and Schedule 2 FA 2008 apply in respect of disposals on or after 6 April 2008 of assets held at 31 March 1982.

Gains or losses arising on disposals on or after 6 April 2008 are computed as if the assets disposed of had been acquired at their market value on 31 March 1982. In effect, allowable expenditure is "rebased" to 31 March 1982 thus dispensing with the need for the kink test and rebasing elections.

The new section 35A TCGA 1992 applies where a person ("P") disposes of an asset on or after 6 April 2008 and—

- P acquired the asset after 31 March 1982 and before 6 April 2008 under a statutory no gain/no loss provision and
- any previous disposal and acquisition of the asset after 31 March 1982 was one to which a statutory no gain/no loss provision applied and
- rebasing under section 35 (2) TCGA 1992 did not apply to the relevant disposal, that is, the disposal of the asset to P

Where these conditions are satisfied section 35A (2) TCGA 1992 provides that the allowable expenditure taken into account in computing a gain or loss when P disposes of the asset on or after 6 April 2008 includes the value of the asset at 31 March 1982 and the indexation allowance due for the period from 31 March 1982 to the month in which P acquired the asset or, if earlier, to April 1998. The previous approach of treating P as having owned the asset at 31 March 1982 with the appropriate consequences for indexation allowance no longer applies.

**Statement of Practice 1/89 (SP1/89)**

SP1/89 explains HM Revenue & Customs (HMRC) practice in relation to rebasing and indexation allowance where a transfer between partners of an interest in an asset that was held by a partnership on 31 March 1982 results in neither a gain nor a loss.

It enables transfers between partners of interests in partnership assets that result in neither gains nor losses to be treated as statutory no gain/no loss transfers for the purposes of the rebasing rules in sections 35 and 36 and Schedule 4 TCGA 1992. Partners who dispose of interests in assets that had been acquired by them as a result of such transfers are treated as having held them on 31 March 1982.

SP1/89 provides that the disposal consideration for a transfer between partners of an interest in a partnership asset that results in neither a gain nor a loss may be calculated on the assumption that an unindexed gain will accrue to the transferor equal to the indexation allowance so that, after accounting for indexation allowance, neither a gain nor a loss accrues. Such a disposal may be treated as a statutory no gain/no loss disposal for the purposes of section 55 (5) TCGA 1992.

For Capital Gains Tax purposes indexation allowance was frozen as at April 1998 and has been abolished for disposals on or after 6 April 2008.

For disposals of interests in partnership assets that occur on or after 6 April 2008 SP1/89 will apply only in relation to corporate partners whose capital gains are chargeable to Corporation Tax.

**Disposals on or after 6 April 2008**
HMRC's practice in relation to rebasing for disposals by non-corporate partners on or after 6 April 2008 will be consistent with the previous treatment under SP1/89. Transfers between partners of interests in partnership assets after 31 March 1982 and before 6 April 2008 that resulted in neither gains nor losses may be treated as statutory no gain/no loss transfers for the purposes of section 35A (1)(b) TCGA 1992.

Where section 35A (2) TCGA 1992 applies in relation to disposals on or after 6 April 2008 the allowable expenditure to be taken into consideration in the calculation of a gain or loss includes the value of the asset at 31 March 1982 and any indexation allowance for the period from 31 March 1982 to the month in which the person making the disposal acquired it or, if earlier, to April 1998.

# Inheritance Tax and Trusts

## Discounted gift plans after HMRC v Bower (2009)

Following HMRC's successful appeal in the recent High Court case of *HMRC v Bower (2009)*, there has been considerable interest in the question of just how IHT-efficient discounted gift plans really are.

A discounted gift plan is typically used to reduce the IHT liability on an individual's estate. If a client has excess capital which he is unlikely to need in the future but from which he would still like to draw an income, he may well be a good candidate to invest in a discounted gift plan. Such individuals will usually be aged 60 or over and should have a reasonable expectation of surviving for the next seven years.

A discounted gift plan comprises an insurance bond held in trust for beneficiaries of the client's choice. Setting up the arrangement involves making a gift of a lump sum which is invested in a bond and the bond is then written in trust. The client reserves the right to receive regular capital withdrawals from the bond and, provided that the annual amount does not exceed 5% of the value of the bond, such withdrawals effectively represent a tax-free income. These withdrawals, which are customarily taken monthly, are agreed in advance.

At the start of the plan, an actuarial forecast is made, based on the settlor's age, sex and state of health, to quantify the sum which he is likely to draw out during his lifetime. This is known as the donor's fund or the retained fund. In essence, the client is carving out this amount for his own benefit and, in consequence, it is not deemed to be part of the gift which he made to the trust so that his transfer of value is less than the amount which he actually paid over. For example, a man aged 70 in good health who put £500,000 into a discounted gift plan, reserving a right to make 5% annual withdrawals of capital (ie. £25,000 per annum), would be entitled to a discount of, say, 45%. In other words, his donor's fund would be valued at 45% x £500,000 = £225,000. His transfer of value is therefore £500,000 – £225,000 = £275,000. Depending on whether the trust is a discretionary (or life interest) trust or a bare trust, this will either be an immediately chargeable transfer or a potentially exempt transfer (PET). In the case of a bare trust, the beneficiaries must be specified when the trust is set up. This makes it less flexible than the discretionary alternative which is more commonly used. The downside of a discretionary trust is that, if the transfer comes to more than the settlor's nil rate band, an upfront IHT liability of 20% will be payable on the excess. However, notice that, because of the discount, a settlor can often place considerably more than the nil rate band in a discretionary trust without triggering a lifetime charge.

As can be seen from the above, the amount of the discount (ie. the donor's fund) is completely free from IHT, with the balance (usually referred to as the trust fund) dropping out of the settlor's cumulative total after seven years. It is important to appreciate that, since all the assets are in the trust, the only access which the settlor has to the donor's fund is in the form of the fixed regular withdrawals which come to an end on his death. It follows then that, on death, there is no value in his estate in respect of the residual donor's fund since it remains in the trust (and does not fall into the estate). This arrangement is viewed as a carve-out by HMRC and so, provided that:

(i) the rights retained by the settlor are clearly defined; and

(ii) the settlor is excluded from all benefit in the trust fund,

there is no reservation of benefit under S102 and Sch 20 FA 1986.

The introduction of the pre-owned asset income tax legislation in FA 2004 led to concerns that discounted gift plans involved settlor-interested trusts which, because they contained intangible property, fell within the Para 8 Sch 15 FA 2004 charge. Surprisingly, however, the position was not viewed in this light by HMRC who developed further the analysis adopted for reservation of benefit by concluding that the donor's fund had, as one barrister has put it, 'not only been carved out and retained by the settlor but that the rights in it were held on bare trust for the settlor'. Hence the Para 8 Sch 15 FA 2004 charge does not apply to the donor's fund because it is not a settlement for IHT purposes and it does not apply to the trust fund since the settlor cannot benefit under it – HMRC's position is set out in their detailed guidance notes on income tax and pre-owned assets in Appendix 1 (which is found in section 5).

More recently, the future of discounted gift plans was thrown into doubt as a result of the changes to the IHT treatment of settlements in FA 2006. Prior to 22 March 2006, the preferred type of trust for the trust fund was a flexible life interest one so that the creation of the trust always qualified as a PET. This is no longer possible, with life interest settlements being treated in the same way as their discretionary counterparts. However, no further problems arose, given that HMRC seemed quite happy to follow the same approach as they use in the context of the pre-owned asset rules.

In conclusion, the advice of one well-known financial planning consultant is worth noting:

> 'When embarking on a discounted gift plan, one must tread carefully. The discount is of course largely dependent on life expectancy and, to avoid scrutiny by HMRC over this all-important figure (which usually happens on death of the settlor within seven years), one must have the discounted gift plan underwritten by the life company, preferably by obtaining a medical report from the settlor's general practitioner. There have been cases where HMRC did not believe the settlor was in good health when the trust was set up and successfully challenged the discount because of lack of medical evidence.
>
> Further, with a discretionary trust, an entry tax charge can easily be triggered inadvertently if the investor's available nil rate band is not determined correctly or if the discount comes into question, not to mention periodic and exit tax charges further down the line.
>
> These points highlight the absolute need for experienced professional financial advice.'

*Article by Robert Jamieson*

**Lecture P530 (14.29 Minutes)**

## What's new with Business Property Relief (BPR)?

### A brief recap

BPR is available for business assets that have been owned for at least two years, and is very valuable - the relief (either on a lifetime transfer or on death) is:

- 100% of the value of: an unincorporated business; an interest in a partnership; shares in an unquoted company; or securities in an unquoted company controlled by the owner.
- 50% of the value of: shares or securities in a quoted company controlled by the owner; or assets used by a company controlled by the owner or by a partnership in which the owner is a partner.

BPR will not be available if the business in question consists wholly or mainly (50% or more) of making or holding investments, or dealing in land, buildings, stocks, shares or securities.

In addition, BPR is not available on specific assets (known as 'excepted assets') that are not used wholly or mainly for the purposes of the business, or that are not required for its future use. This can result in an unexpected loss of BPR where, for example, large cash balances have accumulated and HMRC argue that they are not used or required for future business purposes.

**BPR and holiday lettings**

HMRC regularly updates its internal staff manuals. Sometimes this is for clarity but usually this is to reflect case law or revised interpretations. Keeping track of the changes could turn into a day-job of its own but one recent change worth noting shows that HMRC has reviewed its position on whether holiday lets are eligible for BPR.

Although the amendments to HMRC's internal Staff Manuals may be seen as a change in approach, in practical terms HMRC's treatment has not actually altered at all. Recent tax cases have extended the required criteria outlined in the Manuals to put emphasis on the need for actual services to be provided to the holidaymaker.

HMRC updated its position following legal advice. The IHT Manual has now been updated to state the following:

'In the past we have thought that business property relief would normally be available where:

- the lettings were short term, and
- the owner, either himself or through an agent such as a relative, was substantially involved with the holidaymakers in terms of their activities on and from the premises.

Recent advice from [the] Solicitor's Office has caused us to reconsider our approach and it may well be that some cases that might have previously qualified should not have done so. In particular we will be looking more closely at the level and type of services, rather than who provided them.

Until further notice any case involving a claim for business property relief on a holiday let should be referred to the Technical Team (Litigation) for consideration at an early stage.'

**Trustees of Nelson Dance Family Settlement**

The High Court has upheld the Special Commissioners decision in the case of the *Trustees of the Nelson Dance Family Settlement*, that the transfer of land used in a business into trust (without the transfer of the business itself) would qualify for 100% BPR.

The decision is relevant to sole traders and may provide planning opportunities, particularly for farmers considering transferring land into trust but continuing to carry on the business.

The taxpayer, Mr Dance had a farm and transferred some of the farmland into a trust claiming 100% business property relief. The land had been used in the farming business of Mr Dance but it was not the business or an interest in the business that was transferred into trust, merely the land.

Section 104(1)(a) IHTA states that 100% BPR is available where the whole or part of the value transferred by a transfer of value is **attributable** to the value of any relevant business property as defined in s105(1)(a) (b) or (bb) IHTA. The part of s105(1) relevant to this case is s105(1)(a) "property consisting of a business or **interest in a business;**"

It is generally accepted that BPR relief is not available on a simple transfer of an asset in the business, and that to be eligible for the relief as a transfer of 'relevant business property', the transfer must be made of 'an interest in a business'. HMRC argued that BPR relief was not available on the transfer of the land as it did not comprise an interest in a business.

The High Court has recently upheld the decision of the Special Commissioner, which concluded that the value transferred was not the value of the land but that of the diminution in the transferor's estate by reason of the transfer, which could, therefore, be **attributable** to the value of relevant business property. On this basis, the transfer of the land to the trust qualified for BPR.

It is believed HMRC will seek leave to take the case to the Court of Appeal. The current decision opens up a number of significant planning opportunities, given that any asset of the business can possibly be given away with the benefit of full BPR. Assets such as farm buildings, fields, or possibly even cash, if a business has significant amounts of cash required for a genuine business purpose and not an excepted asset, will, as a result of this decision, potentially be eligible for BPR.

**BPR clearance**

HMRC's non-statutory clearances services that was offered to all businesses from 1 April 2008. A trial period was then introduced for a period of six months (1 May 2008 to 31 October 2008), which extended the clearance to cover BPR. HMRC announced on 23 January 2009 that this service is now available indefinitely.

At the launch of the trial, Revenue and Customs Brief 25/08 stated, 'clearances will be provided to business owners on the availability of IHT BPR where there is material uncertainty over the interpretation of the law. For IHT legislation older than the last four Finance Acts, there is a further requirement that the uncertainty relates to a commercially significant issue'.

HMRC has now extended the scope of the service to the extent that, as with other clearances it 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 BPR
- 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

From 23 January 2009 and provided the above conditions are met, HMRC will provide a view of the tax consequences of a transfer of value that involves a change of ownership of a business where the transfer, leaving aside the application of BPR, would result in an immediate IHT charge.

Clearances in these change of ownership cases will remain valid for a period of six months.

*Article by Francesca Lagerberg*

**Lecture P529 (8.49 Minutes)**

# Administration

## Power to give statutory effect to ESCs

In accordance with the enabling powers in Section 160 FA2008, HMRC have reviewed the existing concessions and expect the majority of them to be within the scope of its discretionary powers as part of its collection and management remit, notwithstanding the apparent limitations to make concessions from the strict application of tax law as held in *The Queen (on application of Wilkinson) v Commissioners for HMRC.*

Because some existing concessions exceed the scope of the discretion under the *Wilkinson* judgement, the effect of those concessions will be maintained by giving legislative effect to 16 ESCs. Others are to be enacted using existing pre-existing powers contained in the legislation for the particular tax involved.

The new legislation covers the following and applies from 2009/10:

1. CERTAIN BENEFITS UNDER OLD PENSION SCHEMES NOT TAXED. New Section 395A ITEPA2003 ensures that benefits under old Section 222 TA1970 schemes approved before 6 April 1980 are not taxed under Section 394 ITEPA2003.
2. EXPENSES INCURRED BY TRADERS ON FOOD AND DRINK. New Section 57A ITTOIA2005 provides for a deduction for any reasonable expenses incurred on food or drink consumed by the trader at a place to which he travels in the course of carrying on the trade, or while travelling to a place in the course of carrying on the trade, if Conditions A and B are met:
    - CONDITION A is met if a deduction is allowed for the expenses incurred by the trader in travelling to the place, or the expenses of travelling to the place are not incurred by him but if they were they would be tax-deductible.
    - CONDITION B is met if at the time the expenditure on food or drink is incurred, the trade by its nature is itinerant; OR the trader only travels to the place occasionally in the course of the trade and either (i) the travel in connection with which the expenditure incurred on the food or drink is undertaken otherwise than as part of the trader's normal pattern of travel in the course of carrying on the trade, or (ii) the trader does not have such a normal pattern of travel.
3. DISPOSAL OF ASSETS LOST, DESTROYED OR BECOMING OF NEGLIGIBLE VALUE. Section 24 TCGA1992 is amended to allow a negligible value claim to be made not just if the asset has become of negligible value, but also where the original acquisition was via a no gain/no loss disposal where the asset was of negligible value at that time. This is subject to the proviso that if there had been an earlier owner, an unbroken series of no gain/no loss disposals arose.
4. SHARES IN CLOSE COMPANY TRANSFERRING ASSETS AT AN UNDERVALUE. Section 125 TCGA1992 is disapplied in relation to a transfer of assets treated as an income or capital distribution, or as employment income.
5. ROLL-OVER RELIEF: ACTIVITIES OTHER THAN TRADES. Section 158 TCGA1992 is amended to extend the relief on the replacement of business assets to those held by a company in which an unincorporated company or other body not established for profit has at least a 90% interest in the company's shares, profits or assets on a winding-up.
6. CGT PRIVATE RESIDENCE RELIEF. The plethora of ESCs on this topic have largely been incorporated in the legislation:
    - Section 223(3) TCGA1992 is amended to allow a period of absence due to the work of a spouse or civil partner to be treated as a period in which the dwelling-house was an individual's only or main residence.

- Section 223 is amended to treat the condition of a period of absence being ignored provided the individual resumes residence, as being satisfied where residence is not resumed due to the place of employment of the individual, or spouse or civil partner.
- A new Section 225B provides for continuing treatment as an individual's only or main residence where he ceases to live with a spouse or civil partner and disposes of the residence to that person in connection with divorce, annulment, dissolution or separation. This is subject to the proviso that the individual does not give notice for another property to be treated as his only or main residence.
- A new Section 225C covers the sale of a private residence under an agreement with the employer on a relocation whereby the individual disposes of the property to the employer or person operating under an agreement with the employer, and is entitled to a share of the profit where the property is later sold by the employer. Provided the share of the profit is received within 3 years of the initial disposal, it is treated as attributable to that disposal.

7. EMPLOYEE TRUSTS. New Section 239ZA TCGA1992 relieves from CGT the gain on disposal by trustees of an EBT where it gives rise to an income tax charge on the employee or other person to whom the property is transferred.
8. WORKS OF ART ETC. Amended section 258(2) TCGA1992 provides that a gain on disposal of an asset is not a chargeable gain if it accrues on a disposal to certain specified bodies, or where the asset is accepted in satisfaction of IHT, and it removes the requirement for the asset to be subject to an IHT undertaking (or undertaking under section 258) to keep it in the UK.
9. FOREIGN-OWNED WORKS OF ART. Amended Sections 5(1)(b). 64 and 272 IHTA1984 provide that the owner of foreign works of art is exempt from IHT if on his death they are in the UK for one or more of the purposes of public display, cleaning, restoration, and for no other purpose.
10. DECORATIONS AND AWARDS. Amended Section 6 IHTA1984 treats as excluded property any decoration or other award for valour or gallant conduct, if there has never been a disposition of the item for consideration in money or money's worth.

## Briefing on new penalties - FAQs

HMRC has produced some detailed guidance on the new penalty regime which can be found on their website at:

http://www.hmrc.gov.uk/about/new-penalties/faqs.htm

The guidance is in the form of a series of questions and answers and is broken down into the following sections:

- General questions about the new penalty systems
- Inaccuracy penalties
- Failing to notify penalty
- VAT and Excise wrongdoing penalties

## Budget predictions 2009

The 2009 Budget will be on 22 April 2009. Here are just some items that are expected to be included:

| Measure | Issues |
|---|---|
| **Corporation tax** | |
| Taxation of Foreign profits | Exemptions and world-wide debt cap issues |
| Definition of ordinary share capital for group relief purposes | The changes relate to the definition of ordinary share capital for determining the existence of a 75% subsidiary for group relief purposes and to the computation of profits in a foreign currency. The need for change has come to light as a result of the recent turbulence in financial markets. |
| Calculation of losses carried forward in a foreign currency | See above |
| Late paid interest | |
| Extension of loss carry back rules | Announced in Pre-Budget Report 2008 - will it be extended for more than one year. |
| Changes to land remediation relief | Japanese Knotweed extension |
| Release of trade debts between connected companies | |
| **VAT** | |
| VAT - Place of supply of services | '2010 package'<br>The businesses that will be affected include those involved in:<br>*Supplying or receiving cross-border services<br>* Reclaiming VAT under the EU 8th VAT Directive procedure |
| VAT rate change | Will there be confirmation or change on the reversal of 15% rate? |
| **Stamp taxes** | |
| SDLT - commercial Sukuk | |
| Stamp Duty /SDRT - stock lending | |

| | |
|---|---|
| **Personal tax** | |
| Personal dividend tax credits (extension of s34, FA 08) | |
| **Powers** | |
| Compliance checks | |
| Harmonised interest rules | |
| Payments, repayments, debt | |
| Filing returns and paying tax on time | |
| Charter | Statutory underpinning |
| **Avoidance** | |
| Principles based approach to finance products avoidance | |
| Manufactured interest anti-avoidance | |
| Film partnership anti-avoidance | |
| Anti-avoidance simplification for employment related securities | |
| Using rules on tax relief for employee liabilities to create artificial deductions | |
| Plant and machinery leasing avoidance | |
| **Capital allowances** | |
| Capital allowances for cars | |
| **Employment taxes** | |
| Disabled company car drivers | |
| **General** | |
| Enacting various extra-statutory concessions | *Wilkinson* case |
| **Property** | |
| Changes to REIT regime | |

**Charities**

| | |
|---|---|
| Change to the substantial donor rules | Result of consultation |

*From Francesca Lagerberg*

**Lecture B526 (12.12 Minutes)**

## Tax administration update

**Power to give statutory effect to ESCs**

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company in which an unincorporated company or other body not established for profit has at least a 90% interest in the company's shares, profits or assets on a winding-up.

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    - Section 223(3) TCGA1992 is amended to allow a period of absence due to the work of a spouse or civil partner to be treated as a period in which the dwelling-house was an individual's only or main residence.
    - Section 223 is amended to treat the condition of a period of absence being ignored provided the individual resumes residence, as being satisfied where residence is not resumed due to the place of employment of the individual, or spouse or civil partner.
    - A new Section 225B provides for continuing treatment as an individual's only or main residence where he ceases to live with a spouse or civil partner and disposes of the residence to that person in connection with divorce, annulment, dissolution or separation. This is subject to the proviso that the individual does not give notice for another property to be treated as his only or main residence.
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**The clearance process**

HMRC's extended clearance process is fully operational across all business taxes, with the aim of providing clearances on which business can rely, consistent with administrative law.

Main aspects are:

- clearance within 28 days as the standard
- the coverage is limited to where there is material uncertainty around the tax outcome of a real issue of commercial significance to the business itself, determined by reference to the scale of the business and the impact of the issue upon it (onus is on the business to demonstrate the commercial significance)
- routing of Local Compliance taxpayers to a dedicated office in Southend (HMRC CLEARANCES TEAM) to ensure effective co-ordination and delivery

A trial period to 31 October 2008 allowed for a clearance application to be made as to whether BPR is available where there is demonstrable material uncertainty about a transaction affecting the

business and there is commercial significance of the transaction. That opportunity was extended indefinitely.

From 27 January 2009 HMRC's view of the tax consequences of a transfer of value that involves a change in ownership of a business is also available on application, provided that the transfer (leaving aside the application of BPR) would result in an immediate IHT charge. The other conditions still need to apply.

Such a clearance is valid for 6 months. If a previous application was rejected under the trial period, but does come within the extended service, a review of the original application may be requested.

The details required about the transaction are as follows:

- When the transaction occurred, the parties involved and any other details of the transaction.
- The proposed date if the transaction has not yet happened, and supporting information such as a draft contract if available, so that HMRC have an understanding of the timeframes under which the applicant is working and can verify that the transaction is genuinely contemplated.
- Any details of the transaction that are contingent (e.g. on future events or the consent of other parties).
- Specified information about the commercial background.
- The applicant's view of the tax consequences with a summarised explanation of the reasoning behind that view.

**Freedom of Information requests to HMRC**

Guidance has been updated, with details of how to look for information already published; submitting a request; information that will not be released; and a log of requests received. See www.hmrc.gov.uk/freedom/foi-index.htm

**Reliance on HMRC's views on tax relief**

In *Refon v HMRC ChD 18/6/08* the taxpayer claimed that in a telephone call to HMRC he was told that tax relief on some travel expenses outlined was claimable provided the expenses were reasonable. When he made the claim it was rejected, with the judgement being that *"a taxpayer could only have a legitimate expectation of holding HMRC to a ruling or statement in respect of his tax affairs if, in his part, he approached HMRC with clear and concise proposals about the future conduct of his tax affairs, made full disclosure of all material facts known to him and made it plain that a considered ruling was being sought, indicating the use he intended to make of any ruling, and if, on their part, HMRC gave him an unequivocal statement about how his affairs would be treated".*

**Using HMRC Manuals and Guidance**

In *Chilcott and others v HMRC SpC727*, the Commissioner stated that HMRC Manuals and Guidance could not be used as aids to statutory construction. In this case that was one of the reasons for the taxpayer losing his appeal, but the comment should be remembered for use against any tax officer who insists on using the Manuals to interpret legislation.

***Arctic Systems* decision can still result in anti-avoidance legislation applying**

No new legislation is likely at present, so the decision can be used to a client's advantage. However, that does not mean to say that all arrangements involving shares owned by minor children are valid.

In ***Bird v HMRC SpC720***, 60% of the issued shares of a family company were issued to the minor children, with their parents Mr & Mrs Bird owning 20% each. All the shares had normal dividend rights and it was held that:

- The issuing of the shares and consequential payment of dividends amounted to the use of a corporate structure to provide an income stream to a minor child, and thereby reduce higher rates of tax. That was a typical situation where the taxation of settlors legislation did apply, and this was consistent with the decision in *Jones v Garnett (Arctic Systems)* where the spouse exemption acted to exclude the settlement provisions which otherwise applied.
- The children did not take part in any commercial transaction. What actually happened is that the grandfather of the minors died and a loan was supposedly made by the minors to

the company from monies prospectively owned by them from the estate. The shares were then issued to them.

A very important aspect to this case is that HMRC were held not to be entitled to make a discovery for the years outside the enquiry window. This was because there was no negligent conduct. The relevant section of the tax return was headed *"Income and Capital from which you have provided funds*". The parents had not made any entry in respect of their minor children. They would have considered HMRC's side notes on this topic, which drew attention to certain extensions, but the assumed reasonable compliant taxpayer would not be expected to enter the children's dividends in the box even after reading the notes and interpreting them at face value. They had not obviously "provided funds for a settlement".

The taxpayers made a last minute decision not to attend the appeal, and HMRC applied for costs on the grounds that Mr & Mrs B had acted wholly unreasonably by not attending. The application was refused as it was not wholly unreasonable for them to make that decision. In any event, the decision against HMRC on the extended time limits issue made an award of costs inappropriate.

**Draft HMRC Charter (published 3/2/09; open to consultation to 12/5/09)**

HM Revenue & Customs makes sure that money is available to fund the UK's public services. We also help families and individuals with targeted financial support. We aim to make the tax and benefits system feel simple to use.

**You can expect HMRC to:**

Treat you as honest, believing you are willing to pay what you owe, claiming only what you are entitled to, unless we have good reason to doubt you.

Respect you, listening to your needs and taking into account your circumstances.

Provide you with accurate information, making it easy for those who try to get things right.

Recognise your right to be represented by someone else.

Pursue relentlessly those that break or bend the rules.

Protect the information that we hold about you.

**HMRC expects you to:**

Work with us to ensure your payments or claims are accurate and made at the right time.

Respect our staff, treating them in the same way as you want them to treat you.

Contact us when you need help, advice or support, letting us know if you have particular needs.

Tell us about changes in your circumstances so that we can get things right as early as possible.

**Accessing information about HMRC (via separate documents)**

Service standards, such as our times for responding when you contact us.

Data protection policy and keeping your information safe and secure.

Complaints process.

Appeals process.

*Article by Gerry Hart*

**Lecture B530 (18.28 Minutes)**

# Business Tax

## IR35 – 10 years on

In March 1999 the then Inland Revenue published a Budget Note with the reference number IR35 and now, ten years on, the resulting legislation continues to confound and confuse. So where exactly are we a decade on and is there a better way forward?

**The outline rules**

IR35 (or the intermediaries legislation) now sits in ITEPA 2003, ss 48 to 61. It seeks out situations where an individual (the worker) provides services to a client through an intermediary, the most common type being the use of a personal service company. It then asks whether the worker is effectively an employee of the client and would have been treated as such but for the interposing of an intermediary. This requires the construction of a 'hypothetical contract' between the worker and the client. This 'contract' is then tested using the rules of employment status to see if the link between the two is like an employment or a self-employment. This means falling back on those often difficult tests like control, mutuality of obligation, provision of equipment, substitution clauses and whether someone is in business on his or her own account.

The thought process is that if an individual provides services to a business via an intermediary but operates effectively as an employee, the individual should pay broadly the same amount of tax and NIC as he or she would have done had he or she been an employee of the business. Those who are found to be within the clutches of IR35 have to undertake a calculation at the end of the tax year. The intermediary must calculate tax and NIC deductions on the basis of the amount of cash and non-cash benefits received from clients (net of VAT and a limited number of allowable expenses paid by the company), less the amount the company has paid to the employee as earnings (plus non-cash benefits). The difference between these amounts is treated as pay on 5 April and therefore liable to PAYE and Class 1 NIC accordingly. The resulting tax, which can often stretch over a number of back-years, can come as quite a shock to those who had not appreciated that IR35 would apply. For example, in the recent case of *Dragonfly Consulting* [2008] EWHC 2113 the losing taxpayer faced a bill of close to £100,000.

**Did it work?**

In any review of legislation one needs to see whether it hit the target it was aimed at. The original IR35 press release said that the main aim was to stop 'Friday to Monday'-style employment status changes, where an employee would simply cease employment, set up a service company and return to essentially the same role but seek to be treated as if he or she were self employed. By the time the rules were implemented from April 2000 the original proposals had broadened and moved on considerably in terms of structure but they were an attempt to prevent people using intermediary structures to reduce their tax bill if there was evidence that they were 'disguised employees'. The fact that by 2007 the Government was having to introduce the managed service company legislation shows that IR35 was not able to completely close the gap in this area.

The Budget Red Book for 2000 said that the implementation of IR35 would bring in £900 million. There still remains no statistical evidence of how much money IR35 has raised. Almost annually the question is raised in Parliament but the standard response is that the information is not available. This year's service company question on the self-assessment income tax return suggests some attempt to capture this type of information but it would be hard for anyone to say with confidence that IR35 has succeeded in relation to its revenue-raising targets.

**Larkstar Data Ltd**

What IR35 has done is spawned numerous tax cases, all of which highlight how hard it can be for someone to know with certainty whether the rules apply or not. Take the recent case of *Larkstar Data Ltd* [2008] EWHC 3284. Here the contractor successfully argued before the General Commissioners that he was not caught by IR35. HMRC appealed to the High Court and the case has now been sent back to the General Commissioners for a rehearing on the basis that they had misdirected themselves in law by not considering all the evidence put before them by HMRC. As is often the situation in IR35 cases, the facts showed factors both in the taxpayer's favour and against.

The company provided the computer consultancy services of Mr Brill primarily to one client for about two and a half years. HMRC argued that IR35 applied. There were few trappings of obvious employment — no sick pay, holidays or bonuses. Mr Brill had to work exclusively at the client's office, which may be a minor indication of employment but the rationale was that this was essential for security reasons. For similar reasons he had to use the client's equipment.

The Commissioners had found that he was encouraged to work the core hours of the client but was not obliged to. This was a source of some contention and the taxpayer had given evidence that suggested he was required to work fixed hours.

There appeared to be limited control over how he did his work, which is an indicator that he was operating as a contractor rather than an employee. There was a substitution clause in the contract, which if genuine can be a strong determining factor in favour of self-employment, but there were some doubts as to whether this could ever be enforced due to security issues.

Mr Brill was outside the company's structure and some effort had been undertaken to ensure he was not subsumed into the business like an employee. His professional independence was apparently the reason he was hired. He occupied no post and had no title. His badge described him as a contractor. There was also no restriction on him taking other clients and indeed he did do this, which again is a good indicator of him being a contractor.

On the downside for his case he appeared to have limited financial risk, apart from loss of income on premature termination and on having to redo unsatisfactory work at his own expense.

The Commissioners found no evidence of mutuality of obligation but the High Court found that they had misdirected themselves on this issue and had been strongly influenced by this misdirection.

HMRC's winning ground for appeal was that the General Commissioners had misdirected themselves in relation to the issues of control and mutuality of obligation and did not refer to nine cases raised by HMRC. The Commissioners had been strongly influenced by their finding on mutuality but at the High Court, Sir Donald Rattee noted that there had not been appropriate consideration of relevant cases which could have led to a different conclusion. The cases had been submitted in advance, although rather strangely HMRC did not appear to have pointed out this fact during the hearing.

The absence of appropriate consideration of the key points the cases raised left Sir Donald with little choice but to request the costly option of a rehearing. By the time this process is followed through the General Commissioners will have been replaced by the new tribunal system.

Does this case provide us with any new information on IR35? Probably not. What it does do is confirm that the issues are complex and easy to get wrong. Many have preferred to take their cases to the Special Commissioners rather than the Generals because of the specialist nature of the legislation. It also shows that even ten years on we still have significant 'grey areas' within the rules.

**Will it ever improve?**

Ten years ago a number of us were heavily involved in the discussions around the implementation of IR35. I asked two well-known tax specialists and commentators, who have lived through the developments, what they now think of the rules. To begin with John Whiting, who then and now is involved with policy issues on behalf of the Chartered Institute of Taxation, noted:

'The main issue is we could have expected that after ten years it would all have settled down and we'd know exactly where we were. But we don't — because, of course, the main underlying issue of employed/self-employed hasn't been sorted out.'

By relying so heavily on the employment status test it is clear that IR35 has simply opened an existing wound, that is not bearing up well under intense scrutiny. As Whiting goes on to say: 'It would be good to have some of the efforts put into IR35 diverted into getting clearer guidelines on employment and self-employment.'

The major stumbling block in any review of employment status is that any new system is likely to have significant losers, particularly if the proposal were phrased so as to make far more people be treated as employees. Other jurisdictions, such as Australia, have sought to codify their employment status rules to produce clearer tests but this has not been easy or without criticism.

The rules remain administratively burdensome. Cases are costly to fight from all sides and HMRC has undoubtedly struggled to police the legislation. Another key commentator in this area is Anne Redston, who points out that:

'A key issue for businesses is not to be complacent — a working method which was outside IR35 in 2000 may have evolved over time so that the individuals are now within the legislation. Since 2000 the case law boundaries have clarified somewhat, although they are still too uncertain for a tax regime which affects small business. All potentially affected businesses should review, at least annually, whether they fall within this regime or not.'

This need for continual review highlights the ongoing burden the rules can provide. So is there a better way forward? There appears no end to the constant flow of cases, which suggests that the rules still lack that crucial clarity. The revenue-raising element behind the introduction of IR35 has not been evidenced and the administrative burden of the rules remains. This all points to an issue that was raised many times back in 1999 — these rules were always just a sticking plaster over more fundamental issues to do with the way small businesses and the self-employed are taxed. If we are ever to tackle this area effectively we need a Government which wholeheartedly commits to a full review of taxation in this area.

*Article by Francesca Lagerberg*

**Lecture B527 (6.51 Minutes)**

# Corporation Tax

## Blackburn and share issues

Mr Alan Blackburn, whose case came before the Court of Appeal at the end of last year is a salutary reminder that the job's not over until the paperwork's done, but it also raises questions about whether the tax system should have to create such bear traps for people who are trying to run a business rather than a paperwork factory.

Throughout the case it was accepted that Mr Blackburn had paid the company £1 in cash for every £1 share he had received, and that all he wanted was to get enterprise investment scheme (EIS) relief against capital gains for doing so. It seems strange that the tax system threw quite so many obstacles in his way.

### The facts

Mr Blackburn ran a company called Alan Blackburn Sports Ltd. He had formed it in August 1998 to own and operate the Isle of Wight Sports Club, and he and his wife were the sole directors and shareholders. In October 2002 he submitted claims for EIS relief against capital gains tax liabilities totalling some £475,000.

The Special Commissioner, Dr John Avery Jones, politely said that Mr Blackburn was 'not a details man'. He relied to a considerable extent on the company's accountant, a Mr Tausig (practising as Michael Cole & Co), who had unfortunately died before the case came before the Commissioner. The problem with the 'details' was that the procedure for many of the share issues was handled very informally. There were six share issues concerned in the case.

### Partly paid

In cases 2, 3 and 4, the shares had been issued prior to the payment of the funds concerned. In a typical case, Mr Blackburn would write to his accountant saying that he intended to put money into the company and that he wanted to get EIS relief for it by purchasing shares at par. The accountant would then send back a 'package' consisting of a draft resolution, share certificate, return of allotment and claim for EIS relief, which Mr Blackburn would sign and return. The money would be paid into the company later.

The argument put forward by HMRC in respect of these issues was that they breached the provision in TCGA 1992, Sch 5B para 1 that the shares should be issued 'fully paid up (disregarding for this purpose any undertaking to pay cash to the company at some future date)'. Since the shares had been allotted prior to the payment by Mr Blackburn, the provision was not met.

The Special Commissioner looked at the authorities and concluded that the issue of shares is the whole process which results in the person concerned becoming a member of the company, and that if the paperwork is handled correctly the last step in that process is the registration of the shareholder. In respect of these shares, the taxpayer contended that, since the intention was to issue fully-paid shares, the issue of the shares was not in these cases complete until payment was received. HMRC argued that, regardless of intention, the shares had been issued prior to the payment and therefore had been issued partly paid.

The Special Commissioner concluded from the paperwork that the intention was indeed to issue fully-paid shares. He therefore felt, particularly in the context of what was essentially a 'one-man company', that it was more accurate to characterise this as a conditional issue of shares, requiring the receipt of the payment to make it unconditional. As such, the shares were not issued partly paid, since they were not unconditionally issued at all until the payment was received. This decision was not appealed by HMRC.

### Receipt of value

The other three share issues, 1, 5 and 6, had a different problem. TCGA 1992, Sch 5B para 13 deals with a situation where an investor receives value from the company at any time within the 'designated period', which at the time was seven years from the acquisition of the shares. Receipt of value includes the repayment of any debt owed to the individual unless it was incurred on or after the date of subscription for the shares.

In respect of the first issue, Mr Blackburn had paid £111,000 to the company three days prior to asking the accountant to issue the shares. At some point within the next three weeks or so the shares were allotted to him, and a further amount of approximately £26,000 was paid.

In respect of the second issue, Mr Blackburn had paid £96,000 to the company prior to asking for shares, and paid the remainder in part before the shares were issued and in part after. For the third issue, the share formalities were not completed until some months after the money had been paid over.

Again, HMRC's case was straightforwardly based on the provisions in the statute. In all these cases money had been paid to the company before any allotment of shares had been decided on by the directors. The only conclusion to be drawn from this was that the payment had created a debt in favour of Mr Blackburn which had subsequently been settled by the issue of the shares. This meant that he had received value from the company and was therefore precluded from claiming relief on the shares.

The Special Commissioner agreed with HMRC's contention, but this was overturned by the High Court. Mr Justice Peter Smith had a case argued before him which had not been put to the Special Commissioner, *Kellar v Williams* [2000] 2 BCLC 390. On the basis of that Privy Council case, he accepted that where money was advanced to the company prior to the allotment of shares it should be characterised as a contribution to the capital of the company, and not as a loan.

**Court of Appeal**

The Court of Appeal first considered the last two share issues, the 350,000 and 240,000 share issues, 5 and 6 in the table. It had been accepted throughout that there was a 'generalised intention' on the part of Mr Blackburn to make the payment in respect of shares. The argument that this constituted an 'informal application for shares' was rejected at the earlier hearings, and also by the Court of Appeal.

However, Lord Neuberger (giving the judgment of the Court of Appeal) said he had 'real difficulty with the notion that any money paid in advance of [the] allotments should be treated as giving rise to a debt in the normal sense of that word'. As he saw it, there was a consistent pattern of Mr Blackburn paying in money over the previous year, for which he had always received a share for every pound that he had paid. It was clear that Mr Blackburn expected to receive shares for his money, and that as the sole effective controller of the company he could ensure that he would.

Lord Neuberger therefore concluded that, both in his personal capacity and in his capacity as director of the company, when Mr Blackburn made the payments he intended that he would receive the shares in exchange. Debt was not the right way to characterise these payments, and there was no reason why they had to be so characterised simply because no formal allotment of shares had yet taken place.

However, the initial 149,998 shares were different. There was no prior course of dealing or any understanding with the accountant prior to the £110,000 being paid into the company. In that situation, a loan to the company, particularly a loan which enabled it to purchase land, was by no means an impossible conclusion to draw from the facts. Since there was only one issue of the 149,998 shares, this defect was enough to make the whole issue non-qualifying.

The Court of Appeal therefore reversed the High Court decision for the taxpayer, but only in respect of the first issue of 149,998 shares. Of the six issues set out in the table that were originally contested by HMRC, therefore, only the first is now non-qualifying; HMRC having conceded 2, 3 and 4 after the Special Commissioner, and having lost 5 and 6 in the Court of Appeal.

*From an article by Mike Truman*

**Lecture B528 (10.59 Minutes)**

## Changes to connected party debt

### The changes

The Pre-Budget Report of November 2008 announced two changes to the loan relationship rules in the case of connected companies.

1. Currently, where interest on a connected party debt is paid late (more than 12 months after the end of the accounting period) relief is given only in the accounting period when the interest is paid rather than the usual accruals basis. It is proposed to disapply this rule in most circumstances.

2. The release of a trade debt between two connected companies attracts no relief in the creditor company, but a tax charge may arise in the debtor company. The proposed PBR 2008 change means that the debtor will not be taxable on the release.

The changes — which should facilitate company reconstructions and sales — will apply for accounting periods *beginning* on or after 1 April 2009.

### The first change

Broadly, it is proposed to disapply the current rules on late paid interest between connected companies, so that no adjustment should be required for corporation tax purposes unless either of the two following conditions apply.

> a) The creditor company is not resident in a 'qualifying territory' as defined by TA 1988, Sch 28AA para 5E; i.e. a country with which the UK has a double taxation agreement containing an appropriate non-discrimination clause (see the *International Tax Manual* at INTM 432112 for a list of qualifying territories).
>
> b) The debtor company is party to an arrangement to avoid tax by obtaining a deduction, but with no corresponding credit brought in by the creditor under the loan relationship rules or an equivalent foreign tax rule.

### The second change

Two companies have a connection if one controls the other or both are under the control of the same person (FA 1996, s 87(3)).

For periods ending before 1 October 2002, 'control' was as defined by reference to TA 1988, s 416, under which the rights of associates are taken into account. For periods beginning on or after that date, the definition is contained in FA 1996, s 87A, inserted by FA 2002.

The test under s 87A is similar to that in TA 1988, s 840: 'control' is defined in terms of the holding of shares or the possession of voting power or powers conferred under the company's articles of association or other document, such that 'a person' may secure that the affairs of the company are conducted in accordance with their wishes. In most cases control will simply mean holding over 50% of the company's ordinary share capital.

It would appear that HMRC interpret 'a person' as meaning a single individual or a company.

### The difference a connection makes

Under FA 1996, s 84, the credits and debits to be brought in for corporation tax purposes must fairly represent the company's profits and losses in respect of its loan relationships, using an 'authorised accounting method'. So assuming GAAP is followed, no adjustment is needed.

However, where a loan relationship exists between connected companies, the legislation requires that, for tax purposes, debits and credits must be determined on an 'amortised cost basis' of accounting (FA 1996, s 87(2)). This is defined by FA 1996, s 103(1) as the cost of the asset/liability as adjusted for amortisation, impairment, repayment or release.

Sch 9 para 6(3) prevents the creditor company claiming relief for any impairment loss in most cases where the companies are connected.

On the other hand, Sch 9 para 5 says, among other things, that when a liability is released under a debtor relationship and the companies are connected no credit needs to be brought in by the debtor company.

However, where the debt is a trade debt, the release is taxable at present, as explained shortly, and this can therefore create a mismatch between the tax treatment of the two companies.

**Release of debt**

When para 5 refers to debts which have been released it means that the creditor company has formally agreed to waive all or part of the debt (CFM5207). This would normally require a deed of waiver to be legally effective unless consideration is given. Such arrangements will of course be unusual. It will more commonly be the case that the creditor has written off the debt or provided against it where no or only partial recovery is expected, but the debt remains legally due.

For non-connected companies the position is straightforward as loan relationship debits/credits will generally be allowable/taxable. For connected companies the position is, as explained, generally the reverse so should be tax-neutral overall.

This is fine as far as the loan relationship rules go, but where the debt is a trade debt … enter TA 1988, s 94.

**Section 94**

Section 94 requires that when a trade debt (for which the debtor has effectively had tax relief) is 'released', the amount released is treated as a receipt of the trade. However, s 94, again, applies only where a debt is formally released (BIM40265) and as I have already noted this will be somewhat uncommon. For many years HMRC regarded a write-back of trade debt to be non-taxable unless s 94 applied, based upon *British Mexican Petroleum Company v Jackson* (1932) 16 TC 570. Since 2001, however, their revised view is that the accounting treatment writing back trade debt to the profit and loss account should be adopted for tax purposes.

The loan relationships legislation, of course, applies only to loan relationships, which are defined by FA 1996, s 81. The debt must:

a) be a money debt; and

b) arise from a transaction for the lending of money.

While a trade debt will usually be a money debt, it generally will not be a transaction for the lending of money. It states quite clearly at CFM5057 that a trade debt is not a loan relationship and it goes on to say that an inter-company debt which arises as a trade debt remains a trade debt even if left outstanding for 'a long time'. It does not magically convert into a loan relationship unless the debt is capitalised by being repaid and then advanced as a loan or by conversion into a loan effected by book-keeping entries.

To get back then to s 94, in the unusual scenario where a trade debt between connected companies is formally released, the law as it stands is that the amount released is taxable as a receipt of the trade of the debtor company. But if a trade debt is not a loan relationship, surely a deduction would be obtained by a connected creditor company in the normal way?

**This is how it goes**

TA 1988, s 74(1)(j) formerly applied to deductions for bad or doubtful debts, but this was repealed by FA 2005 which inserted a new TA 1988, s 88D, reflecting International Accounting Standards terminology of 'impairment losses'. However, s 88D does not apply to loan relationships. As already explained, trade debts are not loan relationships *per se*, but where a company writes off a money debt which has arisen in the course of a trade or property business, FA 1996, s 100(1)(c)(iii) brings the *debit* in the creditor company's accounts within the loan relationship rules.

This means that where the debtor and creditor are connected companies, para 6 will prevent the creditor obtaining relief for any impairment losses arising in respect of a trade debt as it would with any other impairment loss. However, s 100 has no impact on the debtor's tax position.

Thus, as it stands, if a trade debt between connected companies is (unusually) formally released, the creditor company would get no relief for the impairment loss, but the debtor company would be taxable under TA 1988, s 94.

**The change**

The proposed change is to bring the debtor within the loan relationship rules. Since FA 1996, s 80(5) gives the loan relationship rules priority over any other taxing provisions, s 94 will not then apply.

Given that separate rules now apply for income tax purposes anyway, the change appears to render s 88D and s 94 almost otiose; however, it is not intended to repeal these as they could apply to debts which are not money debts, i.e. barter transactions.

It must be said that for most companies the proposed change will be of very little importance since formal debt waivers will be unusual especially between private companies. The explanatory notes suggest that such waivers may be involved in group reconstructions, mergers, etc. Nevertheless, I hope that it has been useful to review the rules regarding connected party debt since it is a topic which many find difficult to 'get a handle on' especially as it is a rather slippery handle as can be seen from the above.

**Summary**

It may help to summarise the rules:

- Where companies are not connected, any loan relationship debits/credits between them will usually follow the accounts treatment.
- Two companies are connected if one controls the other or both are controlled by the same person.
- In general terms, impairment of connected party debt is tax-neutral: no relief is given to the creditor company for any impairment losses, but recognition by the creditor that the debt is impaired will not affect the tax position of the debtor.
- If a creditor formally releases a debt due by a connected company, the release is not taxable on the debtor — unless the debt is a trade debt.
- Trade debts are treated as loan relationships as regards the creditor company and so relief for impairment losses is still denied where the debtor is a connected company.
- Where a trade debt is formally released between connected companies, although the release is not taxable under loan relationship rules the general rule (TA 1988, s 94) applies for taxing the debtor company on release of a trade debt.
- For accounting periods beginning on or after 1 April 2009 where a trade debt is formally released and the debtor and creditor are connected, the debtor will be brought within the loan relationship rules, thus overruling TA 1988, s 94 and the release will not be taxable.

*From an article by Ken Moody*

## Dividend waivers – watch out!

The decision in *Buck v HMRC (2008)* examined the question of whether a dividend waiver can constitute a settlement for income tax purposes under what is now Ss624 – 625 ITTOIA 2005.

**Buck v HMRC**

Mr Buck owned 9,999 shares in a family trading company and the remaining share was held by his wife. Shortly before the company's year ended 31 March 1999, Mr Buck waived his dividend entitlement by formal notice in writing and a dividend of £35,000 per share for that year was then paid out, all of which went to Mrs Buck. They did the same for the following year.

**HMRC's argument**

HMRC argued that the two dividend waivers in 1999 and 2000 and the subsequent payments to Mrs Buck represented an arrangement for the purposes of S620 ITTOIA 2005 so that the anti-avoidance settlement legislation applied. They considered that the let-out in S626 ITTOIA 2005 was not in point, given that the arrangement did not represent an outright gift of income-producing property from one spouse to the other and, in any event, the subject-matter of the gift was wholly a right to income. The taxpayer (who was unrepresented and did not attend the hearing) claimed that there was no arrangement – it was in the company's interest to pay out the maximum dividends available and he had not wanted to receive them.

Unsurprisingly, the Special Commissioners found HMRC's arguments convincing, with the result that the waived dividends were treated as Mr Buck's income and so were taxable on him.

**When would the settlements legislation not apply?**

It has always been thought that a dividend waiver can be a settlement, provided, of course, that the necessary element of bounty is present. This is certainly the case where the waiver enables another shareholder to receive an increased dividend.

However, with dividend waivers, this will not always be the position.

A dividend waiver has been described by one commentator as 'the abandonment of a contingent right so that the relevant shareholder does not receive the dividend'. That does not necessarily mean that anyone else receives more. It will do so if a dividend is proposed of a fixed monetary amount and one shareholder waives his entitlement – in that case, the whole of the fixed sum will then go to the remaining shareholders and they will receive more than they otherwise would. That would represent bounty and the settlement provisions could of course apply.

However, if a dividend is proposed of a fixed amount per share, the fact that one shareholder waives his entitlement does not increase the amounts payable to the others. In those circumstances, there can be no bounty and no settlement.

**Why the Bucks failed**

But it is important not to try to be too clever because, as happened with Mr Buck, if a dividend per share is proposed which is manifestly in excess of the company's distributable profits, the whole arrangement will be a settlement. The amounts payable to the other shareholders will only be possible because the proposed dividend will have been made in the clear knowledge that the waiver would take place.

One cannot take exception to a shareholder receiving a dividend on his or her shares if no-one else receives a corresponding dividend. Where HMRC are likely to become interested is if arrangements are made whereby, say, a 30% shareholder receives more than 30% of the company's distributable profits. In this situation, HMRC will undoubtedly try to invoke the settlement legislation.

The recent provisions on income shifting may have been quietly dropped, but Ss624 – 625 ITTOIA 2005 are still a powerful weapon in the hands of HMRC.

*Article by Robert Jamieson*

# Value Added Tax

## Partial business use

This article considers several recent developments in the area of input tax claims on expenditure which is partly for business purposes and partly for purposes which are not regarded as "business" for VAT. A recent ECJ decision (*VNLTO*) has drawn a new distinction between two different types of "non-VAT-business" use which could have significant consequences for the UK's treatment of such expenditure.

Specifically the notes examine:

- the *SECURENTA* decision of 2008, which confirmed that input tax cannot be deducted where the expenditure is incurred for purposes which are not "taxable economic activity" for the trader – investment in shares does not involve making supplies for consideration, so VAT incurred on expenses related to such an activity is not deductible;
- the *VNLTO* decision of 2009, which restricts the *Lennartz* approach to input tax claimed on expenditure for mixed business and private purposes (the history of that approach is explained in the lecture);
- the 2007 regulations which were introduced in the UK to control the operation of "*Lennartz* accounting";
- an EU Commission proposal to change the rules in this area, not yet effective;
- another ECJ decision which confirms that *Lennartz* still applies to private use.

### Use for business and non-business: SECURENTA

Although the split between business and non-business VAT is not strictly part of partial exemption, it is often carried out at the same time and may be part of the same special method calculation that is used for partial exemption. The ECJ has confirmed the Advocate-General's opinion on the application of the VAT Directive to this apportionment. The UK government made representations to the court in the case, which is useful because this confirms HMRC's policy on how the split should be done. The ECJ appears to agree with the UK government.

The appellant in the case is a German investment company. It raised money and invested it on behalf of investors. The money was raised by the issue of shares and "atypical silent partnerships", and was invested in real estate, securities, financial holdings and investments of all types. It was accepted by all parties that the company had business and non-business activities: its investments in financial holdings in other companies were the "non-economic" type considered by the ECJ not to give rise to a right of input tax deduction in the *Polysar* case. The business activities were both exempt (financial transactions and some property investments) and taxable (other property investments).

The questions referred to the ECJ were:

*1. If a taxable person simultaneously engages in a business activity and a non-business activity, is the entitlement to deduct input tax determined according to the proportion of the assessable and taxable transactions, on the one hand, to the assessable and exempt transactions, on the other hand (the applicant's view), or is the deduction of tax allowed only to the extent that the expenditure connected with the issue of shares and silent partnerships is to be attributed to the applicant's economic activity within the meaning of Article 2(1) of Directive 77/388/EEC?*

*2. If the deduction of tax is allowed only to the extent that the expenditure connected with the issue of shares and silent partnerships is to be attributed to the applicant's economic activity, should the apportionment of the input tax between business activity and non-business activity be carried out according to an "investment formula" or is – as the applicant submits – a "transaction formula", applying Article 17(5) of Directive 77/388/EEC mutatis mutandis, also appropriate?*

The "investment formula" was a method suggested by the German government. The "transaction formula" was a method similar to the normal rules of partial exemption, suggested by the taxpayer.

The UK government's submission was that the proportion of the overhead inputs that is linked to or used for the applicant's non-economic activity does not form part of any input tax deduction

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calculation, because that proportion of the inputs falls outside the system of deduction altogether and should be disregarded entirely (i.e. it is not input tax – in UK terms, it does not fall within s.24(1) VATA 1994, so it does not fall to be apportioned under s.26 and the regulations made in accordance with that section). The government argued that no means of apportionment between business and non-business is not prescribed by the 6th Directive and the manner in which it is done is therefore a matter for the discretion of the Member States.

The Court concluded that some of the costs incurred by the company in raising money from investors were, at least in part, for the performance of non-economic activities, and that could not give rise to the right to deduct. On the other hand, there was nothing in the 6th Directive to say how a business/non-business split should be determined: there are specific rules for partial exemption, but not for this.

The Court accordingly answered the questions as follows:

*1. Where a taxpayer simultaneously carries out economic activities, taxed or exempt, and non-economic activities outside the scope of Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment, deduction of the VAT relating to expenditure connected with the issue of shares and atypical silent partnerships is allowed only to the extent that that expenditure is attributable to the taxpayer's economic activity within the meaning of Article 2(1) of that directive.*

*2. The determination of the methods and criteria for apportioning input VAT between economic and non-economic activities within the meaning of the Sixth Directive is in the discretion of the Member States who, when exercising that discretion, must have regard to the aims and broad logic of that directive and, on that basis, provide for a method of calculation which objectively reflects the part of the input expenditure actually to be attributed, respectively, to those two types of activity.*

The Advocate-General's opinion commented specifically that the Member States, in exercising their discretion in this area, should have regard to the principles of fairness and fiscal neutrality.

ECJ (Case C-437/06): *SECURENTA Göttinger Immobilienanlagen und Vermögensmanagement AG als Rechtsnachfolgerin der Göttinger Vermögensanlagen AG v Finanzamt Göttingen*

**Partial non-business use: VNLTO**

The ECJ has come to a potentially far-reaching and radical decision on input tax which is incurred for mixed use, where part of that use is not for economic purposes.

The traditional understanding has been that use for non-economic purposes did not distinguish between "private use" (e.g. by a sole trader) and "use for activities which do not involve the making of taxable supplies" (e.g. the charitable activities of a charity). Both were regarded as "non-business use" that would not give rise to a right of input tax deduction, except using the *Lennartz* principle for capital expenditure. This provided that a taxpayer acquiring capital expenditure for mixed business and non-business use had a choice:

- full recovery of the input tax immediately, followed by output tax charges under what is now art.16 Directive 2006/112 EC to reflect the non-business use;
- partial recovery of the input tax immediately, followed by no output tax charges.

Art.16 provides: "*The application by a taxable person of goods forming part of his business assets for his private use or for that of his staff, or their disposal free of charge or, more generally, their application for purposes other than those of his business, shall be treated as a supply of goods for consideration, where the VAT on those goods or the component parts thereof was wholly or partly deductible.*"

It has been held that the self-supply charge under art.16 does not on its own justify an initial input tax deduction: there must be some "external" economic use as well as the private use. However, a string of cases since *Lennartz* have held that the trader has an absolute right to allocate the whole of the asset purchased to the business and reflect the private use as an output of the business.

The new case was referred by the supreme court in the Netherlands. It appeared to feature a claim for art.16 and the *Lennartz* approach to apply to inputs other than capital expenditure, although it is not clear how this would benefit the trader – if the private use followed shortly after the input tax claim, it would appear that the effect of art.16 would be very similar to the disallowance of a proportion of input tax.

However, the ECJ has gone considerably further in its judgment. It has drawn a distinction between:

- "private use", which has nothing to do with the taxable purposes of the entity;
- "non-economic use within the purposes of the business" – activities which do not involve making taxable supplies, but which are central to the purposes of the taxable entity.

The second type of activity does not fall within art.16, because it cannot satisfy the words "*their application for purposes other than those of his business*". This means that there cannot be any output tax on a self-supply in such circumstances.

The corollary of this is that input tax incurred for mixed economic and non-economic use (in the new sense) cannot give rise to a full input tax deduction. The future non-economic use *within the purposes of the entity* must be taken into account at the time the input tax is incurred, and it denies the right of deduction at that time.

The ECJ comments that the situation in the present case, which featured general expenditure of a trade body which promoted the interests of its members, was quite different from that in cases where the *Lennartz* approach was confirmed: *P Charles and T S Charles-Tijmens v Staatssecretaris van Financiën* (Case C-434/03) and *Wollny v Finanzamt Landshut* (Case C-72/05). There, the expenditure was on immoveable property, and it was wholly allocated to the business before being partly used for private purposes. This appears to be a distinction which could have four aspects:

- timing: it might be possible to allocate expenditure wholly to the business as long as the non-economic use comes later (but it is not clear how much later);
- type of expenditure: the ECJ appear to accept that the *Lennartz* approach is more appropriate for immoveable property than for other types of expenditure;
- accounting treatment: the ECJ refer to the current taxpayer allocating all the expenditure concerned to "general expenses" in the accounts, rather than exclusively to the "economic" side of its activities;
- type of use: it appears that private use, wholly separate from the taxable activities of the trader, is now to be regarded as something quite different from "non-economic use" which falls within the natural activities of the trader.

At present it is not clear how far the ECJ's decision goes, but it seems at least to cover the fourth point. There are some important issues on which HMRC will need to issue clarification:

- whether the *Lennartz* approach can still be justified by one or more of the first three points on the list, even if the fourth point applies;
- what happens where the *Lennartz* approach has been applied in the past to something that now appears not to be eligible for it.

It may be that traders may now be able to argue that charges should not arise under Sch.4 para.5 in respect of "non-economic use", but where they have in the past claimed back the input tax on the expenditure it may be that the courts will insist that they cannot "have it both ways".

ECJ (Case C-515/07): *Vereniging Noordelijke Land- en Tuinbouw Organisatie (VNLTO) v Staatssecretaris van Financiën*

**The 2007 Lennartz regulations**

The regulations which are used to calculate self-supply charges on private use of business assets applied from 1 November 2007. They are inserted in the General Regulations at regs.116A – N.

At the same time, SI 1995/1268 art.10A was inserted to provide that no self-supply of services in connection with private use of goods or land held or used for the purposes of a business will arise after the "economic life" of an asset has expired.

*SI 2007/2923; SI 2007/3099*

The explanatory notes to the Statutory Instrument contained the following commentary, with additional notes:

*Regulation 116A provides that where a relevant supply of goods occurs during their economic life, the whole or part of the value of the supply which is referable to the use of the goods on or after 1 November 2007 is calculated in accordance with Part 15A of the Regulations.*

Before the introduction of these new regulations, the calculation of the Sch.4 para.5 charge was done on a "fair and reasonable" basis, with no special rules about how it should be done. In particular, it was up to the trader to estimate the useful life of the asset concerned. Notice 700 simply said, "VAT is due on the cost of the supply. Over any period of time, this is the amount of depreciation on the goods plus any other standard-rated costs related to the goods multiplied by the proportion that the private use forms of the total use."

*Regulation 116B provides for the interpretation of Part 15A. The meaning of "goods" is extended to include land held or used for business purposes and references in the regulations to the 'full cost of the goods' is defined by reference of the cost of the goods upon which credit or repayment of VAT has been made by the person making the relevant supply or a predecessor.*

*Regulations 116C and 116D provide for the duration of the economic life of goods. The economic life of goods is 60 months. The economic life of land is 120 months but this is limited to the duration of the maker of the relevant supply's interest in the land where that is less than 120 months at the time when first use of the land occurs.*

Note that the limitation of the economic life to 5 or 10 years, together with the exclusion of any charge after the economic life has expired, means that an asset effectively becomes "VAT-exhausted" after that period. However, if an asset is sold on in a taxable sale to a new owner, a new economic life will commence.

*Regulation 116E determines the value of a relevant supply. The calculation is by reference to a formula that applies the proportion of private or non-business use of the goods made during the prescribed accounting period in which the supply occurs to the proportion of the total cost of the goods attributable to the part of that period occurring within the economic life of the goods.*

The formula appears unnecessarily complicated, but it appears that it will simply reflect the proportion of depreciation of the asset falling within the return period – in the normal circumstance, 3/12 x 1/5 for assets other than land, and 3/12 x 1/10 for land – times the private use percentage.

*Regulation 116F varies the formula contained in regulation 116E for determining the value of a relevant supply where the accounting period in which the relevant supply occurs is preceded by one or more prescribed accounting periods when the goods were not used or made available for use for any purpose.*

This provision adds previous periods of non-use to the calculation of private use. So where some land has not been used at all for a year, and is then used 90% privately for three months:

- there will be no charge under reg.116E during the year of non-use;
- the charge in the period of partly private use will be 15/12 x 1/10 x 90% x the cost of the land;
- in following periods, the charge will revert to the usual 3/12 again.

*Regulation 116G provides for the commencement of a new economic life where a supply of goods or services is made which increases the full cost of the goods from that applying immediately before the supply. The commencement of a new economic life upon the first use of the goods after the supply giving rise to that life will not prejudice any existing economic life and will run concurrently with it for the remainder of the existing economic life.*

This is similar to the capital goods scheme rule that can regard a building and improvements to the building as separate items subject to adjustment over different periods.

*Regulations 116H and 116I make provision for the value of relevant supplies of goods during their new economic life. Regulation 116H varies the formula in regulation 116E so that the value of a relevant supply made in respect of the goods is determined only by reference to the increase in the full cost of the goods resulting from the supply giving rise to the new economic life and the private or non-business use made of them during the new economic life. Regulation 116I provides that where a*

*relevant supply occurs in relation to land or a building which has two or more economic lives at that time, the value of the supply is the total of the amounts calculated in accordance with regulation 116E as varied by regulation 116H as appropriate.*

*Regulation 116J provides that regulation 116L applies in relation to an economic life in respect of goods which have been put to private use or used, or made available for use, for non-business purposes before 1st November 2007 by the person described in regulation 116K or any of his predecessors. The person described in regulation 116K is the person who holds or uses the goods concerned for the purposes of his business on 1st November 2007.*

*Regulations 116L and 116M determine the duration of an economic life treated by that regulation as commencing on 1 November 2007 by reference to a formula that takes into account the value of relevant supplies arising from the use of the goods before 1 November 2007.*

This is the transitional provision that determines the treatment of assets held on 1 November 2007. It is very complex and is set out in full below.

*Regulation 116N permits a person who, within 2 years ending on 21st March 2007, has claimed VAT in respect of goods which he intends or expects will be put to private or non-business use during their economic life to withdraw whole of the claim (or the part referable to non-business use) provided the goods have not been used and the withdrawal is made in accordance with regulation 35 of the Regulations before 1st February 2008.*

This allows someone who opted for "*Lennartz* accounting" while unaware of the imminent new rules to change their minds and reverse their original input tax claim. They can then adopt the approach that HMRC have always preferred – make a partial claim on purchase to reflect the likely extent of business use over the life of the asset, and forget about it after that.

**Transitional rule**

The transitional rule involves the following impenetrable formula:

**116J.** Regulation 116L applies to an economic life that-

(a) would be treated as commencing before 1 November 2007 if that regulation did not apply; and

(b) relates to goods that, before that day, have been put to any private use or used, or made available for use, for non-business purposes by the person described in regulation 116K or any of his predecessors (whether or not a relevant supply arising from that use has been treated as made before that day).

**116K.** The person referred to in regulation 116J(b) is the person who holds or uses the goods concerned for the purposes of his business on 1 November 2007.

**116L.** An economic life of goods to which this regulation applies shall be treated as commencing on 1 November 2007 and lasting for the period of time determined using the formula – D x ((E-F)/E)

where –

D is the number of months which would have been the duration of the economic life concerned if it had commenced in accordance with regulation 116C or had been treated as having commenced in accordance with that regulation by virtue of regulation 116G;

E is the value of element "C" of the formula contained in regulation 116E (as varied where appropriate in relation to that economic life by regulation 116H) for the purpose of determining the whole or, where the use occurs at a time when the goods have two or more economic lives at that time, part of the value of a relevant supply arising from the use of the goods during the economic life concerned;

F is the value determined using the formula – (Gx100)/(X%x100)

where –

G is the total value of relevant supplies of the goods on which VAT has been or will be accounted for in respect of such relevant supplies arising from the goods being put to any private use or used, or made available for use, for non-business purposes before 1 November 2007 (whether or not such supplies are treated as made before or after that day) to the extent that the value of the relevant supplies comprised in the total value was determined by reference to the value of element "E" of the formula used in this regulation in respect of the economic life concerned; and

X% is the extent, expressed as a percentage, to which the goods have been put to any private use or used, or made available for use, for non-business purposes during the period described in regulation 116M as compared with the total use made of the goods in that period.

**116M.** The period referred to in regulation 116L is the period of time commencing at the time when the economic life concerned would have commenced if it had commenced in accordance with regulation 116C or had been treated as having commenced in accordance with that regulation by virtue of regulation 116G and ending immediately before 1 November 2007.

Analysing that…

D is either 60 or 120, or a number lower than 120 in the case of land held on a lease of less than 10 years.

The economic life of the asset falling after 1 November 2007 will not be calculated on the basis of time (e.g. time owned before 1 November 2007/after 1 November 2007), but according to values and the extent of private use.

E is the cost of the asset, including additions.

F is a figure calculated from G, the value of Sch.4 para.5 deemed supplies arising before 1 November 2007 on the figure of cost at E, and X%, which is the proportion of private use as against business use during the period from the acquisition of the asset to 1 November 2007.

*Example*

A building was purchased on a 20-year lease for £1m plus VAT on 1 November 2004. It was used 25% for business purposes, 75% for private purposes from that point on. Sch.4 para.5 charges were calculated for the 12 3-month VAT periods ending on 31 October 2007 using a useful life of 20 years, in accordance with the former HMRC policy.

These self-supply charges would therefore each have been 75% x £1m x 3/240 = £9,375

D = 120

E = £1m

G = 12 x 9,375 = £112,500

F = 112,500 x 100/75 = 150,000

The economic life falling after 1 November 2007 will be:

120 x (1,000,000 – 150,000)/1,000,000 = 102 months

HMRC issued a Revenue & Customs Brief and Information Sheet to give detailed guidance on the application of the rules. Business Brief 15/05, which contained HMRC's previous policy on Sch.4 para.5 charges, was withdrawn.

One point that is interesting is the "three-way choice" that HMRC believed a trader has on purchasing an asset for part business, part non-business use:

- he may treat them as a wholly non-business or private asset, in which case the VAT incurred is not deductible;
- he may treat them as a part business, part non-business asset, in which case the VAT incurred is only deductible to the extent that it relates to the taxable business activities [Value Added Tax Act s.24(5)]; or
- he may treat them as a wholly business asset, the *Lennartz* approach, in which case the VAT incurred is treated as input tax and is deductible in full, subject to any partial exemption ('PE') restriction; however, VAT must then be accounted for if the goods are used for private/non-business purposes.

The first option suggests that such an asset can be excluded from the business altogether, which would mean that no output tax would have to be accounted for on a sale.

The Information Sheet also states that *Lennartz* accounting can only be applied to services which create a new asset which constitutes "goods". It therefore can be used for services which consist in:

- the construction of new movable goods (e.g. a yacht);
- the construction of new building or civil engineering work;

- the construction of an extension or annex to an existing building; and
- the reconstruction of an existing building;

but not for services which merely refurbish or repair existing assets, nor for intangible assets such as software licences or intellectual property rights. This view was rejected in 2008 by the VAT Tribunal in ***Whitechapel Art Gallery*** (VTD 20,720): the Tribunal saw no reason to distinguish between substantial refurbishment expenditure that was capitalised in the accounts and was equivalent to the creation of a new asset, because the alternative would have been to tear down the existing building and start again.

The Information Sheet gives detailed worked examples, including the effect on partially exempt businesses and the operation of the transitional rules with constant and with variable private use.

*R&C Brief 68/07; Information Sheet 14/07*

**Another spanner in the works**

At the end of 2007, the European Commission published a proposed amendment to the VAT Directive which would effectively re-enact the UK's 2003 anti-avoidance rules which were struck down by the ECJ's decisions in *Seeling* and *Charles-Tijmens*. The proposal is to restrict the initial input tax deduction on expenditure (acquisition, construction, renovation or substantial transformation) in relation to immoveable property to the extent to which the building will be used for business purposes. This is effectively removing the *Lennartz* principle for buildings, which is what the UK Government wanted to do in 2003.

The recent ECJ decision in *VNLTO* appears to make this unnecessary, unless the Commission is still worried about individuals making such claims (see the case below for a striking example of that).

*COM/2007/677*

**Swimming pool**

The ECJ confirmed again that a VAT-registered trader is entitled to full and immediate input tax deduction on an asset purchased for part business, part private use, charging output tax later to reflect the private use. The case is particularly striking as the Austrian trader had a house constructed with a swimming pool. The authorities were willing to apply the principle to the cost of the house, but not to the cost of the swimming pool. The referring court was worried that a registered trader might be regarded as obtaining an advantage over others that would constitute an unauthorised State Aid.

The ECJ's response was:

*1. There is no infringement of the principle of equal treatment in the fact that the Community VAT directives entitle a taxable person to full and immediate deduction of input tax on property which he acquires and allocates to his business, then paying output tax progressively on his private use of that property, even if he thus enjoys an identifiable financial advantage over another person acquiring similar property in a private capacity and thus unable to deduct any input tax.*

*2. National legislation implementing the Community VAT directives so as to allow taxable persons such an advantage does not infringe Article 87 EC.*

*3. The standstill clause in Article 17(6) of the Sixth VAT Directive does not cover cases in which a previous exclusion from the right to deduct input tax where output tax was in principle chargeable is subsequently transformed into an exemption from output tax, entailing the impossibility of deducting input tax.*

*4. If a previous exclusion from the right to deduct is thus transformed into an exemption and is therefore not covered by the standstill clause in Article 17(6) of the Sixth Directive, any other exclusion which is dependent for its interpretation and/or application on the existence of the previous exclusion will also not be covered by the standstill clause. However, a self-standing exclusion which was in existence when that directive came into force in the Member State concerned and has not since been modified remains covered by the clause.*

ECJ (Case C-460/07): *Sandra Puffer v Unabhängiger Finanzsenat, Außenstelle Linz*

*Article by Mike Thexton*

**Lecture B529 (22.35 Minutes)**

## Input tax on expenditure on business entertainment provided to overseas clients

HM Revenue & Customs (HMRC) are currently reviewing the input tax treatment of business entertainment provided to overseas clients in the light of a recent European Court of Justice (ECJ) judgment in the joined case of *Danfoss and AstraZeneca (Case-371/07)* [2009] All ER (D) 107 (Feb).

The case concerned a Danish law provision, which excluded certain types of expenditure from the right to deduct VAT, and whether it was still effective, since although, it had been introduced before the Sixth Directive came into force, it had not been applied in practice.

Businesses may wish to consider the relevant time limits applying to potential claims and to submit claims, together with supporting evidence, in order to protect their position, pending HMRC's statement of their position. Businesses should note that, in any event, any claim would be confined to entertainment which is of a kind and on a scale that is reasonable. Any claims submitted should, as a minimum, include—

- Details of the overseas clients (NB overseas suppliers are not covered).
- The type of expenditure (eg meal, drinks, sporting event etc).
- The amount of VAT claimed.
- Evidence to support the fact that the VAT had not previously been deducted.

HMRC do not consider that this decision has any implications for the input tax block on expenditure on entertaining UK business clients. Nor does it have any impact on input tax that can be claimed on expenditure on meals and other entertainment provided to employees–business can continue to claim this input tax subject to the normal rules.

## Revenue and Customs Commissioners v Boots plc [2009]

Regulation 67 of the Value Added Tax Regulations 1995, SI 1995/2518, so far as material, provides—"(1) The Commissioners may permit the value which is to be taken as the value, in any prescribed accounting period or part thereof, of supplies by a retailer which are taxable at other than the zero rate to be determined by a method agreed with that retailer or by any method described in a notice published by the Commissioners for that purpose; and they may publish any notice accordingly. (2) The Commissioners may vary the terms of any method by—(a) publishing a fresh notice, (b) publishing a notice which amends an existing notice, or (c) adapting any method by agreement with any retailer."

During 2002 and 2003, the taxpayer company ran five sales promotions as part of which a customer who purchased goods to a value of at least £15 (the qualifying goods) received a type of voucher called a voupon, which entitled the customer to a credit of £5 against the value of certain specified brands of goods purchased from the taxpayer. At the time of the promotion, the taxpayer accounted for VAT under the terms of a bespoke retail scheme (BRS) agreed with Customs, as it then was, in 1998. The BRS did not address the issue of how to calculate the value of the voupons for VAT purposes. In relation to the qualifying goods purchased, the taxpayer accounted for VAT on the full amount of the consideration received from the customer and made no deduction from that amount in respect of the face value of the voupon. If the voupon was later redeemed, the consideration on the subsequent purchase was reduced for VAT purposes by the £5 credit given in respect of the voupon. Customs had published specific policy in relation to the VAT treatment of face value vouchers, including VAT Notice 727/4 at para 7.18 which stated the following—"If you include gift vouchers with other products for a single charge the supply of the goods and voucher is treated as a multiple supply. This means VAT is only due on the portion of the payment which relates to the goods. You should omit from your DGT [daily gross takings] that part of the payment which relates to the gift

voucher, usually the face value. But you must include in your DGT the face value of the voucher when redeemed by the customer”. The taxpayer was of the view that para 7.18 should have been used to calculate its turnover in respect of the voupon promotion and accordingly, the face value of the voupons should have been deducted from the price of the qualifying goods and only included in the calculation of turnover on redemption. Therefore, the taxpayer wrote to Customs on 25 June 2003, detailing a claim for the repayment of overpaid output tax based on the methodology of para 7.18. On 3 July, Customs rejected the claim, stating that for para 7.18 to apply, there had to be consideration for the supply of the voucher. On 7 October, the taxpayer wrote again to Customs submitting that it believed it was entitled to rely on the VAT accounting treatment contained in para 7.18 and reduce its DGT by the value of the voupons. On 28 November 2003, Customs informed the taxpayer that it agreed with its view on the applicability of para 7.18 and that it would be permitted to account for VAT on the value of qualifying goods less the face value of the voupon but on the full value of the redemption goods. In December 2003, Customs repaid £3,354,435 to the taxpayer. That decision was subsequently withdrawn and on 23 March 2005, an assessment was issued in the sum of £2,006,794 to recover the tax repaid. The taxpayer appealed to the VAT and Duties Tribunal which found that, in November 2003, there had been a binding amendment to the BRS for the period 2002–03 to the effect that the methodology of accounting set out in para 7.18 applied. The tribunal allowed the appeal against the assessment. HMRC appealed.

The taxpayer contended that in November 2003, it was given permission under reg 67(1) of the Value Added Tax Regulations 1995, SI 1995/2518, to account for VAT on voupons by an agreed method of valuation not previously applied. HMRC contended that it had not agreed an amendment to the BRS and had acceded to a claim for repayment based on an erroneous view of the law from which it was entitled to resile. Further, even if there had been an agreement to amend the BRS, it could only have been an agreement to adopt as part of the BRS the methodology of para 7.18 which, on the tribunal's findings, had no application to the voupons. It was common ground that an agreed method of valuation under reg 67 remained binding unless it was varied by agreement in accordance with reg 67(2)(c). Therefore, the primary issue was whether the tribunal had erred in law in its determination that the parties had reached a binding agreement to amend the BRS.

There were compelling factors in the evidence which pointed against there having been an agreement between the parties to amend the BRS and which pointed to the fact that the only issue between the taxpayer and HMRC (previously Customs) in their communications was whether para 7.18 applied, namely—(i) the only issue raised by the letter of 25 June had been whether para 7.18 applied to the voupon promotions and Customs had replied on 3 July that it considered that it did not apply; (ii) the letter of 7 October had set out in more detail the taxpayer's view of the meaning of para 7.18 and its belief that it was entitled to rely on it; (iii) Customs' letter of 28 November had simply confirmed that Customs, at that time, had accepted the taxpayer's reliance on para 7.18. The tribunal had fundamentally misconstrued the correspondence and made a finding unsupported by any of the evidence. Accordingly, the decision was one which no reasonable tribunal could have arrived at. The appeal would be allowed.

The assessment of 23 March 2005 would be confirmed.

## Staff Hire Concession

As announced at Budget 2008 the VAT Staff Hire Concession, which applies to supplies of staff by employment bureaux, is to be withdrawn from 1 April 2009. HMRC have published a brief which is intended to remind affected businesses of its withdrawal and to set out the VAT treatment that should be applied from 1 April. VAT Information Sheet 03/09 issued on 19 March 2009 contains more detailed guidance.

The concession is set out in Part A of the Statement of Practice in Notice 700/34 Staff and in Business Brief 02/04. It enables businesses making supplies of their own staff to exclude from the value of their supply the remuneration element and any PAYE (Pay As You Earn), National Insurance Contributions, pension contributions and similar payments relating to the worker provided such payments are made directly to the worker by the hirer, or a payroll company separate from the employment business supplying the staff. Such employment businesses have thus charged VAT solely on their profit margin and not on the full value of their supply.

Parts B and C of the Statement of Practice in Notice 700/34 Staff are unaffected and will not be withdrawn on 1 April 2009.

Business Brief 10/04 allowed employment bureaux that did not fall within the conditions of the Staff Hire Concession, because they made supplies of staff using self-employed workers, to choose whether to act as agents or principals for VAT purposes until the review of the Staff Hire Concession was completed. As announced at Budget 2008, this concession will also be withdrawn from 1 April 2009.

From 1 April 2009, in line with normal VAT principles, businesses making supplies of staff must charge and account for VAT on the full value of their supply. The correct VAT treatment following withdrawal is as follows—

If you act as a principal (eg employment business) in making a supply of staff using either—

- your own employees (which includes a director of your company) engaged under a contract of services

- self-employed workers who make their supplies to you under a contract for services

then VAT will be due on the full value of the supply (not just the profit margin).

If you act as an agent in providing introductory services of finding employment for workers or workers for your client and the workers enter into a direct contractual relationship with the client, who pays them, then VAT is due on your intermediary service only (based on your commission received). Such supplies are unaffected by the Staff Hire Concession and so will be unaffected by its withdrawal.

If you are making a supply of services other than staff, for example, supplies of care services, then your supply may qualify for exemption from VAT. See Notice 701/57 Health professionals for more information and the qualifying criteria. If your supply is of services other than staff it is unaffected by the Staff Hire Concession and so will be unaffected by its withdrawal.

If you are unsure of the correct VAT treatment of your supplies you should consult Notice 700/34 Staff and Notice 701/57 Health professionals. You may also contact our National Advice Service Helpline.

The HMRC clearance procedure is also available in which we will give their view of the correct tax treatment of your transaction. You can use this procedure where you have demonstrated that there is material uncertainty and that the issue is commercially significant. For further guidance on this see Clearance service for businesses–how to get certainty on significant business tax issues.

**Accounting procedures around 1 April 2009**

The normal time of supply (tax point) rules will apply. However, in respect of supplies spanning 1 April 2009, the Staff Hire Concession will be available to the extent that the service is performed prior to 1 April 2009. For example, if you raise an invoice or receive a payment on Friday 3 April, the concession will by then have been withdrawn. But you may, if you wish, account for VAT on the basis of the value of the services actually performed before and after the withdrawal of the concession, ie you may apportion the consideration for the services between—

- those services performed before 1 April, in respect of which the Staff Hire Concession is available

- those services performed on or after 1 April, in respect of which the Staff Hire Concession will no longer be available

## VAT Repayment Claims and Statutory Interest–Treatment for the purposes of Direct Tax

A number of European Court of Justice Judgments in recent years have resulted in substantial repayments by way of overpaid VAT and Statutory Interest being made to traders for periods covering many years. HM Revenue & Customs (HMRC) has recently legislated to ensure that from 1 April 2009 VAT repayments arising from any "new mistake of law decision" by the courts will be subject to a four year cap (increased from three years with effect from 1 April 2009). However, traders have up until 31 March 2009 to submit claims for periods as far back as the introduction of VAT in 1973 and it is anticipated that significant repayments will be made. These claims for repayment are often referred to as "Fleming" claims.

Section 80 VATA 1994 (as amended by section 3 of the Finance (No 2) Act 2005) is the statutory provision which enables the majority of claims to be made for repayment of output tax overdeclared because of a mistake either of law or fact.

This brief is not intended to provide a definitive technical analysis of the treatment for direct tax purposes of amounts repaid. The circumstances and considerations vary dependent on the particular circumstances of each case. It does however summarise the department's fundamental position and approach for direct tax purposes, as it applies in relation to these repayments.

**Trading income**

It has been suggested by some that as a matter of legal principle, receipts of refunds of VAT credited to the profit and loss account are outside the scope of Corporation Tax. HMRC does not agree with this view, firstly because there is no legal authority in support of this assertion and secondly because what is being repaid is not VAT.

The financial accounts prepared at the time are commonly prepared on a VAT exclusive basis and therefore the original turnover and Case 1 profits were reduced by the excessive amount incorrectly paid over as VAT. The repayment of amounts in respect of VAT, originally wrongly declared, are simply returns to the taxpayer of amounts which would have formed part of the taxpayer's trading receipts.

The reality is that a trader has simply calculated a higher sale price to the customer, because of a mistaken view of the law at the date of the transaction. Having subsequently become aware of the incorrect view of the law at the time of the transaction and that the additional amount received from the customer is not VAT, then clearly the amount is a trade receipt in exactly the same way as if it had resulted from any other mistake eg giving the wrong change.

The repayments represent sums that arose from the sale of goods or services in the ordinary course of its trading activities. The fact that amounts were paid to (the former) Customs and Excise in the belief that they were output tax properly due on those supplies, does not alter their trading character for Case 1 purposes.

**Receipt of interest**

Statutory Interest received in respect of the repayments is interest for tax purposes. While the interest does not arise from any loan relationship as defined by section 81 Finance Act 1996 because it does not arise from the lending of money, section 100 operates to bring interest on money debts within the scope of the loan relationship rules. The period to which a payment relates is the period in which it would properly be recognised under Generally Accepted Accountancy Practice.

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**Current enquiries**

HMRC's view is that that the repayments and interest are demonstrably part of the taxable income of the business and therefore chargeable to direct tax as trading income and interest respectively. However, there are some businesses who are contending that the repayment and/or the interest are not taxable. HMRC view this as a priority compliance risk and will continue to challenge such cases in accordance with our Litigation and Settlement Strategy.

**Identifying non-compliance**

A co-ordinated project is now ongoing to ensure that all current and future non-compliance risk is identified and addressed in a consistent manner, with particular reference to "Fleming" claims. Where potential non-compliance is identified, an intervention will be undertaken to establish the necessary facts.