CONTENTS

PRE-BUDGET REPORT	*(Lectures P571 / B571)*	**3**
PERSONAL TAX		**11**
Non resident landlords	*(Lecture P572)*	**11**
HMRC make case in final day of Gray's Timber		**14**
Anti-forestalling and pensions	*(Lecture P573)*	**17**
CAPITAL GAINS TAX		**18**
Keeping your options open		**18**
INHERITANCE TAX AND TRUSTS		**21**
Medical Benefit Trusts		**21**
ADMINISTRATION		**24**
HMRC new powers – practical advice	*(Lectures P574 / P575)*	**24**
John Grosvenor		**27**
Prior Roofing Ltd		**27**
BUSINESS TAX		**28**
Bringing in a corporate partner	*(Lecture B572)*	**28**
Undeclared cash sales - Mr and Mrs Cooksey		**29**
CORPORATION TAX		**31**
Flat management companies	*(Lecture B573)*	**31**
Reducing share capital	*(Lecture B574)*	**33**
VALUE ADDED TAX		**35**
Repayment disputes	*(Lecture B575)*	**35**
Changes to TOMS from 1 January 2010		**39**
Bingo giant overpaid VAT for three years, rules tribunal		**40**

Disclaimer
Reed Elsevier (UK) Limited takes every care when preparing this material. However, no responsibility can be accepted for any losses arising to any person acting or refraining from acting as a result of the material contained in these notes.

All rights reserved. No part of these notes may be reproduced or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior written permission of Reed Elsevier (UK) Limited

Pre-Budget Report

Pre-Budget Report

The Pre-Budget Report was delivered to the House of Commons on Wednesday, 9 December 2009 at 12.30pm. The following summary highlights the principal tax measures outlined in the Report.

Income tax rates and allowances

For the tax year 2010–11 all income tax allowances and thresholds will be the same as for 2009–10. As previously announced, for 2010–11 an additional 50% rate of income tax will apply for taxable income over £150,000.

For the tax year 2012–13 the higher rate threshold will be frozen at the 2011–12 amount. The personal allowance will be increased and the basic rate limit will be reduced by the same amount.

Income tax—shared lives carers

Measures will be introduced in FA 2010 to establish a new income tax relief for qualifying shared lives carers. The relief will consist of a tax-free allowance that will be available per household.

Carers whose shared lives earnings are less than the tax-free allowance will not be taxed on their income from providing shared lives care. Carers whose shared lives earnings are more than the tax-free allowance will have the option to choose a simplified method for calculating their profits.

The new relief will have effect from 6 April 2010.

Capital gains—private residence relief

Private residence relief is not available on any part of a house which is used exclusively for the purposes of a trade, business, profession or vocation (TCGA 1992 s 224(1), (2)). On disposal, only the appropriate proportion of the gain relating to the part occupied as the principal residence is eligible for relief.

Changes will be introduced in FA 2010 to ensure that entitlement to private residence relief is preserved where an adult placement carer uses part of their home exclusively for the purposes of their business as a carer.

The changes will have effect for disposals on or after 9 December 2009.

Furnished holiday lettings

The furnished holiday lettings (FHL) rules will be withdrawn with effect from 2010–11.

Those who let furnished holiday accommodation but whose FHL business is not actually a trade will no longer be treated as if they were trading for certain tax purposes. Instead they will be taxed under the normal rules for property businesses.

Seafarers' earnings deduction

The seafarers' earnings deduction will be extended to EU and EEA-resident seafarers with effect from 6 April 2011.

Workplace canteens

Legislation will be introduced in FA 2010 to amend ITEPA 2003 s 317 to restrict the exemption for the benefit of free or subsidised meals where an employee has an entitlement, in conjunction with salary sacrifice or flexible benefits arrangements, to employer-provided free or subsidised meals.

The existing position in relation to subsidy benefits that are quantifiable but not connected to salary sacrifice or flexible benefits arrangements will not be affected.

The change will have effect from 6 April 2011.

NICs rates and limits

2010–11

For 2010–11 the lower earnings limits will increase by £2 to £97 per week. The special Class 2 rate for volunteer development workers will increase by 10p to £4.85 per week. All other NICs rates and thresholds will be unchanged for 2010–11.

2011–12

Pre-Budget Report 2008 announced increases of 0.5% to the main rates of Class 1 and Class 4 NICs from 2011–12. These will be increased by a further 0.5%.

From 2011–12, the main rates of Class 1 and 4 NICs will be increased to 12% and 9% respectively. The Class 1 employer rate will be increased to 13.8%. The increased rate will also apply to Class 1A and 1B contributions.

The additional rate of Class 1 and 4 NICs will be increased to 2% from 2011–12.

The primary threshold and lower profits limit will be increased for 2011–12 by £570 over and above plans announced in the 2008 PBR, to compensate the lowest earners for the increases in the Class 1 and 4 rates.

Bank payroll tax

A new bank payroll tax will be introduced by FA 2010. The tax will be set at 50% and will be payable by banks on bonuses paid to employees to the extent that those bonuses exceed £25,000. Banks will also be liable to the bank payroll tax where the bonus entitlement arises in respect of services performed for the bank regardless of who awards the bonus.

The new tax will have effect from 9 December 2009 until 5 April 2010 for all discretionary and contractual bonus awards. The tax will be payable on 31 August 2010.

There is an exception for contractual bonus entitlements where the payer has no discretion as to the amount of the bonus because of a contractual obligation existing at the time of the Chancellor's announcement.

The legislation will be accompanied by anti-avoidance provisions.

Pensions - Restricting tax relief

Budget 2009 set out the Government's intention to restrict tax relief on pensions savings with effect from 6 April 2011 for people with incomes of £150,000 and over. Legislation was also introduced to prevent those likely to be affected from seeking to forestall this change.

The Pre-Budget Report announces the following further changes—

- the income definition for the £150,000 threshold will include the value of employer pension contributions; and
- tax relief for those with incomes below £130,000 before the inclusion of employer pension contributions will not be restricted (other than by the existing annual and lifetime allowances).

FA 2010 will amend the anti-forestalling threshold to income of £130,000 or over. The changes will have effect for contributions paid under money purchase pension schemes or increases in the rights accrued under defined benefit pension schemes on or after 9 December 2009.

Special annual allowance charge

Individuals with income of £150,000 or more, who increase their pension savings on or after 22 April 2009 over and above their normal pattern of regular pension savings, are liable to a special annual allowance tax charge. This charge restricts tax relief on their excess pension savings to the basic rate of income tax. Individuals will be affected only if their total pension savings in the tax year are over £20,000. The rate of the special annual allowance charge is currently 20%.

From 6 April 2010 the special annual allowance charge will be set at the "appropriate rate" – determined by the rate of tax relief given on the amount of pension savings which exceeds the individual's special annual allowance and will restrict tax relief on that excess to the basic rate of income tax.

Short-service repayments

The tax charge arising where a registered pension scheme repays tax-relieved pension contributions to a member who has completed less than two years' service will be increased. Secondary legislation will be introduced to change the rates to 20% on the first £20,000 and 50% thereafter on refunds made on or after 6 April 2010.

The tax charge, payable where certain lump sums, gratuities or other benefits are received from an employer-financed retirement benefits scheme by an entity who is not an individual, will also be increased. The tax charge payable by the recipient will be at a 50% rate for benefits received on or after 6 April 2010.

Tax credits

From 6 April 2010, the child element in child tax credit will increase by £20 above earnings indexation to £2,300 per year. The disabled elements of child tax credit will increase by 1.5%. The elements of the working tax credit (except the childcare element) will increase by 1.5%. The income threshold for those on child tax credit rises to £16,190.

For individuals who start living together or separate, and who report the changes late, HMRC will, from January 2010, take into account what they would have been entitled to receive had they reported the change promptly in determining any overpayment from their old tax credits award.

From 6 April 2011, individuals aged 65 and over will qualify for working tax credits if they work at least 16 hours a week.

Small-scale renewable electricity

The Pre-Budget Report confirms that the income received by those who generate small-scale renewable electricity for their own use through the clean energy cash back scheme will be tax-free.

Equitable liability

Where taxpayers fail to meet the filing deadlines following a determination of tax issued by HMRC, by concession, HMRC will only collect the amount that would have been due for the period had the taxpayer filed a tax return on time.

The concession applies only where a taxpayer—

- shows that the amount of tax due is excessive;
- shows what the correct amount should have been; and
- brings his or her tax affairs up to date, including payment of tax, interest and penalties.

Legislation will be introduced to permit HMRC to continue to apply this treatment provided the relevant conditions are met.

Inheritance tax

Nil rate band

The nil rate band for the tax year 2010–11 will be unchanged at £325,000.

Anti-avoidance

Two schemes which seek to avoid IHT charges on transfers of property into trust are to be targeted. The first scheme reduces the value on which the IHT charge applies by exploiting the rules that relate to future interests in trusts. The second involves purchasing an interest in a trust rather than putting funds directly into the trust, thus avoiding IHT charges on property transferred into trust.

Measures in FA 2010 to counter such schemes will have effect for transfers into a trust where the settlor retains a future interest, or where a future interest in a trust is purchased, on or after 9 December 2009, and interests purchased in trusts on or after 9 December 2009.

Offshore tax

The Government has announced that legislation will be brought forward to ensure that individuals who fail to declare offshore tax liabilities will face the tough penalties attracted by deliberate tax evasion. There will also be a new requirement to notify HMRC when opening offshore bank accounts in certain jurisdictions, supported by a separate penalty regime. Evading tax offshore could therefore result in combined penalties of up to 200% of the unpaid tax.

Company cars and vans

Cars

Provisions in FA 2010 will set the company car benefit tax charge for 2012–13.

A new 10% band will be introduced for company cars with CO_2 emissions up to 99g/km, and existing CO_2 emissions thresholds will be moved down by 5g/km. Qualifying low emissions cars will no longer exist as a separate category.

The appropriate percentage for electric cars will be reduced to 0% for a period of five years from 6 April 2010.

Vans

The current flat-rate benefit charge of £3,000 for all vans will be reduced to nil for electric vans for a period of five years from 6 April 2010.

Fuel

The benefit charge for fuel provided by an employer for private use in a company car or van will be revised with effect from 6 April 2010.

For cars, the figure used as the basis for calculating the benefit of private fuel, currently set at £16,900, will be increased to £18,000.

For vans, the equivalent figure, currently set at £500, will be increased to £550.

Motor industry employees

HMRC have issued revised guidance on calculating the taxable car benefit for employees who work in the motor trade. The revised guidance will be available in the HMRC Employee Income Manual at EIM23651 onwards.

Capital allowances—anti-avoidance

Latent plant and machinery allowances

Measures will be introduced in FA 2010 to prevent tax avoidance through the transfer of an entitlement to benefit from capital allowances on plant or machinery where the tax written down value of the plant or machinery exceeds its balance sheet value ("latent" capital allowances). The legislation will apply to transfers involving the sale of companies and to transfers involving consortia and partnerships where the transfers are tax-motivated.

The changes will have effect broadly for transactions taking place on or after 21 July 2009 (the date when the anti-avoidance measures were originally announced) although further changes will have effect for transactions on or after 9 December 2009.

Plant and machinery leasing

Legislation will be introduced in FA 2010 to counter two types of avoidance involving the leasing of plant or machinery. The changes will ensure that—

- lessor companies are unable to generate tax losses using arrangements intended to result in tax relief in excess of the value of the taxable income; and
- companies and other businesses are prevented from turning a tax-timing advantage into a permanent advantage by ceasing to be within the charge to tax following the sale of the right to income from a lease of plant or machinery.

The changes will have effect where expenditure on plant or machinery is incurred, or a rebate of rentals becomes payable, on or after 9 December 2009, or where the business ceases to be within the charge to tax on or after 9 December 2009.

First-year allowances for new electric vans

Legislation will be introduced to provide a new 100% first-year allowance for business expenditure on new, unused electric vans.

Subject to receiving state aid approval, the measure will have effect for expenditure incurred on or after 1 April 2010 (corporation tax purposes) and 6 April 2010 (income tax purposes).

Small companies' corporation tax rate

The pre-announced increase in the small companies' corporation tax rate will be deferred for a further year. The rate will remain at 21% in 2010–11, after which it will increase to 22%.

Empty property relief

The temporary increase in the threshold for empty property relief will be extended for a further year. For 2010–11 empty commercial properties with rateable values up to £18,000 will be exempt from business rates.

Corporation tax "patent box"

The Government will introduce a "patent box" applying to income from April 2013, and potentially providing a reduced rate of corporation tax on income from patents, to strengthen the incentives to invest in innovative industries. Consultation on the detailed design of the patent box will follow in time for Finance Bill 2011.

Corporate groups—financing costs

FA 2010 will introduce amendments to the "worldwide debt cap" rules in FA 2009 Sch 15.

The proposed changes will include—

- eliminating mismatches in the application of the "gateway test" caused by different accounting treatments of the same debt in single-entity accounts and consolidated accounts;
- excluding securitisation companies from the debt cap rules;
- eliminating mismatches between the computation of UK financing costs and worldwide financing costs where borrowing is undertaken by a partnership, including a limited liability partnership;
- restricting the allocation of disallowances under the debt cap to group companies which are dual-resident investment companies;
- allowing other companies to elect that no disallowance shall be allocated to them;
- amending the definition of a group treasury company to prevent an anomalous result where other companies in the group have income from treasury activities;
- including guarantee fees received from other group companies in a company's financing income; and
- widening the definition of a collective investment scheme to prevent the automatic exclusion of overseas partnerships which, legally, are bodies corporate.

The debt cap legislation as a whole has effect for periods of account of the worldwide group beginning on or after 1 January 2010 and the further changes will have effect from this date.

Risk-transfer schemes

Legislation will be introduced in FA 2010 to restrict Exchequer exposure to losses from overhedging and underhedging structures to the real economic loss from those transactions. This will be achieved by ensuring that any losses from these arrangements, other than the real economic loss at group-level, are ring-fenced and can only be offset against profits from the same arrangements.

The measure will have effect for accounting periods beginning on or after 1 April 2010 subject to transitional arrangements.

Sale of lessors

Alternative treatment

FA 2010 will make provision to offer a lessor company an option to elect for an alternative treatment when it is sold. This will remove the need to calculate an immediate charge under the provisions of FA 2006 Sch 10 (the "Sale of Lessor Companies" legislation) but ensure that tax is collected on the profits of the leasing business following the sale.

The measure will have effect from 9 December 2009.

Consortia

Measures in FA 2010 will prevent a consortium of companies from exploiting provisions of FA 2006 Sch 10. By restructuring the consortium arrangement so that shares in the lessor company are held indirectly it is possible to avoid the full effect of Sch 10 when there is a change in the interests held by the consortium members.

The proposed measures will make changes to the definition of a company owned by a consortium so that the provisions of Sch 10 will apply to a company held indirectly by the members of the consortium.

The measure will have effect from 9 December 2009.

Research and development

Small and medium-sized enterprises (as defined for enhanced R&D relief purposes) can claim enhanced tax relief for expenditure on R&D under CTA 2009 Pt 13 Ch 2 (ss 1043–1062). CTA 2009 ss 1052 and 1053 require any intellectual property created as a result of the expenditure to which the R&D is attributable to be vested in the company.

Measures in FA 2010 will remove this condition with effect for any expenditure incurred by an SME company on R&D in an accounting period ending on or after 9 December 2009.

Film tax relief

FA 2010 will correct an anomaly in the way in which the amount of surrenderable loss is calculated for the purposes of film tax relief.

Under the proposed change the amount surrenderable for tax credit will be calculated as the lesser of—

- the available qualifying expenditure; and
- the loss for the period, plus any unsurrendered loss brought forward.

The legislation will have effect for accounting periods ending on or after 9 December 2009 and will be treated for those periods as always having had effect.

Life insurance companies

Legislation will be introduced in FA 2010 to amend the rules used to apportion the profits of a life insurance company derived from each type of insurance business to ensure that, when recognised, deferred profits are taxed on an appropriate basis.

The changes are in response to perceived manipulation of the deferral of tax on non-profits business.

As a result of the changes, when deferred profits are ultimately recognised they will be taxed on the basis of the mix of business in the fund when the profits arose. Profits already deferred will be taxed on the basis of the mix of business in the period beginning before 9 December 2009.

The measures will have effect for periods of account beginning on or after 9 December 2009.

North Sea Oil

FA 2010 will extend various measures that were introduced in FA 2009 to provide support through the North Sea fiscal regime for investment in the UK and the UK Continental Shelf (UKCS) area.

FA 2009 Sch 40 Pt 1 provides that chargeable gains will not arise on the swap of UK/UKCS licences in some circumstances. That measure will be extended (with effect from Budget Day 2010) to cover certain payments which are made between the parties to a licence swap agreement.

FA 2009 Sch 40 Pt 2 provides that chargeable gains will not arise in some circumstances where disposal proceeds are reinvested in new oil trade assets and the disposal and acquisition qualify for rollover relief. The scope of this reinvestment relief will be widened (with effect from Budget Day 2010) so it can apply when proceeds are reinvested in exploration and development expenditure, including drilling costs.

FA 2009 Sch 44 introduced a field allowance relief to provide an incentive to invest in new fields. This will be extended (with effect from 22 April 2009) to investment in fields that have previously been decommissioned.

The field allowance thresholds to qualify as an ultra high pressure/high temperature field will be reduced (with effect from 1 April 2010).

Gilt-edged securities

Changes will be introduced in FA 2010 to counter avoidance using index-linked gilt-edged securities.

Where companies or groups enter into transactions involving index-linked gilt-edged securities they will no longer be able to benefit from the tax exemption on the inflationary return, to the extent that the company or group has entered into arrangements so that it is not economically exposed to the inflation-linked return.

The measures will have effect with respect to index-linked gilt-edged securities held by companies on or after 9 December 2009.

Accounting standards

Changes are to be made to IAS 39 (and FRS 26 in the UK) which will affect the tax treatment of loans, derivatives and sale and repurchase agreements.

FA 2010 will provide a power to amend the loan relationships and derivative contracts rules through regulations. The amendments will be limited to those necessary to ensure the rules continue to operate fairly and efficiently where companies adopt the modified accounting standards.

Regulations made under this power will generally have effect for accounting periods beginning on or after 1 January in the year in which the regulations are made.

VAT

Standard rate

The temporary reduction in the standard rate of VAT to 15% will end on 31 December 2009. As already announced, there will be a small concession to businesses who continue to trade across the midnight deadline until they close or 6am on 1 January 2010 (whichever is earlier).

Flat-rate scheme

The flat-rate percentages were re-calculated in December 2008 to reflect the temporary reduction in the standard rate of VAT. The percentages are to be adjusted with effect from 1 January 2010 to reflect the return to the 17.5% standard rate of VAT.

The changes are effected by the Value Added Tax (Amendment) (No 5) Regulations, SI 2009/3241 reg 9. Technical adjustments are also made to the rates to ensure that they reflect the latest data about business VAT liabilities in each sector.

Stamp taxes—avoidance

Share transfers

Following the ECJ decision in *HSBC Holdings plc and anor v Revenue and Customs Comrs* (Case C-569-07), HMRC announced that they will not seek to apply 1.5% stamp duty or stamp duty reserve tax (SDRT) when new shares are first issued to an EU clearance service or depositary receipt system.

Legislation will be introduced in FA 2010 to remove exemptions for transfers where companies and depositary receipt issuers arrange a scheme under which new shares are issued to an EU clearance service or depositary receipt system without the payment of 1.5% stamp duty or SDRT and the shares are subsequently transferred to a depositary receipt system or clearance service outside the EU. The measure will have effect for scheme transfers made on or after 1 October 2009.

Disclosure of tax avoidance schemes

Regulations will be introduced to extend the disclosure of tax avoidance schemes rules to require the disclosure of certain stamp duty land tax (SDLT) schemes that concern residential property with a value of at least £1 million.

Users of all SDLT avoidance schemes, for both commercial and residential property, will be required to report the use of the scheme back to HMRC.

Regulations will come into effect no later than 1 April 2010.

SDLT holiday

The stamp duty land tax holiday for residential properties up to the value of £175,000 will end as planned on 31 December 2009.

Insurance premium tax

Insurance premium tax (IPT) is paid by an insurer on the gross premium charged under a taxable insurance contract. This includes any commissions or fees unless they are charged to the insured under a separate contract. Changes will be made to close an avoidance scheme involving an "administration fee" charged under a separate contract. The legislation brings certain fees charged under a separate contract in connection with personal life insurance into the scope of IPT.

The changes will have effect for payments made on or after 9 December 2009.

See also HMRC Brief 47/2009 "Action following the high court judgment in the Homeserve IPT appeal".

Climate change levy

FA 2010 will include measures to increase the reduced rate of climate change levy from 20% to 35%.

Following royal assent to FA 2010 regulations will be introduced to require relief claimants affected by the change to give their energy suppliers fresh certificates confirming their new relief entitlement.

The new reduced rate will have effect for supplies of taxable commodities treated as taking place on and after 1 April 2011. The requirement to give new certificates will have effect on and after 1 April 2011.

Excise duties

Budget 2008 announced that the duty differential for biofuels would end in 2010–11. Legislation will be introduced in FA 2010 to amend the duty rates for biodiesel and bioethanol for road use, alongside changes to other duty rates for hydrocarbon oils and alternative fuels.

Secondary legislation will be introduced to maintain the 20ppl duty differential for biodiesel produced only from waste cooking oil for a period of two years.

Landline duty

A landline duty of 50 pence per month for each line is to be introduced to help fund the roll-out of superfast broadband to 90% of the country by 2017. The new duty is expected to be introduced in the financial year 2010–11.

Lecture P571 (13.25 Minutes)

Lecture B571 (10.41 Minutes)

© Reed Elsevier (UK) Limited

Personal Tax

Non resident landlords

From 6 April 1996, if a landlord usually lives outside the UK their letting agent or tenant normally has to deduct tax from property income. However, landlords can apply to Charities Assets and Residency (CAR) Residency for approval to receive the income of their rental business with no tax deducted.

The Non Resident Landlord Scheme applies to:

- letting agents who handle or control UK letting income on behalf of a landlord whose usual place of abode is outside the UK.
- tenants who make payments directly to a landlord whose usual place of abode is outside the UK.

Unless they have been notified by CAR Residency that they must pay rental income with no tax deducted, letting agents **must** deduct and account for tax on rental income received less allowable expenses paid. Tenants must deduct and account for tax on rental income paid direct to the overseas landlord.

Letting agents and tenants must account quarterly to Accounts Office Cumbernauld (using return form NRLQ) for the tax deducted, without the need for an assessment, within 30 days of the end of the quarter. Quarters run to 30 June, 30 September, 31 December and 31 March. Letting agents and tenants with no tax liability for a quarter need not complete a quarterly return (unless, exceptionally, Audit & Pension Scheme Services (APSS), issues them with a notice requiring a return).

Letting agents and tenants of non-resident landlords must also make annual information returns to APSS (on form NRLY) with the exception of tenants authorised to pay their landlord with no tax deducted. Letting agents must complete annual information returns even if they are authorised to pay all their non-resident landlords with no tax deducted.

Letting agents

For the purposes of the scheme, 'letting agents' are persons who act in the management or administration of a non-resident landlord's rental business. This may include friends and relatives of a non-resident landlord as well as professional letting agents.

Meaning of 'usual place of abode'

'Usual place of abode' is not identical in meaning to residence, or ordinary residence, but a person who is not resident in the UK should normally be treated as having their usual place of abode outside the UK. You should interpret the term in accordance with the following guidelines.

- Individuals have a usual place of abode outside the UK if they usually live outside the UK. You should still regard the term as applying to them even if in a particular year they are resident in the UK for tax purposes, as long as the usual place of abode is outside the UK. (For example the individual may count as resident in the UK in a particular year because of a six months' visit, or a visit of a shorter time when he has a place of abode available in the UK.) Do not treat someone as having their usual place of abode outside the UK if they are only temporarily living outside the UK, say for six months or less.
- Companies that have their main office or other place of business outside the UK, and companies incorporated outside the UK, will normally have a usual place of abode outside the UK. However if the company is treated as resident in the UK for tax purposes, do not treat it as having a usual place of abode outside the UK.
- Trustees have a usual place of abode outside the UK if all the trustees have a usual place of abode outside the UK.

De-minimis limits

Tenants who make payments directly to a landlord whose usual place of abode is outside the UK and who pay £100 or less a week in rent, do not have to deduct and account for tax unless they have been told to do so by CAR Residency. There is no de-minimis limit for letting agents.

Approval to receive rental income with no tax deducted

Non-resident landlords can apply to CAR Residency for approval to receive their rental income with no tax deducted if:

- their tax affairs are up to date, or
- they have never had any UK tax obligations, or
- they expect not to be liable to UK income tax.

They must also undertake to comply with SA.

When approval has been given, HM Revenue & Customs sends a:

- notice of approval to receive rent with no tax deducted to the Non resident landlord, and
- separate notice to the letting agents or tenants named on the application form authorising them to pay rent to the Non resident landlord without deducting tax

Authority to pay rent to a Non resident landlord with no tax deducted is generally backdated to the beginning of the quarter in which HMRC receives the Non resident landlord's application. As the tax year for the Non resident Landlords Scheme starts on 1 April, the quarters are the three-month periods that end on 30 June, 30 September, 31 December and 31 March. So if a Non resident landlord applies to us on, say, 20 September, the authority we send to his letting agent/tenant will usually take effect from 1 July.

Calculating the tax deduction

Letting agents or tenants must generally tax the rental income they pay to Non resident landlords unless HMRC has told them not to. In calculating the amount to tax, they take into account any 'deductible expenses' they pay in a quarter. These are expenses that they can reasonably be satisfied will be allowable expenses for the Non resident landlords when the profits of their rental businesses are computed.

When calculating the amount to tax, letting agents/tenants should:

<u>Add</u> together the rent they actually receive in the quarter plus

- any rent that they had the power to receive, and
- any rent paid away at their direction to another person

<u>Less</u>

- any deductible expenses that they paid in the quarter, and
- any deductible expenses that were paid away in the quarter at their direction by another person

It is the date letting agents/tenants actually receive/pay the rents (or pay the deductible expenses) that determines when they calculate tax. The periods for which the rents (or expenses) are due are not relevant.

Broadly, in calculating the profits of a rental business, expenses are allowable where

- they are incurred wholly and exclusively for the purposes of the rental business
- they are not of a 'capital' nature

Expenses paid by letting agents and tenants which will normally be allowable expenses are:

- accountancy expenses for the rental business
- advertising costs of attracting new tenants

- cleaning
- costs of rent collection
- Council Tax while the property is vacant but available for letting
- gardening
- ground rent
- insurance on buildings and contents
- interest paid on loans to buy land or property
- interest paid on loans to build or improve premises
- legal and professional fees
- maintenance charges made by freeholders, or superior leaseholders, of leasehold property
- maintenance contracts (for example gas servicing)
- provision of services (for example gas, electricity, hot water)
- rates
- repairs which are not significant improvements to the property, including
  - mending broken windows, doors, furniture, cookers, lifts, etc.
  - painting and decorating
  - replacing roof slates, flashing and gutters
- water rates

Letting agents and tenants can deduct only those expenses which they pay or which are paid on their direction. This means they cannot deduct

- expenses which the landlord pays, even if they have details of the expenses
- expenses which have accrued in a quarter but which have not been paid in the quarter
- capital allowances
- any personal allowances due to the landlord.

Excess expenses

Where the deductible expenses for any quarter exceed the rental income to be taken into account for the quarter, letting agents should treat the excess expenses as follows:

Carry back
- firstly, by carrying back excess expenses and deducting them from rental income of the same landlord for previous quarters in the same year to 31 March, taking later quarters before earlier quarters; and

Carry forward
- secondly, by deducting the balance of any excess from rental income of the same landlord received for subsequent quarters, taking earlier quarters before later quarters. The carry forward of excess expenses is not restricted to quarters within the same year to 31 March.

Repayable amounts

Where the excess is carried back it will reduce a letting agent's tax liability in respect of that earlier quarter. This reduction is called a 'repayable amount'. A repayment is obtained by setting-off the repayable amount from the total tax due to HMRC in respect of other non resident landlords for the same payment quarter as that in which the excess expenses arise. If they cannot set off all the

repayable amount in this way, they can claim a repayment from the Accounts Office, Cumbernauld, on the form NRLQ which they complete for the quarter in which the excess expenses arise.

As tenants account for tax on rents paid there can be no question of excess expenses generating a repayment of tax when letting agents are not present.

Lecture P572 (14.02 Minutes)

HMRC make case in final day of Gray's Timber

The *Gray's Timber Products Ltd* (GTPL) case entered its second and final day in the Supreme Court on 15 December 2009.

Michael Sherry QC concluded his submissions on behalf GTPL by revisiting the issue of the subscription agreement.

The terms of G's share issue were expressly set out in the subscription agreement. G's shares were defined as 'ordinary shares… to be subscribed to G'. This is narrower than the ordinary shares G actually held.

Mr Sherry referred to how the subscription agreement covers what happens to G's shares in the event of his death: all G's shares bar one must be sold. That one share falls in the hands of the estate or a relative. That is, it devolves to G's estate.

Thus, G's rights under the subscription agreement survive death, and hence the estate duty authorities relied on in the Court of Session, were in point.

Mr Sherry demonstrated that the subscription agreement gives rights that continue to apply to G's shares and be enforceable by G even if he ceases to hold such shares.

Furthermore, under Gray's Group Limited's (GGL) articles of association (adopted on the same day as the subscription agreement), the directors have traditional discretions – e.g. in the event of death – to register the transfer of shares to the estate.

Therefore, it is possible to transmit G's shares, and it follows that in those circumstances the holder of the shares will have rights under the subscription agreement.

Lord Justice Walker considered this an extraordinary argument and noted that it is not one that has been deployed anywhere before. Lord Justice Hope agreed and said this argument should have been recorded in Mr Sherry's written submission to give HMRC's counsel a chance to consider the argument and respond.

Under time pressure, Mr Sherry outlined the pertinent points from his written submissions. He drew attention to Lord Justice Mackay's Court of Session judgment, where he accepted that, for Jewson Ltd to acquire the beneficial interest in the entire issued share capital of GGL, the payment had to be made to G. In Mackay LJ's opinion, the payment of this amount was 'equivalent to a settlement of a debt' falling due by GGL to G.

Mr Sherry contended that, with regard to employment-related securities, the general rule is that tax arises when a share is acquired. There are statutory rules that defer when the tax is paid. The QC contended that to tax a security on disposal as provided for under chapter 3D of ITEPA 2003, part 7 is therefore a departure from the general scheme.

He reiterated that the rights contained in the subscription agreement are intrinsic to the G shares, and therefore tax is not chargeable under chapter 3D. To find otherwise would be inconsistent with the scheme behind chapter 3D.

Finally, Mr Sherry discussed an alternative point, to be considered if his other submissions are unsuccessful: if the subscription agreement creates rights that are not intrinsic to G's shares then such rights are a separate asset from those shares. This approach was in substance adopted by the majority of the Court of Session.

This point had not expressly been taken previously; it was precipitated by the Court of Session judgment, and it had not been raised with the Special Commissioner. Hope LJ was reluctant to accept it being raised.

Mr Sherry urged consideration of the alternative point and quoted Lord Justice Oliver's judgment from *Brady & Another v Brady & Another* [1989] AC 755, in which it was held that it was wrong to ignore such a point where the wrong tax is charged: it is a 'declaration of illegality'.

He argued that, given the context of the original dispute, being a matter of the statutory construction of part 7 of ITEPA 2003, this point is within the scope of the argument made throughout the case.

Hope LJ agreed the whole scheme of part 7 needs to be considered. Chapter 1 provides a single definition of 'market value' that runs throughout the part. When the definition of market value is applied in this way, this limits the scope of chapter 3D whether the rights concerned are personal or not.

David Johnston QC, leading counsel for HMRC, began his case by considering the definition of market value. Section 421 of ITEPA 2003 defines market value as having the same meaning as that given in the TCGA 1992. The proper construction of market value goes back a long way.

Mr Johnston considered in detail the relevant case law in which market value is considered, including *Commissioners of Inland Revenue v Crossman* [1937] AC 26, *Lynall v Inland Revenue Commissioners* [1972] AC 680, *Duke of Buccleuch & Another v Inland Revenue Commissioners* [1967] 1 AC 506, and *Inland Revenue Commissioners v Gray (Fox's Executor)* [1994] STC 360.

Mr Johnston's submissions are summarised as follows:

- G's shares are identical to all the other shares in GGL. It is not the case that the hypothetical purchaser postulated by the market value test steps into G's shoes. In line with *Crossman* and *Lynall*, the purchaser can buy shares with rights and/or restrictions attached to them. The rights under the subscription agreement do not affect the price that a hypothetical purchaser is willing to pay. This is because the rights are personal to G and do not attach to the shares. Therefore G's shares are worth the same as all other shares in GGL. Hope LJ argued that one cannot just ignore the fact G had special rights in relation to his shares that had some sort of value, as it enabled him to insist upon being paid extra consideration for his shares. Mr Johnston said the sale agreement gave the meaning of 'consideration' as being 'undivided consideration'. The allocation of the consideration between the sellers is not a matter for the purchaser.

- Mr Johnston pointed out that where a hypothetical purchaser buys G's shares only, G would not get the consideration as set out in the subscription agreement because only 5% of GGL's issued share capital would be sold.

- Mr Johnston cited *Attorney General v Jameson* [1905] 2 IR 218, *Crossman* and *Lynall*, in which the courts were urged to use well-established valuation practices. This approach should be adopted in determining chapter 3D. Brown LJ asked what the role of chapter 3D is: is it to try to ensure that there is a charge to income tax by virtue of employment, rather than a charge to capital gains tax? Mr Johnston agreed it was and referred to the paradigm stop-loss provision, in which the employer indemnifies the employee against any loss in value of the security.

- Purposive approach: Mr Johnston explained that, although there is a general presumption that employment-related securities should be taxed on acquisition, this presumption is rebutted by clear legislation, as contained in various elements of part 7 of ITEPA 2003. A purposive approach should be taken when interpreting this legislation; the language of the section and the purpose it seeks to achieve should be considered. He contended that, in relation to chapter 3D, personal rights should be disregarded because there is not specific mention. Under chapter 3D, if the actual consideration received is always equivalent to the market value of the security then this provision becomes redundant; there should never be a tax charge.

- Stop-loss provision: this is essentially an agreement to purchase shares at a price that is different to the market value. If the appellant's argument is correct then the stop-loss indemnity is taken into account as part of the shares' market value.

- HMRC's FAQs: the Revenue accepted the answers were not clear or accurate, and so the guidance was removed in 2005. No great significance should be attached to this, according to Mr Johnston. The guidance has now been superseded.
- ITEPA 2003, part 7: Mr Johnston argued it is not appropriate to seek an extensive degree of uniformity between disparate chapters of part 7. They are concerned with charging income tax on employment-related securities. That income tax is measured against the capital gains tax meaning of market value. The differences between the chapters are more striking than the similarities. Mr Johnston disagreed with Mr Sherry's view that the chapters should be approached with flexibility. Mr Sherry's suggestion that there is a degree of common ground concerned undervalue at the time of acquisition. This is a general proposition that does not cover other chapters: i.e. chapter 3D, which deals with a tax charge arising on disposal. In relation to the paradigm case for chapter 3D, there is no question of undervalue there at all, just the loss being stopped. The primary purpose of chapter 3D is to cover the stop-loss situation, and it is an anti-avoidance mechanism. Similarly, undervalue is not considered in chapters 3B, 4 and 5. A variety of techniques, some contrasting, are used in part 7. Therefore there is no consistent approach. By way of example, under s428 (chapter 2, relating to restricted securities) the tax charge is levied by reference to the proportion of unrestricted market value not paid at the outset. Therefore tax is applied on the value arising on the release of the restriction (i.e. it is based on the proportion of the increase in value, as opposed to the whole value). By contrast, under s 479 (chapter 5, relating to options) tax is chargeable on the whole of the gain. Therefore the nature of the tax charge is not uniform across part 7, either. If full unrestricted market value is paid on acquisition then no tax charge arises under chapter 2. Mr Johnston contended that the purpose of each chapter is not necessarily served by using the same interpretation of market value throughout.
- Chapter 3C: with partly paid shares, the failure to pay the full purchase price is not naturally considered to be a notional loan; it is 'deemed' to be. This is different to the stop-loss situation. Therefore chapters 3C and 3D are not necessarily 'mirror images' of one another, as Mr Sherry had argued.
- Chapter 3D: this captures the difference between actual value and an increase in value (i.e. the gain). Hope LJ said it is accepted that the language of the chapter is so wide that one has to rely on the other chapters in part 7 to put it into context. Mr Johnston said the wording of chapter 3D says nothing about how to treat personal agreements; it is silent. Therefore it is only if personal agreements are disregarded that chapter 3D can apply.
- Mr Johnston argued that in this case, G's shares are convertible securities subject to a chargeable event. The disposal of G's shares falls squarely within chapter 3, and that is the basis on which it should be taxed. There is no reason for it to be taxed in two different ways.
- Collateral documents: under chapter 3 the right to convert can be embedded in collateral documents. This is also expressly stated in chapters 3B and 3C. In contrast, chapter 3D is silent on this point. Rodger LJ made the point that it must therefore follow that, where the legislation is silent on the point, one should not infer it to avoid confusion. There is no reason to infer meaning from provisions in one chapter meaning into another. Therefore, the decision whether collateral documents affect the valuation exercise under chapter 3D should be taken by reference to chapter 3D alone.
- There was little Mr Johnston could add for HMRC in relation to Mr Sherry's alternative point given it was only introduced at a late stage. In any event, the question for determination in this case was the market value of the employment-related security. It was not about the new point that had been raised, which in Mr Johnston's view placed too much emphasis on MacKay LJ's comments in the Court of Session. Mr Johnston submitted that when dealing with matters of this complexity there was no need to introduce a case (*Brady*) that is not directly applicable. Mr Johnston urged the court to refuse the alternative point, apparently on the basis that treating the right to enhanced consideration as a separate asset would not be the correct characterisation of the arrangements relating to G's shares.

Mr Sherry responded to the points raised by Mr Johnston largely by reiterating his earlier arguments.

Judgment was reserved.

Taxation, 16 December 2009

Anti-forestalling and pensions

The structure of the anti-forestalling charge for pensions in FA 2009 produces an unfortunate 'cliff-edge' effect and gives rise to potentially very high marginal income tax rates. This comes about because, if the £150,000 income threshold is breached, the 20% charge applies in full to any 'irregular' pension contributions over the normal £20,000 limit. It is best explained by an example.

Illustration

Two individuals have virtually identical incomes for 2009/10. Alan has a total income of £169,995, while Ben's is £170,000. Although Ben has only £5 more income than Alan, he will pay £2,000 more in tax than Alan if they both pay a one-off pension contribution of £30,000 (neither has paid any contributions in recent years). This is because, after deduction of the special annual allowance to which they are both entitled, Alan will be below the £150,000 relevant income limit whereas Ben will not be. As a result, Ben will incur the special annual allowance charge of 20% on £10,000 of his contribution, thereby producing a frighteningly high marginal rate of tax.

Note that, if Ben paid a charitable donation under Gift Aid of, say, £5, this would save him the £2,000 tax charge!

Article by Robert Jamieson

Lecture P573 (10.50 Minutes)

Capital Gains Tax

Keeping your options open

The focus of this article, however, is the capital gains tax implications for EBTs arising upon the exercise of employment-related share options.

Market value rule

Unless expressly disapplied by other provisions, s17 TCGA 1992 substitutes market value for actual consideration for the purpose of determining the disposal proceeds and acquisition cost where a transaction takes place other than at arm's length.

One situation in which its application raises potential complications is where shares are acquired on the exercise of an employment-related share option.

Such shares are invariably acquired for a consideration which is less than their market value and so, if the market value were to apply, a gain would be treated as arising to the party satisfying the option (e.g. the employer).

This will not affect an employing company (or a related company) that issues new shares to option-holders because this does not constitute a chargeable disposal; however, it is potentially significant where shares already in issue are transferred to option holders.

Before 2003

HMRC's position was that the market value rule did not apply in respect of the exercise of a share option. This was on the basis that, where a share was transferred under an option agreement, this was not as a consequence of the employment relationship.

In other words, the shares acquired by virtue of exercise were due to a taxpayer's status as option-holder and not as employee.

The *Mansworth v Jelley* position

The effect of the decision in *Mansworth v Jelley* [2003] was to overturn the previous practice and recognise that it was the existence of a relevant employment relationship at the time of exercise which triggered the market value rule.

That case specifically related to the tax treatment of the option-holder; however, as a result, it followed that the satisfier of the option exercise (usually the employer) was to be treated as having made a disposal for consideration equal to the market value of the shares at the relevant time.

The response

In response to the decision in Mansworth v Jelley, FA 2003, s 58 inserted s 144ZA into TCGA 1992, and this applies to the exercise of options on or after 10 April 2003.

S144ZA disapplies s 17 in relation to the exercise price of an option where the option 'binds the grantor to sell'.

Accordingly, where s 144ZA applies, the disposal proceeds are determined by reference to the actual exercise price, rather than market value. It should be noted that s 144ZA does not disapply s 17 with respect to the consideration paid for the grant of an option. The total disposal proceeds will be determined by adding the actual exercise price to the market value of the option at the date of grant.

It is common for employment-related options to be granted for no consideration with an exercise price not less than the market value of the shares over which they are granted at the time of grant.

Such options will generally be of negligible value when they are granted.

Problem solved?

At first glance, s 144ZA appears to solve the problem outlined above whereby EBTs are treated as receiving the market value of shares transferred in satisfaction of employment-related share options.

However, on closer analysis, uncertainty arises as to whether the requirement in s 144ZA(2) that the option binds the grantor to sell the shares has actually been satisfied.

In an EBT structure, it is usually the employer company that grants the options to an employee, but it is the trustee, in its capacity as trustee of the EBT, that satisfies the option exercise by the transfer of shares.

As there is no statutory definition of 'grantor', it is unclear whether the trustee satisfies the requirements for the disapplication of s 17.

For approved save-as-you-earn options and company share option plan options, the ambiguity surrounding s 144ZA is not a problem, because a trustee transferring shares in satisfaction of such options should be entitled to an express disapplication of s 17 under TCGA 1992, Sch 7D paras 10 and 13 respectively.

Unfortunately, however, there is no equivalent provision in respect of enterprise management incentive (EMI) options or ordinary unapproved share options.

A small measure of comfort may be derived from HMRC's guidance in their *Capital Gains Manual* at para CG12398 that s 144ZA should disapply s 17 on exercise of an unapproved option, but the lack of legislative clarity leaves an unattractive element of uncertainty.

Trust property

In addition to the general rule in s 17, a chargeable gain may arise to the trustee of an EBT as a consequence of TCGA 1992, s 71. This provides for a deemed disposal and immediate reacquisition at market value by a trustee of property held on discretionary trust when a beneficiary becomes absolutely entitled to it.

The effect of s 71 is that, where the trustee of an EBT holds shares on discretionary trust for the employees of its parent company, and an employee on exercising his option becomes absolutely entitled to receive some of the shares, the trustee is at that time deemed to have disposed of and immediately reacquired the relevant shares at their market value.

He will also have realised a chargeable gain equal in amount to the difference between such market value and the base cost of the shares to the EBT.

Applying TCGA 1992, s 239ZA

Extra-Statutory Concessions Order 2009 (SI 2009 No 730) inserted s 239ZA into TCGA 1992. Its purpose is specifically to relieve the trustees of EBTs from tax on gains arising on the disposal of assets to beneficiaries (under s 17) or on a deemed disposal and reacquisition under s 71.

The key point to draw out here is that the relief under s 239ZA is restricted to situations where 'an amount that is equal to or exceeds the market value of the asset is chargeable to income tax as employment income'.

On a strict interpretation, this could be seen as excluding the situation where the amount brought into the charge to income tax falls short of the market value of the share acquired.

This is because the amount chargeable to income tax in respect of the exercise of an ordinary unapproved option is calculated by deducting from the market value on exercise the aggregate of the amount (if any) paid in consideration for the grant of the option and the amount paid on exercise.

Even if it is accepted that the legislative intention was not to exclude the situation described above (and this must be the logical interpretation, because it is otherwise difficult to conceive of a situation in which s 239ZA actually would apply), a sizeable doubt must remain as to its application in respect of EMI options.

These benefit from a favourable tax treatment which does not recognise taxable income as arising on exercise in the same manner as applies for ordinary unapproved options.

The inexact drafting of s 239ZA leaves practitioners in the unenviable position of waiting for judicial interpretation if and when the point comes to be tested in litigation, or at least for HMRC to issue guidance, neither of which had, at the time of writing, been published.

Suggested solution

Perhaps the simplest solution to the issues described above is to avoid the use of EBTs to hold shares intended to be used to satisfy EMI options.

nstead, the options can either be satisfied by the issue of new shares, or be granted and satisfied by way of a transfer of existing shares by the grantor company.

In the former case, no chargeable gain arises to the issuer, because (as explained earlier in this article) the issue of shares does not constitute a chargeable disposal for the purposes of TCGA 1992.

In the latter scenario, the grantor should be eligible for disapplication of s 17 under s 144ZA. By eliminating the trust from the structure, the deemed disposal and reacquisition under s 71 is also avoided.

Unfortunately, it is not so straightforward where an existing EBT holds shares intended to satisfy EMI options.

One solution is to satisfy options by the issue of new shares or the transfer of existing shares by the grantor of the options, and to reclassify the shares held by the EBT as non-voting deferred ordinary shares with negligible value.

These essentially worthless shares could then be repurchased and cancelled by their issuer for nominal consideration. If desired, it should thereafter be possible to terminate the EBT.

Whichever of these scenarios you might be presented with as an adviser, consideration should certainly be given to the potential tax liabilities before the option is exercised, rather than afterwards.

From an article by Rebecca Armour and John McLean, Taxation 2 December 2009

Inheritance Tax and Trusts

Medical Benefit Trusts

Medical benefit trusts (also known as corporate healthcare trusts) are a way of providing healthcare benefits to employees. They are sometimes used as an alternative to conventional private health insurance products, and they are often structured to resemble conventional insurance as closely as possible, because that is what employees are used to.

Structure

Conventional insurance would involve an employer paying premiums to an insurer in exchange for the insurer providing the employees with medical insurance. With a medical benefit trust, the employer instead pays cash to a trust which has the employees (and perhaps relatives of the employees) as beneficiaries. The trust either pays for medical treatment or reimburses the employees their medical expenses. Typically a third party will be paid to administer the trust and deal with claims handling, etc. The third-party administrator will usually be part of a big insurance group and will therefore often assist with drafting the detailed rules governing entitlement under the trust.

Although the basic structure is simply described, the details of the trust (including the beneficiary population and the rules describing the benefits to be provided) can be as simple or as complicated as the employer likes.

Benefits

A detailed examination of the non-tax benefits of the structure is beyond the scope of this article. A large employer would hope to save money as compared to conventional insurance, because it does not have to fund the insurer's profit margin (although it does have to pay the third-party administrator) — in effect the employer is self-insuring. The trust model can also be more flexible, with the possibility of changing the benefits more regularly, and more easily, than pursuant to conventional insurance contracts.

However, one of the benefits is an insurance premium tax (IPT) saving. Since insurance premiums are subject to IPT at 5%, by putting in place a structure which does *not* involve an insurance contract, the employer should save a significant amount (although note the VAT implications — see below). This sort of structure is only suitable for relatively large employers — if you have a small number of employees, claim patterns are harder to predict and the trust administration will lack the economies of scale.

IPT

IPT is charged on premiums paid pursuant to contracts of insurance and it is therefore crucial that the structure does not give rise to such a contract. The term 'contract of insurance' is not defined for the purposes of tax legislation; instead one must rely on the extensive case law which has been built up by regulatory and (to a much lesser extent) tax cases. A significant degree of comfort can be derived from the fact that a beneficiary's rights are rights under a trust, not under a contract, but this is not a complete answer since (depending on the details of the contractual relationship between employer and employee) it may be possible for an unintended contract of insurance to be created.

In practice there is a substantial overlap between chargeability to IPT and the carrying on of insurance business for regulatory purposes, which means that specialist regulatory advice will be essential. If no FSA-regulated activities are being carried on, it is highly unlikely that IPT will be chargeable. Note that the regulatory advice can have implications for the drafting of the trust deed and employee communications, so it will be important for regulatory and tax advisers to work in tandem.

The only likely IPT cost will come if the trustee decides to take out 'stop-loss' insurance to cover unexpectedly high claims; stop-loss insurance is a conventional insurance product subject to IPT in the usual way.

Benefit-in-kind and corporation tax treatment

Assuming that the structure secures the intended IPT saving, an employer's main aim will generally be for benefit-in-kind tax and NIC to be calculated in the same way as for conventional insurance (that is, based on the cost per employee incurred by the employer). What the employer will want to avoid is employees being taxed on what comes out of the trust to individuals, since this would have the inequitable result of higher tax bills for individuals who need to call upon the trust more.

The way to achieve this is to make sure that the benefit being provided by the employer is the *right to reimbursement* of specified medical expenses rather than the actual reimbursement itself. HMRC has produced guidance on the conditions which must be satisfied in order to achieve this result.

Summary of HMRC conditions

Condition 1	The trust confers on each employee an absolute right to reimbursement of specified medical treatment
Condition 2	The employer's annual contribution for each employee is identifiable
Condition 3	Contributions to the trust must be irrevocable and the employer excluded from benefiting
Condition 4	The trust cannot be terminated before all claims for treatment for periods for which contributions have been made by the employer have been met
Condition 5	It is a term of the arrangements that no change can be made such that one of these conditions would be breached

The conditions make it clear that employees must have certainty regarding their rights under the trust; in practice this means that only a trust which is fundamentally non-discretionary will satisfy HMRC conditions. If the trustees have discretion to pay or not pay medical expenses, no benefit is received by the individual until an actual cash payment is made out of the trust. The detailed rules for the trust will therefore need to be scrutinised. Sometimes an apparent discretion in the rules will turn out to be shorthand for detailed objective protocols which it would be onerous to draft into the trust itself. As long as the instances of this are limited, HMRC will generally accept that this 'discretion' does not breach Condition 1.

The other key point to note is that annual contributions made in respect of each employee must be identifiable. In practice this means that contributions per employee made by the employer should generally be calculated in a similar way to insurance premiums, based on predicted claims per employee per claim year. Payments may then be made in instalments to minimise the trust's surplus assets. If payments are actually calculated each month (perhaps based on the previous month's claims), this would risk breaching Condition 2, since the trust starts to look less like a substantive party to the arrangements and more like a mere conduit for employer payments.

Subject to meeting HMRC's conditions, Class 1A NICs will be payable on the benefit in kind rather than on payments out of the trust.

Corporation tax deductions should be available to the employer on contributions paid into the trust. Deductions should not be subject to any delay under CTA 2009, s 1209 (formerly FA 2003, Sch 24), since the benefit to employees is the right to receive payment/reimbursement of medical expenses, which will be triggered by the payment into the trust. This constitutes a 'qualifying benefit' for s 1209 purposes.

VAT

Although IPT costs will be significantly reduced, the administrator is likely to be making standard-rated supplies. If the employer cannot recover VAT generally, no VAT recovery will be possible in respect of the trust arrangements. If the employer is entitled to partial or full VAT recovery on its overheads, there are two ways in which VAT recovery might be sought.

1. If the trustee is a corporate entity, and a member of the employer's group, the trustee itself should be able to register for VAT (as part of the employer's VAT group) and recover the VAT. This route relies on the fact that in certain circumstances HMRC will allow a single VAT registration to cover both trustee and non-trustee activities. This will be the case where

the person carries on a business and it is also a sole trustee of a trust whose activities are so closely connected to those of the normal business as to be part of it (by analogy with pension trustees).

2. Otherwise the parties can attempt to structure the administration agreement as a tripartite one between trustee, employer and administrator, in such a way that there is a provision of services to the employer in respect of which the employer can recover the input tax under a Redrow-type analysis. Careful attention will need to be paid to the role of the employer in this scenario, since it will need to be more than a passive payer in order to be the recipient of services.

Inheritance tax

As long as only the employer entity (or entities in the case of a group) contributes to the trust, and the employer is not a close company, contributions to the trust will not be 'chargeable transfers' for the purposes of IHTA 1984. If the employer is a close company then, as with all employee benefit trusts, care will be required to exclude 5%- plus participators from benefiting.

It should also be possible to structure the trust so that it falls within the exemption from periodic inheritance tax charges pursuant to IHTA 1984, s 86 by limiting the class of beneficiaries.

Sharing the cost

It is a common feature of many medical benefit trusts that the employer will permit relatives to be covered as well as employees, in exchange for a contribution from the employee (which may or may not represent the full marginal cost to the employer). Any employee contribution can be structured in a variety of ways but it is preferable from a tax point of view for contributions to be made by way of salary sacrifice (that is, the employee waives his or her right to an amount of salary and the employer makes an additional contribution, rather than the employee making a contribution to the employer/trust out of taxed income). This is because the receipt of the benefit will only be subject to Class 1A NICs, whereas the sacrificed salary would be subject to Class 1 NICs.

There are potential implications of a direct employee contribution into the trust, including inheritance tax. Such a structure could also give rise to additional regulatory concerns and so should be considered carefully.

Article by Janet Hoskin and Matthew Rowbotham, Tax Journal 14 December 2009

Administration

HMRC new powers – practical advice

Introduction

There are an awful lot of risks we face as professionals in the tax world – from dealing with clients and providing advice to generic risks such as failing to complete a main residence or a group relief claim. There are also the risks associated with HMRC's new powers programme and the changes that are continuing at pace – for example are we up to speed with the legislative changes and are we giving our clients appropriate advice in view of all the changes?

The new powers project continues at pace and has led to a huge amount of new material, not just legislation but new guidance, HMRC commentary, consultation documents and over 120 other sizeable papers on the proposed changes issued along the way by the powers committee.

By far the biggest issue for professional advisers to come out of all this is, in my view is Schedule 36 FA 2008 – information and inspection powers. This Schedule provides HMRC with new powers to inspect business premises and amended powers to call for documents and information from the taxpayer and 3rd parties.

1) Visits to business premises

In the past HMRC could not demand to inspect records or anything else for that matter at the business's premises except for VAT and payroll matters. FA 2008 changed all that, HMRC's logic being that the ability to see the business in the flesh as it were can give the inspector a better commercial perspective.

HMRC's review may well cover several taxes at once, perhaps requiring several officers to visit. It will also involves cross checking of data to prime records such as delivery notes, inspection of assets used in the business and perhaps discussions with appropriate personnel. Hence, in practice, our clients need to recognise that such a visit will not be straightforward and that careful follow up will be needed to ensure that off the cuff responses were correct and that nothing is lost in translation between the visit and the next stage. The new approach will be based on risk, so if a visit is arranged, which is relatively labour intensive even if only one inspector attends, it is highly likely that the inspectors expect to find something and may be difficult to shake off if they don't.

The legislation provides for only seven days notice of a visit which does not have to be in writing. It may be that less, perhaps no, notice will be given if the visit is approved internally by an appropriately authorised officer. In relatively rare cases, primarily where HMRC expects the taxpayer to be obstructive from the outset, HMRC will seek approval for the visit from the tax tribunal, which adds weight to any potential penalty for obstructing the inspectors.

Once on the premises it may be that HMRC officers will want to wander around at will, look at whatever documents and assets they please and ask questions of relevant staff. However, we need to be fully aware of what is allowed in practice; otherwise we will be doing our clients a possible disservice by allowing the legislation to gradually be interpreted more widely than was intended.

Inspection or search?

The new rules give powers to inspect only, not to search. It has been suggested that this means to inspect by eye rather than by hand and this is confirmed in HMRC's guidance to staff, although this recognises that it is usually more complicated than that.

By way of example consider a room with various files on the table as requested by the inspector. In the corner is a filing cabinet. The inspector cannot go over and open the filing cabinet to see what's in it; that is considered to be searching. However, if, for example, he has been told that the invoices backing up the books he is reviewing are stored in the filing cabinet then he can open it at will to inspect the invoices.

The distinction may be tricky in practice and it is not likely that HMRC visitors will voluntarily restrict their activities so we need to be robust and remember that our clients still have the right not to have their premises searched.

Interviewing and questioning staff

Whilst visiting the premises HMRC may also take the opportunity to ask questions and discuss issues with the proprietor, directors or relevant staff. However, the new legislation only creates a power to inspect, it does not give HMRC officers any power to interview or to demand answers to questions at all. Again I expect it is unlikely that the visitors will make this restriction clear to the taxpayer, so we have to ensure the new powers are not abused.

Since answers cannot be demanded there can of course be no penalty for refusing to answer questions. However, it is worth noting that in the new penalty rules brought in by FA 2007 for incorrect documents such as tax returns, the word "document" can include an oral reply. Hence a penalty might be due if incorrect responses are given, so even if you want to be helpful, it is perhaps a false economy to give immediate off the cuff responses unless they are very simple responses or given with the caveat that records will need to be checked to be sure of the answer.

What are premises?

When the new legislation was drafted it didn't preclude HMRC turning up at an individual's home. An amendment was later made so that the power could not be used to visit premises used "solely" as a dwelling.

Proprietors of many businesses often have an office at home, or write up the books at home, hence private homes may still be visited if an HMRC officer believes that any sort of business activity is carried on there. On a practical level, I believe this that very few visits will be made to private homes. This is because the legislation also includes the express caveat that visits can be made only

> "*…if the inspection is reasonably required for the purposes of checking that person's tax position*".

In the vast majority of cases how can it be "reasonably required" that the records are reviewed at home rather than anywhere else, such as at the business's main premises? In practice, if an inspector tries to arrange such a visit he should be challenged; HMRC officers are in fact instructed to explain why they need to visit a person's home.

In some cases it may be that there are no other premises, for example a sole practitioner accountant working from a spare room or a converted garage. In these circumstances HMRC cannot enter or inspect any part of the premises used solely as a dwelling, and can only visit the rooms used for business purposes.

Section 58 of schedule 36 FA 2008 categorically states that "premises" includes any means of transport. Hence there may be requests for access to those premises, for example for the boot to be opened. However, during Parliamentary debates on the Finance Bill it was categorically stated that the means of transport which may be considered as premises and therefore inspected covered things such as mobile chip vans and market stalls run from vans. The minister added that it does not mean that a car is business premises (although it is of course a business asset).

However, already the wider interpretation is catered for in HMRC's draft instructions hence it may inevitably become the norm that these powers are exercised using the widest possible interpretation of the rules.

Refusing access

If the taxpayer refuses access or asks that the inspector leaves, their instructions are simply to withdraw. There is no penalty for doing this.

The reason for no penalty is simply that it is *only* if the tax tribunal has authorised the visit that a penalty can be levied, for deliberately obstructing an HMRC officer during a visit. HMRC can carry out a visit with little or no notice without approval of the tribunal so it is unlikely that a time consuming pre-authorisation will be sought in most cases, hence no penalty at all.

I would go further and add that, if a tribunal has authorised the visit but no advance notice has been given there should be no penalty at least initially. The Government is on record as stating that the new powers must be used reasonably so HMRC will surely have to concede that it is unreasonable to levy a penalty for obstruction if all the taxpayer has asked is that the visit is delayed until such time as he can arrange representation to deal with issues that he is far from expert in.

© Reed Elsevier (UK) Limited

Start date

Finally, there is no transitional period. The new powers became active on, and must be used for all cases from, 1 April 2009, even if those cases started before then. If an enquiry was already open at that date, inspectors cannot use a new schedule 36 power to seek data that was previously unavailable under the old powers.

2) Information powers

The familiar sections allowing data to be gathered as part of an enquiry have all been, as has section 20 of TMA. They are replaced by a single set of rules which significantly widen what can be demanded, for example:

- there is no need for an enquiry to be open;
- the powers can be used to look for a discovery;
- there is no right of appeal against demands for "statutory" records;
- there is no need for a tax return to have been submitted;
- in-year checks can be made; and
- there is no restriction to a particular year.

The already powerful section 20 TMA – the power to call for documents of the taxpayer and others - is also extended. For example, the new rules do not require approval of the tax tribunal and *information* can be demanded from 3rd parties (in the past only *documents* can be demanded).

The wording is very wide in that the data can be demanded for the purposes of checking the taxpayer's "position". That is then defined as the person's position as regards **any** tax (including foreign tax), including **past, present and future** liabilities without any time limit. Although this includes items that are more than 6 years old there is an express provision that the data demanded under an information notice is reasonably required. It can only be reasonably required if it could affect a person's tax position. Hence, documents over 6 years old are unlikely to be reasonably required as, under the new time limits in schedule 39 FA 2008, the assessment cannot be changed after that period unless the discrepancy was deliberate.

There is a very limited right of appeal in the new rules. Demands for "statutory records" cannot be appealed at all. Those are records which are needed in order that the taxpayer can make a complete and correct return. The logic is that such records must therefore be relevant hence no appeal right is appropriate. However, there is no appeal mechanism to determine whether a particular item is in fact a "statutory record" in the first place.

There is another subtle difference between information and documents in that the legislation requires those receiving a notice to "produce" documents but to "provide" information. The former means "to bring something out from somewhere and show it", which can be done anywhere. The latter, on the other hand, is interpreted as "to give someone something that they need", which indicates that the thing in question must reach the other person rather than simply being made available so that they have to come and get it.

Finally, a reminder that there is no need for an enquiry to be open before an information notice is issued, nor is there any need for a discovery. The new rules set out four conditions, only one of which must be met before an information notice is issued. One of those conditions is simply that HMRC suspects that tax has gone un-assessed. There is no need for HMRC to have discovered an under assessment, merely that it suspects this is the case so an information notice can be issued to check.

Article by John Cassidy at PKF

Lecture P574 (14.50 Minutes)

Lecture P575 (11.42 Minutes)

John Grosvenor

The appellant, who had a glass and glazing business, made two late payments in respect of his self-assessment liabilities. He was also registered for gross payment under the construction industry scheme.

HMRC said the taxpayer no longer met the compliance test and sent him a notice withdrawing gross payment status.

The taxpayer claimed he did not receive this notice and the first he knew of it was when contractors told him they had been instructed by HMRC to pay him net.

As a result of this the taxpayer appealed, saying his livelihood would be at risk if contractors had to pay him net, because they disliked bothering with tax matters.

He claimed the late payments of tax were not deliberate but caused by cash flow problems.

HMRC said this did not constitute reasonable excuse.

The First-tier Tribunal decided that original notice withdrawing gross payment status had been delivered to the appellant's address. HMRC's computer records showed it had been sent to him, and he had received other post from HMRC.

Furthermore, no post had been returned undelivered. Thus the notice was determined as having been delivered and therefore having effect.

As to the appellant's claims for reasonable excuse, the tribunal rejected these. The consequence of cancellation of gross payment status was not relevant to the appeal.

The taxpayer's appeal was dismissed.

Prior Roofing Ltd

During 2007, the taxpayer company was late making payments under the construction industry scheme. HMRC withdrew the firm's gross payments status. The company claimed it had a reasonable excuse.

The taxpayer had been in business since 2003 as a specialist roofing contractor. It worked exclusively for major house-building companies, which were often late in paying subcontractors. The company also suffered a severe reduction in business in 2007 as the construction industry began to slow down.

The bank refused to extend the company's overdraft facility, so the directors gave up some of their salaries and approached their suppliers in the hope they would be patient in claiming payments due.

The First-tier Tribunal considered the evidence and decided the circumstances the company had faced were exceptional and led had directly to the compliance failures. The tribunal felt that matters were beyond the control of the company directors: i.e. a 75% reduction in trading volume coupled with the unhelpful banking environment.

The directors were doing the best they could to meet their obligations to HMRC. This constituted reasonable excuse for failing to make their construction industry payments on time.

The company's appeal was allowed. The tribunal added, however, that this should not be considered a 'blanket excuse' by other firms adversely affected by the economic situation.

Business Tax

Bringing in a corporate partner

The scenario

We act for a professional services business which trades as a limited liability partnership (LLP). There are two members of the LLP, one of whom has an annual profit share of around £300,000. He is anxious to avoid 50% income tax if possible. The member in question is unmarried, but does have a long-term partner who does not work and has no income of their own.

The member and his partner are considering forming a limited company owned 50:50 by each of them. The company would acquire at market value 80% of the member's fractional share of the LLP. Consideration for the acquisition by the company would be left outstanding on loan account for the member.

Setting up the company

Having issued shares to the member and his partner at nominal value, the company will then acquire about 80% of the member's 50% share of the LLP at an open market value.

Since open market value will be used, the net balance sheet of the company will be unchanged showing the goodwill and any other assets acquired as an asset and the debt due to the member as a liability.

Capital gains tax

Such a transaction would give rise to a capital gains tax liability on the member as he is disposing of whole or part of his business but entrepreneurs' relief should be available.

Goodwill would then be stuck in the limited company with the potential double tax hit if the goodwill is disposed of at a future point.

Diverting profits

This idea works as a way of diverting future partnership profits into a company, so that they are taxed at 21% (on the numbers given), rather than 40% or 50% income tax rates.

If he is able to not draw all income, he can use the company to defer income tax charges in the hope that by the time that he wants to draw the funds the tax rate will have dropped.

This would have been the case even if the member had decided to incorporate on their own.

Benefit of partner involvement

It is proposed that funds be extracted from the company by way of dividends to ensure that then partner's personal allowance and basic rate tax bands are utilised.

Obviously, this is dependent on the company having distributable reserves which must not be overlooked.

Using the loan

The member will no doubt wish to use some of the cash generated from the partnership to repay part of his loan to the company.

Given the changes from 6 April, it will be advantageous to take dividends in preference to loan repayments during the current tax year while the income tax rates remain at 40%.

From 2010/11, when the 50% rate kicks in, loan repayments can be used as a tax free means of temporarily replacing income and hence give some flexibility to manage tax rates.

Settlements legislation

It is stated that the purpose of the plan is to transfer income from the member to his partner and clearly he would not be prepared to pass 50% of the future income of the company to a third party.

This expectation of future dividends not matched by any effort on the part of the partner (i.e. the transfer of earnings from the member to his partner) will create the bounty required to bring the proposals within the settlement provisions.

Lord Hoffman's judgment in Jones v Garnett specifically confirms that this transfer of future earnings is caught by the settlement provisions (although in that case, of course, the two individuals were married which then allowed the spouse 'get-out' to come into play).

It is necessary to stand back and view the entire arrangement and see whether it is one that would be entered into with an unrelated third party.

Non trading company

As proposed, it does not look as if the company is necessarily active in the trade which could cause some problems in the future when the business is disposed of:

- Business property relief could be denied
- The company would pay corporation tax on any gains with no entrepreneurs' relief being available

It may be possible to resolve these issues by arranging that the company actively participates in the activity of the partnership somehow, so that a disposal of the shares would qualify for entrepreneur's relief.

Employment related securities

Assuming that the member becomes a director, the right to subscribe for the shares will be deemed to be by reason of his prospective employment as a director.

Since his partner will acquire her shares from the company (and not from an individual as part of a domestic arrangement), her right to acquire the shares is likely to be treated as obtained as a result of the prospective employment of the member and they also will be employment-related securities.

Conclusion

MBC and his client will need to consider whether these benefits will outweigh the creation of an immediate capital gains tax charge, the possible future double charge through goodwill being in the company and the set up and ongoing costs of maintaining the structure.

Taxation Forum, 2 December 2009

Lecture B572 (8.53 Minutes)

Undeclared cash sales - Mr and Mrs Cooksey

The taxpayers, a married couple, traded in partnership until 1987, when they incorporated the business to a limited company.

In 1998, HMRC opened an investigation into the couple's tax affairs: the department had received information suggesting the taxpayers had underdeclared their income for more than 20 years and that they had not disclosed income from money invested overseas.

HMRC issued assessments covering the period from 1982/83 to 2000/01.

The couple appealed.

The First-tier Tribunal said the husband was not 'a credible witness' and did not accept his evidence.

There had been undeclared cash sales for many years, the proceeds of which had been invested offshore.

The taxpayers had not disproved the assessments under appeal.

The case had been carried out properly by HMRC with information supplied to the taxpayers on a reasonable timescale.

The taxpayers' appeals were dismissed.

Corporation Tax

Flat management companies

Under the Landlord and Tenant Act (LTA) 1987 s 42, residential service charges received by a flat management company controlled by the occupiers of the flats are ordinarily received as capital in the company's capacity as trustee and are therefore outside the scope of "Property Income" (previously Schedule A). Certain landlords (mainly public bodies or charities) are not within LTA 1987 and the following rules do not apply to them.

A service charge is an amount payable by a tenant of a building, in addition to rent, directly or indirectly for services, repairs, maintenance, insurance or the landlord's costs of management which may vary according to the relevant costs.

The trustees may set up two types of fund—

(a) a sinking fund which sets aside sums to meet major repairs and renewals which do not arise every year, and

(b) a service charge fund to meet routine day to day costs and minor repairs. The contribution to this fund should be revised annually to balance the actual expenditure.

The service charge should <u>not</u> be included in the company's corporation tax return, but a separate return should be made by the company in its capacity as trustee on form 41G(Trust) or it should supply the following information in respect of each trust—

(a) the full title of the trust fund;

(b) the names and addresses of the trustees;

(c) the name and address of any professional agent acting;

(d) the date the trust was established under the terms of the lease;

(e) the company's corporation tax reference, where appropriate;

(f) the gross amount of any investment income received each year which has not been included on a corporation tax return; and

(g) whether the trust is a sinking fund, a service charge fund or both.

The trustees are under the normal obligation to notify chargeability to income tax.

The exemption from charge under Property Income does not extend—

(i) to any ground rent payable in addition to the service charge which is taxable on the landlord as Property Income; or

(ii) to income from the investment of a surplus on a service charge fund.

Section 65 FA 2007 amended Section 480 ITA 2007 so that investment income derived from service charges paid in respect of dwellings in the United Kingdom and which are held on trust are exempted from the charge at the trust rate and the dividend trust rate. The basic rate will apply in totality.

'Service charges' are defined as having the meaning given by section 18 of the Landlord and Tenant Act 1985. Because that Act only applies to England and Wales it is extended to include similar payments made in relation to dwellings in Scotland and Northern Ireland. The exemption applies equally to service charges held on trusts by Registered Social Landlords who are exempted from Section 42 LTA 1987

For 2007-08 and later years such income is charged at the standard rate.

In many flat management companies the LTA 1987 will not apply and so the tax treatment of the fund will depend on the general status of the fund.

The Landlord and Tenant Act 1987 applies only to England and Wales. Section 42 LTA 1987 applies where the tenants of two or more dwellings are required under the terms of their lease to contribute to the same costs by the payment of service charges (as defined in Section (18)(1) LTA 1985). Such sums paid, or the investments representing those sums, or income accruing thereon, are held by the 'payee' on trust to defray any expenses incurred in connection with service charge expenditure. Subject to such payments of service charge expenditure the funds are held on trust for the tenants for the time being. The 'payee' can be the landlord or any other person to whom the service charges are payable by the tenants under the terms of the lease. Section 18 (1) LTA 1985 states that 'service charge' means – 'an amount payable by a tenant of a dwelling as part of or in addition to rent

1 which is payable, directly or indirectly, for services, repairs, maintenance or insurance or the landlord's costs of management, and

2 the whole or part of which varies or may vary according to the relevant costs'.

The 'relevant costs' are the costs or estimated costs incurred or to be incurred by or on behalf of the landlord, or a superior landlord, in connection with the matters for which the service charges are payable (Section (18)(2) LTA 1985). If the landlord is an 'exempt landlord' (as defined in Section 58(1) LTA 1987) then Section 42 LTA 1987 does not apply. Therefore for Section 42 LTA 1987 to apply;

- The landlord must not be an 'exempt landlord', and
- tenants of two or more dwellings,
- under the terms of the lease,
- must be required to contribute directly or indirectly for repairs, maintenance, etc., and
- those charges, or part of them, must be variable.

If any of those elements are missing then Section 42 LTA 1987 does not apply and normal trust rates will apply to any investment income derived from service charge deposits.

Lecture B573 (9.42 Minutes)

Reducing share capital

Companies Act 2006

CA 2006, s 641 to s 657 have made a significant change for the benefit of private companies, taking effect from October 2008.

It is now stated at s 641(1) that a limited company can reduce its share capital:

> '(a) in the case of a private company limited by shares, by special resolution supported by a solvency statement …
>
> (b) in any case, by special resolution confirmed by the court …'

It goes on to say that the new rules are 'subject to any provision of the company's articles restructuring or prohibiting the reduction of the company's share capital' and that any reduction must leave the company with at least one non-redeemable share in issue.

Share reduction more effcicient

There are circumstances where a share reduction will be a more efficient version of a share buy-back.

Assume that you subscribed for, say, 50,000 £1 shares in X Ltd five years ago at par, but the company's business has not thrived. You agree a share reduction whereby your holding is reduced to nil, and you are repaid the £50,000.

A share reduction would be more straightforward and less expensive for the following reasons:

- you can receive non-cash assets for some or all of the consideration;
- you can agree to receive your due payment by instalments;
- the reduction in capital will constitute a distributable reserve (see below);
- there will be no stamp duty.

However, one draw back is that you cannot receive more than the £50,000 originally subscribed for the shares.

Reserves of the company

What is the effect of a share reduction on a company's distributable reserves?

Under *Companies (Reduction of Share Capital) Order 2008: Statutory Instrument 2008/1915)* the Secretary of State has ensured that the amount of the reduction in share capital is distributable. There is no requirement that any amount paid for the shares should diminish distributable reserves, and no requirement that a reserve akin to a capital redemption reserve be created. Where the shares are being repaid, the book-keeping is simple: credit bank, debit issued share capital.

Dissolving a company

A company may apply to have its name struck off the register (under s 1003). This will normally require that the company has become dormant, and has discharged its liabilities, and in consequence has distributed its surplus assets to members.

But to get into a position of having no assets, a company has to distribute its surplus assets to members and Taxes Act 1988, s 209 stipulates that any distribution out of the assets of a company in respect of shares will be taxable effectively as an income dividend rather than being subject to capital gains tax, which would be more desirable in most circumstances, except in a winding up.

So, it is normal in these circumstances to approach the Inspector of Taxes for the distribution of assets, made as a prelude to a dissolution, to be treated as though it were in a formal liquidation of the company. If certain assurances are given, the inspector will normally consent to this application (under ESC C16).

In order to have no assets, the company must distribute its share capital which is prohibited under the Companies Acts. So what can happen is that if the company, in defiance of this rule, does so

distribute, then the amounts or assets so transferred to shareholders remain a debt owed to the company (and remain therefore an asset of the company).

It is stated in s 1012 that all property and rights of the company immediately before its dissolution are deemed to be bona vacantia and belong to the Crown or the Duchies of Lancaster or Cornwall. This is subject to possible restoration to the register, see s 1029, but a restoration can be costly, time-consuming and complicated.

However, the authorities have indicated that they will not pursue such matters where the share capital does not exceed £4,000. So, for a straightforward conventional private limited company with a share capital of, say, £1,000 ordinary shares only, the distribution can go ahead in the knowledge that the bona vacantia point will not be taken.

Share capital - £4,000

However, many private limited companies have an issued share capital well in excess of £4,000; how should this type of company be dealt with?

Since 1 October 2008, the reduction of a private company's share capital by special resolution and solvency statement makes this process much easier. So, if the consent of the inspector, under ESC C16, has been obtained, the company can proceed to reduce its share capital to an amount below £4,000 and then distribute all remaining net assets and apply for dissolution.

Possible challenge

It is worth considering a scenario that may be challenged.

Suppose that in the year 2000 a trading company had two shareholders, Messrs A and B (50 shares each). Mr B wished to be bought out.

So Mr A formed a new company, A Ltd, to buy out Mr B. A Ltd bought all the issued shares of the trading company for £1 million, of which £500,000 was paid in cash to Mr B (perhaps by instalments or loan notes) and £500,000 new ordinary £1 shares were issued to Mr A.

The outcome is that Mr A now controls A Ltd, which controls the trading company (there may have been a hive up of the business into A Ltd subsequently).

In 2010, Mr A wishes to reduce the share capital by £499,000 (i.e. to £1,000) and to receive payment at par from the company. If successful, he will have a significant capital gain, because his CGT base cost will have been equal to the amount he subscribed for his original 50 shares in the trading company before 2000.

This may, however, be subject to entrepreneurs' relief and perhaps annual exemption. Note that it cannot be an income distribution because actual value was subscribed for the 500,000 shares, albeit that value had a low CGT base cost.

It is likely that HMRC would challenge this proposal and deny clearance under ITA 2007, s 701 because he would be extracting value in excess of the amount originally subscribed in a tax-effective manner, i.e. not simply repaying what he had put in by way of the original subscription. Note that this is my own view of the likely response of HMRC, and has not been tested.

From an article by David Jeffery, Taxation 9 December 2009

Lecture B574 (14.37 Minutes)

Value Added Tax

Repayment disputes

This article reviews a number of recent developments in disputes between HMRC and taxpayers over repayment claims, including:

- the settlement of the Scottish Equitable case, in which the Tribunal decided in 2005 that the cap had been so badly brought in at the outset in 1996 that it could not be enforced at all, even for reclaims arising after that date;
- other disputes on capping, both in relation to transitional period claims and post-1996 tax;
- the direct tax consequences of receiving a VAT repayment and interest on it;
- the argument now proceeding through the courts on whether VAT repayments should come with compound rather than simple interest;
- a case about repayment supplement which may be payable under s.79 VATA 1994 if HMRC do not pay a repayment return within 30 days of receiving it.

Cap confirmed by Court of Session

An insurance company submitted a repayment claim in September 2002, relating to output tax which it had paid between January 1995 and January 1998 in respect of services that it realised should have been treated as exempt following the CA decision in Century Life plc.

The Commissioners rejected the claim on the basis that it had been made outside the three-year time limit of s.80 VATA 1994. The company appealed, contending that s.80(4) should be treated as wholly invalid because it failed to provide for a transitional period, as required by the ECJ decision in Grundig Italiana SpA v Ministero delle Finanze. The Tribunal accepted this contention and allowed the appeal,.

It was reported that questions would be referred to the ECJ, but the Court of Session has now itself reversed the Tribunal's decision, holding that the failure to provide for a transitional period did not render the three-year time limit invalid.

Court of Session: HMRC v Scottish Equitable plc

HMRC have issued a Brief to comment on this decision. Apart from predictably celebrating the court's confirmation that the cap was not fundamentally flawed, they say that a significant number of appeals to the First Tier Tribunal (Tax Chamber) are on hold pending the outcome of this litigation. They suggest that appellants will need to consider whether they wish to withdraw their appeal or proceed to a full hearing. HMRC are now taking steps to have these appeals restored to the Tribunal list so that, where necessary, a hearing date can be fixed.

Presumably a hearing will only be necessary if a taxpayer has failed to appreciate the significance of the court's decision, or believes that it is worth pursuing an appeal all the way to the ECJ.

R&C Brief 41/09

No cap on capping disputes

A company received services in April 1997, before the input tax cap was introduced on 1 May 1997. The services related to a proposed merger; the deductibility of this as input tax was discussed with Customs, who ruled that it was not allowable. The company nevertheless deducted some of it in its return for the quarter to 30 June 1997; the rest was accepted as not allowable in accordance with the case authorities at the time. Subsequently Customs raised an assessment to disallow the claim, and this was paid by the company in October 1997.

After the 2005 decision of the ECJ in Kretztechnik, the company decided that it would have been entitled to the whole of the VAT on the expenses. This is now accepted by HMRC. However, HMRC argued that the claim was capped. The company contended that it had rights at 1 May 1997

because the invoices were dated in April, and it was therefore entitled to make a claim under the Fleming rules.

HMRC argued that the April 1997 invoices could only have been claimed in the return to 30 June 1997, and there were therefore no rights at 1 May 1997. The whole of that amount was subject to the cap. HMRC also argued that the fact that the input tax had been deducted, then assessed and paid, and then claimed back again, turned the claim from a reg.29 input tax claim (capped from 1 May 1997) to a s.80 claim (capped from 4 December 1996).

The Tribunal considered the reg.29/s.80 point in detail, even though it was considered only a minor part of the appeal. It concluded that the claim was still a reg.29 claim in spite of the later assessment.

The major point was whether the rights accrued up to 30 April 1997, where this fell in the middle of a return period, were "pre-existing rights" within the Fleming principle. The Tribunal considered the precedents (which did not contain any directly relevant decisions) and the construction of the UK and EU law, and concluded that they were not. The trader had the right to deduct on a VAT return, and that VAT return could not be filed until after 30 June 1997. The possibility of a trader going on holiday and filing the return before the end of the return period was rejected as unrealistic. The introduction of the claims cap was quite different from the change of rate of VAT on 1 December 2008, which would have to apply to all traders on the same date, even if that was the middle of a return period. The claims cap applied to all the VAT creditable for the return to 30 June 1997 on the same date, whether it was incurred before or after 1 May.

First Tier Tribunal (TC0004): Cable & Wireless plc

An individual was registered as a management consultant. She failed to submit four returns in 2004 and received central assessments for £540 each time, which she paid. She died in 2008 and her husband, as personal representative, filed nil returns to cancel the assessments. HMRC refused to repay the £2,160 because of the three-year cap.

The Tribunal held that it had no discretion to override the cap in these circumstances and dismissed an appeal against the refusal to repay.

First Tier Tribunal (TC0057): Jeffrey Koundakjian

Guidance on capped repayment claims

HMRC have issued updated guidance to their staff on how to handle claims which might be subject to the three-year (becoming four-year) cap. It was amended on 6 August to replace a version from July 2009. It covers every aspect of the procedure in great detail with legal back-up, and it will be useful for anyone proposing to make a "historical" VAT claim to read it in detail. It also considers the question of interest on repayments, including the arguments about compound interest.

HMRC Release 12 August 2009

Impact of Fleming claims

A Freedom of Information Act request has revealed the following estimate of the cost of Fleming claims to the Exchequer:

The Budget 2009 forecast for VAT receipts included an allowance for repayments in this connection of £4.8 billion: £2.7 billion for 2009-10 and £2.1 billion for 2010-11.

The estimate was based on:

- the existing analysis of claims received well before the deadline;
- for those received in the run up to the deadline for new claims, a sampling exercise to determine the number of duplicate claims received, the average value of claims, the time period covered (which would affect the exposure to statutory interest);
- survey of the Large Business Service's Sector Lead Officers to identify any individual claims above £20m notified to them. Each of these was individually examined to determine the likely amount to be repaid after verification; and

HMRC's provisional assessment of the likelihood of success of the new claims, based on both evidence from previously verified claims and an examination of the sample of new claims.

These provisions will be updated in the 2009 Pre-Budget Report to reflect latest information on these factors.

Treasury Freedom of Information Disclosure 29 July 2009

Direct tax on repayments

HMRC have issued a Brief to explain their views on the direct tax treatment of VAT repayments arising under "Fleming claims" (and, by extension, other claims). Apparently some have suggested that a VAT repayment is outside the scope of corporation tax.

HMRC say that they do not accept this. VAT originally overpaid and recovered would in the earlier period have been excluded from turnover: customers would have paid it to the trader but it would have been treated as not belonging to the business. If it is recovered from HMRC, it becomes turnover, and is taxable accordingly. The Brief does not say when the recovery should be treated as taxable – the normal principle for timing of such receipts is that the accounting policy of the company is followed, which would put the receipt in the period in which it became reasonably certain that the money would be recovered. Although there may be an ingenious argument in favour of excluding such receipts from direct tax, HMRC's position seems very strong.

HMRC also state their view that interest paid on repayments of VAT is also chargeable to corporation tax. Although it does not arise on a "loan relationship", which is normally required for a charge to arise, it is deemed to do so by s.81 FA 1996. In this case, there is a specific reference to the timing of the charge and the relevance of Generally Accepted Accountancy Practice (GAAP – which most accountants think stands for Generally Accepted Accounting Principles).

The loan relationships rules do not apply to income tax traders. Perhaps someone will attempt to argue that interest paid by HMRC does not fall within the income tax provisions, although no-one has done so on previous occasions when repayments have been common (e.g. when opticians won their landmark case in 1995).

R&C Brief 14/09

There is an article in Taxation, 9 July 2009, about R&C Brief 14/09 in which HMRC explained their view that VAT repayments and interest on them are generally chargeable to direct tax. John Hiddleston refers to some direct tax case law to explain that it is not as clear-cut as HMRC seem to think.

Taxation 9 July 2009

Claims for compound interest on repayments

A group of motor dealers appealed to the Upper Tribunal about HMRC's refusal to pay compound interest on "Elida Gibbs" and "Italian Republic" claims that had been paid out to them in 2003 – 2005 with simple interest calculated in accordance with s.78 VATA 1994. They argued that the statements of the ECJ in Test Claimants in the FII Group Litigation v HMRC (2007), of the House of Lords in Sempra Metals Ltd v HMRCs (2007) and by Henderson J in FJ Chalke Ltd and another v HMRC (2009) all supported the assertion that compound interest should have been paid on their claims.

HMRC responded by acknowledging that compound interest "should be paid in certain circumstances", but they argued that the UK legislation would not permit the award of compound interest in the circumstances of any of the claimants.

The Tribunal accepted HMRC's argument that the appeals were out of time. If they had wished to object to the award of simple interest, the claimants should have done so within the normal period after the original decisions to repay in 2003 – 2005. The application for compound interest did not lead to a new decision to refuse to pay compound interest: the earlier decision to pay simple interest was the point at which 30 days started to run. There was no justification for extending the time limit for appealing; the later judicial decisions did not give the appellants more time to argue about their interest awards.

Further, it was clear from the legislation that s.78 only provided for simple interest. Suggestions that it should be interpreted to require a payment of compound interest were contrary to the "grain of the legislation". The Tribunal considered the relationship between community law and domestic law which had led to the award of compound interest in Sempra Metals, but did not find that the same principles were engaged in the current cases.

Upper Tribunal: John Wilkins (Motor Engineers) Ltd and others v HMRC

This will not be the end of the matter. Some claimants are pursuing a claim for restitution under civil law through a Group Litigation Order (the FJ Chalke case). The High Court's decision in that case in May (that the claim was out of time) made it inevitable that the Upper Tribunal would hold against the current appellants on the same ground, but both decisions are likely to be appealed further and higher courts – or, ultimately, the ECJ – may hold that compound interest is due.

Interest claim strike-out: one-all

In 2007 Grattan plc applied for an award of interest on a compound basis to be added to repayments of VAT that had been made in 2005 with "simple" statutory interest. HMRC refused, regarding the application as an appeal out of time against the decision to award simple interest in 2005. HMRC's attempt to have the appeal struck out has been through the Tribunal and High Court once owing to a procedural mix-up, but has now returned to the Tribunal for a full hearing.

The company argued that the decision to refuse compound interest was made in a letter in February 2008, and this was appealed in March 2008, just one day after the 30 day time limit. The Tribunal did not agree. In reality, Grattan had not considered the possibility of claiming compound interest in 2005; the letter of February 2008 was not a new decision but confirmation of an old one, that had not been appealed when it was made. The application to strike out the appeals in respect of the 2005 repayments was granted.

However, there was also a separate repayment, also made with simple interest, which was released by HMRC following the Fleming decision. There had been no decision on interest in that regard in 2005 – the only decision was that given in February 2008. The application to strike out this appeal was therefore dismissed. The claim for compound interest on this appeal will be substantial – the VAT was £71m and simple interest under s.78 was £95m.

First Tier Tribunal (TC00139): Grattan plc

Repayment supplement

A company made a reclaim in April 2006 which was paid to it in July 2006. The company claimed that it had only "received" the repayment on 31 July 2006, when a payable order was sent to it by HMRC, and this was more than 30 days after the submission of the claim (disregarding days spent on reasonable enquiries). HMRC argued that they had "paid" on 27 June 2006, when a form of instruction was signed by one of its officers and sent to another officer. This was before the "trigger date" of 4 July, so no supplement was payable.

The Tribunal identified the following questions which needed to be addressed:

- what was the meaning of "issued" in this context: in particular could a document sent by one HMRC officer to another be the "issue" of such an instruction;
- on whom did the burden of proof in relation to the facts fall?
- on the evidence, and in the light of the answers to the preceding questions, what was the relevant date?

The Tribunal considered the regulations which define the period for s.79 (SI 1995/2518 regs.198 – 199), and the enquiries that were made following the submission of the return. It was agreed between the parties that the return had been submitted on 25 April; by 26 June, when an HMRC officer sent an approved payment recommendation to the Credibility team in Liverpool, the total time was 63 days of which 40 had been taken up with "reasonable enquiries".

At the hearing, it was not clear what happened between 26 June and 31 July. There were forms authorising payment which were faxed between HMRC officers, but no payment was made. It is surprising that more documentation was not produced to show what had happened to an attempted payment of £117,000, but HMRC suggested that they had "probably" attempted to pay that amount to a bank account of the trader which had been closed. After that payment was rejected, they issued the payable order by mail.

The chairman concluded that an internal instruction from one HMRC officer to another was not a payment instruction "issued" for the purposes of s.79. There must be an instruction to someone outside the department in order to effect payment. The burden of proof lay on HMRC to show when an instruction had been issued, because only they would have access to the information. He reached

this conclusion after the hearing, and asked HMRC for further evidence to show what happened to the attempted payment. The appellant was given the opportunity to comment on this evidence.

The further evidence did show that HMRC attempted to pay the closed bank account on or before 29 June 2006. That satisfied the statutory test and ruled out repayment supplement.

The chairman went on to examine the counting of days in more detail. HMRC and the taxpayer had produced schedules of days but had been inconsistent about "counting inclusively". The statute requires inclusive counting: in particular the date on which the officer becomes satisfied that a repayment should be made is part of the "reasonable enquiries" period. The revised count of days suggested that the total delay was 66 days, of which 36 were taken up with enquiries. HMRC just managed to issue the instruction within the required period, and the appeal was dismissed.

On the other hand, they had not produced enough evidence at the hearing to support that conclusion. The chairman therefore awarded costs of £100 to the appellant.

First Tier Tribunal (TC00180): Beast in the Heart Films (UK) Ltd

Article by Mike Thexton

Lecture B575 (22.49 Minutes)

Changes to TOMS from 1 January 2010

HMRC Brief 74/09, issued on 4 December, states:

Changes to the Tour Operators' Margin Scheme: transitional provisions

Revenue & Customs Brief 27/09 outlined changes to the Tour Operators' Margin Scheme (TOMS) which will take effect from 1 January 2010. This Revenue & Customs Brief sets out transitional arrangements in relation to supplies that straddle this date. These are necessary because the TOMS has its own rules with regard to the time of supply, deductibility of input tax and calculation of output tax due.

Background

The TOMS is a mandatory scheme which applies to supplies made "for the direct benefit of the traveller", that is, the end customer. However, the UK has permitted businesses to opt out of the TOMS for supplies made to business customers for their own consumption, for example, business travel for employees, thus allowing business customers to recover input tax on such supplies. The UK has also allowed businesses to include within the TOMS, supplies made to other tour operators for onward resale, that is, supplies that are not being made for the direct benefit of the traveller. As announced in Revenue & Customs Brief 27/09, both of these arrangements are being withdrawn with effect from 1 January 2010. The transitional arrangements outlined in this Brief are designed to ensure that VAT is correctly accounted for on supplies that straddle this date.

TOMS time of supply rules

'The TOMS has its own time of supply rules, which differ from the normal rules. These are set out at paragraph 4.14 and 4.15 of Public Notice 709/5. The operator must choose one of two methods to work out the tax point for margin scheme supplies and any in-house supplies sold within a margin scheme package. Method 1 uses the date of departure of the traveller or the first date on which the traveller occupies any accommodation, whichever happens first. Method 2 uses the date of receipt of payment of a certain size and a tax point is created when a payment is received which exceeds 20% of the selling price. A tax point is also created each time the payments received to date which have not already been accounted for exceed 20%, when added together.

Input tax and output tax

Under the TOMS, tour operators cannot recover any UK or EC VAT charged on the travel services bought in and resold — the suppliers of such goods and services account for tax on them in their own Member States. In turn, they account for VAT only on the margin achieved on their supplies under the TOMS, and not the full selling price.

Effect of removal of opt-in

Removal of the opt-in and application of the normal rules mean that, where tour operators have not previously recovered VAT on goods and services supplied to them for the direct benefit of the traveller, they may recover that VAT from 1 January 2010 for supplies being made after this date. Equally, from 1 January 2010 they should account for output tax on supplies made after this date on the full value of the supply (including payments received prior to 1 January 2010) in accordance with the normal time of supply rules. A VAT invoice must also be issued to customers. However, the customers, being themselves tour operators, will only be able to recover VAT if they are in turn supplying the travel services to another business for resale. If tour operators use the date of receipt of payments exceeding 20% of the selling price as their tax point (and have accounted for output tax at that time), they should also issue a belated VAT invoice in respect of those payments.

Effect of removal of opt-out

Removal of the opt-out means that the TOMS rules must apply to supplies of designated travel services made after 1 January 2010. As the normal rules apply before that date, tour operators may recover VAT on supplies of goods or services received before 1 January 2010 for supplies being made for the direct benefit of the traveller after that date. The secondary legislation withdrawing the opt-out provides that the value of those supplies on which input tax is recovered cannot be included in the calculation of the margin for supplies being accounted for under the TOMS.

Equally, tour operators using the opt-out should account for VAT under the normal rules where they issue a VAT invoice or receive a payment before 1 January 2010 for supplies of travel services being made by them to another taxable person. This means that the selling price which feeds into box 2 of the provisional calculation and box 1 of the annual calculation should reflect only the balance of the price payable on or after January 2010.'

Bingo giant overpaid VAT for three years, rules tribunal

HMRC faces a demand for almost £26 million following a decision by the VAT and Duties Tribunal in the case between the department and Rank Group plc.

The tribunal ruled that the bingo giant overpaid VAT on certain types of amusement machines between 2002 and 2005. As a result, the leisure company is to request that the Revenue repays £25.9 million in the first quarter of 2010.

The decision follows an interim ruling from the tribunal in August 2008 that the UK's VAT treatment of amusement machines contravened the EU's principle of fiscal neutrality.

In May 2008, the tribunal made a separate ruling in Rank's favour on the application of VAT to bingo.

Both rulings have been appealed by HMRC, and the Court of Appeal is scheduled to hear the cases in the coming April.

Earlier this week, the High Court confirmed that participation fees for playing mechanised cash bingo should have been exempt from VAT.

© Reed Elsevier (UK) Limited