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Personal Tax

Tips, Gratuities, Service Charges and Troncs

HMRC has reintroduced its Booklet E24 on tax treatment of tips etc. This follows the publication of a new Code of Practice stipulating that tips can no longer be made to count towards the National Minimum Wage, with effect from 1 October 2009.

Tip/gratuity/service charges

A tip/gratuity is an uncalled for and spontaneous payment offered by a customer either in cash, as part of a cheque payment, or as a specific gratuity on a credit/debit card payment.

A service charge is an amount added to the customer's bill before it is presented to the customer. If it is made clear to the customer that the charge is a purely discretionary amount and there is no obligation to pay, the payment is a voluntary service charge.

<u>VAT</u>

Tips are outside the scope of VAT when genuinely freely given.

Restaurant service charges are part of the consideration for the underlying supply of the meals **if** customers are required to pay them and are therefore standard rated.

If customers have a genuine option as to whether to pay the service charges, it is accepted that they are not consideration (even if the amounts appear on the invoice) and therefore fall outside the scope of VAT.

<u>Income Tax</u>

If customers give cash tips directly to employees or leave them on the table and individual employees keep them without any involvement from the employer, then PAYE does not apply.

PAYE must be operated on all amounts of tips paid by an employer to an employee. Responsibility for operating PAYE rests with the employer even where the employer delegates the task to an employee.

<u>National Insurance Contributions (NICs)</u>

Legislation provides that any amount paid to an employee which is a payment “of a gratuity” or is “in respect of a gratuity” will be exempt from NICs if it meets either of the following two conditions

– it is not paid, directly or indirectly, to the employee by the employer and does not comprise or represent monies previously paid to the employer, for example, by customers

– it is not allocated, directly or indirectly, to the employee by the employer.

By “allocate” they mean deciding who should receive what amount by way of tips.

In most cases where you pass tips to an employee, you are liable for both employer and employee NICs because neither of the conditions above are satisfied.

If you:

– are responsible for allocating tips, and

– pass tips to your employees, and

– consider that you are not allocating the tips either directly or indirectly

– should contact your local HMRC office for advice.

Payments you are legally obliged to make to employees, such as payments which form part of a contractual arrangement or undertaking, cannot be accepted as being payment “of a gratuity” by the employer.

A contractual payment is any payment made to an employee as part of an agreement between the employee and their employer, such as

- any payment that forms part of the terms and conditions of the employment
- a payment that is promised, guaranteed or underwritten by the employer even if the payment (or part of it) is paid by a third party.

If, however, tips are paid to the employer, the subsequent payment from the employer to the employee, even if the payment is a contractual payment, can still be "in respect of" a tip. If a payment by the employer is "in respect of" a tip, NICs are due if the employer allocates the payment directly or indirectly to the employee, but NICs are not due if the employer does not allocate the payment.

Tronc

A tronc is a special pay arrangement used to distribute tips, gratuities and service charges.

The tronc master is a person, other than the employer, responsible for arrangements to share tips amongst employees.

<u>Income Tax</u>

Where the troncmaster is in control of the tips and responsible for sharing them amongst employees, the employer must tell HMRC unless the arrangement came into existence before 6 April 2004. This is so HMRC can identify the person responsible for PAYE in each period.

HMRC may check an arrangement exists to share tips amongst employees and that the troncmaster accepts that role. A PAYE scheme will be set up for the tips in the troncmaster's name unless different PAYE arrangements need to be made.

The troncmaster is personally responsible for all aspects of operating a PAYE scheme. He or she may be held responsible for any failure to deduct tax from payments from the tronc. Troncmasters who need help in understanding their PAYE responsibilities should contact HMRC for advice.

A troncmaster with a PAYE scheme may use the employer's payroll to operate PAYE on his or her behalf (the employer effectively acting as a payroll agent), but the troncmaster's PAYE records must be kept separate from the employer's. The tronc PAYE scheme must be entirely independent of the employer's scheme and must be run as such.

Example

Frances opened a bistro in 2007. She allows the employees to keep all the cash tips and passes to them the tips received by cheque and credit/debit card in full. Mary, the head waitress, offers to collect all the tips and distribute these to the other employees each week. Frances has no involvement in this at all.

Mary is running a tronc and is the troncmaster. Frances must tell the HMRC office that deals with the PAYE for the bistro of Mary's appointment and any future change of troncmaster.

Mary is responsible for operating PAYE in the normal way on payments from the tronc. If she fails to deduct tax from payments she makes from the tronc, she may be held personally liable.

If the employer, business partner or official of the company (for example, a director) performs the role of troncmaster, they are considered to be making payments as if they were the employer and therefore the payments should be paid through the employer's payroll.

<u>National Insurance Contributions</u>

Where payments made from a tronc attract NICs liability, the troncmaster is not required to pay NICs on those payments. Responsibility for calculating any NICs due and making payment to HMRC rests with the employer.

Payments of tips will not attract NICs if the:

- troncmaster is allocating money that originally was not paid to the employer and the employer does not pay the money directly or indirectly to their employees, or
- employer does not determine, directly or indirectly, the allocation of those tips.

By "allocate" we mean deciding who should receive what amount by way of tips.

National Minimum Wage

The right to be paid the National Minimum Wage (NMW) is a statutory right. Regardless of any written or oral agreement between the employer and the worker, the law makes it clear that the worker has a statutory right to be paid at least the NMW by their employer.

For pay reference periods which start on or after 1 October 2009 amounts paid by the employer to the worker which represent tips, gratuities, service charges or cover charges paid by customers do not count towards national minimum wage pay.

For pay reference periods which started prior to 1 October 2009, tips, gratuities, service charges and cover charges could count towards national minimum wage pay if they were paid by the employer to the worker via the employer's payroll.

Reviews Of Records

From time to time the HMRC carry out reviews of employers' records to make sure things are in order for PAYE, NICs and separately for NMW. If there is both an employer PAYE scheme and a tronc PAYE scheme then it is likely, though not automatic, that records for both schemes will be reviewed at the same time.

HMRC factsheets "*Employers and contactors – reviewing your records*", "*Large employers and contractors – reviewing your records*" and the Business Link guidance "*National minimum wage law*" provide more details including:

– which records will be required
– how long to keep those records
– how the review will proceed.

Legislation

The tax legislation relating to **troncs** is contained within Regulation 100 of Income Tax (Pay As You Earn) Regulations 2003 (SI 2003/2682).

For NICs the legislation relating to "gratuities and offerings" is contained at paragraph 5, Part 10, Schedule 3 of the Social Security (Contributions) Regulations 2001 (SI 2001/1004).

The national minimum wage legislation relating to tips, gratuities, cover and service charges that do not count for national minimum wage pay purposes is contained at regulation 31(1)(e) of the NMW regulations 1999 (SI 1999/584).

Booklet E24 contains some useful examples that help clarify the treatment of tips, gratuities, service charges and troncs.

You can get further information from your HMRC office or go to www.hmrc.gov.uk

Taken from Booklet E24(2009)

Lecture P561 (9.46 Minutes)

Tax and divorce

While the personal side of divorce can be very distressing, what is often ignored is that with some degree of co-operation between the parties there are sensible and simple tax and financial planning steps that can be taken to alleviate some of the money pain.

Income tax and allowances

In the UK, individuals are of course liable to income tax on their personal income. The income of their spouse/civil partner is not taken into account when calculating any liability.

Married couples allowance is now only available where one spouse/civil partner was born before 6 April 1935, meaning that unless this situation applies, marriage and divorce have no income tax impact per se.

However, it is often the practice between couples, particularly where one spouse does not work or has little income in their own right, for couples to transfer ownership of income generating assets between spouses in order to equalise levels of income and take advantage of allowances and lower tax rates. This is unlikely to be an attractive option post-divorce.

Capital gains tax (CGT) on non-cash assets

Spouses and civil partners who live together can pass assets between each other with no chargeable gain or loss arising. Assets are treated as being transferred at a value that gives rise to no gain, and no loss.

Spouses and civil partners are treated as living together for these purposes unless they are separated under a Court Order, by a deed of separation or they are separated permanently. The no gain/no loss transfer rule continues to apply during the tax year of separation only. Therefore, for CGT purposes, it is better to separate early in the tax year, providing a longer period in which the transfer of assets can take place without giving rise to CGT liabilities. Clearly the realities of life mean that such timing is rare.

There are certain targeted anti-avoidance rules which mean that it may not be possible to offset losses against capital gains if one of the main purposes of the transfer between spouses was the utilisation of a capital loss, or the transfer was not an 'outright gift'.

It is also important to note that spouses/civil partners are treated as 'connected persons' for CGT purposes until the divorce is final. This will affect the CGT position on the transfer of any assets between them after the tax year of separation but before the divorce is final. In these cases, the value used in any CGT calculation would be market value (as transactions between connected persons). This could result in an unexpected tax charge arising on the spouse making the disposal.

The family home

A transfer of the share in the family home may not give rise to a CGT liability owing to Private Residence Relief (PRR). PRR offers relief from CGT throughout the whole period of ownership provided that certain criteria are met. In essence, as well as periods of residence in the property, and certain specific absences, the last three years of ownership normally qualify for relief provided the property has been your main residence at some point in time.

Therefore, if one of the couple moves out of the family home on separation, PRR relief remains available for three years after moving out. In addition, if a property which has been your PRR at any time is let for a period, any pro-rated uplift in value while the property is rented out may be covered by Letting Relief (up to a maximum of £40,000).

It might be the case that only one spouse has the legal title of the property. However, CGT applies to beneficial ownership and courts in matrimonial cases have established the apportionment of beneficial ownership between the divorcing parties. If, as part of the settlement, one party transfers their beneficial ownership to the other, this is a disposal for CGT purposes. If the transfer takes place after three years following moving out of the family home, then PRR may continue to be available on a concessionary basis (ESC D6).

The spouse who moves out is regarded to be living at the matrimonial home as their main residence provided that the eventual transfer is part of a financial settlement, not a sale to a third party, the property has remained the main residence of the transferee, and the transferor has not elected for a different property to qualify for PPR relief. However, if advantage is taken of this concession this prevents any other property owned at the same time qualifying for PRR for this same period, it may, therefore, be more beneficial to suffer a tax charge on a proportion of the gain (calculated on a proportion of the period of ownership) on the matrimonial home (which may be partly covered by the CGT annual exemption) rather than forego relief on another property in the future.

Stamp Duty Land Tax (SDLT) is payable when an interest in UK land and property is purchased, exchanged or transferred between parties. The amount of SDLT payable depends on the amount of consideration given. 'Consideration' for the purposes of SDLT includes 'assumption of a debt', eg a mortgage, given as consideration. Therefore, where the chargeable consideration for a land transaction consists of partly or completely accepting liability for a mortgage or a release of debt, the amount of

the debt involved shall be taken to be the chargeable consideration for the transaction. The current rates of SDLT vary between 0% and 4%.

There are valuable exemptions from SDLT on divorce or dissolution of a civil partnership. Transactions may be exempt from SDLT if they are made subject to a court order or other certain types of divorce agreement.

Mesher orders

In some circumstances, the court will postpone the sale of the family home until certain conditions are met, such as the children reaching 18. These are called **Mesher** orders and detail can be found in the HMRC Capital Gains Manual at CG 65365. There was a good article with examples on this issue in Taxation dated 3 September 2009 at page 171 onwards.

Inheritance tax (IHT) and gifts

Unlike CGT, IHT may be levied on both cash and non-cash assets. However, gifts to individuals are only potentially liable to inheritance tax, chargeable only if the transferor dies within seven years of the gift.

Assets that were transferred to a deceased's spouse/civil partner are specifically exempt from IHT, although this exemption is limited to £55,000 if the recipient spouse is not UK domiciled. On divorce, a couple remain married for IHT purposes until the decree absolute is granted. Until that time assets can be transferred between the two without IHT becoming payable on a subsequent death. Unlike the rules for CGT, the parties do not have to be living together for this to apply. Therefore, a transfer of a share in the matrimonial home before the decree absolute is granted is unlikely to give rise to any IHT consequences.

Of course the financial settlement may not be finalised until after the marriage has been dissolved so the spouse exemption would not be available at this time. However, other exemptions may instead be available if the transfer of assets is due to a court order and it would be reasonable to assume that there was no gratuitous intent to benefit the ex-spouse. Failing that, any other transfers would be potentially exempt transfers, meaning there would be no IHT liability provided the donor survives seven years.

Pensions

A pension often represents the greatest entitlement to income of one or both parties to a divorce and is possibly one of the greatest assets. It is compulsory that such entitlements are taken into consideration, and the three key options available are offsetting pension benefits, pension attachment orders and pension sharing orders.

Offsetting pension benefits

The most common way to deal with pension benefits in a settlement is to take the value of pension rights into consideration but to equalise estates by transferring other financial assets of the marriage. A simple example would be where one spouse keeps their pension fund and the other keeps the family home. This method does make for a clean break and each party retains their own existing pension benefits.

Pension attachment orders

Pension attachment orders (formerly known as earmarking orders) have been available in England and Wales since 1 July 1996. One of the main problems with attachment is that it does not allow a 'clean break' between the divorcing couple.

Attachment orders do not transfer ownership of any of the pension to the ex-spouse. This means the member still has full control (subject to what the trustees will allow) over how the pension is run. In addition, the benefits are taxed at the marginal rate of the member who retains the liability for the income tax on the whole pension, even the part of the pension that is earmarked to the ex-spouse. Some of the other drawbacks are as follows:

- Benefits remain with member so the ex-spouse has no control over the timing of benefits and the ex-spouse has no control over the investment risk
- Income benefits cease on member’s death, although a lump sum death benefit is may be earmarked in the attachment order

- Benefits cease on ex-spouse's death or remarriage
- If the member retires early on a reduced pension, this means a reduced pension for the ex-spouse as well

Pension sharing orders (PSO)

With a PSO, the court awards a slice of the pension benefits (a pension credit) to the ex-spouse, based upon a percentage share of the 'cash equivalent transfer value' (CETV). A corresponding pension debit reduces the value of the former spouse's benefit.

For occupational pension schemes the award can be in the form of an internal or external transfer. An internal transfer (often called 'shadow membership') involves the ex-spouse becoming a separate member of the former spouse's occupational pension scheme in their own right and for certain schemes is the only option. An external transfer involves the transfer of the CETV to another pension scheme chosen by the ex-spouse. This is the more common result as it provides for greater choice and control.

Where the ceding scheme is a personal pension scheme, the CETV is always transferred to a scheme chosen be the ex-spouse, usually another personal pension.

Pension sharing orders come into play typically when a couple has a modest amount of disposable wealth and a large proportion of their assets are tied up in a pension arrangement.

PSOs can often be used as a negotiating technique by parties during a settlement dispute. Typically, one spouse may ultimately keep their pension and give a half share of the matrimonial home in return. However, in cases where the pension is split, the pension share does not have to be 50/50 and if the parties are unable to agree, the split will be set by the court. In practice, the split of the pension value is likely to be unequal, so as to achieve a 50/50 split of the ultimate 'deferred income', due to the different life expectancies of males and females.

Contributions to pension schemes

Since April 2006, there is a 'lifetime allowance' that applies for tax purposes. The lifetime allowance is effectively the maximum amount of pension benefit that a member can accrue without attracting tax penalties. On divorce, there is no increase in the allowance for pension rights foregone which can, potentially, restrict an individual's ability to rebuild their pension rights after pension sharing. The lifetime allowance for the 2009/10 tax year is, however, £1.75 million and this is only likely to be an issue for individuals with relatively high levels of pension benefit. Note that individuals may continue to contribute above this limit, but the tax benefits will be significantly reduced.

Francesca Lagerberg, Head of Tax at Grant Thornton UK LLP

Lecture P562 (9.56 Minutes)

Philip John Wright

A case concerned whether or not workers were employed under a contract of service or for services.

The original appeal had been heard by the General Commissioners in 2005. They had decided that the workers were self employed, so HMRC appealed.

In the High Court (*CRC v Wright* [2007] STC 1684), the judge allowed the appeal. However, he said the General Commissioners had applied the wrong test and should have asked whether the taxpayer had sufficient day-to-day control over the workers to make them his employees.

He therefore remitted the case back to the General Commissioners for reconsideration.

Some delay followed, and it was decided to remit the case to the Special Commissioners instead, given the complexity and legal issues involved.

The taxpayer, however, objected. He wanted a local hearing and said that he could not afford to pay a barrister to take his case to the Special Commissioners. They agreed to sit outside London if the parties wished. The appellant was not happy and said that he would not 'be taking part in any retrial'.

After considerably more wrangling, the matter came before the Special Commissioners in March 2009. The appellant did not appear, but the commissioner proceeded with case and found for HMRC.

The appellant therefore applied to have the decision set aside.

The tribunal judge said that it was clear that the appellant's decision not to attend the hearing was a deliberate one. However, this was not the crucial factor.

First, he looked at the High Court's order to remit the case to the General Commissioners. He said that once the rehearing had been ordered, the identity of the commissioners for the retrial was unimportant.

However, he found the appellant's objections 'entirely understandable'. He noted further that delays had not all been down to the appellant; the Revenue had also contributed, for example, on a couple of occasions it taken weeks to reply to the appellant's letters.

The judge agreed that the case presented to the Special Commissioners had been unfair as the only witnesses to appear had been for HMRC.

Overall, the judge concluded that in the interests of justice, the decision should be set aside and the appeal listed for rehearing before a First-tier Tribunal local to the appellant.

He also gave directions for the rehearing to take account of the fact that the appellant did not have a paid representative.

Grace v CRC before the Court of Appeal

The only contemporary case in which an unrepresented taxpayer successfully established that he was not resident in the UK for tax purposes has reached the Court of Appeal.

Mr Grace is an airline pilot employed by British Airways on long-haul flights arriving and departing from Heathrow and Gatwick airports.

He owns a house in Horley which he uses effectively as a hotel in between flights. He has no other social or family ties in the UK, apart from an ex-wife and two children whom he has not seen for over 30 years.

Mr Grace set up home in Cape Town, South Africa in 1997 and now commutes to the UK for work. He owns a house, a car and a private plane in Cape Town as well as having family and a well-structured social network there.

HMRC argued that he was resident and ordinarily resident in the UK and taxed him accordingly. An appeal was successful in front of Special Commissioner, Dr Brice.

This was appealed to the High Court by HMRC. Mr Justice Lewison decided that not only had the commissioner made an error of law in reaching this conclusion, but that such error justified overturning her decision.

Issues for the Court of Appeal

Lord Justices Dyson, Waller and Lloyd heard arguments from Malcolm Gammie QC and Keith Gordon on behalf of Mr Grace and by Ingrid Simler QC and Akash Nawbatt on behalf of HMRC.

Mr Gammie led his submissions by categorising the issues to be considered as twofold. First, did the commissioner make such a perverse finding on the facts that no other commissioner in that position would have reached the same conclusion? In that case the decision ought to be overturned.

Second, did the commissioner make an error or misdirection of law? In that case the decision may stand (if the error does not affect the final conclusion) or may be remitted to the Commissioners for redetermination (if the error might have led to the final conclusion).

Dealing with the issues in turn, Mr Gammie relied on Dr Brice's 'impeccable' decision in the case of Shepherd (SpC 484) and on appeal by Mr Justice Lewison [2006] STC 1821 to argue that only the commissioner was in a position to reach a decision on the events of 1997 in Mr Grace's case.

This was because she heard the evidence tested in cross-examination and had the benefit of the arguments made by HMRC on the law. Day count, he added, was plainly a question of degree which was a matter for the commissioner to determine.

Mr Gammie considered each of the errors that the judge had alleged that the commissioner had made. To each, he explained why Dr Brice was in fact right or that the issues had ceased to be relevant in the case.

Miss Simler started by reminding the court that it was accepted that there was an error of law in the commissioner's approach to employment as a temporary purpose.

She explained to the court that the intention of staying in a place was irrelevant, that there could be no doubt that employment was considered a settled purpose and that a 'real home' test must not be conducted when considering the issue.

She argued that that error together with other identified issues amount to such an error of law which vitiates the decision and warrants overturning.

Miss Simler further challenged the commissioner's decision on residence as ignoring the principle of dual residence.

She argued that Dr Brice had erred in finding similarities with noted case law, in particular CIR v Zorab 11 TC 289 and CIR v Brown 11 TC 292 which, she argued, were cases where the subjects were never resident in the UK prior to the relevant period.

Lord Justice Waller did not seem persuaded by this line of argument as he noted that Dr Brice is a very experienced Special Commissioner and that such an error would make her seem 'ridiculous'.

Miss Simler asked if she could 'ride on two horses' and explained that while she saw the force of Lord Justice Waller's argument and did not suggest that the commissioner was 'ridiculous', she had dealt with dual residence and TA 1988, s 336 in the same paragraph of her decision, as such her conclusion was flawed.

In reply, Mr Gammie highlighted that most of the authorities that HMRC relied on concerned the question of 'ordinary' residence. If someone is said to be 'ordinarily resident' it does not necessarily follow that he is 'resident'.

He concluded by referring the court to Lysaght where the Court of Appeal had sought to treat someone's employment differently from the other factors that should be considered when determining residence.

This attempt had been rejected by the House of Lords who held that residence was a matter for the commissioner to consider in light of a person's attachment with a place.

Judgment was reserved.

Smith v Revenue and Customs Comrs

In 1998 the appellant, who was resident and ordinarily resident in the UK for tax purposes, commenced working with S, a Delaware corporation whose principal place of business was in Florida. Under his contract of employment S was entitled to, inter alia, benefits under a stock incentive plan. In a memorandum dated 21 October 1998 S informed the appellant that it had updated the provision of benefits and protection in the event of a change in the control of S. The change in control agreement between S and the appellant provided that, for a period of 13 months after a change of control—which was defined to include a merger or share exchange—the appellant could exercise all his stock options immediately, whether they had vested or not, and could call upon S to purchase his S shares, or any shares issued in exchange for them, at the price paid on the change in control. In 2001 T offered, pursuant to a merger agreement, to buy S by way of a share for share exchange. Just before that exchange the appellant exercised all his share options and so held shares in S. He then commenced employment with T and, on the share for share exchange, exchanged all his S shares for shares in T which were then valued at $47 each. Prior to his employment with T, the appellant was verbally assured by T that he was not waiving his rights under the change in control agreement. In June 2002, when the price of the T shares was $17 each, the appellant exercised his right under the change in control agreement and called upon T to purchase his T shares at the price paid on the change in control. The appellant therefore

disposed of his T shares to T at a price which exceeded market value at the date of the disposal, and the amount of the excess was £1.5m. HMRC opened an enquiry into the appellant's tax return for the year ending 5 April 2003 and thereafter issued a closure notice, amending his tax return by including an amount of £1.5m, on the basis that it was to be treated as an emolument of the appellant's employment and chargeable to tax under Sch E because the appellant had disposed of his T shares to his employer for a consideration which exceeded market value and had acquired the shares in pursuance of a right or opportunity available to him by reason of his employment within the meaning of TA 1988 s 162; or if s 162 did not apply, then the difference between the price paid by T for the T shares and their market value was a benefit for the purposes of TA 1988 s 154. The appellant appealed contending: (1) on the s 154 issue: on disposing of his shares to T he was exercising a right he had had since 1998 to dispose of any conversion shares at their price on a change in control and the obligation to pay such a price had been assumed by T. He had received that to which he was already entitled and so no further additional benefit had been provided; and (2) for the purposes of s 162: he had not acquired his T shares by reason of his employment with T but pursuant to a merger agreement under which T made a general offer to all S shareholders to exchange shares in T for shares in S; it was because he held shares in S that he became entitled to shares in T on the merger. Furthermore TA 1988 s 168(3)(b) had no application to s 162, as it only applied where benefits were "provided" to an employee. Section 162 only applied where shares were acquired in pursuance of a right or opportunity "available" by reason of employment and that was a question of fact; there was nothing which deemed a share to have been so acquired simply because the share was acquired from the employer. HMRC submitted that (1) the benefits to which s 154 applied were widely defined in s 154(2) as "benefits or facilities of whatsoever nature", and included the benefit of selling an asset for more than market value; the benefit had been provided by T who was the appellant's employer within the meaning of TA 1988 s 168(3); and (2) s 162(1)(a) applied where an employee acquired shares in any company whether the employing company or not. The test of whether the appellant had acquired the T shares "in pursuance of right or opportunity available by reason of his employment" was a wider test than "by reason of employment". The appellant's employment with S furnished him with the opportunity to acquire his T shares and all his T shares had been acquired by reason of that opportunity. Section 168(3)(b) reinforced that view because the appellant had been provided with the right or opportunity to acquire the shares and that was capable of being a provision within the meaning of that section. The subsection specifically referred to all provisions mentioned in Ch II and that included s 162.

The judge found that a benefit to which TA 1988 s 154 applied was provided to the appellant by reason of his employment and that a payment of cash could be a benefit. On the facts the benefit which was sought to be taxed was the payment by T to the appellant of the difference between the (higher) price paid by T when the appellant disposed of his T shares and the (lower) market price on that date. The payment was made because T had agreed, on the occasion of the merger with S (the appellant's previous employer) to honour all the terms and benefits of S's employee plans and the change in control agreement. The provisions in the change in control agreement were described in the memorandum of 21 October 1998 as "the provision of benefits and protection" and there was a clear intention to give a gratuitous benefit to each employee. Had the payment been provided by S, it would have been a benefit to which s 154 applied; when provided by T it remained a benefit within the meaning of s 154(2). Moreover the benefit was provided to the appellant by reason of his employment: the benefit was the payment by T of an advantageous price for the appellant's shares. That was a benefit and, at the time it was provided, T was the appellant's employer and the benefit was provided at the cost of T who was the appellant's employer. The provision of the benefit was therefore deemed by s 168(3) to be made for the appellant by reason of his employment. It was clear on the authorities that a payment of cash was a benefit.

The judge considered that on the proper interpretation of TA 1988 s 162, the reference to "his employment" in s 162(1)(b) was clearly linked to the earlier reference at the beginning of s 162(1)(a) to a person being "employed in employment to which this Chapter applies". Thus the section applied when an employed person acquired shares by reason of that employment, ie employment by the same employer. The question was whether the appellant acquired his T shares in pursuance of a right or opportunity available to him by reason of his employment with T. On the facts the appellant acquired his shares in T after he became employed by T. His right or opportunity to acquire the T shares was available to him in pursuance of the general offer and because he held S shares and not because he was employed by T. The same right or opportunity

was available to all S shareholders to exchange S shares for T shares. Therefore the appellant did not acquire the T shares in pursuance of a right or opportunity available to him by reason of his employment with T. As no benefit was provided by T to the appellant when he acquired his T shares, there was no "provision" within the meaning of TA 1988 s 168(3) at the time of the acquisition and so the acquisition of the shares were not deemed to be made by reason of his employment with T. The provision mentioned in s 168 was the provision of a benefit and the benefit provided under s 162 was that mentioned in s 162(2)(b), namely the payment of a consideration in excess of market value on the disposal of certain shares—defined in s 162(1)(b) as shares that were acquired by reason of the employment (namely the employment with T). Accordingly as the T shares were not acquired by the appellant in pursuance of a right or opportunity available to him by reason of his employment with T within the meaning of s 162, and therefore the benefit (of the payment of a consideration which exceeded market value) was not chargeable under s 162, it followed the benefit was not excluded by s 154(2)(b) from being a benefit chargeable under s 154, and it remained chargeable under s 154. The appeal would be dismissed.

Appeal dismissed.

Capital Gains Tax

Joint share ownership plans

In recent months, companies have been looking ever more closely at ways of structuring their employee share incentive arrangements in order to ensure that key members of staff receive CGT treatment on their share disposals. With the introduction of the 50% tax rate from 6 April 2010 (referred to in the previous chapter) and a 0.5% NIC increase from 6 April 2011, the current CGT rate of 18% looks very attractive – indeed, the difference between the top rates of income tax and CGT in 2010/11 will be wider than it has been for many years.

One idea which has been around for some time but which is currently receiving greater attention by both listed and unlisted companies is the joint share ownership plan. This involves the employee acquiring shares in his employer company alongside a third party, usually an employee benefit trust (the trust), with the employee being entitled to the subsequent growth in value of the shares. The employee must of course pay for his interest in the shares, but this upfront payment will generally be low and, importantly, his potential gains should only be liable to CGT.

The underlying intention of the arrangement is to enable the employee to receive the growth in value of the company's shares, while at the same time qualifying for CGT treatment. The idea is based on the premise that two people can jointly own unequal interests in shares in the same way as two people can jointly own unequal interests in land. In economic terms, the structure is similar to a market value option, with the employee receiving just the growth in value of the shares.

How the plan works

The employee and the trust jointly acquire shares, either by way of a subscription for new shares or a purchase of existing shares. The trust will usually hold the legal title to the shares for administrative reasons, but the employee and the trust will both have a beneficial interest in the shares.

The employee's interest will entitle him to most of the future growth in value of the shares. Typically, the plan will impose an annual increase in the value of the shares (eg. 5%) which must be achieved before the employee receives any value. The employee's interest may also be forfeited if he leaves or if performance targets are not met. As mentioned earlier, the amount which the employee will pay for his interest will usually be small.

The trust's interest is limited to the current value of the shares plus the annual 5% increase (if such a hurdle has been imposed). Other than this hurdle increase, the trust is not entitled to any of the growth in value of the shares.

After an agreed time, the employee's rights crystallise and he is either given a fixed number of shares equal to the growth in value obtained or alternatively the shares are sold and the employee receives his proportion of the relevant disposal proceeds.

The plan will normally specify what happens in relation to voting rights, dividends and other corporate events such as rights issues or takeovers during the tenure of the arrangement.

The company will need to fund the trust in order to enable it to acquire its interest in the shares – as a rule, this will be by way of a loan. The loan will be repaid by the trust when the shares are sold, although there is a risk that there may be a shortfall if the shares drop in value.

One of the most important aspects of a joint share ownership plan is to ensure at the outset that the employee's interest is correctly valued for tax purposes. In practice, HMRC normally accept that the value of the employee's interest in the shares at acquisition should be low, given that the trust owns all the current value of the shares and the employee is only entitled to their growth in value, usually above a further threshold. However, if the employee pays less than the value of his interest, there

will be an income tax and NIC charge on the difference. Working with experienced valuers should reduce the risk in this area. Employers may wish to agree the valuation with HMRC, although this can only be done once the employee has acquired his interest.

When the shares are sold, a CGT charge will arise.

Advantages

The employee should achieve favourable CGT treatment for his gain, while paying relatively little at the outset for his interest in the shares.

Joint share ownership plans are very flexible. They can be used by both listed and unlisted companies and can be tailored to specific circumstances (eg. in connection with appropriate performance criteria).

No separate class of share is required and so there is no need to alter the company's existing capital structure before introducing the plan.

Disadvantages

Unlike a company share option plan, the employer will not be entitled to a corporation tax deduction. However, for companies with large losses brought forward, this may not be too problematic.

Actual shares must be available at the time of the award. If the shares are to be bought in the market, this will have immediate cash flow implications.

The upfront valuation of the employee's interest is critical and it is very important to get this correct. If the desired value is not agreed with HMRC, there could be a large and unexpected income tax (and NIC) charge.

The plan is not HMRC-approved and so there is always a risk of a challenge. Having said that, many companies and their advisers seem to believe that it is a risk worth taking.

Article by Robert Jamieson

Lecture P563 (13.18 Minutes)

Inheritance Tax and Trusts

Astall and another v CRC

The taxpayers took part in a scheme designed to create an artificial loss. They set up trusts to which they lent money in return for a security.

These were then sold to a third party and redeemed at 5% of the redemption price. The taxpayers claimed the loss in their tax returns which HMRC refused.

The Special Commissioner concluded that the securities were not relevant discounted securities as defined in FA 1996, Sch 13 para 3 and dismissed the taxpayers' appeals. The High Court supported the Special Commissioner, so the taxpayers appealed.

The Court of Appeal said that the mere fact that someone intends to obtain a tax advantage does not make a statutory relief unavailable.

However, it was necessary to give a purposive construction in order to determine the nature of the transaction, and then decide whether the statute would apply to the actual transaction.

The question to be asked was whether there was any real possibility of a redemption at a deep gain. Realistically, in this instance, the primary objective of the transaction was to devalue the security in order to create a loss.

The commissioner was right to find that the taxpayers' securities had not involved a deep gain and that the transaction was carried out to reduce tax.

The taxpayers' appeals were dismissed.

Court of appeal

Inheritance Tax on contributions to Employee Benefit Trusts

The purpose of this note is to set out HM Revenue & Customs (HMRC) current view on the Inheritance Tax position in relation to contributions to an Employee Benefit Trust. Although the same principles apply where an individual makes a contribution to an Employee Benefit Trust the main thrust of this note is aimed at the more common scenario where the contribution is made by a close company as defined in s102(1). All statutory references are to IHTA 1984 unless otherwise stated.

Employee Benefit Trust within S86

For the purposes of this note it is assumed that the Employee Benefit Trust satisfies the provisions of s86 that is, essentially the trust is one where the funds are held at the trustees' discretion to be applied for the benefit of 'all or most of the persons employed by or holding office with the body concerned' (s86(3)(a)).

Impact of S13 on whether the contribution is a transfer of value

The effect of s13 is that an Inheritance Tax charge arises under s94 on contributions to an Employee Benefit Trust made by a close company where:

- the contribution is to an Employee Benefit Trust which satisfies s86
- the participators (as defined in s102(1)) in that company and any person connected with them are not excluded from benefit under the terms of the Employee Benefit Trust (so that s13(2) disapplies s13(1))
- the contributions are not allowable in computing the company's profits for Corporation Tax purposes (s12) and/or it is not shown for the purposes of s10 that the contributions are made in arms-length transactions not intended to confer a gratuitous benefit.

Participators excluded from benefit

Where the trust deed specifically purports to exclude the participators from benefit but nevertheless the participators do benefit in fact for example:

- by payment to them of loans or
- by assigning funds from the Employee Benefit Trust on sub-trusts for their benefit and that of their family

then HMRC take the view that s13(2) disapplies s13(1) and the Inheritance Tax charge under s94 arises because the funds have been applied for the benefit of the participators.

Impact of MacDonald (HMIT) v Dextra ('Dextra')

This decision applies to contributions made before 27 November 2002.

In that case, the trust deed gave the trustee wide discretion to pay money and other benefits to beneficiaries and power to lend them money. The potential beneficiaries of the trust included past present and future employees and officers of the participating companies in the Dextra group and their close relatives and dependants. The trustee did not make payments of emoluments out of the funds in the Employee Benefit Trust during the periods concerned, instead the trustee made loans to various individuals who were beneficiaries under the terms of the Employee Benefit Trust.

The point at issue was whether the company's contributions to the Employee Benefit Trust were 'potential emoluments' within the meaning of s43(11)(a) FA1989 being amounts 'held by an intermediary with a view to their becoming relevant emoluments'.

The House of Lords held that the contributions by the company to the Employee Benefit Trust were potential emoluments as there was a 'realistic possibility' that the trustee would use the trust funds to pay emoluments. This meant that the company's deductions were restricted. The company could only have a deduction for the amount of emoluments paid by the trustee within nine months of the end of the period of account for which the deduction would otherwise be due. Instead relief for the amount disallowed would be given in the period of accounting in which emoluments were paid.

Sch 24 FA 2003

This statute applies to contributions made after 27 November 2002.

S143 and Schedule 24 Finance Act 2003 prevents a deduction for Corporation Tax purposes until the contribution made for employee benefits is spent by a payment that has been subjected to both PAYE and National Insurance contributions. Thus the position already established in Dextra is therefore effectively formalised by legislation for events on or after 27 November 2002.

Dispositions allowable in computing profits for Corporation Tax purposes - S12

HMRC take the view that there is nothing in s12 that enables its relieving effect to be given provisionally while waiting to see whether the contribution will become allowable for Corporation Tax purposes.

A deduction in the Corporation Tax accounts can be permanently disallowed by the following:

- capital expenditure disallowed by s74(1)(f)ICTA1988.
- expenditure not wholly and exclusively incurred by s74(1)(a)ICTA

Also the timing of a deduction can be **deferred** to a later period by the following:

- generally accepted accounting practice (UITF13 and UITF32) which capitalises Employee Benefit Trust contributions by showing them as an asset on the company's balance sheet until and to the extent that the assets transferred to the intermediary vest unconditionally in identified beneficiaries
- expenditure subject to s43 FA89 that is, the Dextra decision - see above
- and post 27 November 2002 expenditure subject to Sch 24 FA 2003 - see above

It is HMRC’s view that if expenditure is not allowable for any of these reasons then relief under s12 is not available. The effect of this for Inheritance Tax purposes is that the contribution to the Employee Benefit Trust is a chargeable transfer under s94, assuming that participators are not excluded from benefit (s.13(2))

Relief from the Inheritance Tax charge is only available under s12(1)IHTA to the extent that a deduction is allowable to the company for the tax year in which the contribution is made.

IHT provisions on due date for tax and interest

Where, on HMRC's view of the matter, a charge to Inheritance Tax arises under s.94, any tax payable is due six months after the end of the month in which the contribution is made or at the end of April in the year following a contribution made between 6 April and 30 September inclusive. Interest is charged on any unpaid tax from the due date.

Does s10 IHTA provide protection from the Inheritance Tax charge?

The s10 test is a stringent one and in the view of HMRC it must be shown inter alia that there was no intent to confer any gratuitous benefit on any person. The possibility of the slightest benefit suffices to infringe the requirement.

HMRC note that

- by its very nature an Employee Benefit Trust is a discretionary trust
- to satisfy the conditions of s86 the trustees' absolute discretion must remain unfettered
- the potential 'beneficiaries' normally include the participators themselves, former employees and the wives husbands widows widowers and children and step children under the age of 18 of such employees and former employees
- contributions to an Employee Benefit Trust will often confer a gratuitous benefit on the participators

In these circumstances, HMRC think it will normally be difficult to show that s10 is satisfied at the date the contributions were made to the trust. HMRC take the view that it is the possibility of gratuitous intent at the date the contribution is made that we have to consider.

Charge on participators under S94

Where a disposition is not prevented by s13 from being a transfer of value, a charge arises under s94 and the transfer of value is apportioned between the individual participators according to their respective rights and interest in the company immediately before the contribution to the Employee Benefit Trust giving rise to the transfer of value.

Summary

This sets out HMRC's current view. Pending the resolution of any legal challenge to this view, existing cases will be pursued by HMRC on this basis.

Revenue & Customs Brief 49/09

Commentary

If loans are being made to participators on a permanent basis, with little chance of these funds being used to benefit employees and so the liklihood of tax deduction remote, then I guess that HMRC's interpretation sounds reasonable.

However, a loan is capable of being repaid and the funds used to provide emoluments at a later date when a tax deduction would be available to the company and PAYE and NIC would fall due. Can an IHT charge be justified in these circumstnaces?

It would seem that the potential timing issue in relation to S12 was not considered when the legislation was drafted. Surely relief should still be available once the disposition becomes allowable for corporation tax, and the fact that the disposition becomes allowable some years after it was made, should not be a reason to deny the relief at that stage.

Could the taxpayers not complete an initial account based on no s 12 relief, paying the relevant amount of IHT to over. This could be corrected later, with the IHT being repaid, once the disposition becomes allowable for corporation tax at some point in the future.

Lecture P564 (7.22Minutes)

Administration

All change at the tax tribunals - a quick guide

Since 1 April 2009 we have seen a major change in the way that tax appeals are dealt with in the UK. This is the culmination of years of discussion and consultation - in fact so much pre-discussion occurred that many wondered if the change would ever happen at all.

The following is an outline, but no more than that, of the many changes which have now taken place to help steer you through the structure of the new UK tax court system.

The new tribunal structure

From 1 April 2009 all tax appeals are being heard within the new unified two-tier tribunal system. The previous tax tribunals - such as General and Special Commissioners and the VAT tribunals - ceased to exist and their functions were transferred to the new tribunal.

The two-tiered new tribunals system consists of:

* the First-tier Tribunal; and

* the Upper Tribunal.

Each is a single tribunal but is organised into chambers dealing with different areas of law. There are currently four chambers in the First-tier Tribunal:

- Social Entitlement
- War Pensions and Armed Forces Compensation
- Health, Education and Social Care; and
- Tax.

The three Upper Tribunal chambers are:

- Administrative Appeals
- Lands
- Finance and Tax.

There is a Senior President of Tribunals who is responsible for the whole tribunal system. In addition, each chamber has a president. Each chamber has its own set of rules, which are set out in secondary legislation and are likely to be added to by practice directions and statements.

As you will have guessed, tax appeals against decisions of HMRC come within the Tax Chamber at the First-tier and the Finance and Tax Chamber at the Upper Tier. Of course there is an exception and as ever it is tax credits. These appeals are dealt with in the Social Entitlement and Administrative Appeals Chambers.

The normal channel for an appeal

Most appeals will start at the First-tier Tribunal. A small number of complex cases will start at the Upper Tribunal where there are difficult legal issues and relatively little fact-finding. The tribunal and not the appellant choose which tier the case begins at. Nevertheless, if the First-tier Tribunal decides to refer a case to the Upper Tribunal the parties' consent is required.

As well as hearing appeals, the tribunal deals with applications eg to postpone tax or make a late appeal where HMRC has refused. Applications will also be made by HMRC, for example for permission to issue information notices.

The Upper Tribunal is a superior court of record with all the powers and authority of the High Court. As such its decisions are binding and create a precedent. Its main role is to hear appeals from decisions of the First-tier Tribunal and applications for permission to appeal. It can carry out judicial review in certain circumstances.

Appeals can be made against decision of the First-tier Tribunal unless an express exception applies (eg for certain applications for information notices). Appeals go to the Upper Tribunal, and can only be made on a point of law and with the permission of either the First-tier or (where this is refused) the Upper Tribunal. On appeal, the Upper Tribunal can either re-make the decision or send it back to the First-tier Tribunal.

From the Upper Tribunal there is a further appeal on a point of law to the Court of Appeal (in England, Wales and Northern Ireland). The High Court is no longer part of the appeals route. The onward appeal requires the permission of the Upper Tribunal or, if that is not given, of the Court of Appeal. In Scotland, appeals from the Upper Tribunal will be to the Court of Session. Appeals from the Court of Appeal or Court of Session are to the Supreme Court (formerly the House of Lords) and require permission.

Who sits on the tribunal?

Those sitting in the tribunal will be either 'judges' or 'members'. Judges in both tiers have to be lawyers or persons who have 'gained experience in law' which makes them 'suitable for appointment' (ss 4 and 50, and Schs 2 and 3, Tribunals, Courts and Enforcement Act 2007 (TCEA 2007)).

Members other than judges are not restricted to legally-qualified people, though they may include lawyers who do not qualify as judges. Non-legal members must have tax or business experience, and could include accountants, tax professionals and those in business. A number of well-known figures in the tax world are now sitting on various tribunals around the UK.

All previous members of the Special Commissioners were transferred automatically to become members of the Tax Chamber. This did not apply to the General Commissioners who lost their positions.

The Tribunals Service

The Tribunals Service is an executive agency of the Ministry of Justice (MoJ). It is responsible for all administrative matters once tax appeals have been sent to the tribunal. HMRC are responsible for the handling of tax appeals before they are passed to the tribunal.

This has led to some changes to the way in which HMRC handles appeals. First, it is no longer responsible for getting tax appeals listed for hearing. Appellants themselves have to contact the Tribunals Service directly.

Internal review

Secondly, HMRC has introduced a new 'internal review' procedure. This is innovative and if it works could be a cheap and effective mechanism to help resolve issues. The idea is that HMRC will take a fresh look at a decision which a taxpayer has disputed, and (depending on the outcome) this may remove the need for a tribunal hearing. The review is a statutory right but is not mandatory for the taxpayer. They can appeal to the tribunal after the review if they disagree with its outcome but they cannot take an appeal to the tribunal while a review is in progress.

Internal review is a new concept for direct tax, and it replaces the previous non-statutory reconsideration process for VAT and the mandatory review arrangements for other indirect taxes, except that is retained for restoration decisions, ie those which involve goods seized by HMRC.

Reviews are carried out by HMRC staff who should be separate from the officer who made the disputed decision and have not been involved with the case. The review officer is required to check whether the decision is in line with legal and technical policy and practice. The review officer also must consider whether the case is one which HMRC would want to defend at a tribunal hearing. The taxpayer can submit extra information.

HMRC has set up a dedicated team based in Londonderry which is handling reviews for self assessment and PAYE cases. The most recent information about the Londonderry review unit (8 May 2009) is that it had received 357 review requests and of these, 76 were decided in favour of the taxpayer, 46 upheld HMRC's original decision, 68 were in progress and the rest were awaiting paperwork in order to start the work.

Other key points are:

- HMRC must complete the review within 45 days, although it will be open to the parties to agree a longer period if necessary.
- HMRC must write to the taxpayer with the review decision, and the taxpayer then has 30 days to appeal or notify the appeal to the tribunal.
- Where HMRC does not complete the review within the review period, then the review is treated as upholding HMRC's view of the matter. HMRC must notify the appellant of this as soon as possible. The appellant then has 30 days from when they hear from HMRC to appeal to the tribunal.

Time limits are important at each stages of a review to avoid missing the opportunity of notifying or making an appeal.

Location of hearings

First-tier Tribunal cases will be heard in various locations around the UK. The Tribunals service has around 130 hearing centres. Where possible the hearing will be arranged at a venue reasonably close to where the appellant lives or works. Most hearings will be public although a request for part to be heard in private is permissible in areas of confidentiality (reg 32, SI 2009/273).

The Finance and Tax Chamber of the Upper Tribunal will be based in London although it is likely that some appeals will be heard at other locations such as Edinburgh and Manchester.

The published decisions of both tribunals can be found on the Tribunals Service website. First-tier Tax Chamber decisions have the notation 'TC' and a number.

The role of tax advisers

The rules for both First-tier and Upper Tribunals permit an appellant to appoint a representative, and there are no stipulations about what qualifications a representative must have. He or she does not have to be a lawyer. Thus an accountant or tax adviser may represent a client in the tribunal proceedings. To be appointed, the representative's name and address must be notified to the tribunal.

There is also provision in the rules for the appellant to be accompanied at a hearing by another person who, although not formally appointed, may represent or assist the appellant if the tribunal gives permission.

Where to find further information

Both the Tribunals Service and HMRC have published further information and guidance about the new tax appeals system. HMRC has a website page about Tribunals Reform (www.hmrc.gov.uk/about/tribunals-reform.htm) and various factsheets.

The HMRC1 factsheet *HM Revenue & Customs decisions – what to do if you disagree* gives an overview of the new arrangements for appeals, reviews and tribunals from 1 April 2009, and is aimed at potential appellants. On the HMRC website, a page entitled 'What to do if you disagree with an HMRC decision' (www.hmrc.gov.uk/dealingwith/appeals.htm) has links to guidance on appealing against different types of HMRC decision (direct tax, tax credits, VAT, restoration of seized goods, etc). Much more detail can be found in the new *Appeals Reviews and Tribunals Manual*.

HMRC has also published the *Tribunals Reform Awareness* training package which has been produced for HMRC staff, and the *Tribunals Reform Review Officer Guided Learning Unit* which, as the name suggests, is designed for officers carrying out internal reviews.

The Tribunals Service website is www.tribunals.gov.uk. There are sections specifically for the Tax Chamber of the First-tier tribunal (www.tribunals.gov.uk/tax/) and the Finance and Tax Chamber of the Upper Tribunal (www.tribunals.gov.uk/financeandtax/). Each of these includes forms and guidance for making appeals, a list of rules and legislation, and a register of published decisions.

Article by Francesca Lagerberg

Lecture P565 (9.38 Minutes)

R (oao Prudential plc) v Special Commissioner (and related applications)

Prudential marketed a tax avoidance scheme, which became the subject of an investigation by HMRC.

As a result of that investigation, notices were served by HMRC to Prudential under TMA 1970, s 20(1) and to a third party under s 20(3). These sections have now been replaced by FA 2008, s 113 and Sch 36. The issue of the notices was authorised by a special commissioner.

Prudential challenged the issue of the notices on the grounds that the material was covered by legal professional privilege and was not relevant to the tax liability.

Prudential argued that the principle of legal professional privilege (LPP) should apply to tax advice communications between an accountant and his client in the same way as it would between a lawyer and his client. HMRC argued that to do this would be to create a new or extended right.

The court rejected Prudential's contentions and dismissed the applications. The judge noted that LPP was 'a fundamental right at common law'.

He also noted that Prudential had 'put forward a compelling, and indeed unanswerable, case that in modern conditions accountants have the expertise to advise on tax law and it is firms of accountants, rather than firms of solicitors, who do give such advice and represent clients in disputes with the Revenue on many aspects of their tax affairs'.

However, he concluded that there was 'no existing authority that clients of accountants and other professions (apart from lawyers) have a right to claim LPP on the basis of legal advice privilege.

Indeed, it is accepted by Prudential that if I was to hold that accountants have such privilege this would be a first'. In fact, agreeing that there was a disparity here, he felt that if one were to equalise matters, rather than increase the rights of non-lawyers, the present rights of lawyers should be removed.

Following the decisions in *Three Rivers District Council and Others v Governor and Company of the Bank of England* (No 6) [2004] UKHL 48, there was 'a clear policy justification for singling out communications between lawyers and their clients from other professional communications'.

High Court

Miss MM Anderson (Deceased) v HMRC

In 1998, the taxpayer took out investment bonds with Clerical, Medical & General (CMG) and also with Scottish Provident. In February and March 2002, she wished to purchase a property and the bonds were encashed leading to gains of £24,588 and £8,619 respectively.

These chargeable event gains were shown on the 2001/02 tax return and an amount of £7,306 was shown as 'tax treated as paid'.

It subsequently came to light that the CMG bond was an overseas bond, so that no tax credit should have been claimed. HMRC raised an assessment under TMA 1970, s 29 on the basis that the self assessment was insufficient and relief given was excessive.

An appeal that the assessment had not been validly made was lodged in October 2005. The taxpayer died in February 2006.

On behalf of the taxpayer, it was argued that there was no fraudulent or negligent conduct as required by s 29(4). The judge saw no merit in this argument and gave consideration to both s 29(4) and s 29(5).

Referring to *Langham v Veltema* [2004] STC 544, the judge said that an inspector was only prevented from making a discovery assessment if the taxpayer or his representatives 'in making an honest and accurate return, have clearly alerted him to the insufficiency of the assessment, not where the Inspector may have some other information [in this case chargeable event information from the insurance company] not normally part of his checks, that may put the sufficiency of the assessment in question.'

Here, on the basis of the information available from the taxpayer, the inspector could not have been expected to have been aware that the tax credit had been wrongly claimed.

Furthermore, a reasonable taxpayer would have taken care that tax relief was available and would have checked this before the simple numerical calculation of relief was performed.

The fact that the taxpayer had been suffering ill-health at the time did not affect this conclusion and the appeal was dismissed.

Business Tax

Trading within a charity

ITA 2007

The completion of the tax law rewrite project, with the issue of the Income Tax Act 2007 means that all of the statutory authority for charity tax exemptions for charitable trusts has changed. The new legislation is, as one would expect, rewritten in clear style and better laid out than before. It can be found in Part 10 of the Act, running from sections 518 to 564.

The new legislation does not change existing charity law, but the most recent direct tax changes affecting charities can now be incorporated into the legislation – in particular those changes introduced in Finance Act 2006.

The following notes provide a rounded view of non charitable expenditure, and reflect the overall position, including the changes, which are noted.

Treatment of trading profits – outline

In ITA 2007 the exemption for trading income is set out in Section 524 and 525 and excludes from total income the profits of a charitable trade. Section 525 defines a charitable trade for these purposes.

"For the purposes of this Part a trade carried on by a charitable trust is a charitable trade in relation to a tax year if throughout the basis period for the tax year—

- trade is exercised in the course of carrying out a primary purpose of the charitable trust,
- work in connection with trade is mainly carried out by beneficiaries of the charitable trust.

This exemption is unchanged from the terminology in TA 1988, S505.

However, ITA 2007 deals more directly with the changes introduced by Finance Act 2006, which segregates as separate trades activities which relate partly to the primary purposes of the charity and partly not, and similarly in relation to the "work carried out by beneficiaries" test.

The effect of this separation is to provide full tax exemption on the aspects that meet the primary purpose test or the work carried out by beneficiaries test, and to potentially bring within the charge to tax activities which do not meet these tests. The profits arising may, however, be exempt under the exemption for small scale trades. Where such a separation is required, the expenses and receipts of the trade must be allocated between the two activities using a just and reasonable apportionment.

Section 526 then provides the tax exemption applying to small scale trades which was introduced in Finance Act 2000, and Section 529 deals with profits from fund-raising events previously exempt by concession. More details on these are given below.

Trades which are not wholly primary purpose trades

In some cases, a trade may amount, in part, but not wholly, to a primary purpose trade. For example, the trade might offer a range of goods or services, only some of which are within a primary purpose, or the trade might serve some customers who are not beneficiaries or patrons of the charity, as well as those who are.

Examples of such trades are

- a shop in a museum, selling a range of goods, some of which are related to a primary purpose of the charity (i.e. education and the preservation of property for the public benefit). In this case, the sale of direct reproductions of exhibits and catalogues would be related to the primary purpose, but the sale of promotional pens, mugs, tea towels, stamps etc, would not;
- a school or college letting accommodation to students (the beneficiaries of the charity) in term- time, and to tourists out of term- time;
- a theatre restaurant selling food and drink to the theatre audience (the beneficiaries of the charity), but also to the general public.

It is under these circumstances that Section 525(2) ITA 2007 requires that the trades now be treated as two separate trades. This rule was introduced in Finance Act 2006 in relation to periods beginning after 22 March 2006.

Exemption for small trades

Section 46 of the Finance Act 2000 provided a blanket exemption from tax for moderate income from small trading activity. The current tax exemption for charitable trusts is now included in Section 526 ITA 2007, and covers post cessation receipts and adjustment income in the same way as routine trading profits.

The measures exempt from tax under Schedule D Cases I or VI income (referred to in ITA 2007 as trading and miscellaneous incoming resources) which is subject to a claim for exemption by the charity, and:

- It is applied for charitable purposes only
- The charity's gross income for the chargeable period does not exceed the requisite limit for the tax year(see below), or
- The charity had at the beginning of the period, a reasonable expectation that its gross income for the period would not exceed that limit.

(Section 528(1) ITA 2007)

The trading incoming resources are defined as the incoming resources required to be taken into the account in calculating the profits or losses in the basis period of any non exempt trade carried on by the charitable trust, plus adjustment income and post cessation receipts relevant to that basis period. (Section 528(2))

The requisite limit is the greater of :

- £5,000, and
- the lower of £50,000 and 25% of the charity's incoming resources for the period.

(Section 528(6))

Gross income for these purposes is the income that would otherwise be taxable under Schedule D cases I or VI, apart from the new relief, before any deductions for costs. When the chargeable period is less than 12 months, these limits are reduced pro rata.

Exemption for profits from fund raising events

This was previously covered by Extra Statutory Concession, and is now the subject of statutory exemption for charitable trusts. The concession still applies to company charities.

Where a fundraising event qualifies under the VAT rules as an exempt event, the profits from that event will be exempt from direct tax provided that they are applied for charitable purposes. The exemption from VAT is considered below in some detail.

Section 529 ITA 2007 expresses the exemption as applying to profits of a trade carried on by a charitable trust so far as they arise from a VAT-exempt event, cross referring to the relevant VAT legislation in Group 12 of Schedule 9 to VATA 1994.

Article by Rebecca Benneyworth

Lecture B561 (17.16 Minutes)

Public benefit and charities 2009

The Charities Act 2006 finally achieved Royal Assent in late 2006 when the Charities Bill 2005, which replaced the 2004 Bill lost for the General Election was passed. The Act will be implemented over the next 1 to 2 years, and effects a number of quite significant changes on the sector.

New Charitable purposes

The Act includes a new definition of a charity, and a definition in statute for the first time of charitable purposes, which have previously largely been determined according to case law. Section 1 of the Act defines a charity as an institution which is established for charitable purposes only and falls to be subject to the control of the High Court in the exercise of its jurisdiction with respect to charities. This definition applies in England and Wales only.

The new range of charitable purposes wider than the existing law – running to 12 specific purposes forms part of the definition of charitable purposes, but is qualified by the requirement that the purpose is for the public benefit as defined by Section 3 of the Act. Thus, all charities will in future have to satisfy a “public benefit” test, rather than certain purposes being deemed to be for the benefit of the public as now.

The new range of purposes is :

(a) the prevention or relief of poverty;

(b) the advancement of education;

(c) the advancement of religion;

(d) the advancement of health or the saving of lives;

(e) the advancement of citizenship or community development;

(f) the advancement of the arts, culture, heritage or science;

(g) the advancement of amateur sport;

(h) the advancement of human rights, conflict resolution or reconciliation or the promotion of religious or racial harmony or equality and diversity;

(i) the advancement of environmental protection or improvement;

(j) the relief of those in need by reason of youth, age, ill-health, disability, financial hardship or other disadvantage;

(k) the advancement of animal welfare;

(l) the promotion of the efficiency of the armed forces of the Crown, or of the efficiency of the police, fire and rescue services or the ambulance services.

The public benefit test

Every purpose listed above must also be tested to ensure that the purpose is for the public benefit in the way the charity applies it. This means that many existing charities, which exist for the purposes of

- The relief of poverty
- The advancement of education or
- The advancement of religion

will no longer automatically be granted charitable status on the basis of their aims alone. All charities will have to satisfy the public benefit test, and demonstrate the nature of the benefit and the breadth of likely beneficiaries to achieve charitable status.

The determination of whether public benefit is satisfied rests with the Charity Commission, which is required by the Act to produce guidance on the operation of the public benefit test under Section 4 of the Act. The guidance will thus have statutory effect, and adequate public consultation is necessary before the final guidance is issued or revised. Trustees are required by Section 4(6) to have regard to such guidance when exercising any powers to which the guidance is relevant.

It is clear that some charities are considering whether meeting the public benefit test is in their best interests and whether, in fact they may lose charitable status and start to operate as a commercial concern. This particularly applies to some fee paying schools, who may find it difficult to meet the test.

Guidance on public benefit

Guidance has been issued by the Charity Commission on public benefit, which is designed to support trustees in meeting the requirements. This guidance has statutory force, as it is required to be available under the Act.

There are two key principles of public benefit and, within each principle there are some important factors that must be considered in all cases. These are:

Principle 1: There must be an identifiable benefit or benefits

Principle 1a It must be clear what the benefits are

Principle 1b The benefits must be related to the aims

Principle 1c Benefits must be balanced against any detriment or harm

Principle 2: Benefit must be to the public, or section of the public

Principle 2a The beneficiaries must be appropriate to the aims

Principle 2b Where benefit is to a section of the public, the opportunity to benefit must not be unreasonably restricted:

- by geographical or other restrictions; or
- by ability to pay any fees charged

Principle 2c People in poverty must not be excluded from the opportunity to benefit

Principle 2d Any private benefits must be incidental

The principles of public benefit apply to all charities, whatever their aims. Each charity must be able to demonstrate that its aims are for the public benefit. Public benefit decisions are about whether an individual organisation is a charity and not about whether particular types of charity or groups of charities, as a whole, are for the public benefit.

Principles of Public Benefit

Principle 1: There must be an identifiable benefit or benefits

Principle 1a It must be clear what the benefits are

It must be clear what benefits to the public arise from carrying out a charity's aims. Examples of different sorts of benefit include providing housing for the homeless or giving medical care to the sick. It should be possible to identify and describe the benefits provided but that doesn't mean they must be able to be quantified or measured; non-quantifiable benefits will be taken in account as long as it is clear what they are.

Most benefits are self evident but sometimes we may need evidence depending on the type of benefit provided. Sometimes benefit can be shown by a consensus of objective and informed opinion. In some cases we may ask for evidence of independent, expert opinion from someone suitably qualified. It will usually be for the organisation's trustees to provide evidence that their organisation's aims are for the public benefit but we may sometimes need to check evidence from other sources.

Principle 1b The benefits must be related to the aims

Benefits must be related to the charity's aims, so benefits which arise from the charity's work that are not related to its aims will not be taken into account. Where a charity has more than one aim, each of those aims has to meet the public benefit requirement; it will not be enough if only some do.

Principle 1c Benefits must be balanced against any detriment or harm

Finally, benefits must be balanced against any detriment or harm which arises. Examples of detriment or harm could include something that is damaging to the environment or mental or

physical health or encourages hatred towards others. In judging whether this detriment occurs, we would need to see real evidence; we will not just assume it. Where there is more detriment than benefit, or where the organisation has aims that are illegal or is a sham, it would not be charitable.

Principle 2: Benefit must be to the public, or section of the public

Principle 2a The beneficiaries must be appropriate to the aims

While this sounds like a statement of the obvious, who constitutes the 'public' or 'a section of the public' varies according to the charitable aims. Sometimes a charity's aims are intended to benefit the public generally, sometimes a specific section of it. Who benefits, and how, will depend on the organisation's aims. Considering who the charity's aims are mainly intended to benefit is important when deciding whether the public benefit requirement is met.

It is not a simple matter of numbers, but the number of people who can potentially benefit must not be insignificant. The 'class' of people who can benefit must be sufficiently large or open given the charitable aim being carried out. The actual number of people who can benefit at any one time can be quite small as long as anyone who could qualify for the benefit is eligible. So, for example, it is fine to offer only a small number of rooms in a care home as long as anyone who is eligible to apply can be considered for those limited places.

It is important that the opportunity to benefit is not unreasonably restricted given the nature of the charity's aims and the resources it has. If the benefit is to a 'section of the public', rather than the public generally, then the restrictions must be reasonable and relevant to the charity's aims. If they are not, this will affect public benefit.

Principle 2b Where benefit is to a section of the public, the opportunity to benefit must not be unreasonably restricted:

- ***by geographical or other restrictions; or***
- ***by ability to pay any fees charged***

Ways in which restrictions might apply to the 'class' of people who can benefit include geographical restrictions, those involving charitable need, such as poverty, age or ill-health, and those involving personal characteristics, such as gender, race or religion for example. We will consider the circumstances in each case when deciding whether that restriction is reasonable. At the extreme, charities must not be seen as 'exclusive clubs' that only a few can join. So, where the aims of a charity are more closed, inward-looking and exclusive, greater justification for the restriction may need to be provided.

Many different sorts of charities can, and do, charge for their services or facilities. Charities can charge fees that more than cover the cost of those services or facilities, provided that the charges are reasonable and necessary to carry out the charity's aims, for example, in maintaining or developing the service provided. However, where, in practice, the charging restricts the benefits only to people who can afford to pay the fees charged, this may result in the benefits not being available to a sufficient section of the public.

Principle 2c People in poverty must not be excluded from the opportunity to benefit

The fact that the services will be charged for and therefore provided **mainly** to people who can afford to pay does not necessarily mean the organisation's aims are not for the public benefit. However, if an organisation excluded people from the opportunity to benefit because they could not pay the fees, then its aims would not be for the public benefit. In particular, people in poverty must not be excluded from the **opportunity** to benefit. So it would not, for example, be enough to reduce very high fees slightly to enable more 'middle income' people to benefit, if people in poverty were still excluded from the opportunity to benefit.

In general, the lower the fees that are charged, the greater the opportunity there is likely to be for most people to have the opportunity to benefit. But where the fees charged are, of necessity perhaps, very high, then trustees of those charities will have to think about other ways in which people who cannot afford those fees can benefit in some material way related to their charity's aims. This does not mean charities have to offer services for free, or offer concessions on fees, although clearly that would help. There could be other ways of benefiting people who cannot afford the fees in a way that is related to the aims. For example, one way of doing this might be an independent school working in partnership with a local state school, or an arts charity might broadcast concerts or operatic performances via TV or radio to a wider audience. What matters is that people unable to pay are not excluded from the opportunity to benefit, whether or not they actually choose to take up the opportunity.

Principle 2d Any private benefits must be incidental

Where people or organisations benefit from a charity, other than as a beneficiary, then those sorts of 'private' benefits must be incidental, which means they are a necessary result, or by-product, of carrying out the charity's aims. Where private benefits are more than incidental this might mean the organisation is set up for private, rather then public, benefit and so might not be charitable.

Reporting on your charity's public benefit

Charity trustees have a new duty to report in their Trustees' Annual Report on their charity's public benefit. The level of detail you will need to provide in your public benefit report will depend on whether your charity is above or below the audit threshold. An audit is required when a charity's gross income in the year exceeds £500,000, or where income exceeds £100,000 and the aggregate value of its assets exceeds £2.8 million. Most charities already explain their activities in their Trustees' Annual Report and so this information now needs to be set in the context of the charity's aims to show how in practice the aims have been carried out for the public benefit.

Trustees will also need to confirm that they have had regard to our public benefit guidance where relevant

For smaller charities, below the audit threshold, trustees are required to include a brief summary in their Trustees' Annual Report of the main activities undertaken in order to carry out the charity's aims for the public benefit. Trustees can, of course, provide fuller public benefit statements if they wish.

For larger charities, above the audit threshold, trustees are required to provide a fuller explanation in their Trustees' Annual Report of the significant activities undertaken in order to carry out the charity's aims for the public benefit, as well as their aims and strategies. They are required to explain the charity's achievements, measured by reference to the charity's aims and to the objectives set by the trustees.

It is up to the charity's trustees to decide how much detail they want to provide to clearly illustrate what their charity has done in the reporting year to meet the requirement; the Commission will not be prescriptive about the number of words or pages needed. But a charity that said nothing on public benefit in its Trustees' Annual Report, or produced only the briefest statement with no detail, would be in breach of the public benefit reporting requirement.

Assessing public benefit

The Charity Commission will assess whether the aims of all organisations applying to register as charities are for the public benefit. Charities that are already registered have to continue to meet the public benefit requirement. We will do this by carrying out research studies on the extent to which different types of charity are meeting the requirement and by working with representative professional and umbrella bodies and with users of those charities.

In some cases we may need to carry out detailed assessment of individual charities. Where that needs to happen we will advise the trustees on what needs to change in order to meet the public benefit requirement, and give clear reasons and advice on what happens next where it is not possible for the organisation to meet the requirement. No charity will be expected to make changes overnight and we will take reasonable account of how much time and resources might be needed by a charity that needs to make changes in order to meet the requirement. A charity or anyone affected by one of our public benefit decisions, that disagrees with it, can seek a review of that decision using our internal decision review procedures and, if they consider it necessary, can make a further appeal to the new

Charity Tribunal and, ultimately, to the courts. However, by working constructively with charity trustees and undertaking extensive public consultation on our public benefit guidance, we would hope such circumstances would be rare.

Article by Rebecca Benneyworth

Lecture B562 (15.34 Minutes)

Claiming capital allowances on fixtures

References in the article are to Part 2 Chapter 14 of the Capital Allowances Act 2001 unless stated otherwise.

Definition

Section 173(1) defines a fixture with further definitions in HMRC's *Capital Allowances Manual* CA 26025 and *Stamp Duty Land Tax Manual* SDLTM 04010.

It is still necessary to ascertain that a fixture qualifies for capital allowances as plant and machinery with the standard considerations, such as the functional test.

Lists A, B and C in s 21 to s 23 are also relevant in distinguishing if something is treated as part of the building.

Rate

The rate of allowance is also open and fixtures may qualify as integral features, though the annual investment allowance is potentially available for allocation against these.

Equipment lessors

Operating leases: involve lessee in neither ownership nor capital expenditure so cannot entail capital allowances.

Finance / hire purchase leases: allowances normally go to the lessee under s 176 as long as the lessee has a qualifying activity and interest in the land.

A lessor cannot claim without an interest in the land, but can instead claim allowances with a joint election under s 177 if the lessee would have otherwise qualified; or if the lessor would instead qualify on the criteria under s 179.

Long funding leases: Chapter 14 does not apply and so the lessee automatically receives the allowances. But it still applies when a long funding lease is for background plant or machinery in a building where existing fixtures are included with a building lease, for example items included in SI 2007/303.

An interest in land

Whether a fixture is owned outright or leased, the importance of having an interest in land is exemplified in *J C Decaux* (SpC 84). Bus shelters and other street furniture provided to local authorities were held to be fixtures and not chattels, but as the company had no exclusive interest in the land or ability to control or occupy it, it could not claim allowances.

Furthermore, apart from the portaloos, the fixtures were not leased, Decaux received advertising income instead. Had they been chattels then allowances could have been claimed under s 67.

It is not a requirement that the land be owned, merely that one has an interest in it: a lease, easement, licence to occupy, etc. under s 175. Section 176(3) determines who has entitlement to a claim and where there are two or more persons with an interest in the land, e.g. landlord and tenant, the claim goes to the person with the lowest interest. Disagreements go to the tribunal (s 204).

Residential lets

Section 17 gives allowances in a property business, subject to s 35 when it is 'not qualifying … in a dwelling house' and nor will it be either for furnished holiday lets after 5 April 2010. No elections within chapter 14 will give allowances on dwelling houses.

Despite HMRC's repeated references to 'furnished lettings', in their *Property Income Manual* at PIM 3010, which appear to tweak the dwelling house restriction, s 35 is unequivocal and the possible inference in PIM 3010 that non-furnished lettings falling outside Extra-statutory Concession B47 may qualify for allowances is a case of HMRC being loose with their vocabulary.

Not even the installation of an energy-efficient boiler would receive allowances if it otherwise qualified under s 45A, as s 45A does not override s 35. However plant and machinery serving communal parts of flats for example can still qualify under apportionment (see *Capital Allowances Manual* CA 20020).

Energy services

The rule about having an interest in the land in order to claim allowances is relaxed for energy services providers that provide equipment under an energy services agreement. They may sign a joint election under s 180A so that the energy service provider, whose qualifying activity is wholly or mainly providing energy management services, receives the allowances.

Such agreements are defined in s 175A, and are for the design, obtaining, operation and maintenance of plant and machinery which saves or uses energy more efficiently.

Ostensibly an energy services provider could not make a claim for allowances (notwithstanding the election) if the client could not itself have claimed the allowances because it was not within the charge to tax, e.g. a local authority. In the case of energy efficient products which would achieve the 100% first year allowance, this problem is solved by s 180A(2).

Changes in ownership

What is the position where a fixture is already present and there is a change in land ownership?

Where the freehold of land is purchased then, as long as part of the consideration is attributable to the fixture, the new owner will receive allowances, so the documentation must confirm this.

Similarly where the vendor of the land only leases the fixture, a payment made to the vendor by the purchaser for the release of the vendor's lease obligation will qualify for allowances, including under an energy services agreement (s 181 to s 182A).

Where the freeholder instead grants a lease for the land rather than sells it, a joint election under s 183 will give allowances for a fixture to the new lessee, but the freeholder as original lessee must have been entitled to an allowance whether or not he is actually subject to UK tax, and the new lessee must have paid a capital sum for the fixture.

No election is necessary where the lessor of the land was not entitled to allowances nor had used the fixture for a qualifying purpose (s 184).

In these cases, care must also be taken to ascertain whether any third party prior rights apply: that is, if a third party with a different interest (lower or higher) and prior right is still treated as owning the fixture and has claimed allowances.

The cost for capital allowance purposes would be limited to no more than the original cost of the asset when new. This includes the value of any building alterations incidental to the installation of plant and machinery under s 25, including any new expenditure (s 185(1)(a) and (3)).

The limit does not apply if the vendor's expenditure was under s 538 contributions rules. If the fixtures are acquired from a non-claimant, for example a property dealer as stock in trade, the purchaser may still look back further to the most recent balancing capital allowances event.

It is up to the claimant to prove his case about past owners and disposal values (*Capital Allowances Manual* CA 26400), or HMRC will not give allowances under this section.

There is also the possibility of restricted allowances for the purchaser if the fixture has previously formed part of an industrial buildings allowance or research and development allowance for the vendor, and s 186 and s 187 give a formula for the allowable amount.

Disposal values

A disposal value arises on cessation of a qualifying interest. This can happen under a sale, discontinuance of trade etc., but also where the fixture is severed from the land.

For each circumstance there is an extended table of disposal values to be applied under s 196, similar to the general table in s 61, and s 66 gives precedence to s 196 for fixtures. The other general rules in s 62 and s 63, such as proceeds not to exceed initial qualifying cost and values to use upon gifts, still apply.

The anti-avoidance rule under s 197 must be noted. Under s 61 where the parties agree a sale price on general pool items they are free to do so with no restriction even where they are connected. This gives rise to some useful balancing allowances on incorporations (see event one in the s 61 table, but there must be proceeds of at least £1).

However, s 197 can disapply such freedom with fixtures. If there is a scheme or arrangement and one of the main purposes is the obtaining of a tax advantage, and the disposal value is less than the notional written down value, then the latter must be used.

This is the net residual value assuming all allowances that could have been made, including first year allowances (HMRC's manual still refers to the old 25% WDA rate and needs updating). The buyer's price is unaltered (CA 26750).

Subject to s 197, a joint election is available under s 198 for vendor/purchaser to fix the price of the fixture, though not exceeding the vendor's initial expenditure qualifying for allowances, with the form of election in s 201.

The election overrides the s562 rule which otherwise dictates the requirement for a just and reasonable apportionment of property sold together with other property.

Buyer and seller have to use the same apportionment in their returns. HMRC do not accept figures until those submitted to each party's tax district concur (CA 12100, but HMRC do not always do this at lower values).

They also ignore figures if they are unreasonable, or if they undervalue assets subject to capital allowances (thereby avoiding balancing charges) but only where something else has been overvalued, i.e. no disallowance where it was just a bad deal. HMRC must consult the district valuer before agreeing figures.

From an article by Rob Durrant-Walker, Taxation, October 2009

Corporation Tax

Five practical tips for managing corporation tax during a recession

Given that many companies are in financial difficulty during the present recession, it is important for all organisations to review and tighten their business processes. In particular, the opportunity to manage the company's corporation tax burden should not be overlooked.

Set out below are five practical tips to ensure that companies maximise the benefits of the tax reliefs available to them and that deductions for their costs are accelerated wherever possible.

Make provisional loss claims

If a trading company with a 31 December year end has started making losses, the delay between paying tax for the previous profitable year (say, 2008) and using the losses from 2009 to reclaim the 2008 tax can have a detrimental effect on cash flow. However, once it is known that there are losses in an accounting period, the company can submit a provisional claim for those losses to be carried back. This can reduce (or eliminate) a tax liability which would otherwise be due. Companies can currently carry back up to £50,000 of trading losses for two further years in addition to the normal (unlimited) one-year carry-back relief.

Consider stock write-downs

Accounting rules require trading stock to be held at the lower of cost and net realisable value. At present, some sizeable stock write-downs are likely. Given that these write-downs are generally an allowable deduction for corporation tax purposes, companies should give careful consideration to their effect with particular regard to the following:

- current year profits and the creation of losses;
- how to use the resulting losses (ie. by way of carry-back or group relief); and
- any necessary planning if the losses are to be carried forward.

Review provisioning policies

It is important to assess the company's accounting policies to ensure that provisions for expenditure of a revenue nature are made in accordance with FRS 12 and are allowable for corporation tax purposes. As far as bad debt provisions are concerned, evidence of actions taken to attempt to collect the relevant debts should be documented. HMRC often seek to disallow a specific provision where no such action has been taken.

Obtain tax deductions for repair work

If a company has a legal obligation to carry out future repair work (for example, under the terms of a lease), it is possible to obtain a tax deduction for this as long as there is an appropriate provision in the accounts. If there is no legal obligation, a tax deduction is only available if the work has been carried out by the company's year end.

Plan for capital allowances

WDAs have now been reduced from 25% to 20% and there is an AIA of 100% for up to £50,000 of capital expenditure on most forms of plant or machinery. Companies should consider the timing of their additions, possibly by deferring some expenditure to a subsequent accounting period so that they are able to take advantage of two tranches of the AIA. This may be preferable to using the one-off 40% FYA. In addition, the introduction of an integral features pool, albeit with allowances set at only 10%, should not be overlooked – this has expanded the range of expenditure on which capital allowances can be claimed.

Article by Robert Jamieson

Lecture B563 (13.00 Minutes)

Online filing – corporation tax developments

On 1 September 2009, a Press Release emanating from HMRC and Companies House formalised a move towards a joint filing arrangement which will have a significant impact on companies over the next two years. It is already established that HMRC will require online filing of company tax returns and supporting information from 1 April 2011, but Companies House have now agreed to accept data in a similar format (known as iXBRL).

The mandatory online filing requirement for corporation tax returns (together with the related accounts and computations) applies to accounting periods ended after 31 March 2010 and so the first period which is likely to be affected by the new regime will be the year ended 30 April 2010. However, this stipulation is only in point for returns and accounts delivered after 31 March 2011 and so it is possible to avoid mandatory online filing by submitting returns and accounts early. For example, if a company has a year ended 30 June 2010, the HMRC filing deadline is 30 June 2011. This company would therefore be subject to mandatory online filing. However, if the return and accounts are filed early on, say, 25 March 2011, the company would not be caught by the online filing requirement.

The next challenge is to understand the format of company returns and accounts under the new rules. While it is currently possible to file a return online with the accounts and computations in PDF format, from the date of compulsion all files must be in iXBRL format. This new format is the subject of the agreement between Companies House and HMRC, given that Companies House have now agreed to accept accounts in iXBRL as well. The idea is to allow companies to make a single filing which will meet both HMRC and Companies House requirements, thus saving them time and effort. Work will continue towards this goal over the next two years, but joint filing will not be compulsory.

Indeed, many smaller companies are concerned that meeting Companies House filing deadlines will mean that their company tax returns will have to be filed before the normal HMRC time limits if a single filing is to be made. This will undoubtedly deter some companies from following the single filing option. Indeed, it will be recalled that, when some years ago HMRC looked to reduce the permitted period for filing company tax returns and bring it more into line with Companies House deadlines, this move was widely criticised and HMRC were forced to back down.

The ICAS have already raised concerns about this recent announcement, with particular reference to the computer industry producing appropriately compliant software. While the information submitted to Companies House is the accepted norm which organisations would want to see in the public domain, the data sent to HMRC is far more detailed. One genuine worry about joint filing is that the wrong information could easily go to the wrong place.

Article by Robert Jamieson

Lecture B564 (7.08 Minutes)

Marks and Spencer plc

In yet another appeal in the long-running Marks & Spencer corporate losses case, the company and HMRC could not agree on the treatment of losses.

By way of background, M&S wanted to offset losses incurred by its EU subsidiaries against its UK profits, by making group relief claims.

This was refused by the Revenue on the ground that losses from overseas subsidiaries could not be offset against UK profits.

After the Special Commissioners found for HMRC, the High Court referred to the European Court of Justice for a preliminary ruling as to whether the domestic group relief provisions infringed EU law.

The ECJ said that they did not, except where the non-resident company had exhausted the possibilities available to it in its own country with regard to past and future periods (the no-possibilities test).

The case was remitted to the High Court, which dismissed the appeal concerning the French subsidiary's losses and remitted the appeal concerning the German and Belgian losses to the Special Commissioners. The Court of Appeal ([2008] STC 526) upheld this decision.

The First-tier Tribunal (TC 5) then heard the appeal relating to the German and Belgian losses, which allowed it in principle.

The issue now concerned how the tribunal's earlier decision should be applied to the losses, which had been agreed by both parties. HMRC said that for any year the lesser of the UK and foreign losses should be allowed.

The company however claimed that the no possibilities should be applied to the local law losses and, the conversion of the losses to which the no-possibilities test applied was necessary to ensure that greater losses were not available than would have been the case had the losses been incurred by a UK-resident subsidiary.

The tribunal decided that HMRC's argument was 'too literal a reading of what the ECJ decided'.

Philips Electronics UK Ltd (TC 176)

The taxpayer company, resident in the UK, claimed consortium relief for the years 2001 to 2004 in relation to the losses of a UK branch of an associated Netherlands company.

HMRC refused the claims on the ground that TA 1988, s 403D and s 406(2) prevented the losses of a UK branch of a non-resident company being surrendered if part of the losses is deductible abroad.

The company appealed, contending that the provisions infringed EU law.

The First-tier Tribunal judges agreed that both s 403D and s 406(2) contravened EU law and therefore should not be used to prevent consortium relief being available.

The taxpayer company's appeal was allowed.

Philips Electronics UK Ltd (TC 176)

Value Added Tax

Simple or compound interest

In *John Wilkins (Motor Engineers) Ltd and others v Revenue and Customs Comrs*, five companies which traded as car dealers had accounted for output tax on sales of demonstrator cars on which input tax had been blocked and which should have been treated as exempt, and on payments from manufacturers which should have been treated as discounts on the sale price of the cars.

HMRC made the repayments together with simple interest under VATA 1994 s 78. The companies contended that they were entitled to compound interest (following *CIR v Sempra Metals Ltd* [2007] STC 1559, HL).

Dismissing the companies' appeals, the Upper Tribunal held that s 78 could not be construed in such a way as to allow for interest to be compounded. Such a conclusion "would go beyond interpretation and pass into the realm of legislation". The tribunal also held that the appeals were out of time.

Partial exemption developments

This article examines a number of recent developments in the area of VAT and land transactions.

Not exclusively for ticket sales

An "eligible body" put on operatic performances, for which the tickets were exempt within Group 13 Sch.9 VATA 1994. It claimed that the input tax on its production costs were residual, rather than exclusively incurred in making the exempt ticket supplies. It should therefore be able to recover a proportion of the input tax because of its taxable sales of sponsorship, programmes, CDs, selling a production to the Barbican and prop and equipment hire. Tickets comprised about 65% of the income.

The Tribunal examined the agreements between the company and its sponsors, and found that there was an "inseverable link" between the sponsorship agreement and an obligation to put on three high-quality operas. The cost of the productions was therefore linked to the sale of sponsorship and was residual.

HMRC argued that the link was too indirect: there was no link between any individual input and the sponsorship supplies. The taxpayer's case is described as the "but for" argument, rejected by the Court of Appeal in Mayflower Theatre Trust: "but for the expenditure, the taxable turnover would not have arisen". The Tribunal chairman (Sir Stephen Oliver QC) distinguished the earlier case on the grounds that the link between a sponsorship agreement and the three operas to be put on in the current season was much more specific than the more nebulous deal enjoyed by the sponsors of Mayflower.

The chairman also concluded that the production costs were used to make all the taxable supplies put forward by the company. The company sought to exploit its productions in any manner that it could, and there was a sufficient link to show that the costs were incurred in making all the supplies.

First Tier Tribunal (TC0045): Garsington Opera Ltd

Not exclusively for refreshments

A members' golf club supplied exempt sporting services and taxable refreshments. It carried out a refurbishment of its bar and lounge facilities and claimed that the input tax was exclusively used to make taxable supplies of catering, so the whole of the input tax was recoverable.

The Tribunal examined the arguments about attribution in detail and disagreed with the club. Some of the comments are interesting because they cast further light on how attribution should be considered:

"The Tribunal is therefore looking at not only the physical use of the lounge/dining area but also its economic use. In this context it is not possible to say that the area was used 'exclusively' for taxable supplies. Certainly its primary physical use related to taxable supplies, being the area where the members congregated and consumed the drinks supplied by the bar and the food supplied by the kitchen. Even then this use was not exclusive as there were additional events held in the lounge which were in themselves exempt charitable events which the Commissioners argued would alone mean that the area was not used for exclusively taxable supplies. The more pertinent point however is the use of the clubhouse by the members is an intrinsic part of the their membership and inseparable from the exempt supplies of sporting services. The economic driver behind the refurbishment was not merely to make the taxable supply from the bar and the kitchen but, as recognised by the Club in the minutes of the 2007 AGM, to provide an attractive facility for the attraction of new members. The costs incurred in the refurbishment thus had a direct and immediate link to the exempt supply or in other words were a cost component of that supply. As Mr. Darby very fairly said, the Club could not survive without lounge and dining facilities and these had to be at their most attractive to build up the membership. This was the economic driver behind the refurbishment. As pointed out previously, the direct and immediate link does not have to be the closest link but a sufficient link."

First Tier Tribunal (TC0094): Bridgnorth Golf Club

Attribution of advertising expenditure

A building society's VAT group makes supplies of residential estate agency services (taxable) and mortgages and other financial services (exempt). A dispute arose in relation to the treatment of newspaper advertising expenditure: the building society argued that the adverts were for the estate agency services and so were attributable to wholly taxable supplies, while HMRC contended that the advertisements were residual and some of the input tax incurred would be irrecoverable.

The disputed advertisements were the normal kind published by estate agency businesses: generally full-page spreads in newspapers, filled with descriptions of individual residential properties. Some contained a "strapline" mentioning (without details) other services offered by the business; some contained more details; some contained only properties.

HMRC contended that the promotion of the estate agency business led to the earning of exempt income from mortgage advice, as with the phones and insurance in Dial-a-Phone. There was a sufficient direct and immediate link between the advertising expenditure and the exempt income.

The society argued that the link was not direct and immediate, and did not satisfy the criteria laid down in BLP Group plc for an input to be residual. There was no doubt that there was a direct and immediate link to taxable supplies; there was no reason to look further. HMRC's argument was a version of the "but for" test rejected by the Court of Appeal in the Mayflower Theatre Trust case – "but for" the advertisements, there would not be as much exempt income; but that was not a sufficient link for input tax purposes.

The Tribunal ruled that any advert which mentioned, however briefly, mortgage services or related exempt activities would be residual; however, adverts which did not mention them at all would be directly attributable to making taxable supplies. The chairman agreed with the society's counsel that the incidental promotion of the exempt activities was a consequence of the advert but was not its purpose, and the case of Royal Agricultural College was more relevant than Dial-a-Phone.

First Tier Tribunal (TC00146): Skipton Building Society

Proposed special method upheld in Tribunal

A company engaged in the casino, restaurant, bar and entertainment business proposed a floor-area based special method for partial exemption. HMRC rejected it and the company appealed to the Tribunal.

The Tribunal examined the way in which the business was organised at the several different locations operated by the company. It noted that a significant amount of food (taxable) was in fact given away to gamblers. In addition, significant areas of the properties were not used to make any supplies, but were communal areas, passageways, reception etc. Some 71% of residual input tax was argued to be property-related, which the company contended made the use of floor areas a reasonable proxy for "use" of inputs.

The proposed special method took the floor areas that were used to make supplies and ignored the rest. It was proposed that residual input tax should be recovered using a calculation as follows:

- the "T" part would include the whole of the area given over to taxable gaming and entertainments, but only a proportion of the areas of bars and restaurants – that would be reduced to reflect the proportion of food and drink that was given away free;
- the "E" part would include the remainder of the bar and catering areas and the exempt gaming areas as well.

HMRC used their normal arguments against floor-based methods, citing the Tribunal's decision in Vision Express in support. They also argued that treating all the residual input tax as property-related was not likely to produce a fair result.

The Tribunal disagreed. The situation was quite different from that in the opticians' cases. Allowance had been made for the cross-subsidisation of food and gaming by removing the "free food and drink" from the "T" part of the calculation. The case was different from that of Aspinalls, in which most of the food and drink was given away; here, the catering was a genuine business activity which made a significant contribution to overheads. Overall, the Tribunal was satisfied that the proposed method would produce a fair result.

It was then necessary to consider whether it gave a fairer result than the existing special method (which dated from 1993). That was turnover-based, and the company's counsel had several criticisms of it. The two significant ones were that:

- it was wrong to use turnover as a proxy for use in this case because there were more costs incurred in earning £1 of catering income than there were in earning £1 of gaming income;
- a turnover-based method would produce unpredictably fluctuating results depending on how lucky the customers were, and this was clearly unfair and unreasonable when the costs did not vary at all.

The Tribunal accepted these arguments and allowed the appeal. The proposed method was fair and reasonable, and more so than the existing method.

First Tier Tribunal (TC00154): London Clubs Management Ltd

Override notice

In December 1994 Loughborough University (LU) agreed a special method with Customs & Excise. Over the next few years amendments were made to the method which were not formally agreed but were accepted in practice, which meant that by 2004 the method in force was a "de facto" method. In August of that year LU sent a letter to Customs stating "this is a special method override notice", proposing to override the existing method in some respects but not in others.

Customs replied, stating that LU should continue to apply its special method but should also calculate the recoverable input tax on the basis of the use or intended use of inputs, and should adjust the input tax claimed under the method on the basis of use. This would continue until a new special method could be agreed.

In December 2008, while a new method was still being debated, LU applied to the Tribunal for a preliminary ruling on the status of a special method override notice. In particular, they wanted to know whether the issue of a notice required or permitted HMRC to revisit the whole of the special method, or whether its effect could or would be limited to the matters mentioned in the notice itself.

The taxpayer's counsel argued that the principles of effectiveness, legal certainty, legitimate expectation and proportionality should limit the effect of the override notice to the matters which were mentioned in it. The Tribunal examined the wording of the regulations and decided that they plainly meant something different: it was necessary to calculate the whole of the recoverable input tax on the basis of use and compare that with the result of the agreed method. It was not possible for the taxpayer to limit the effect of the notice it had issued only to those matters which it chose.

First Tier Tribunal (TC0059): Loughborough University

Payback policy

HMRC have commented on the payback rules in reg.109 SI 1995/2518 in the light of the High Court's decision in the Community Housing Association case. A housing association was found to

have used various inputs in making a supply of "unfinished development projects" to a subsidiary which had been set up to enable it to recover input tax on construction of houses. HMRC had persuaded the Tribunal that no supply had been made, but the judge overturned that decision.

HMRC say that they will not appeal, but the wording of the Brief suggests that they do not agree with the decision. The payback rule is explained as follows:

VAT Regulation 109 in SI 1995/2518, 'payback' allows a business to recoup input tax on costs that are incurred to make exempt supplies, but are instead used wholly or partly to make taxable supplies. Payback also applies to costs incurred for both taxable and exempt purposes, but actually used to make wholly taxable supplies. A payback claim cannot be made unless:

- costs in question were not used as originally intended
- change of use arises after the end of the partial exemption longer period (if there is one)
- change of use results in taxable supplies or both taxable and exempt supplies if the original intention had been to make a wholly exempt supply

HMRC then explain their views on what will constitute a "supply" for the purposes of triggering the payback rule:

Supply covers a wide range of circumstances but there are some basic requirements that must apply before a supply can exist. The recipient of the supply must receive some benefit, he must provide some consideration and the consideration must be paid in return for the benefit.

Any business making a supply will incur costs in doing so. These are the cost components of the supply. Conclusions on what the cost components of any supply are will flow from an analysis of the nature of that supply. The mere raising of invoices and passing of funds between companies does not automatically create supplies. Careful analysis may be called for, especially if the companies are close associates.

The implication seems to be that "we still do not think that CHA made a supply to its subsidiary".

R&C Brief 57/09

Lecture B565 (22.32 Minutes)

Acrylux Ltd

The appellant, a company, owned a substantial property which was hired out for weddings, murder mysteries and various other events on an exclusive hire basis. While it was hired out on a self-catering basis, the company did sometimes recommend people for waitressing, cleaning, etc.

HMRC claimed that the property was similar to an hotel or, failing that it was akin to holiday accommodation. The supply was therefore not an exempt supply.

The taxpayer claimed that it was not a commercial property. It was a large private dwelling house, hired out on an exclusive basis and it was entirely up to the hirer to decide how the property was used. No catering or other services were provided. Thus the supply was exempt.

The tribunal said that the principal supply made by the appellant was that of the property for short-term use. Any other associated services were minor. The supply of the property included only the basic requirements needed to sustain two or three days' use.

It noted that the fact that the property could be put to various uses, including sleeping, rather than just being a supply of sleeping accommodation as such, did not prevent it from being a taxable supply.

Furthermore, the supply of short-term weekend hires was effectively provided by the hotel sector. Thus the tribunal concluded that the property was a similar establishment within VAT 1994, Sch 9 Group 1 item 1(d), which made the supplies taxable.

The appellant argued, however, that it had acted on the basis of advice from HMRC's national advice line. On this basis, the tribunal felt that the appellant had a reasonable excuse for its actions and no serious misdeclaration penalty should be imposed.

The appellant's appeal against the assessment was dismissed, but its appeal against the penalty was allowed.

This case shows the danger, says independent VAT consultant Neil Warren, of accepting telephone advice from the national advice line when the tax at stake is large and the principles are complex.

He feels that the judges clearly thought that HMRC had misled the taxpayer because they reversed the penalty on the underpaid tax. They could only have reduced the tax if the advice had been in writing.

Service charges

This Revenue & Customs Brief sets out HM Revenue & Customs' (HMRC) view of the judgment of the European Court of Justice ('ECJ') in the case of RLRE Tellmer Property sro v Finanční ředitelství v Ústí nad Labem [2009] STC 2006 ('Tellmer') and confirms that the UK's current VAT treatment of service charges is unchanged following this decision.

Background

The issue was whether the leasing of apartments and the related cleaning of the common parts of the apartment building formed a single exempt supply by the landlord, Tellmer. Tellmer argued this was the case but the Czech authorities argued that the cleaning services amounted to a separate taxable supply. The ECJ agreed that in the circumstances of Tellmer, the cleaning services could be separated from the property rental as a separate taxable supply.

In the UK, it is common for property leasing and letting to include the provision of service charges for, amongst other things, cleaning services; to this extent there is some parallel with Tellmer. HMRC's current policy is that where the service charge arises as a condition under a lease and is to be provided by the lessor (or his agent) without the lessee having a choice, then we treat the rent and the service charge as consideration for a single supply - this is the case in most property leasing. This follows the Judgment of the ECJ in the case of Card Protection Plan Ltd v Customs and Excise Comrs (Case C-349/96) [1999] STC 270 ('CPP') where the Court held that there is a single supply where one or more elements are to be regarded as constituting the principal supply, whilst one or more elements are to be regarded, by contrast, as ancillary supplies which share the tax treatment of the principal supply.

The ECJ sought to apply the principles established in the case of CPP, and in two more recent ECJ cases, Levob Verzekeringen BV v Staatssecretaris van Financiën (Case C-41/04) [2006] STC 766 and Ministero dell'Economia e delle Finanze v Part Service Srl (Case C-425/06) [2008] STC 3132, which also dealt with the issues of single and separate supplies. In reaching its judgment in the present case the ECJ concluded, on the basis of the limited facts available, that two separate supplies were made rather than a single indivisible supply. This must have been because, on the facts of the case, the tenants in the Czech Republic were not required to obtain the cleaning of the common parts from their landlord, but had a real option whether to ask their landlord to perform the cleaning of the common parts for additional consideration or to obtain those services themselves from a third party.

If, however, there is a requirement for service charges to be paid but the services are either provided by a different person to the lessor (or his agent) or they do not arise as a condition under the lease agreement, then HMRC's policy continues to be that in such circumstances these services are a separate supply from the lease. However, under certain circumstances, they can be treated as exempt by concession - see Notice 48, ESC 3.18.

Impact of Tellmer

It is clear from the decision of the ECJ that Tellmer itself provided both the property leasing and the cleaning services to the tenants. However, the tenants had the choice of making an independent contract with a third party to provide the cleaning services. In the particular circumstances the court did not consider that the cleaning services were ancillary to the property letting and, as a result, concluded that they constituted a separate supply.

On this basis, since the UK only treats leasing of property and related service charges as a single supply, where the services are provided by the lessor (or his agent) as a condition under the lease agreement, HMRC considers that the findings in Tellmer are consistent with existing UK policy.

Revenue and Customs Brief, 27/10/2009

Herling Ltd

VATA 1994, Sch 8 Group 5 Item 1 zero rates 'The first grant by a person … constructing a building … designed as a dwelling or number of dwellings … of a major interest in, or in any part of, the building, dwelling or its site'.

The taxpayer granted long leases on holiday properties that it had built in North Cornwall and did not charge VAT assuming that they were zero-rated.

He argued that this was the case as Notice 709/03, paragraph 5.3, indicated that standard rating would apply if the property could not be occupied for the whole year and there was no prohibition on this here.

HMRC issued assessments charging VAT on the consideration, because they were of the opinion that zero-rating did not apply because of VATA 1994, Sch 8 Group 5 Note 13. This removed from exemption buildings where the grantee of the interest was not entitled to reside there throughout the year.

The assessments were made on the basis that VATA 1994, Sch 1 Group 1 – which exempts, subject to conditions, the grant of any interest in or right over land or of any licence to occupy land from VAT – did not apply.

Although there was no prohibition in the leases on a grantee residing in the property all year, HMRC referred to the planning permission which stated that consent was given on the basis that the buildings were 'for holiday accommodation only and for no other purpose'.

In fact, the council's planning consent approved the 'Construction of 28 new two-bedroom holiday homes with 52-week occupancy …'.

However, it also stated that 'the site is not within an area where residential development would normally be permitted, therefore any such use, other than the proposed holiday use, would be contrary to the policies of the Cornwall Structure Plan and the District Local Plan in respect of such development'.

HMRC did not contend that 52 weeks was less than a year and accepted that this equated to a year.

The taxpayer contended that there was no legal reason to prevent occupation of the property for a full year.

The judge noted that, although holiday use and use as a private residence were not mutually exclusive, he did not believe that a holiday home could be a principal residence.

He had no hesitation in agreeing that zero-rating was excluded by Note 13 and dismissed the appeal.